Draft Decision

Australian Rail Track Corporation

Access Undertaking

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Commissioners:

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Contents

Glossary

ACCC	Australian Competition and Consumer Commission
AN	Australian National
ARTC	Australian Rail Track Corporation
CPI	Consumer Price Index
DRP	Australian Competition and Consumer Commission, *Draft Statement of Regulatory Principles for the Regulation of Transmission Revenues*, May 1999.
DORC	Depreciated Optimised Replacement Cost
GSR	Great Southern Railway
gtkm	gross tonne kilometres
IAP	Indicative Access Proposal
IGA	Inter Governmental Agreement signed by the Commonwealth, State and Territory governments in November 1997
kgtkm	'000 gross tonne kilometres
NCC	National Competition Council
NPV	Net Present Value
NR	National Rail Corporation Limited
MRP	Market Risk Premium
PTMS	PTM Strategies
QCA	Queensland Competition Authority
QR	Queensland Rail
SAIIR	South Australian Independent Industry Regulator
SCT	Specialised Container Transport
SRA	State Rail Authority of New South Wales
TPA	*Trade Practices Act, 1974*
WACC	Weighted Average Cost of Capital

Executive Summary

The draft decision is to accept the undertaking subject to ARTC addressing certain concerns raised by the Commission.

The application

Significant reforms to the rail industry have been initiated by the Commonwealth Government in the past decade. These reforms have been designed, in part, to introduce a more commercially focused rail industry. In conjunction with the reforms being implemented at the State and Territory level, this has resulted in significant changes to ownership structures and governance arrangements.

As part of this ongoing reform process, Australian Rail Track Corporation (ARTC) has submitted an undertaking to the Commission in respect of third-party access to the rail network it owns and manages. The undertaking was submitted pursuant to the provisions of Part IIIA of the TPA. The clauses contain ARTC's commitment to the Commission of the principles and processes for negotiating access and actual terms and conditions which will form the basis for access to its network. This report contains the Commission's draft decision and the results of the assessment of each of the clauses in the undertaking against the legislative criteria in section 44ZZA(3) of the TPA. The legislative criteria impose an obligation on the Commission to ensure that the undertaking, among other things, achieves an appropriate balance between the interests of the infrastructure owner and access seekers and the public interest.

The ARTC rail network comprises standard gauge tracks linking Wodonga, Melbourne, Adelaide, Broken Hill (in New South Wales), Tarcoola and Kalgoorlie (in Western Australia). The network is part of the larger standard gauge network linking all capital cities from Brisbane to Perth, as well as Broken Hill in NSW and Alice Springs in the Northern Territory. The network is utilised by both passenger and freight operators.

This is the first rail access undertaking submitted to the Commission and it has been made pursuant to the Inter-Governmental Agreement (IGA) signed by all governments in Australia in November 1997. That agreement established ARTC with the objective of becoming the sole manager and provider of access to the interstate network, thus facilitating the process of gaining access to the nation's interstate network and encouraging the use of rail infrastructure by rail service operators. The IGA also provided for ARTC to submit an undertaking to the Commission in respect of access to the entire interstate network once it secured the necessary arrangements with the states.

The Commission's assessment process

Part IIIA establishes a legal regime to facilitate access to the services of certain facilities of national significance. The Commission's role in assessing undertakings is prescribed by section 44ZZA of the TPA. Once an undertaking has been submitted the Commission must decide whether or not to accept the undertaking after conducting a public consultation process. In making its decision the Commission is required to have regard to the criteria set out in section 44ZZA (3). The criteria are:

- the legitimate business interests of the provider;
- the public interest, including the public interest in having competition in markets (whether or not in Australia);
- the interests of persons who might want access to the service;
- whether access to the service is already the subject of an access regime; and
- any other matters that the Commission thinks are relevant.

If the Commission accepts an undertaking from ARTC then the terms and conditions in the undertaking form the basis on which rail operators can obtain access to ARTC's rail track services. Once accepted the services covered by the undertaking cannot be declared.

If the undertaking is not accepted by the Commission, rail operators and other interested parties have the option of seeking declaration of rail track services. Declaration gives current and potential rail track users the right to negotiate terms of access with ARTC in the first instance, and if the negotiations prove unsuccessful, the opportunity to have the Commission arbitrate the access dispute.

To assist in assessing ARTC's undertaking the Commission has formulated a number of principles. The Commission considers that, as far as possible, the undertaking should reflect these principles. The principles address three broad issues:

- pricing for access to ARTC's rail track that focuses on efficient outcomes;
- processes for gaining access including negotiation and dispute resolution provisions that provide for timely, commercially negotiated outcomes; and
- providing clear provisions that allow enforceability of the undertaking.

Also of importance is the Competition Principles Agreement which, amongst other things, provides for a principle of competitive neutrality[1] and, in respect to prices oversight, that the prime objective should be one of efficient resource allocation.[2] Consistent with this Agreement the Commission has assessed ARTC's proposal on the same basis that would apply if a privately owned firm had lodged the proposed undertaking. That is, ARTC is presumed to operate as a commercial, profit-maximising business with a view to maintaining or increasing shareholder value over time and the Commission has focussed on ensuring that ARTC has the appropriate incentives to allow for efficient access to and provision of the network. The Commission recognises that there is ongoing debate about the degree to which road transport, to the extent that it represents an alternative to rail transport, competes on a neutral basis regarding cost recovery and taxation. While measurement of any such non-neutrality is beyond the scope of the Commission's assessment of this undertaking,

[1] In the context of the Competition Principles Agreement, competitive neutrality refers to the business activities of publicly owned entities not enjoying any net competitive advantage simply as a result of their public sector ownership [*Competition Principles Agreement 3(1)*].

[2] *Competition Principles Agreement 2(4)(b).*

the Commission notes that ARTC is not expected to achieve full recovery of economic cost in the short to medium-term.

In assessing ARTC's proposed undertaking the Commission has formed the view that the interstate rail network has many of the characteristics common to natural monopolies. These include:

- investment in specialised assets that is to a large extent irreversible;
- correspondingly high sunk fixed costs leading to economies of scale; and
- network effects.[3]

The Commission also notes that some of ARTC's customers have significant sunk investments in infrastructure associated with the ARTC network, which could potentially provide ARTC with leverage in commercial negotiations. There may however be some limits to ARTC being able to take advantage of any consequent market power when the nature of the markets in which its customers operate is considered.

In making its assessment of ARTC's proposed undertaking the Commission has not attempted to closely define the boundaries of the market in which ARTC operates. A significant proportion of ARTC's revenues is however, derived from the interstate transport of freight, especially full container loads. Moreover, in considering the environment in which ARTC operates, the Commission regards the following features as important:

- Both ARTC and the above-rail operators have argued that the majority of ARTC's revenues, that is those earned from the interstate transport of freight, are earned in markets that, in most cases, are subject to a substantial degree of competition from non-rail sectors, predominantly road.
- Existing charges set by ARTC in the marketplace result in revenues that fall significantly below a level that would allow for the business to earn an adequate long-term economic rate of return.
- ARTC is not vertically integrated. That is, ARTC does not, and does not propose to, operate above-rail services.

A number of provisions that ARTC intends to commit itself to in the proposed undertaking may act as constraints to the misuse of market power. ARTC intends to commit to ongoing reductions in real prices charged to users. This, combined with a proposed curb on price discrimination, implies that future profitability will depend on growing the amount of traffic on the network and on greater operating and cost efficiency. Given that the most significant revenue sector of the ARTC business is freight that could alternatively travel by road or sea, there appears to be an incentive to drive greater productivity from the asset and ensure that the physical asset is maintained to increase rail's relative competitiveness.

[3] A network effect occurs when users of an infrastructure service benefit from other users deciding to use that infrastructure. In ARTC's case this may include, for example, the ability to connect with other users, the availability of complementary products or reduced network access costs.

While these circumstances suggest that ARTC's pricing behaviour may be constrained by competition and its own pricing policy, the Commission has found that the constraints on ARTC's non-price conduct may be less effective. A number of clauses in the undertaking, notably those dealing with negotiation processes, capacity management, network extensions and capacity additions, contain provisions that the Commission considers do not satisfy the legislative criteria in Part IIIA. In particular, it is considered that the effect of certain provisions is to give ARTC unnecessary broad scope in its dealings with access seekers. As a result, the Commission recommends changes be made to certain provisions that impose more stringent obligations on ARTC and/or greater safeguards for access seekers, thus achieving a more appropriate balance between the interests of the infrastructure owner and access seekers.

The Commission has therefore considered the proposed undertaking from the point of view of setting in place a structure that:

- recognises that competition imposes some degree of constraint, particularly in relation to inter-modal freight;
- ensures that ARTC has the appropriate incentives to allow it to work towards developing the economic sustainability of the interstate rail track business; and
- provides safeguards against exploitation of market power that ARTC may currently hold, or could hold at some future time.

Scope of undertaking

The undertaking sets out the terms and conditions of access to ARTC's rail network. The services to which the undertaking applies include passenger as well as freight services provided by operators.

The undertaking has a term of five years with provision for a review upon expiry. The undertaking may be varied by ARTC and may also be reviewed at ARTC's discretion. Both variations to the undertaking and reviews of it, would be carried out by the Commission under the provisions of Part IIIA.

Comments from some operators suggested the undertaking deals almost exclusively with freight services and did not seem to acknowledge that passenger services had different characteristics. The undertaking does not contain provisions for passenger services to be given priority in time path allocation or for ARTC to provide access to passenger services at subsidised prices. It was argued, for instance, that passenger services had different specifications from those of the indicative service. It was also argued that many passenger services were more time-sensitive than freight services and relied on government subsidies to be commercially viable and that this should be reflected in the undertaking. The Commission was not convinced that the undertaking needed to highlight the differences between passenger and other services. While the technical characteristics may differ, the undertaking does not preclude negotiations on services other than the indicative service, or in other ways differentiate the negotiation principles and processes that apply to different types of services.

Some operators submitted that the undertaking should apply to the entire interstate network not just the tracks under the control of ARTC in Victoria, South Australia and Western Australia. The Commission considers that it could not assess an undertaking from ARTC in respect of tracks not under its control because ARTC would not be considered an access provider in relation to those tracks within the meaning of Part IIIA.

As the undertaking does not cover the entire interstate network, it is important that in the interests of facilitating the movement of rail traffic across state borders, it interfaces well with other access regimes. The Commission considered a number of interface issues and concluded that while the level of interface is not optimal, ARTC's approach should provide an adequate level of interoperability with other access regimes. The undertaking itself represents an important step towards improving interstate rail access for train operators. The Commission therefore anticipates that further access undertakings covering other parts of the interstate rail network can use ARTC's undertaking, and the Commission's assessment of it, as a guide.

The undertaking applies to agreements executed pursuant to the terms and conditions of the undertaking and does not affect existing agreements. However, the undertaking and many of ARTC's contracts with operators contain a "like price for like service" clause which commits ARTC to ensure uniformity of access charges for all operators providing a like service and operating within the same end market. There is no equivalent of this for non-price terms and conditions.

Negotiating for access

The basic framework for negotiating access to ARTC's network consists of the following steps:

- preliminary meetings and exchanges of information;
- submission of an access application by the operator;
- preparation of an indicative access proposal by ARTC; and
- negotiations to develop an access agreement for execution.

The framework is supported by a number of time lines and obligations on ARTC as the parties progress through the negotiation process.

The undertaking commits ARTC to "negotiate in good faith". This requires ARTC to be reasonable and have appropriate justification for any decisions it may make in the negotiation process, including whether or not to refuse to negotiate with an applicant. Operators are offered further protection in negotiations with ARTC by the dispute resolution process set out in clause 3.11. Clause 3.11.1(a) provides that if any dispute arises in the context of negotiations pursuant to the undertaking, it can be referred to the dispute resolution process. In addition, various clauses contain specific references to dispute resolution. The obligation to negotiate in good faith allows the Commission some discretion in matters it may pursue. For example, if circumstances were brought to the Commission's attention that ARTC had refused to negotiate with an applicant

without good cause, the Commission could inform ARTC that a dispute had arisen relating to the obligation to negotiate in good faith in the undertaking, and that this potentially may be a breach of the undertaking.

The negotiation provisions give ARTC the right to establish the "bona fide" of the applicant by applying criteria regarding prudential requirement that the applicant must satisfy before negotiations can proceed. These seek to determine whether the applicant is solvent and whether it has been in default of access agreements. The Commission considers that these criteria satisfy the legislative requirements in Part IIIA but has recommended that ARTC should also be bound by an obligation to explain in writing to the applicant reasons why it has refused to negotiate on these grounds.

The negotiation provisions include obligations on confidentiality. These provide that information exchanged as part of the negotiation of access pursuant to the undertaking is to be kept confidential to the purposes for which the information was required. They also provide for exceptions when confidential information may be disclosed. The undertaking also allows parties to enter into confidentiality arrangements if required. The Commission accepts these provisions but has recommended that amendments should be made that would allow information to be published in certain situations.

The negotiation period commences with the acknowledgment by the applicant that it intends to progress negotiations on the basis of the indicative access proposal (IAP) prepared by ARTC. The negotiation period lasts a maximum of ninety days after which negotiations lapse and must recommence from the start if parties wish to continue.

The IAP must set out a number of details including the results of a capacity analysis and a copy of ARTC's standard terms and conditions. In response to expressions of concern from operators, ARTC committed in its revised undertaking to provide more information on capacity that would allow operators to quantify utilisation of the network. The Commission, however, remains uncertain whether operators would, even on the basis of this additional information, be able to quantify maximum capacity and determine the level of capacity utilisation. The Commission thus invites comments on the adequacy of information for the calculation of capacity utilisation. It is clear that operators place considerable emphasis on this as a basis from which to engage in effective negotiations with ARTC. In recognition of this, the Commission recommends that disputes about matters arising from clause 3.7 dealing with the IAP contain a specific reference to dispute resolution processes under clause 3.11.

As noted, the negotiation process includes a number of time lines to ensure that negotiations take place in an orderly and timely manner. To ensure that the requirements in the undertaking achieve a balance between obligations imposed on operators and ARTC, the Commission recommends that a time limit also be imposed on ARTC in relation to the submission of a revised IAP. The Commission also recommends that ARTC be required to give notice of intent to end negotiations rather than simply end them (in the event of certain conditions being satisfied).

In other cases the Commission recommends deletion of clauses that would have the effect of providing ARTC with exemptions from the application of section 44ZZJ of the TPA on possible enforcement action against breaches of the undertaking.

The undertaking's negotiation provisions also include reference to a list of matters that represent core aspects of an access agreement. These core elements of an access agreement encompass issues that have the following general characteristics:

- issues that must be dealt with (but without setting out details of any commitments or obligations);
- formulae for price variation and measuring under-utilisation of capacity;
- the ability of ARTC to perform tasks;
- the right of ARTC to make demands on operators; and
- obligations on operators to perform tasks or comply with requirements.

This list (contained in Schedule C to the undertaking) does not present a detailed description of the core elements of an access agreement. Nevertheless, the Commission is of the view that this list promotes understanding of issues that ARTC considers to be important in providing access to its infrastructure, without compromising access seekers' ability to negotiate reasonable terms and conditions.

The Commission's approach in assessing the negotiation provisions of the undertaking has been based on the premise that the undertaking should not be so detailed and prescriptive that it would have the effect of reducing the scope for negotiation. In applying the assessment criteria in Part IIIA, the Commission has endeavoured to balance the interests of the infrastructure owner and access seekers by seeking an appropriate balance between certainty of terms and conditions desired by operators and the exercise of discretion by ARTC in the pursuit of its own self-interest. The Commission is of the view that the negotiation provisions of the undertaking enhance certainty and clarity, without limiting the scope for access seekers to negotiate around these terms and conditions.

While the Commission considers that the negotiation provisions of the undertaking generally satisfy the legislative criteria in section 44ZZA(3) of the TPA, the Commission has made a number of recommendations to improve the negotiation process.

Dispute resolution

The amended undertaking provides for the parties to "use reasonable endeavours acting in good faith to settle the Dispute as soon as is practicable". There is provision for a three-step approach to dispute resolution:

- **Negotiation** between the parties.
- **Mediation** by a person appointed by agreement between the parties or by the President of the Law Society of South Australia if the parties can not agree on a mediator. Mediation is optional subject to agreement between the parties.
- **Arbitration** by the Commission taking into account the provisions of the undertaking, the objectives and principles in Part IIIA of the TPA and the Competition Principles Agreement. In making a determination, the

Commission is to be bound by Division 3 Subdivision D of Part IIIA and sections 44V, 44W and 44X of the TPA.

The Commission is prepared to adopt the role of arbitrator under the undertaking. As such, a number of recommendations are made in relation to the proposed dispute resolution process. These include:

- the appointment of a conflict manager / panel of mediators;
- allowing the publication of arbitration decisions (subject to considerations of commercial confidentiality); and
- allowing joinder of arbitrations by the arbitrator.

The role of the conflict manager is detailed in chapter D4 of this draft decision. The recommended first step in the dispute resolution process is a meeting with the conflict manager. The initial meeting with the conflict manager is designed to either immediately resolve the dispute, or to establish the most appropriate processes for consensual resolution in light of its particular circumstances. These processes – for example, mediation or expert determination - can be run concurrently with arbitration, if either party considers arbitration appropriate.

Publication of arbitration decisions would provide increased market transparency, and discourage disputes arising over matters on which the Commission (as arbitrator) has expressed a clear position. Similarly, the joinder and notification of arbitrations is designed to expedite the arbitration process by limiting the potential for separate, bilateral arbitrations that are in many respects very similar.

In light of the provisions of the undertaking, the draft decision outlines the Commission's proposed approach to arbitration. The undertaking requires the Commission to have regard to the indicative access charges. The undertaking does not however, explicitly provide indicative prices for services other than the indicative service. The Commission would consider any pricing dispute referred to it for arbitration in light of its particular circumstances. Where a train consist is not explicitly described in the undertaking, the prevailing market prices provide a general indication of differences in both the market value of certain types of services and the opportunity costs (to ARTC) associated with them. Proper application of the arbitration criteria would thus involve some consideration of these prices. This approach does not preclude ARTC from differentiating its charges on the basis of other criteria (listed in Part 4 of the undertaking) but may provide a starting point for the consideration of disputes brought to arbitration.

The draft decision also suggests that the enforcement mechanisms in the arbitration provisions should be strengthened and, in relation to dispute resolution, a number of recommendations relating to the drafting of the undertaking are made. For example, the undertaking should expressly allow the Commission to levy charges to recover any costs associated with arbitration.

Pricing principles

This part of the undertaking sets out the principles used by ARTC to derive access charges. Access charges will be based on an indicative access charge that ARTC publishes for services in specific geographical segments and which have the following characteristics:

- axle load of 21 tonnes;
- maximum speed of 110km/h and an average speed of 80km/h; and
- length not exceeding 1500 metres east of Adelaide and 1800 metres west of Adelaide.

Departures from these indicative charges will take account of the characteristics of individual services, including technical aspects, the particular segments of the network to which access is sought, the opportunity costs to ARTC, the impact on other traffic on the network (including system capacity and flexibility) and the market value of the particular time path being sought.

Access pricing will not however differentiate on the basis of the identities of operators or between like services operating within the same end market.

Access charges will be structured as a two-part tariff comprising a fixed component and a variable component. The fixed component will be levied on a $/km basis and be specific to each train service type and segment. The variable component will be related to distance and mass and be levied in terms of $/kgtkm (gross tonnes kilometre). The fixed charge represents around 20-40% of charges for freight-type services and around 45-60% of charges for passenger services, on average. Both components of the access charge will be open to negotiation.

Access pricing will be subject to floor-ceiling revenue limits. The floor is given by the incremental or avoidable cost of providing a service, which excludes depreciation and a return on assets employed. The ceiling is defined as the full economic cost of providing a service over a certain segment of track including the costs specific to a service, depreciation and an allocation of indirect costs, and a return on assets employed. ARTC claims that the costs are forward looking and include planned efficiency improvements.

The indicative access charges are effectively price-capped. There is provision in the undertaking for indicative access charges to be adjusted annually by a factor which is the greater of CPI-2% or 2/3 of CPI.

In evaluating ARTC's proposed approach to access pricing, the Commission has considered the likely incentives facing ARTC and the impact that the adoption of the undertaking would have on these incentives.

A number of submissions emphasise the intensity of the competitive pressures exerted from road transport. These submissions tend to argue that the undertaking should expressly provide that the effect on competition should be an explicit criterion which ARTC should take into account in setting access charges.

The Commission's view of the implications of competition is somewhat different. The Commission considers that to some degree competition has the effect of constraining ARTC's ability to increase charges and/or lower service quality. As a consequence, ARTC's returns appear to be well below the full economic cost of providing services. In the longer-term this may undermine investment incentives and compromise the sustainability of the network.

The Commission also considers that, in the event that competition proves not to impose genuine constraints on ARTC's pricing behaviour, the price-capping of the indicative access charges, combined with the imposition of floor/ceiling price limits, provide users with substantial protection against monopolistic pricing.

In developing the floor and ceiling limits, ARTC has used a cost-based analysis that for the most part is consistent with the Commission's "building block" approach as described in the Draft Statement of Regulatory Principles.[4] The Commission's view is that ARTC's estimates of operating costs, asset values and the weighted average cost of capital are reasonable.

The Commission is however concerned about the possibility of prices leading to revenues that fall outside the bands. Although interested parties have not expressed concerns with ARTC's approach, and the "right of veto" may theoretically protect users from pricing above economic cost, it seems possible that in a case where downstream competition is less than perfect users may agree to the higher prices even where they breach the revenue ceiling. Such a situation would have potentially adverse consequences for allocative efficiency. The draft decision also invites comment from interested parties as to whether users or access seekers would be in a position to establish where ARTC's revenue limits actually lay on any particular segment.

The draft decision notes that the undertaking includes indicative access charges for a specifically defined service. For other service categories, the undertaking states that ARTC will 'have regard to' the indicative access charges. The indicative access charge, and the indicative service, represent a subset of ARTC's current schedule of prices.

The draft decision interprets these provisions as implying that, for the other types of services currently provided by ARTC, some consideration of the broader schedule may be considered during negotiations. This may have the effect of price-capping the charges for those services as well as for the indicative service explicitly included in the undertaking.

The Commission has also closely considered other aspects of the pricing principles, in particular the commitment to not differentiate charges between users of like services who are operating in the same end markets, and the structure of the indicative charges.

The Commission has some concerns with the 'like services' provision in relation to the extent to which it limits ARTC's ability to recover its economic costs, particularly in relation to those markets most constrained by strong inter-modal competition. Against that, however, is the concern that discriminatory pricing may have potentially

[4] Australian Competition and Consumer Commission, (1) *Draft Statement of Principles for the Regulation of Transmission Revenues*, May 1999.

detrimental effects on competition in downstream markets, particularly where inter-modal competition is less intense. On balance, the draft decision does not object to the inclusion of the like services clause.

In relation to ARTC's proposed price structure, the Commission has some concerns that the magnitude of the flagfall component of ARTC's charges (the 'fixed charge') may act as a deterrent to new entry in the above-rail market. That said, the Commission's general view is that, provided price levels are not set at a point that represents an abuse of market power, price structure is most appropriately decided through commercial negotiation, augmented by the availability of arbitration.

If, over time, it appears that the two-part tariff is frustrating the attempts of potential entrants to gain access to the ARTC network, then this could be taken into account in evaluating an appropriate framework beyond the current 5-year period. On balance, and in light of the fact that price structure is open to negotiation, the draft decision accepts the structure proposed by ARTC.

Again, a number of recommendations are made in relation to the drafting of the clauses detailing the pricing principles.

Management of capacity

The undertaking sets out the processes by which the ARTC will deal with capacity issues, such as assessing capacity, allocating capacity, transferring capacity and cancelling capacity. A key aspect of managing capacity is assigning access rights where multiple applicants seek access to mutually exclusive access rights.

Where two or more applicants have applied for access to mutually exclusive access rights, ARTC proposes to allocate access on the basis of the proposal that generates the highest net present value of future returns, adjusted for risk.

ARTC proposes to reserve the right to withdraw train paths allocated to an operator under an access agreement in the event that the operator has under-utilised its capacity entitlement ARTC has also proposed that an operator may cancel train paths or assign them to third parties (subject to approval of ARTC).

The Commission accepts this part of the undertaking and considers that it satisfies the legislative criteria in section 44ZZA(3) of the TPA.

It considers that the method of allocating scarce capacity in the event of competing requests for similar access rights is not inappropriate. However, the Commission notes the concerns from operators that ARTC may not provide sufficient information to enable them to make an independent assessment of whether capacity is indeed scarce, or whether ARTC may be abusing its discretion in forcing the costs of constructing additional capacity onto operators. As noted, ARTC changed its commitment in the revised undertaking to provide significantly more information on capacity. However, the Commission seeks operators' views on whether they will now have sufficient information at their disposal to independently assess the extent of spare capacity in the network.

Network connections

Clause 6 provides the general framework for how ARTC intends to deal with requests from access seekers for extensions to the network and expansions of capacity.

ARTC proposes to approve requests for connections to its network provided certain conditions are met: relevant government approvals; the connection does not reduce capacity; the connection complies with ARTC's interface, safety, engineering and operational standards; ARTC's train control directions are observed by operators using the connection; and the construction and maintenance costs associated with the connection is met by the owners of connecting track.

ARTC commits to approve the construction of additional capacity if:

- it is commercially viable to ARTC; or
- if the applicant agrees to meet the cost of additional capacity, either directly or through increased charges; and
- the extension to the network is, in the opinion of ARTC, technically and economically feasible, and does not compromise the integrity of the network.

The Commission has accepted these provisions on the basis that ARTC is entitled to seek to ensure that additions to capacity and extensions of the network maintain the operational, technical and safety standards in the overall network. However, the Commission noted the concerns of operators on these matters, particularly that the decision to approve requests for extensions or additions to capacity could be subjective and at ARTC's discretion. The Commission considers that ARTC should be required to explain in writing reasons for its decisions on applications for extensions to the network and additions to capacity. This would provide operators comfort that ARTC would not abuse its discretion in seeking to obstruct entry on the basis that additions to capacity or extensions to the network threaten the integrity of the infrastructure.

Network transit management

The undertaking sets out ARTC's transit management procedures. ARTC states that these ensure that in essence those services that enter the network on time will generally exit on time, while those that suffer operator incidents will frequently be delayed and exit the network later than their scheduled arrival time.

ARTC argues that these principles have been in use since its inception and are widely supported by operators as being fair and reasonable. ARTC further claims that operators support these rules because they make users accountable for their performance on the network. Under the network transit management rules, users who manage their services effectively are insulated from the flow on effects in terms of delays from poor performers.

The Commission considers that these rules meet the legislative criteria in Part IIIA. The network transit management rules are understood by operators and seem to be applied by ARTC in an effective manner. The Commission notes, however, that some

operators have questioned the suitability of some of the rules that have been proposed and have suggested that they should be further considered in the context of an industry forum. The Commission considers that while the rules seem to have provided an effective basis on which to manage the network, there is no reason rules could not be further refined or improved. The Commission would welcome industry initiatives to review these rules at appropriate intervals to ensure that they continue to be appropriate. Depending on the timing, changes to the network transit management rules may be incorporated into the Commission's final decision or, if necessary, could be the subject of a variation to the undertaking.

Performance indicators

Section 8 of the undertaking imposes an obligation on ARTC to maintain the network in a fit for purpose condition and to publishing a set of specified performance indicators on its website. The Commission is encouraged by ARTC's willingness to publish performance indicators and its commitment to maintaining the network in a fit for purpose condition.

However, the Commission considers that, as currently drafted, the "fit for purpose" clause is quite vague, and therefore would be difficult to enforce. For example, it is not clear what the purpose that the network is to be fit for is, or to what standard the network should be maintained. Accordingly, the Commission considers that what constitutes 'fit for purpose' condition needs to be appropriately defined.

Schedules

The schedules contain further terms and conditions of access which are pertinent to the assessment of the undertaking. The schedules are the following:

- Schedule A: Access Application
- Schedule B: Information to Accompany Access Application
- Schedule C: Essential Elements of Access Agreement
- Schedule D: Indicative Access Agreement
- Schedule E: Description of Network
- Schedule F: Network Management Principles

The Commission accepts schedules A, B and E. In each case, the schedules contain descriptive information on the access application, information which is to accompany the application and of the rail network. The schedules promote understanding of ARTC's requirements for the provision of access to its rail network and represent an adequate balance of the interests of the various stakeholders. The Commission considers that these schedules satisfy the assessment criteria in section 44ZZA(3) of the TPA. Schedule C contains the list of essential elements of the access agreement. The Commission's position in respect of Schedule C is that it also satisfies the requirements of section 44ZZA(3) of the TPA. Schedule F was considered in the context of assessing the network transit management procedures, and in the final analysis the Commission expressed the view that it would not raise concerns under the assessment criteria.

Schedule D contains an indicative access agreement. The indicative access agreement adds clarity to access seekers and promotes understanding of the responsibilities and obligations of parties should access be granted. Recognising the desirability to maintain a certain level of flexibility and the ability to negotiate, the indicative access agreement is included as a guide for those access seekers wishing to negotiate outside of the published agreement. While ARTC states that the indicative access agreement is incorporated into the undertaking as a guide, it is prepared to be bound by its terms and conditions.

The Commission's assessment of the indicative access agreement suggests that, in its substantive form, it is acceptable under Part IIIA, but the Commission has identified certain aspects which may cause concerns. Among these substantive matters, a key issue was whether the terms and conditions in the indicative access agreement were consistent with the provisions of the undertaking. In this regard the Commission recommended that certain charges (overweight rolling stock and parking charges) and the possibility of renewal of existing contracts, contained in the indicative access agreement, also be provided for in the undertaking. The other key recommendation made by the Commission was that, as it is precluded from acting as an arbitrator in respect of disputes arising from actual access arrangements, the Commission should not have a role in the dispute resolution mechanism, or indeed any role, under the indicative access agreement.

Conclusions and Draft decision

The Commission's assessment of the indicative access agreement suggests that, in its substantive form, it is acceptable under Part IIIA. The Commission has found that the undertaking generally satisfies the legislative criteria pursuant to which the assessment was carried out and represents an adequate basis for negotiating access to ARTC's rail network.

However, the draft decision raises concerns with a number of provisions in the undertaking. Primarily, these concerns relate to principles and processes for negotiating access and resolution of disputes rather than prices charged for access. The Commission also makes recommendations regarding the provisions covering service levels. Other key issues concerned the indicative access agreement. Specifically, whether the terms and conditions in the indicative access agreement were consistent with the provisions of the undertaking. The Commission made recommendations in this regard. The other key recommendation made by the Commission was that, as it is precluded from acting as an arbitrator in respect of disputes arising from actual access arrangements, the Commission should not have a role in the dispute resolution mechanism, or indeed any role, under the indicative access agreement.

Approval of the undertaking is subject to ARTC addressing the concerns raised by the Commission in this draft decision.

A Introduction

Significant reforms to the rail industry have been initiated by the Commonwealth Government in the past decade. These reforms have been designed, in part, to introduce a more commercially focused rail industry. In conjunction with the reforms being implemented at the State and Territory level, this has resulted in significant changes to ownership structures and governance arrangements.

In 1991, the Commonwealth Government owned the Australian National Railways Commission, trading as Australian National (AN). AN owned and maintained track in New South Wales, Western Australia, South Australia, Tasmania and the Northern Territory. It also provided intrastate rail freight services in South Australia and Tasmania; and interstate rail freight services in the Northern Territory, South Australia, Western Australia and New South Wales. Finally, it provided passenger services on the Indian Pacific, Ghan and Overland trains.

Since this time, the Commonwealth Government has split up AN, separating out rail track, freight and passenger services. In 1991-92, National Rail Corporation (NR) was formed to conduct interstate rail freight operations in Australia. NR's shareholders are the Commonwealth, New South Wales and Victorian Governments. NR commenced commercial operations in April 1993. In 1997-98, the Commonwealth Government horizontally separated and privatised AN's intrastate freight operations in Tasmania and South Australia.

Subsequently, a number of private operators have commenced interstate rail freight operations in competition with NR. These include Patrick Rail, Specialized Container Transport (SCT), and Toll Rail. Over this period, rail freight haulage has been steadily increasing from 85.8 billion net tonne kilometres in 1989-90 to 134.2 billion net tonne kilometres in 1999-2000.

In 1997-98, AN's interstate passenger services were sold to Great Southern Railway, which operates the long distance passenger trains between Perth, Adelaide, Sydney and Alice Springs.

In an effort to, among other things, improve the efficiency and competitiveness of the rail industry, Commonwealth and State Transport Ministers agreed to the establishment of a national rail track access company to provide access to the interstate rail network. Following the Rail Summit in September 1997, an Inter-Governmental Agreement (IGA) was signed to this effect on 14 November 1997.

Australian Rail Track Corporation Ltd (ARTC) was incorporated in February 1998 and commenced operations on 1 July 1998. AN's mainline interstate track was transferred to this company. ARTC was established to manage the infrastructure, and access to, the standard gauge rail network connecting the mainland capital cities between Brisbane and Perth. Currently, ARTC has responsibility for management of access and track maintenance in South Australia (and parts of New South Wales and Western Australia) as track owner and in Victoria as track manager via a fifteen year lease agreement.

An element of the IGA between the Commonwealth and State Transport Ministers was that ARTC would lodge an access undertaking application with the Australian Competition and Consumer Commission ('the Commission') after consulting with track owners.

On 22 February 2001, ARTC submitted an access undertaking to the Commission under section 44ZZA of the *Trade Practices Act 1974* (TPA). The undertaking was subject to amendments submitted to the Commission on 14 and 21 September. The undertaking sets out the terms and conditions of providing access to the interstate mainline standard gauge track linking Kalgoorlie in Western Australia, Adelaide, Wolseley and Crystal Brook in South Australia, Broken Hill in NSW and Melbourne and Wodonga in Victoria.

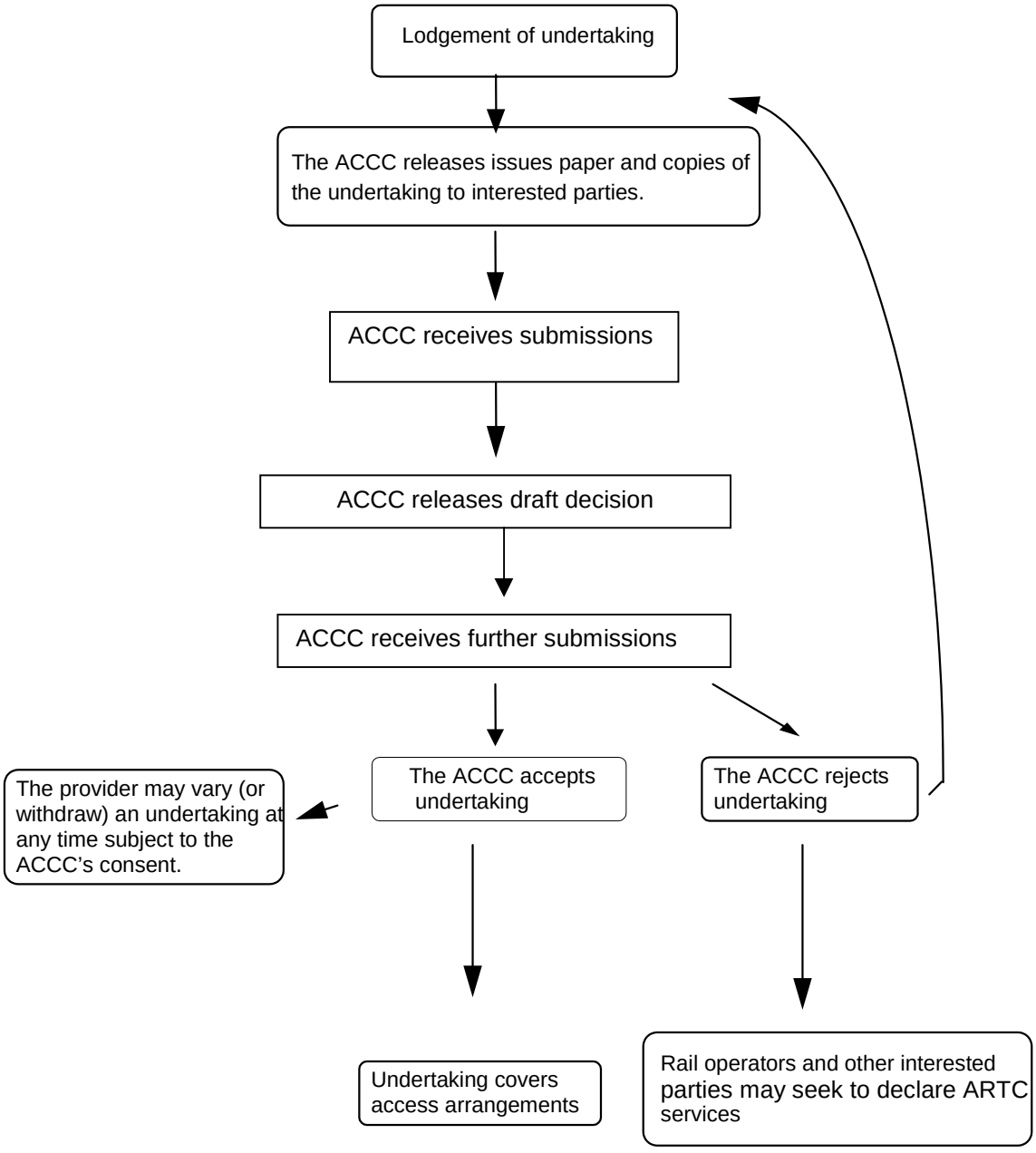
ARTC's undertaking consists of an undertaking application and appendices. The access undertaking describes the terms and conditions on which the service provider proposes to make access to this rail network available to third parties, the process for determining access and the dispute resolution process. The proposed undertaking is for a term of five years from one month after acceptance by the Commission.

A1 Commission assessment process

Figure 1 provides a summary of the procedures involved in the Commission's assessment of an undertaking. For more details see chapter 4 of the Commission publication *Access Undertakings - a guide to access undertakings under Part IIIA of the Trade Practices Act*.[5]

[5] This document is available from the Commission's website at www.accc.gov.au.

Figure 1: Assessment Procedure for ARTC undertaking



Following receipt of undertaking on 22 February 2001, an Issues Paper was released on 29 March and submissions were sought by 4 June. Fourteen submissions were received (see Appendix A for a list of parties that lodged submissions).

As part of the public consultation process, the Commission organised a public forum which was held at the Commission's Melbourne offices on 16 August 2001. The forum was attended by representatives from all key industry players as well as government departments and other regulatory agencies.

Subsequently, on 14 and 21 September, ARTC lodged revised versions of the undertaking. These were also distributed to interested parties and comments sought on

the amendments proposed by ARTC. The Commission received further submissions from SCT, Freight Rail Corporation and Toll and considered these in arriving at a draft decision.

The Commission has made a draft decision to accept the undertaking pending resolution of some issues by ARTC. The Commission now invites submissions from interested parties on this draft decision. Submissions should be delivered to the Commission by **31 January 2002** and addressed to:

Margaret Arblaster
General Manager – Transport and Prices Oversight
Regulatory Affairs Division
Australian Competition and Consumer Commission
GPO Box 520J
MELBOURNE VIC 3001

Fax (03) 9663-3699

Alternatively, submissions can be e-mailed to the following address:

renato.viglianti@accc.gov.au

The Commission will hold another public forum at the Commission's Melbourne offices on Monday 17 December 2001. The purpose of the forum is to provide an opportunity for interested parties to discuss the Commission's draft decision.

B Access undertaking proposed by ARTC

This section describes the key features of the ARTC undertaking.

B1 Part 1 'Preamble'

This part of the undertaking provides background information on ARTC, its objectives and functions pursuant to the IGA of November 1997, under which it was established. It outlines the reasons why ARTC is submitting an undertaking to the Commission under Part IIIA of the TPA and the general objectives of the undertaking.

The relevant points in this part of the undertaking are:

1. ARTC was established to manage the process of granting access to the interstate rail network.

2. The undertaking covers terms and conditions of access to that part of the interstate rail network which comprises the network, ie tracks which ARTC either owns or leases and for which it has responsibility for the granting of access. The network comprises the interstate mainline standard gauge track linking Kalgoorlie in Western Australia, Adelaide, Wolseley and Crystal Brook in South Australia, Broken Hill in New South Wales, and Melbourne and Wodonga in Victoria.

3. ARTC intends to price access to the services in an equitable, transparent and non-discriminatory manner in order to encourage growth of the rail market.

4. The undertaking seeks to achieve outcomes which strike a balance between the interests of ARTC, potential access seekers and the public.

B2 Part 2 'Administration of undertaking'

This part defines the scope of the undertaking and notes that it applies only to services defined in the undertaking. The undertaking does not apply to parts of the interstate network not included in the definition of the network or to extensions of the network or tracks that other track owners may connect to the network. The undertaking does not affect existing access agreements.

This part also sets out the term of the undertaking which is five years from one month after approval of the undertaking by the Commission. There is provision for variations to the undertaking at ARTC's discretion and subject to consent from the Commission.

B3 Part 3 'Negotiating for access'

This part sets out the framework within which ARTC intends to deal with operators wishing to have access to services provided by its network. It covers matters such as the initial negotiation procedures, issues relating to confidentiality, the actual

application of request for access, negotiations following the lodgment of an application, the finalisation of an access agreement and dispute resolution.

The principle issues of this part of the undertaking are the following:

1. **Framework**. ARTC commits to negotiating in good faith and outlines a series of steps to be followed in negotiating access.

2. **Parties to Negotiation.** This part of the undertaking stipulates that ARTC will only deal with accredited operators or applicants who acquire the services of an accredited operator in providing the services. The applicant must meet certain criteria to commence negotiations, including that it is solvent and has not defaulted on other access agreements. ARTC may refuse to negotiate with the applicant if it considers that the applicant has failed to meet these criteria. The matter may be referred to arbitration if the applicant considers that ARTC has unreasonably refused to negotiate. Likewise ARTC may request arbitration if it considers the applicant's request for access frivolous and wishes to cease negotiations.

3. **Indicative Access Proposal.** Within 30 days of acknowledging the applicant's request for access, ARTC undertakes to provide an indicative access proposal stating, among other things:

    - the extent of available capacity;
    - details of the nature and cost of additional capacity that may be required to meet the demands of the applicant in the case of insufficient existing capacity;
    - whether access applications exist from other operators which may reduce available capacity for the applicant;
    - a copy of ARTC's standard terms and conditions of access;
    - access charges; and
    - indicative train path availability.

4. **Negotiation.** Negotiations towards an access agreement may commence as soon as the applicant notifies ARTC of its intention to do so following receipt of the indicative access proposal by the applicant. The applicant may request that the indicative access proposal be revised if it considers that ARTC has not prepared it in accordance with the terms of the undertaking. If the applicant considers that the revised indicative access proposal is not satisfactory it can refer the matter to arbitration. Continuation of negotiations is conditional upon several factors, including that available capacity is not reduced as a result of an access agreement reached with another operator. Where two or more applicants are seeking mutually exclusive access rights, ARTC intends to grant access to the applicant which potentially provides "the highest present value of future returns to ARTC after considering all risks associated with the Access Agreement" [clause 3.9(d)(ii)].

5. **Dispute Resolution.** The amended undertaking provides for the parties to "use reasonable endeavours acting in good faith to settle the Dispute as soon as is practicable". There is provision for a three-step approach to dispute resolution:

    - **Negotiation** between the parties.
    - **Mediation** by a person appointed by agreement between the parties or by the President of the Law Society of South Australia if the parties can not agree on a mediator. Mediation is optional subject to agreement between the parties.
    - **Arbitration** by the Commission taking into account the provisions of the undertaking, the objectives and principles in Part IIIA of the TPA and the Competition Principles Agreement. In making a determination, the Commission is to be bound by Division 3 Subdivision D of Part IIIA and sections 44V, 44W and 44X of the TPA.

B4 Part 4 'Pricing principles'

This part of the undertaking sets out the principles used by ARTC to derive access charges. The stated objective is to apply access charges which aim to achieve a practical balance between the legitimate business interests of ARTC, the interests of operators wishing to have access to the services provided by ARTC and the interests of the public. In doing so, access charges are designed to achieve the following ends:

- recover reasonable costs incurred by ARTC in providing access and a fair and reasonable return on investment which reflects the risks involved;
- promote efficient use and investment in the network; and
- stimulate customer confidence and growth of the rail industry.

Access charges will be based on an Indicative Access Charge that ARTC publishes for services in specific geographical segments and which have the following characteristics:

- axle load of 21 tonnes;
- maximum speed of 110km/h and an average speed of 80km/h; and
- length not exceeding 1500 metres east of Adelaide and 1800 metres west of Adelaide.

Departures from these indicative charges will take account of the characteristics of individual services, including technical aspects, the particular segments of the network to which access is sought, the opportunity costs to ARTC, the impact on other traffic on the network (including system capacity and flexibility) and the market value of the particular time path being sought.

In other respects, access pricing will be uniformly applied and will not differentiate between types of operators or between like services operating within the same end market.

Access charges will be structured as a two-part tariff comprising a fixed component and a variable component. The fixed component will be levied on a $/km basis and be specific to each train service type and segment. The variable component will be related to distance and mass and be levied in terms of $/kgtkm. Both components of the access charge will be open to negotiation; however, the fixed component is proposed to be levied irrespective of usage.

Access pricing will be subject to floor-ceiling revenue limits. The floor is given by the incremental or avoidable cost of providing a service, excluding depreciation and a return on assets employed. The ceiling is defined as the full economic cost of providing a service including the costs specific to a service, depreciation and an allocation of indirect costs, and a return on assets employed. ARTC claims that costs are forward looking and include planned efficiency improvements.

Returns on assets are calculated by applying ARTC's weighted average cost of capital (WACC) to the value of the assets employed, based on a DORC valuation (depreciated optimised replacement cost).

ARTC's assets have been independently valued by Booz, Allen and Hamilton. The optimised replacement cost for ARTC's assets was assessed at $2.5 billion while the discount for the current condition of the assets was estimated at 44% giving a DORC of $1.4 billion.

ARTC has opted for a straight line method of depreciation applied to the DORC value of the asset base. In calculating an annual depreciation charge, ARTC has taken into account both the useful life and the economic life of its physical assets bearing in mind the economic life of businesses using the infrastructure and technological obsolescence.

The WACC for ARTC was assessed by Equity and Advisory. The real pre-tax WACC was estimated to be within a range of between 6.8% and 8.4% with a mid point of 7.5%.

ARTC's indicative access charges are such that revenues are at the low end of the floor-ceiling range for each of the specified segments. ARTC claims that the indicative access charges are market based rather than cost based and are designed to promote use of its infrastructure in view of competition from road transport.

There is provision in the undertaking for the indicative access charges to be adjusted annually by a factor which is the greater of CPI-2% or 2/3 of CPI.

B5 Part 5 'Management of capacity'

This part of the undertaking sets out the processes that ARTC will follow in dealing with capacity issues. ARTC's initial indicative access proposal will include an assessment of capacity to ascertain the extent to which the applicant's requirements can be met within existing capacity constraints.

Where two or more applicants seek access to mutually exclusive access rights, ARTC undertakes to grant access to the operator which offers the most favourable terms and conditions. In such a case ARTC will base its decision on the basis of "the highest

present value of future returns" that an access agreement will produce having regard to the relevant costs and risks.

Access rights to train paths may be cancelled by the operator or assigned to another party, subject to certain conditions including the approval of ARTC. The undertaking also provides for ARTC to withdraw assigned access rights to specific train paths where these have been under utilised.

B6 Part 6 'Network connections and additions to capacity'

Where additional capacity is necessary to meet the demands of an access seeker, ARTC will consider building the extra capacity provided the addition to capacity is in ARTC's commercial interests bearing in mind its overall business activity and the economic and technical feasibility of the extra capacity created. ARTC will consent to the provision of the extra capacity if:

- the applicant meets the costs directly, or through increased access charges or through other means such as periodic payments, subject to approval of ARTC; and
- the extension is consistent with the operational, engineering, and safety requirements of ARTC as well as its overall business interests.

Any addition to capacity will be ultimately owned and managed by ARTC.

The undertaking also provides for owners of other tracks to connect to ARTC's network, subject to the following conditions:

- The connections do not reduce capacity in other Parts of ARTC's Network;
- The connections interface satisfactorily with ARTC's requirements on procedural, physical, technical, operational, engineering and safety standards;
- The onus is on track owners to ensure that all users of the connection comply with the directions of ARTC's train controllers regarding entry and exit from the network; and
- The costs of building and maintaining the connections are borne by the other track owners.

B7 Part 7 'Network transit management'

This section sets out ARTC's objectives in train management which is to exit trains according to their contracted exit time. In the case of conflicting between trains in transit, the network management principles set out in Schedule F will apply.

B8 Part 8 'Performance indicators'

This section sets out ARTC's obligations to maintain the network in a fit for purpose condition and to publishing a set of specified performance indicators on its website.

B9 Schedules

There are a number of schedules presented as part of the undertaking. These are:

- Schedule A – Access application
- Schedule B – Information to accompany access application
- Schedule C – Essential elements of access agreement
- Schedule D – Indicative track access agreement as at commencement date
- Schedule E – Network
- Schedule F – Network management principles
- Schedule G – Segments

In addition, the undertaking includes material providing details on asset valuation and WACC as well as other supporting documentation.

C Legislative Framework and Principles for Assessing ARTC's Undertaking

C1 Introduction

This chapter provides an overview of the legislative provisions relevant to ARTC's access undertaking. It also discusses the principles underlying the Commission's approach to assessing the undertaking.

C2 Access undertakings and Part IIIA of the Trade Practices Act

Part IIIA establishes a legal regime to facilitate access to the services of certain facilities of national significance. It provides three alternative mechanisms for achieving access:

- undertakings;
- declaration; and
- effective regimes.

By lodging an access undertaking ARTC has opted to pursue the first of these. The advantage of this approach is that it "...provides a means by which the owner or operator of a facility can obtain certainty about access arrangements, before a third party seeks access".[6] It can also avoid the possibility of time consuming and expensive disputes about whether a service should be declared and the terms and conditions on which access should be granted.

The Commission's role in assessing undertakings is prescribed by section 44ZZA of the TPA. Once an undertaking has been submitted the Commission must decide whether or not to accept the undertaking after conducting a public consultation process. In making its decision the Commission is required to have regard to the criteria set out in section 44ZZA (3). The criteria are:

- the legitimate business interests of the provider;
- the public interest, including the public interest in having competition in markets (whether or not in Australia);
- the interests of persons who might want access to the service;
- whether access to the service is already the subject of an access regime; and
- any other matters that the Commission thinks are relevant.

If the Commission accepts an undertaking from ARTC then the terms and conditions in the undertaking form the basis on which rail operators can obtain access to ARTC's rail

[6] Second Reading Speech accompanying the *Competition Policy Reform Bill 1995*, page 7.

track services. Once accepted the services covered by the undertaking cannot be declared.

If the undertaking is not accepted by the Commission, rail operators and other interested parties have the option of seeking declaration of rail track services. Declaration gives current and potential rail track users the right to negotiate terms of access with ARTC in the first instance, and if the negotiations prove unsuccessful, the opportunity to have the Commission arbitrate the access dispute.

In this case the third mechanism for achieving access, establishment of an effective regime, requires an application by state or territory governments The services covered by the ARTC undertaking are not the subject of an application for certification to the NCC.

The Commission's publications *Access Regime - a guide to Part IIIA of The Trade Practices* and *Access Undertakings – a guide to Part IIIA of the Trade Practices Act* ("Access Undertakings Guide") provide further information about Part IIIA and access undertakings. The publications:

- provide an overview of the legislative regime established by Part IIIA, including the role of undertakings;
- set out procedures for assessment and lodgement of access undertakings;
- provide an overview of the legislative criteria for assessment of undertakings and the main factors that the Commission will take into account in applying them; and
- provide guidelines on what an owner/operator of a facility should include in an undertaking.

The publications can be obtained from all Commission offices and from the Commission's website.

Elements of an access undertaking

The Access Undertakings Guide sets out the matters that an undertaking should cover in order to provide an effective third party right of access.

In particular, the Access Undertakings Guide notes that:

> The Commission needs to be satisfied that the undertaking is sufficiently detailed to be court enforceable. Thus the boundaries to negotiations specified in an undertaking must be clearly defined.
>
> As a starting point for negotiations undertakings should:
>
> - clearly specify what services are subject to the undertaking;
> - specify what terms and conditions are open to negotiation;
> - provide a framework for negotiations including clearly defined boundaries for the negotiations;
> - provide relevant information necessary for meaningful negotiations;

- include effective provisions for dispute resolution;
- provide for potential third party users to be fully informed about non-negotiable terms and conditions; and
- specify an expiry date for the undertaking.

Negotiations could cover a range of issues, which might include:

- access prices;
- service standards;
- connection and disconnection arrangements;
- capacity constraints and extension of capacity;
- trading and queuing policies; and
- review and expiry.

Acceptance by the Commission of an access undertaking removes from third parties the right or potential right to gain access under Part IIIA to the service as a declared service. The rights of third party access to a declared service are substantial rights. Accordingly, the Commission in considering an undertaking is likely to be concerned to ensure that the proposed undertaking provides a clearly enforceable basis by which third parties can gain access to such services on reasonable terms and conditions (whether set out in the undertaking or to be negotiated).

C3 Principles for assessing ARTC's access undertaking

To assist in assessing ARTC's undertaking the Commission has formulated a number of principles as set out below. The Commission considers that, as far as possible, the undertaking should reflect these principles.

The principles address three broad issues. The first is pricing for access to ARTC's rail track. The second is processes for gaining access including the negotiation and dispute resolution provisions in the undertaking. The third is enforceability of the undertaking.

Principles for assessing ARTC's access undertaking

The Commission considers that as far as possible ARTC's access undertaking should reflect the following principles:

Access pricing

- Access prices should be no more than the efficient costs incurred by ARTC, including a normal commercial return on efficient investment.
- Access prices should provide ARTC with incentives to provide services at efficient levels of cost and quality and to undertake efficient investment.
- Access prices should provide incentives for efficient use of rail track infrastructure.

Negotiation and arbitration

- Access processes should promote commercially negotiated outcomes in a timely manner.
- Access processes should provide timely and effective dispute resolution processes.

Enforcement

- The provisions in the undertaking should be sufficiently clear to allow enforcement.

C3.1 Access undertaking principles and the legislative criteria

The Commission considers that the principles outlined above provide an effective means of applying the legislative framework, and are consistent with the criteria set out in section 44ZZA of the TPA. This section considers each of the legislative criteria and how the principles give effect to them. The discussion first focuses on the Commission's access pricing principles. The negotiation and arbitration principles and the enforcement principle are discussed separately.

Legitimate business interests of the service provider

This criterion focuses on the commercial considerations of the service provider (in this case ARTC). As stated in the Access Undertakings Guide, in assessing undertakings against this criteria the Commission will take into account the service provider's obligation to shareholders and other stakeholders.

By allowing ARTC to recover the costs of providing the service access undertaking principles address the requirements of this criterion. Cost recovery allows the service provider to earn a commercial rate of return on investments commensurate with the risks associated with the investment. This outcome is consistent with those that could be expected in competitive markets.

The interests of potential third party users

This is the counterpart to the 'legitimate business interests' criterion. It addresses the interests of access seekers.

The access pricing principles are directed to achieving reasonable prices for users and as such address the requirements of this criterion. The resulting prices should reflect efficient provision of the service and should not incorporate pricing designed to generate monopoly profits.

In relation to investment incentives there is a degree of common interest between third party users and service providers. The service provider has a legitimate interest in achieving commercial returns on investments. It is also in the long-term interests of users that prices and returns are sufficient to provide the incentives needed to induce service providers to invest in and maintain services. This is addressed by the second of the access pricing principles. 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.

In some cases access arrangements may incorporate non-price barriers to access. Where the service provider is vertically integrated it may use its own services as an input to compete in downstream markets. In such cases the service provider may have incentives to use non-price barriers to prevent entry and in doing so may prevent competition to its downstream services. However if the service provider is vertically separated, as is the case with ARTC, it should have fewer incentives to discourage access. This is because increased usage increases ARTC's revenues for any given price. Nevertheless, there may be situations where vertical separation does not result in a complete absence of non-price barriers. Accordingly, while the access undertaking principles do not explicitly address the question of non-price barriers to access the Commission's assessment of ARTC's undertaking has not overlooked the issue of non-price barriers, particularly where raised by interested parties.

The public interest

This criterion explores the extent to which an access undertaking contributes to the improved welfare of the broader community. The Commission will be guided by the objectives of the TPA, namely 'to enhance the welfare of Australians through the promotion of competition and fair trading and provision for consumer protection'. This objective emphasises the role of competition in promoting the welfare of Australians. Competition is a device for promoting economic efficiency. As explained in the Hilmer Report:

> Competition policy is not about the pursuit of competition for its own sake. Rather it seeks to facilitate effective competition in the interests of economic efficiency...[7]

[7] Commonwealth of Australia, *National Competition Policy*, Report by the Independent Committee of Inquiry (Hilmer Report), 1993.

Accordingly the Commission's assessment of the public interest criterion has focused on efficiency considerations. The access pricing principles address each of the three elements of efficiency – dynamic, productive and allocative.

Dynamic efficiency requires that firms have appropriate incentives to invest and innovate. It is addressed by the first and second access pricing principles which provide for prices which cover the costs of providing the investment including commercial returns on investments. The reference to 'efficient investment' in the second access pricing principle is targeted at achieving cost effective investment solutions, both in terms of the cost of the investment and its effectiveness in achieving the desired outcomes.

Productive efficiency requires that firms have appropriate incentives to produce services of a given quality at least cost. Prices which are no higher than the cost of providing the service using the most efficient means generally available (as required by the first access pricing principle) encourage the service provider to continually improve performance with the aim of lowering cost.

Allocative efficiency requires that firms employ resources to produce goods and services that provide the maximum benefit to society. This is usually promoted by access prices that are cost based (as required by the first access pricing principle) since cost based prices usually reflect the value of society's resources consumed in providing the service.

In this case one of the main issues in terms of allocative efficiency is usage of rail versus road. The approach of limiting prices to efficient costs goes some way to achieving allocative efficiency by avoiding distortions to consumption decisions arising from monopoly pricing. Nevertheless the Commission recognises that this market may be distorted by inefficient road pricing arrangements and therefore that cost based prices may not promote allocative efficiency in all circumstances.

The third access pricing principle (access prices should provide incentives for efficient use of rail track infrastructure) also promotes allocative efficiency by encouraging use of spare capacity.

C3.2 Whether there is an existing access regime

In some instances, a service provider may already be covered by an access regime. Access regimes may take the form of:

- State regimes;
- Commonwealth regimes; or
- private regimes such as industry based access codes.

The Commission is required to consider whether access to the service is already the subject of an access regime.

In this instance the Commission is not aware of any access regime or codes covering ARTC's services.

C3.3 Any other matters the Commission thinks relevant

This criterion gives the Commission the flexibility to consider circumstances specific to a particular service. As an example the Commission's access undertakings guide refers to regulatory provisions and community service obligations that apply to the service provider. These may be relevant to ARTC and can be taken into account in considering ARTC's cost base.

C4 Principles for negotiation and arbitration and the legislative criteria

Part IIIA of the TPA establishes an access regime which encourages negotiation of terms and conditions of access in the first instance with recourse to arbitration only when the negotiations fail. The principles for negotiation and arbitration adopted for assessing ARTC's access undertaking reflect this.

The principles for negotiation and arbitration are also consistent with the legislative criteria for assessing undertakings in section 44ZZA. It is in the interests of potential third party users and in the public interest that the negotiation and arbitration processes proposed by ARTC are effective. There are several elements to effectiveness. The first is that the principles for negotiation are set out with clarity ensuring that the parties are under no uncertainty regarding processes and obligations. The second is that the time frames are reasonable. Unnecessary delays can be a means of frustrating access. The third is that the dispute resolution processes are independent and impartial, and that the dispute resolution body has appropriate skills.

The requirements of an undertaking in relation to negotiation and arbitration are discussed in some detail in chapter 3 of the Commission's Access Undertakings Guide.

C5 Enforcement

Section 44ZZJ of the TPA sets out the mechanism for enforcing access undertakings. It provides for the Commission to apply for a Federal Court order if it considers that the service provider has breached any terms of the undertaking. The Federal Court can make an order:

- directing the provider to comply with the undertaking;
- directing the provider to pay compensation for any breach; or
- any other order that the Court thinks appropriate.

In order for the Federal Court to enforce the undertaking it will need to be able to clearly identify the terms and conditions set out in the undertaking. Hence the principle that the provisions in the undertaking should be sufficiently clear to allow enforcement. This principle covers terms and conditions of access as well as processes for gaining access and for dispute resolution.

Compliance with the provisions of the undertaking is an obligation that falls on the access provider. The undertaking concerns ARTC's obligations in relation to the granting of access to its rail network. It is submitted solely by ARTC. The undertaking cannot impose obligations on the behalf of applicants. Any failure by an operator to comply with the obligations that the undertaking purports to provide for it, is not a breach of the undertaking. While the undertaking expresses itself as seeking to impose obligations on operators, it does this only on the basis of ARTC requiring operators to respond to certain events and enable ARTC fulfil its obligations.

D Assessment of the ARTC Undertaking

This section analyses the access undertaking, highlighting comments made by interested parties in their submissions to the Commission.

The Commission has assessed the undertaking against the criteria in the TPA. This section of the paper discusses the factors considered by the Commission in reaching its decisions and how those factors relate to its consideration of the criteria.

The discussion follows the structure of the ARTC Undertaking. Each clause of the Undertaking has been assessed against the criteria in section 44ZZA(3) of the TPA. Only those clauses that raise concern are addressed in detail. By and large, issues about style of expression or definitions, rather than substance, were ignored unless these were considered to have material effect on the interpretation of clauses. Where it was deemed appropriate such concerns are considered as "drafting issues".

D1 Preamble

ARTC proposal

Part 1 of the undertaking provides information on ARTC and the objectives of the undertaking. The key objectives can be summarised as follows:

- As a vertically separated infrastructure owner, and pursuant to the objectives of the Intergovernmental Agreement under which ARTC was established, ARTC claims to be committed to encouraging access to the part of the interstate network which is under its control.
- ARTC intends to promote use of its network by adopting transparent and equitable pricing principles designed to provide access on a non-discriminatory basis.
- The objective in respect of infrastructure maintenance is to achieve "efficient infrastructure practice". Cost efficiency will be pursued by out sourcing maintenance subject to a competitive tendering process.
- The undertaking is designed to facilitate negotiations over terms and conditions for access, including dispute resolution, that reach a balance between the needs of the access provider, access seekers and the public interest. Section 1.2(c) of the preamble states that the undertaking is an attempt to:

reach an appropriate balance between:

(i) the legitimate business interest of ARTC:

(A) the recovery of all reasonable costs associated with the granting of Access to the Network;

(B) a fair and reasonable return on ARTC's investment in the Network and Associated Facilities (including maintenance costs) commensurate with its commercial risk; and

(C) stimulate customer confidence and market growth in the rail industry;

(ii) the interest of the public:

(A) increase competition ensuring efficient use of resources;

(B) reducing the potential for abuse of market power by operators or major users of single purpose infrastructure facilities; and

(C) promoting other relevant social objectives, such as an increase of freight traffic from road to rail;

(iii) the interests of Applicant's wanting Access to the Network:

(A) providing Access to the Network on fair and reasonable terms; and

(B) providing Access in an open, efficient and non-discriminatory manner.

Views of interested parties

Operators have raised concerns with some of the statements of objectives in the preamble to the undertaking.

FreightCorp and Toll in their joint submission have questioned the significance of clause 1.2(c)(ii)(B) which links the public interest with, among other things, the need to reduce the potential for abuse of market power by operators. They indicate that it is not necessary for the undertaking to incorporate this provision given the broader functions of the TPA (annotated undertaking, page 7).

National Rail (NR) argues that the preamble is not sufficiently clear on what is meant by efficient access and efficient infrastructure. NR points out that to this extent the undertaking does not give "reassurance that there will be continuing advancement of efficiency going forward" (submission page 6). According to NR there should be a forward looking approach based on the notion of "continuous improvement".

Other comments on the preamble centred on the type of comments made by ARTC in respect of its objectives as the owner of rail track. For example, ARTC states in clause 1.1(f) that it "seeks to stimulate customer confidence and market growth in the rail industry in an evolving environment…". Operators have indicated that such statements are of vague significance and have questioned their relevance in an undertaking.

Commission's position

Nature of preamble

A preamble contains preliminary statements, usually as an introduction to a formal document, that serve to explain its purpose. It assists in the interpretation of the document but does not impose a legal obligation on ARTC *per se*.

The statements made by ARTC in the preamble fall largely into this category. They are generally of an explanatory nature and assist in the interpretation of other substantive clauses and do not raise concerns.

Some clauses, however, were potentially of concern and these are considered below.

Return and risk

Clause 1.2(c)(i)(B) states that a legitimate business interest of ARTC includes a fair and reasonable return on ARTC's investment in the network and associated facilities (including maintenance costs) commensurate with its commercial risk.

Section 44ZZA(3) of the TPA states that the Commission may accept the undertaking, if it thinks it appropriate to do so having regard to:…

> (a) the legitimate business interests of the provider;

The issue is whether a fair and reasonable return on ARTC's investment in the network and associated facilities (including maintenance costs) commensurate with its commercial risk may be considered a legitimate business interest.

Guidance on this point may be obtained from the Access Undertakings Guide, which states that the Commission's analysis of legitimate business interests of the service provider will focus on the commercial considerations of the service provider. That is, the Commission will take into account issues such as the provider's obligations to shareholders and stakeholders and the need to earn commercial returns on the facility and incentives for the provider to maintain, improve and invest in the efficient provision of the service. Specifically, the Access Undertakings Guide states that one of the issues the Commission will consider is the:

> ongoing viability of services covered by the undertaking and commercial returns on investment in the facility.
>
> The Commission takes the view that pricing principles included in an undertaking should permit service providers to gain prospective returns on their investments commensurate with the risks involved.[8]

It is appropriate to consider the concept of "risk" as encompassing "normal commercial risk". It is appropriate for a business to seek to cover normal commercial risk. Having said this, the Commission does not consider that its obligation to take into account the legitimate business interests of the provider extends to protecting providers from normal commercial risk. It is reasonable to consider clause 1.2(c)(i)(B) of the undertaking consistent with ARTC's legitimate business interest.

Abuse of market power by operators

FreightCorp and Toll raise the issue whether the undertaking should have as one of its objectives the desirability of minimising the potential for abuse of market power by operators (clause 1.2(c)(ii)(B)) when there are provisions in the TPA specifically intended to deal with such issues. The relationship between Part IIIA and other sections of the TPA dealing with abuse of market power is documented in the Access Undertakings Guide. Essentially, Part IIIA is intended to deal with potential misuse of market power in the context of providing access to infrastructure facilities in a more effective way than would be possible under the provisions of section 46 of the TPA.

[8] Australian Competition and Consumer Commission, (2) *Access Undertakings*, September 1999, p5.

In clause 1.2(c) of the undertaking, ARTC states that it is seeking a balance between the interests of access seekers, the infrastructure owner and the public interest. In this regard, the ARTC undertaking is trying to achieve consistency with the criteria in section 44ZZA(3). However, it is difficult to envisage how ARTC may seek to achieve the objective of countering the market power of operators and, beyond that, whether it is the objective of the undertaking to do that. The Commission considers that the public interest criterion for assessing undertakings under Part IIIA of the TPA encompasses the desirability of constraining the potential for misuse of market power by the infrastructure owner. Part IIIA was not introduced into the TPA to deal with concerns about anti-competitive practices of operators in downstream industries. Among other things, by purporting to set out to limit the potential for abuse of market power by operators, ARTC is implicitly seeking to impose obligations on the conduct of operators. As noted, provisions of the undertaking that impose obligations on operators are not enforceable. In any event, it is arguable as to what benefit such an objective could have beyond what is expressly provided for in Part IIIA of the TPA.

Accordingly, the Commission recommends that clause 1.2(c)(ii)(B) of the undertaking be deleted.

Interests of applicant

Clause 1.2(c)(iii) states that:

> …the interest of Applicants wanting access to the network:
>
> (A) providing Access to the Network on fair and reasonable terms; and
>
> (B) providing Access in a open, efficient and non-discriminatory manner;

FreightCorp and Toll propose to insert the word 'including' in the following manner:

> ...the interest of Applicant's wanting Access to the network, ***including*** [emphasis added]:
>
> (A) providing Access to the Network on fair and reasonable terms; and
>
> (B) providing Access in a open, efficient and non-discriminatory manner;

The issue is whether ARTC's exclusion of the word 'including' remains consistent with Section 44ZZA(3) of the TPA.

The Access Undertakings Guide states that the Commission will take into account a **range** of factors when assessing the interests of applicants or potential third party users. The factors listed in the Access Undertakings Guide representative of ARTC's clause include whether the terms and conditions are reasonable; whether processes are transparent; whether prices are based on efficient provision of services and whether there is provision or need for avoiding price discrimination ('ring fencing'). Other factors not limited to these are also listed. It appears that the intention with all criteria listed under section 44ZZA is that they be interpreted in a non-exhaustive manner. The factors listed in the clause are consistent with the Access Undertakings Guide, but, should not be interpreted as the sole factors when considering the interests of the applicant. As such, it would be consistent with interpretation of the legislation for the list of factors to be non-exhaustive and for 'including' to be inserted.

In other respects, the Commission considers that the preamble satisfies the requirements of the assessment criteria in section 44ZZA(3) of the TPA.

Recommendations

Clause *1.2(c)(ii)(B) of the* ARTC undertaking be deleted.

Clause *1.2(c)(iii) of the* ARTC undertaking be amended by adding the word "including". For example: the interests of Applicants' wanting Access to the Network, *including*:

D2 Scope and administration of undertaking

Part 2 describes the scope, applicability and term of the undertaking, and the review arrangements. It notes that the undertaking only applies to the negotiation of new access agreements or the negotiation of access rights in addition to those already the subject of an access agreement. These clauses are important as they help set the boundaries of the undertaking and therefore determine the undertaking's enforceability.

D2.1 Scope of undertaking

The scope of the undertaking encompasses important issues such as the definition of the services provided by ARTC and the infrastructure with which these services are provided. Also of relevance is the related issue of interface between the ARTC undertaking and the regimes covering tracks in adjoining jurisdictions. These are considered in turn below.

D2.1.1 Definition of services: freight and passenger services

Comments on this issue have centred on the notion that the undertaking does not recognise services other than freight services. Notably, it has been submitted that passenger services are disadvantaged under the provisions of the ARTC undertaking.

ARTC proposal

Clause 9.1 defines the services to which the undertaking applies as:

> A train run by the Operator using the Network which provides railway freight or passenger services including work Trains (ARTC Undertaking, page 45)

Views of interested parties

Freight Australia

Freight Australia utilises ARTC tracks in Victoria to provide intrastate rail services. This is primarily grain traffic moving from Northwestern Victoria to the port of Portland and "runs on train paths which are to some extent dictated by the grain shipping program".[9] Freight Australia believes that the ARTC undertaking does not

[9] Australian Competition and Consumer Commission, (3) *Workshop on ARTC Undertaking*, 16 August 2001, Auscript, p. 12. This document is available from the Commission's website at www.accc.gov.au.

provide for the characteristics of its traffic. Instead, the ARTC undertaking is designed to cater for long-distance traffic that typically runs on the interstate network between the eastern states and Perth. According to Freight Australia:

> ..such access requirements would be typified by scheduled paths, planned well in advance of the run dates and used almost every week of the year. In such a situation, flagfall "take or pay" obligations "healthy trains having utmost priority and availability of access being predominantly based on path availability…are appropriate. However, each is inappropriate for typical Freight Australia access to the Interstate Mainline.[10]

To deal with this, Freight Australia propose that:

> As a minimum, the Access Undertaking should acknowledge the terms and conditions in the Interstate Agreement but it would be more preferable for a more integrated approach between the ARTC network and the Freight Australia network and operations to be developed.[11]

VIC Department of Infrastructure (VDI)

The concerns raised by VDI centre around the fact that tracks leased by ARTC in VIC are used by various operators to provide subsidised passenger services. Some of these utilise "premium" train paths. Under Section 10 of the Transport Act 1982 (Vic), passenger services have priority in Victoria. VDI argues that the ARTC undertaking does not explicitly refer to these services or that they currently have priority. It is also argued that ARTC could in the future take over the management of other tracks in VIC, such as for example, the yet to-be standardised broad-gauge track between Seymour and Wodonga (currently leased to Freight Australia and running parallel to the standard gauge track leased to ARTC). VDI would like the ARTC undertaking to provide for operators running passenger services on these tracks to continue to be given access to appropriate time paths on reasonable terms.

Great Southern Railway (GSR)

GSR operates the passenger services The Ghan, Indian Pacific and The Overlander. GSR also argues that the ARTC undertaking should note that trains running on ARTC tracks are not just freight trains but include passenger trains as well. GSR raises the issue of the undertaking not recognising passenger services provided with the assistance of government subsidies. This issue is in essence about the desirability of engaging in price discrimination when social/political considerations are of significance.

State Rail Authority of NSW (SRA)

SRA operates passenger services between Sydney and Melbourne. SRA is also concerned about the low level of acknowledgment of passenger services in the ARTC undertaking. Among other things, SRA points to the description of the indicative service having the characteristics of freight trains. In addition, the proposal to allocate scarce capacity on the basis of the most commercially favourable proposition to ARTC, also discriminates unfavourably against long-distance passenger services. SRA argues

[10] Freight Australia, Submission p. 4.
[11] *ibid*., p. 4.

that passenger services are more time-sensitive and should be given priority under the undertaking.

Commission's position

The concerns raised by interested parties can be categorised as follows:

- **Passenger services have different characteristics relative to freight services and yet the undertaking does not seem to recognise this.** The definition of services in the undertaking incorporates passenger as well as freight services. While the indicative service is of a configuration that seemingly differs from that of a typical passenger service, the undertaking does not preclude negotiations over services with characteristics other than the indicative service.
- **Operators currently providing services on ARTC's tracks should be able to continue to have access to the tracks pursuant to the undertaking on the same terms and conditions as they have been up to now.** The undertaking should not restrict operators from being able to negotiate new access agreements on the same terms and conditions they have enjoyed under existing agreements. However, there do not appear to be grounds for an undertaking to provide assurances that existing arrangements would be permitted to be rolled over into the future without a review, a renegotiation option or otherwise without agreement between the parties.

  Clause 2.8 of the indicative access agreement provides for renewal of access rights in certain circumstances for holders of long term contracts. But renegotiated access is to be in accordance with the undertaking, unless otherwise agreed.

  As a matter of principle, the Commission considers that automatic rolling over of contracts is quite a different matter and that such a provision would not achieve a desirable balance of interests as required under Part IIIA. With conditions in the rail industry subject to changes, one of the parties in the contract will be worse off if contracts are not adjusted to reflect new market conditions. There is also a public interest issue. Entry of potentially more efficient operators may be deterred if existing operators are able to exercise a right of automatic renewal and the network is approaching capacity constraints. The issue of the relationship between the undertaking and existing contracts is further explored in section 2.3 of this report.

  In the specific case of passenger services raised by certain operators, if the continued use of premium time-paths is essential to some operators as part of government policy designed to achieve certain social objectives in respect of passenger services, and ARTC is bound to supply these timepaths irrespective of commercial considerations, then these should be formally recognised in the undertaking. ARTC have not included in the undertaking a provision in respect of such obligations. As such, there does not appear to be a basis for excluding these services from the negotiations provisions of the undertaking.

In some cases, as pointed out by the VIC Department of Infrastructure, state legislation provides for passenger services to have priority. The undertaking does not preclude ARTC from giving priority to passenger services but it does not contain an obligation on ARTC to do so.

The Commission notes that the undertaking requires ARTC not to discriminate between operators in giving access to its network. As mentioned, the Commission has received a submission that suggests that ARTC may be required by law to discriminate in favour of operators of passenger services operating in Victoria in certain circumstances. The Commission has relied upon ARTC to satisfy itself that it is legally able to comply with each of the obligations that the undertaking provides for it. The Commission makes clear that, should it accept the undertaking from ARTC, it would not alter ARTC's general legal obligations or provide any defence to ARTC in respect of them.

Should it however be the case that ARTC could be required by law to discriminate in favour of passenger services in Victoria, then the Commission considers that ARTC should expressly provide for this in its undertaking.

- **The undertaking should recognise that certain services, particularly passenger services, are provided by operators with the assistance of government subsidies.** The fact that some operators require government assistance to provide services they would not otherwise commercially provide, should not affect the commercial decisions ARTC makes in respect of negotiations with those operators. If these operators require further concessions from ARTC financed through government subsidies, these would need to be formally recognised in the undertaking. The undertaking does not include a provision regarding the needs of operators who provide services that would not otherwise be commercially viable.
- **The undertaking should provide that if the ARTC were to gain control over additional tracks in the future, it should provide access to existing operators on no worse conditions than is presently the case.** ARTC cannot give an undertaking in respect of track it does not control, or reasonably expects to control, as it would not be a provider of a service in respect of that track within the meaning of Part IIIA of the TPA. However, ARTC has amended the original undertaking and now has committed in clause 2.1(d) that, should it become an access provider under Part IIIA of the TPA in respect of tracks not presently under its control, it will lodge with the Commission an undertaking covering access to those tracks (see further comments in section D2.1.2).

D2.1.2 Definition of network

ARTC proposal

The facilities covered by the undertaking are included in the network, which is defined in clause 9.1 as “the network of railway lines delineated in Schedule E”.

Schedule E describes the network as encompassing tracks owned by ARTC in SA, extending to Broken Hill in NSW (from Crystal Brook) and Kalgoorlie in WA, and leased in VIC. The network as described in ARTC's undertaking is part of the standard gauge interstate network linking all capital cities in Australia from Brisbane to Perth.

The undertaking does not apply to parts of the interstate network not included in the definition of the network or to extensions of the network or tracks that other track owners may connect to the network.

Views of interested parties

Submissions have generally emphasised the desirability for the scope of the ARTC undertaking to be expanded so that it includes tracks in adjoining jurisdictions. This would enable ARTC to create a national access regime covering all tracks in the interstate network.

National Rail

NR points out that ARTC was established pursuant to an Intergovernmental Agreement to be the manager of access to the entire interstate network. While ARTC is not presently in a position to act as the single provider of access to the entire network, there is an expectation that it will be in the future. The present undertaking is seen as the initial step with other jurisdictions eventually joining the ARTC access regime to establish a national access regime. According to NR this expectation is sufficient for ARTC to be considered an access provider in relation to the entire network under the meaning of section 44ZZA, viz "a person who is, or expects to be, the provider of a service".

Accordingly, NR concludes that the definition of the interstate network adopted in the undertaking should be broadened so that the scope of the undertaking extends to the entire interstate network. The terms and conditions of the undertaking would apply to the segments outside the current control of ARTC when it was able to gain effective control of those particular tracks.

Commission's position

The Intergovernmental Agreement which established ARTC clearly stipulates that one of ARTC's key objectives is to promote use of Australia's rail infrastructure by, among other things, facilitating the process of gaining access to the tracks by operators. A key plank of this strategy was for ARTC to act as the sole manager and provider of access to the entire interstate network.

As already noted, ARTC is not in a position to provide an undertaking covering access to the entire interstate network because it does not meet the test of being an access provider under Part IIIA in respect of tracks outside SA and VIC. Essentially, ARTC does not have control over tracks in other jurisdictions. Access to tracks in QLD, NSW, WA and NT is subject to the terms and conditions stipulated in the respective access regimes covering rail services in those states. Establishing a common framework for access to all tracks in the interstate network is beyond the control of ARTC, depending largely on the policies of the respective state governments.

It is understood that ARTC is committed to the process of establishing a national rail access regime, as envisaged in the Intergovernmental Agreement. To this end, ARTC will submit an undertaking in respect of additional tracks over which it may gain control in the future. To ensure this commitment is reflected in the undertaking, ARTC has amended the original undertaking and introduced a new clause 2.1(d) providing for the lodgement of an undertaking to the Commission in respect of access to any tracks that may come under its control. The Commission considers that this is a positive response from ARTC on this particular issue but is of the view that, all things considered, it would probably be preferable to amend the existing undertaking than submit a separate one. Nevertheless, the appropriateness of either step may depend on the particular circumstances involved at the time.

D2.1.3 Interface with tracks in other jurisdictions

Operators, government bodies and regulatory agencies have made comments about the fact that as parts of the interstate rail network are outside the scope of the undertaking, there may be inconsistencies between the access arrangements in the parts of the interstate network covered by the undertaking and those outside ARTC's control. This raises the issue of how the network covered by the ARTC undertaking interfaces with other rail access regimes. At the very least, some government and regulatory bodies have argued, the ARTC undertaking should attempt to achieve consistency with the terms and conditions found in the regimes of adjoining jurisdictions.

ARTC proposal

The undertaking submitted by ARTC relates exclusively to tracks under its control. There are provisions in the undertaking that cover connections to the ARTC network that set out conditions for other track owners to observe. These conditions deal with operational, engineering and procedural standards that connecting track owners must observe. In all other respects the undertaking appears to be independent of access regimes in other jurisdictions.

Views of interested parties

National Rail

National Rail (NR) argues that the undertaking should include an objective to promote the adoption of a uniform code of access to all parts of the interstate rail network, not just the network outlined in the undertaking. It argues that the issue of consistency with other access regimes or codes – uniformity of track access arrangements covering the interstate network and contiguous intrastate networks – is critical to National Rail and other rail operators.

South Australian Independent Industry Regulator (SAIIR)

The SAIIR fulfils the functions of regulator and arbitrator in the Tarcoola to Darwin regime certified by the NCC. SAIIR has submitted that the ARTC undertaking must reflect the facts that ARTC's tracks are geographically linked to the tracks covered by the Tarcoola-Darwin regime and that ARTC has a role in facilitating access to the Tarcoola-Darwin line. According to SAIIR:

> Interface issues are defined as those issues (including pricing) which directly affect two or more railways. Such issues arise because anyone wishing to operate a rail service on the Tarcoola-Darwin railway is likely to need access both to this infrastructure and also to infrastructure owned by ARTC as well as potentially infrastructure owned by other track owners.
>
> The potential for interface issues requires a coordinated approach to interstate rail services, and consistency between the various access frameworks.
>
> The Undertaking contains no explicit recognition of such interface issues.[12]

SAIIR has submitted that just because the ARTC undertaking is the first in the interstate network to be assessed under Part IIIA, it is not sufficient reason for the interface issues to be neglected. Indeed, SAIIR consider that there are issues associated with ARTC's access arrangements which give rise to the need for the ARTC undertaking to include "codification" similar to what will be necessary in third-party access regimes like Tarcoola-Darwin. Access arrangements applying with respect to the interstate rail network are pivotal and have important consequences for all connecting State regimes. It is also important that key principles and methodologies be codified because they will set precedents for other regimes.

If such codification is not done, at the very least the undertaking should incorporate an obligation on the part of ARTC to consult with interfacing jurisdictional regulators to reveal its approach beyond that provided in the letter of the undertaking and to enter into dialogue with a view to achieving acceptable regulatory outcomes.

Finally, SAIIR argues that if appropriate provisions for regulatory coordination cannot be included in the undertaking, it is essential the Commission delay its approval until such time as all principles and methodologies are codified and subject to the Commission's assessment against national competition principles.

New South Wales Government

The New South Wales Government states that the limited area covered by the ARTC undertaking in the definition of "network" cannot achieve true interstate rail access as it cannot provide access for train paths with origins and final destinations outside the ARTC network. The New South Wales Government argues that this problem inherent in the undertaking cannot be solved by ARTC alone, but rather requires ARTC and the States and Territories to work together. It adds that the rail access provider in New South Wales, Rail Infrastructure Corporation, is currently working with ARTC in order to see whether the interface between the ARTC network and the New South Wales network can be improved.

Transport WA

Transport WA argues that it is of some importance to Western Australia that the ARTC undertaking is framed with an "interstate" perspective in mind to ensure that its influence across the Western Australia – South Australia border is fully recognised and addressed. It claims that the ARTC undertaking does not make provisions to establish an appropriate interface with respective access regimes in other States or Territories. Transport WA notes that while there are many similarities between the ARTC

[12] South Australian Independent Industry Regulator, *Submission*, p. 5.

undertaking and the Western Australian rail access regime, there are different negotiation and dispute resolution processes, pricing principles, and accountability and sanctioning arrangements. ARTC has entered into an agreement with Westnet, the new vertically integrated owner of former Westrail's freight business, to "wholesale" access to the track west of Kalgoorlie to Perth.

Queensland Rail

Queensland Rail (QR) argues that the maintenance of consistency, or the incorporation of ways to manage any inconsistencies, across the various rail access regimes should be a consideration of the Commission in assessing ARTC's undertaking. Further, QR considers that it may be appropriate to allow ARTC to review its undertaking in the future to facilitate the promotion of consistency across rail access regimes.

Freight Australia

Freight Australia argues that the undertaking is really only relevant to the present ARTC activities (South Australia and Victoria). It adds that the traffic demands in other states (New South Wales and Western Australia) are different and therefore the South Australia/Victoria solution is unlikely to be appropriate.

FreightCorp and Toll (FCT)

The submission from FCT notes that it may be appropriate to anticipate interface issues under a formal consultation process that would allow operators and other interested parties to make submissions.

Commission's position

As ARTC cannot provide an undertaking under Part IIIA of the TPA in respect of the entire interstate network, the issue of interface between the ARTC undertaking and rail access regimes covering other parts of the network is an important one. There seems to be general agreement that rail infrastructure is presently under utilised in Australia. Growth of rail traffic to a large degree depends on the competitiveness of rail relative to other modes of transport, principally road. The competitiveness of rail is enhanced when rail traffic can move seamlessly and efficiently from origin to destination. A lack of consistency in the rules that govern the movement of rail traffic across jurisdictions, including rules about access to tracks, can have a detrimental effect on the efficiency of rail movements.

Much of the traffic on ARTC's network is "in transit", that is, originates and ends on tracks not controlled by ARTC. As such, it can be argued that it would be in ARTC's interest to ensure that its undertaking does not conflict with the terms and conditions of access to other tracks in the interstate network thus maximising the natural advantages rail may have over road over longer distances. Having said this, the scope for ARTC to minimise conflict with other regimes is limited due to the fact that it must seek compatibility with several regimes: the ARTC network connects with tracks covered by three different access regimes, viz NSW, WA and NT.

As trains move across jurisdictions, the quality of traffic flow can be affected by several types of interface issues: management of access; traffic flow arrangements;

dispute resolution and operational and procedural arrangements. There are economies in centralising access management, dispute resolution and traffic flow management and also in having a high degree of uniformity of operational rules and requirements. In the absence of complete uniformity of the latter, a single provider of access and a single decision-maker on disputes and traffic flow matters, train services can be expected to run less efficiently than otherwise might be the case.

Access management

ARTC is constrained in its ability to become the single provider and manager of access to Australia's interstate network because it does not have control over rail tracks outside of SA and VIC. This is a matter outside the control of ARTC as the current arrangements in place do not provide ARTC sufficient control over the infrastructure in NSW, WA and QLD and NT to be deemed an access provider under Part IIIA.

In NSW, the access regime in place is not presently certified under Part IIIA of the TPA.[13] It is understood that the NSW government is in the process of formalising its approach to rail access in NSW, which may include a role for ARTC.

In WA, the rail access regime is not certified under Part IIIA. ARTC has an agent/wholesaler arrangement with Westnet, the recent acquirer of Westrail's vertically integrated freight business, to on-sell access to operators wishing to provide rail freight services west of Kalgoorlie to Perth. However, this arrangement does not give ARTC control over the infrastructure.

In QLD there is a short piece of track that is part of the interstate network linking Brisbane and Sydney. The undertaking from Queensland Rail (QR) covering access arrangements in QLD has not been approved by the Queensland Competition Authority (QCA). ARTC does not presently have any role in respect of this track.

In NT, the access regime applying to the proposed line from Tarcoola in SA to Darwin in the NT, was certified by the Commonwealth Treasurer in February 2000. The regime will take effect when operations begin on any part of the newly constructed line between Alice Springs and Darwin. The existing line from Tarcoola to Alice Springs, is owned by ARTC but control will pass to Asia Pacific Transport Consortium as winner of the tender for the construction of the Alice Springs to Darwin rail link. It is understood that ARTC has an access agency role in respect of the Tarcoola to Alice Springs line and there will be a similar arrangement in respect of access to the Tarcoola-Darwin line when it is completed.

In assessing ARTC's undertaking against the criteria in section 44ZZA(3), the Commission cannot ignore the potentially dysfunctional effects on the demand for services provided by ARTC, and in turn on intra and inter modal competition, that may result from the fact that access to Australia's interstate network is the subject of four different access regimes. However, the Commission is cognisant of the constraints on ARTC in achieving an optimal level of consistency across jurisdictions. It also notes that ARTC and relevant authorities in various jurisdictions are cooperating with a view

[13] The regime had been previously certified by the NCC for a fixed term, expiring in December 1999.

to fostering the development of arrangements which will minimise inconsistencies across access regimes.

Operational and procedural arrangements

As far as operational and procedural interface arrangements are concerned, these differ across regimes. The potential for the ARTC undertaking to be consistent with the operational standards of neighbouring access regimes is limited. On the other hand, consistency with the National Code of Practice is far easier. A National Code of Practice is in the process of being implemented with the aim of achieving harmonisation of rules and requirements of providing rail services on the interstate network. The Code covers all aspects of rail services. Volumes already published focus on safety and communications while additional volumes will cover track, civil and electrical infrastructure and rolling stock design and maintenance. However, compliance with the Code is voluntary. As such ARTC is not in a position to make commitments in the undertaking in respect of operational and procedural arrangements contained in the National Code of Practice.

Traffic management

Another potential aspect of ARTC's operations where interface issues may be important includes allocation of time paths, particularly in times of congestion caused by events in tracks in adjoining jurisdictions. Again, to some degree, delays caused by unforeseen delays in tracks in other networks, are beyond the control of ARTC. From time to time ARTC will be required to make decisions in relation to delayed entry. ARTC claims that its network management principles are well understood by operators and have been in use since ARTC's inception. Essentially, the rules of transit management ensure that trains that enter the network on time are assured of exiting on time. Those operators who do not comply with scheduled entry times risk being held up until there is capacity in the network for them to continue.

The assessment of the network management principles against the criteria in section 44ZZA(3) of the TPA is discussed in chapter D8 of this report. The Commission considers that the management of flows of traffic into the ARTC network is generally based on sound principles and would enable ARTC to deal adequately with interface issues that might arise in traffic management.

Dispute Resolution

The ease with which the ARTC undertaking inter-relates with other access regimes in respect of dispute resolution is a key issue in interstate rail access. In recognition of this, the Commission has accepted a role in the dispute resolution process in this undertaking. Through such a role, the Commission intends, where appropriate, to seek to implement a national approach to dealing with disputes involving interjurisdictional interests.

The Commission considers that it would be difficult to be prescriptive about the precise processes to be adopted to facilitate interface on dispute resolution. It is noted that in the Tarcoola to Darwin certified regime, there are provisions that aim to specifically deal with interface issues. These include the regime allowing for an arbitrator to be selected who can conduct arbitrations under other regimes. If this is not possible the

arbitrator under this regime must consult with arbitrators under other regimes when relevant to the dispute being considered.

The Commission recognises that this level of prescriptiveness may be appropriate in the case of the Tarcoola to Darwin regime. In the case of the ARTC undertaking, however, the Commission is of the view that it is desirable to maintain a level of flexibility to allow for the particular circumstances of individual disputes. The Commission is a Commonwealth agency with a national focus and will consider consulting widely in resolving disputes as appropriate in each case, including regulators and arbitrators in the relevant jurisdictions.

Summary

In coming to a view on the matter of interface issues, the Commission recognises that the ARTC rail network is itself part of a larger rail network and as such, it is important that in the interests of facilitating the movement of rail traffic across state borders, it interfaces well with other access regimes. Optimal interface can only be achieved if the owners of the connecting tracks cooperate to bring about a complete integration of the management of the entire interstate network. As noted, the Commission is aware of efforts towards this end. Nevertheless, the Commission is required to assess the ARTC undertaking pursuant to the criteria in section 44ZZA(3) of the TPA. While the Commission notes the constraints on ARTC to achieve an ideal level of interface with other tracks, it considers that the proposed processes for managing interjurisdictional traffic movements in the undertaking achieve an adequate level of interoperability with adjoining tracks.

The Commission considers that the undertaking itself represents an important step towards improving interstate rail access for train operators. Other jurisdictions may be expected to follow with access undertakings covering other parts of the interstate rail network. ARTC's undertaking, and the Commission's assessment of it, can be used as a guide for this process.

Overall, the Commission concludes that matters covered by the scope of the undertaking do not raise concerns under the legislative criteria in section 44ZZA(3).

D2.2 Grant, duration, term and review of undertaking

ARTC's proposal

ARTC proposes that the undertaking take effect one month after it is accepted by the Commission and expire at the earlier of the end of the term or the termination of the undertaking. The undertaking is proposed to have a term of five years from its commencement date. A review of the undertaking is at the discretion of ARTC subject to approval from the Commission and prior consultation with operators.

ARTC argues that the rail industry is undergoing a range of significant changes at the current time, ranging from the restructure of state based entities such as Rail Infrastructure Corporation in New South Wales to complete privatisation as occurred in Western Australia. It argues that this environment of uncertainty is not conducive to capital investment in rail by the private sector. ARTC adds that such uncertainty has,

perceptually at least, been exacerbated by the lack a consistent national access regime. ARTC believes, therefore, that the undertaking will provide some stability in an industry and environment undergoing transition in structure and form.

However, ARTC recognises that in five years the environment will have evolved and the changes arising from the current reforms will have had an opportunity to settle down. On this basis, ARTC is of the view that this will be an appropriate time-frame in which to review the undertaking in order to evaluate the effectiveness of the current undertaking and assess its suitability for the next phase of industry development.

Views of interested parties

FreightCorp and Toll

FreightCorp and Toll have inquired in their joint submission whether it is appropriate for the undertaking to become effective after it is approved by the Commission when section 44ZZA(5)(a) of the TPA stipulates that an undertaking comes into operation when accepted by the Commission. They agree that the five-year term appears appropriate. FreightCorp and Toll note that prior to seeking the approval of the Commission to vary the access undertaking, ARTC will consult with operators regarding the proposed variation. FreightCorp and Toll suggest that the undertaking should state what is meant by consultation and should assert that operators and interested parties may make submissions to the Commission in respect of the proposed variation. FreightCorp and Toll also believe that it is appropriate to have a review of the undertaking 12 months after it is accepted. They further argue that no variation to the undertaking should vary, or require any operator to agree to vary, an access agreement.

National Rail

NR claims that there should be provision for stakeholders other than ARTC to initiate reviews. NR contends that the undertaking should be revised to provide for it to be reviewed at the request of (say) any two customers. Once a review is initiated, NR argues that it should be conducted in a transparent manner, with transparent review criteria.

New South Wales Government

The New South Wales Government argues that the five year term appears reasonable, particularly given that it is the first rail undertaking lodged with the Commission and the undertaking process is so far untested in rail.

SCT

According to SCT the term of the undertaking should not be five years. This is considered too short and suggest it should be 15 years which is the term recommended by the National Competition Council in its assessment of SCT's application for the declaration of rail services provided by NSW Rail Access Corporation.

Commission's position

Timing of effectiveness of undertaking

Clause 2.2 states that "ARTC undertakes to the Commission that it will comply with the terms and conditions specified in this Undertaking in relation to the grant of Access to Operators to the Network for Services. This Undertaking takes effect one (1) month after it is accepted by the Commission [under] section 44ZZA(3) of the TPA …"

FreightCorp and Toll raise the point that section 44ZZA(5)(a) of the TPA provides that an undertaking comes into operation at the time of acceptance by the Commission.

Section 44ZZA(5) states:

> If the Commission accepts the undertaking:
>
> (a) the undertaking comes into operation at the time of acceptance;

The Commission considers that the approach adopted by ARTC in stipulating the time the undertaking becomes effective is not inconsistent with the provisions of Part IIIA of the TPA.

The undertaking becomes operational when approved by the Commission as it becomes at that date an instrument that is binding on ARTC if it is acted upon. By stating that the undertaking becomes effective one month after approval, ARTC is essentially delaying its implementation. This can assist achieve a smooth transition to negotiating access pursuant to the provisions of the undertaking. Both ARTC and operators could benefit from such a "grace" period.

On the other hand, it may be argued that if ARTC are to receive the benefit ensuing from acceptance of the undertaking (protection from declaration), it should also be bound by its obligations at the same time. However, on this occasion, one month is arguably not a significant period of time.

Termination/withdrawal of undertaking

Clause 2.2(b) states that the undertaking will continue until the earlier to occur of:

> (a) the expiry of the Term; or
>
> (b) termination of this Undertaking in accordance with its terms or the TPA.

FreightCorp and Toll suggest that the TPA does not anticipate 'termination' rather it anticipates 'withdrawal' and the clause should be changed to reflect this.

Section 44ZZA(5)(b) provides that "the undertaking continues in operation until its expiry date, unless it is earlier withdrawn". Section 44ZZAA(7) provides that "the provider may withdraw or vary the undertaking at any time, but, only with the consent of the Commission".

It is clear the TPA contemplates withdrawal of the undertaking, with the consent of the Commission and does not contemplate termination. It would be appropriate, when discussing circumstances under which the undertaking would cease, that the

undertaking reflect what is intended in the TPA. That is, the undertaking will continue until withdrawn with the consent of the Commission. As such, the clause should be amended to reflect this approach.

Term of undertaking

The Commission does not consider that the term of the undertaking is inappropriate. The Commission concurs with the view that the rail industry is undergoing a period of substantial change, from both the supply and demand aspects of the industry. A review in five years provides the opportunity to reassess the undertaking in the light of developments in the industry, particularly as far as access arrangements are concerned. For this same reason the Commission does not consider that a formal review of the undertaking in twelve months is warranted. The fact that the undertaking has a term of five years should not act as a deterrent on ARTC and operators entering access arrangements of a longer duration.

Review of undertaking

The Commission considers that it is appropriate that a review of the undertaking should be at the initial discretion of ARTC. Among other things, the undertaking was voluntarily submitted by ARTC and is legally binding on ARTC. The interests of operators are afforded sufficient protection by the fact that the review is subject to approval by the Commission, that the review would be conducted under the provisions of Part IIIA of the TPA.

Further, any amendments proposed by ARTC during the term of the undertaking would also be subject to the provisions of the TPA. ARTC have proposed to consult operators prior to seeking a review.

Drafting issue

Clause 2.4(c) states that "ARTC may only vary the undertaking with the consent of the Commission under section 44ZZA(6) of the TPA". FreightCorp and Toll comment that it is in fact section 44ZZA(7) that provides for variation with the consent of the Commission, not section 44ZZA(6).

Sections 44ZZA(6) and (7) state:

> (6) If the undertaking provides for disputes about the undertaking to be resolved by the Commission, then the Commission may resolve the disputes in accordance with the undertaking.
>
> (7) The provider may withdraw or vary the undertaking at any time, but, only with the consent of the Commission.

It is clear that the appropriate section that should be referred to in the clause relating to variation of the undertaking, is section 44ZZA(7) of the TPA. As such, the undertaking should be amended to reflect this.

Recommendations

Clause 2.2(b) of the ARTC undertaking be amended to replace "termination" with "withdrawal":

"*withdrawal* **of this Undertaking in accordance with its terms or the TPA"**

Clause 2.4(c) of the ARTC undertaking be amended to reflect correct section of TPA that deals with variations:

"ARTC may only vary the Undertaking with the consent of the Commission under section 44ZZA(*7*) of the TPA".

Overall, clauses of the undertaking dealing with the duration, term and review of the undertaking are acceptable to the Commission. The provisions in these clauses contain an appropriate balance of the interests of ARTC, access seekers and the public.

D2.3 Existing contractual arrangements

ARTC's proposal

Clause 2.5 states that the proposed undertaking applies to new access agreements and to the negotiation of new access rights in addition to those already the subject of an access agreement. Clause 2.5 also provides that the undertaking can not require changes to be made to an existing access agreement.

Views of interested parties

National Rail

National Rail argues that clause 2.5 should be amended to reflect the fact that access agreements executed between ARTC and operators may contain enforceable provisions dealing with variation of access rights (as is, in fact, provided for in the indicative access agreement).

FreightCorp and Toll

FreightCorp and Toll note that it is possible under the provisions of the undertaking for access seekers to negotiate more favourable terms than operators which already had access agreements in place. They argue that operators with existing access arrangements could be disadvantaged. They claim, therefore, that the access undertaking should allow operators with existing access agreements the option to bring their existing agreements into conformity with Schedule C or the indicative access agreement to ensure they are not disadvantaged relative to outcomes negotiated pursuant to the undertaking.

At the same time FreightCorp and Toll argue that the provision in clause 2.5 (viz, that "nothing in this Undertaking can require a party to an existing access agreement to vary a term or provision of that agreement") is not sufficiently strong to prevent amendments to the undertaking flowing automatically through to existing access agreements. To prevent this, FreightCorp and Toll have submitted that clause 2.5 of the undertaking should be strengthened.

SCT

The concern about the possibility of access agreements incorporating more favourable terms and conditions contained in the undertaking was also raised by SCT at the public forum:

> What would happen if we signed an agreement first and the undertaking provides for more favourable terms and conditions than the agreement we have signed? Will we able to access those?[14]

Commission's position

Existing contracts

Clause 2.5 deals with the relationship between the undertaking (and access contracts executed pursuant to the provisions of the undertaking) and existing contractual arrangements. Essentially, it is proposed that the undertaking should relate only to future agreements negotiated pursuant to the terms and conditions of the undertaking and that thus it should have no bearing on existing contracts.

Operators are concerned that those with existing contracts could be locked into arrangements less favourable than could be available to new access seekers under an undertaking. Operators would like potentially more favourable terms and conditions available to new access seekers to be also made available to those who negotiated contracts prior to the approval of the undertaking. Operators would also like this "non-discrimination" provision to apply to contracts negotiated under different undertakings, thus ensuring that amendments effected over time are automatically reflected in existing contracts.

As a matter of principle, the Commission considers that an undertaking represents something of a "base case", around which operators can negotiate actual terms and conditions of access, including more advantageous terms and conditions than may be provided for in the undertaking itself. However, it is not the purpose of an undertaking to act as an instrument for improving terms and conditions in existing contractual arrangements.

Accordingly, the Commission does not believe that the ARTC undertaking should contain a provision whereby changes to the undertaking are automatically fed into existing access agreements.

It is noted, however, that ARTC has proposed not to differentiate between "like" services in formulating its access charges (clause 4.3). This gives access seekers security that they can gain access to ARTC tracks at prices that are no worse off than offered to other applicants with "like" services. This provision is also contained in the indicative access agreement (clause 5.6), ensuring that no operator should be disadvantaged as far as pricing is concerned, relative to other operators, provided the services are alike.

This commitment to not discriminate on price is **not** expressly provided for in respect of other terms and conditions.

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[14] Australian Competition and Consumer Commission, (3) *op. cit.*, p. 16.

In this regard, however, the Commission notes that in the public forum held on 16 August (as part of the public consultation process conducted to assess the undertaking), ARTC made a commitment to give operators an opportunity to change existing agreements to reflect more favourable terms negotiated in new agreements.

> It has, in fact, been our practice that if there are any proposed amendments to an access agreement and that we intend to execute those agreements and those amendments … we actually circulate them to all contract companies and … we even circulate those to those that aren't contracted with us. And the framework has been that any contract operator can take up the choice of that amended clause in their existing contract. So, effectively, ARTC in negotiating variations to the indicative access contract is mindful that in having given that variation it has an obligation under its contract to offer it to all and therefore the cost benefit of that particular thing is available to all. And some customers can choose to take that amendment up or they may like their contract in its present form.[15]

The Commission points out that this statement from ARTC is not reflected in the terms of the undertaking. ARTC is not required to have this commitment incorporated in the undertaking but if ARTC wishes to formally do so it may seek to vary the present undertaking. Operators may need to be aware of this when negotiating access.

The "non-discriminatory" pricing provisions are assessed in detail in section D5 of this report.

Another source of concern for operators is the potential for ARTC to seek variations to existing agreements as a result of amendments to the undertaking. Reflecting this concern, FreightCorp and Toll have submitted that clause 2.5 of the undertaking should be strengthened to ensure that ARTC is not permitted to require an operator to vary an existing agreement purely as a consequence of changes to the undertaking.

The Commission is of the view that clause 2.5 in the undertaking provides adequate protection to operators from ARTC seeking potentially detrimental variations to existing contracts. It has the effect of ensuring that changes to the undertaking do not automatically require changes to existing access agreements. But it does not prohibit parties from seeking amendments to access agreements in the light of changes to terms and conditions in either the undertaking or new agreements executed.

The Commission considers that clause 2.5 does not require modification as it satisfies the requirements of the assessment criteria in section 44ZZA(3) of the TPA.

D3 Negotiating for access

Part 3 of the undertaking outlines the process which ARTC will follow to negotiate with an operator to gain access to ARTC's network.

D3.1 Basic approach and framework

Clauses 3.1 and 3.2 of the undertaking outline the broad objectives and approach that ARTC wishes to adopt in conducting negotiations for access.

[15] *ibid*., p. 46.

ARTC's proposal

ARTC proposes to attempt to strike a balance between flexibility to accommodate different circumstances and the desirability of providing certainty to prospective access seekers. The framework for negotiation provides for:

- preliminary meetings and exchanges of information;
- submission of an access application by the operator;
- preparation of an indicative access proposal by ARTC;
- negotiations to develop an access agreement for execution; and
- dispute resolution procedures.

Further, in an amendment to the original undertaking ARTC has replaced the general objective to "…not seek to frustrate the negotiation process" with a commitment to "negotiate in good faith".

Views of interested parties

Many of the comments from operators on the original undertaking centre around the notion that ARTC "not seek to frustrate the negotiation process". This is not considered appropriate. For example, FreightCorp and Toll noted in their submission that:

> ….ARTC undertakes not to seek to frustrate the negotiation process. This should not be mistaken for an obligation to negotiate in good faith by some other name. Note that there is the world of difference between an obligation to do something and an obligation not to do something. In this context, ARTC is agreeing not to do something. This is unsatisfactory. [16]

They conclude that "a mutual obligation to negotiate in good faith should be imposed on ARTC and each applicant".[17]

FreightCorp and Toll

FreightCorp and Toll also argue that ARTC should provide on request relevant information necessary for meaningful negotiations. This encompasses information on capacity. FreightCorp and Toll suggest that the findings of the Queensland Competition Authority (QCA) should be considered closely, particularly in relation to disclosure of capacity information to provide access seekers with information necessary for meaningful negotiations.

In the QCA's Draft Decision on Queensland Rail's Draft Undertaking (Volume 2 – The Draft Undertaking, December 2000) the QCA states that "… QR should disclose sufficient capacity information to allow access seekers to conduct their own capacity analysis".

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[16] Freight Rail Corporation and Toll Rail, *Submission by Freight Rail Corporation and Toll Rail concerning the Australian Rail Track Corporation Access Undertaking*, pp. 10-11.

[17] *ibid*, p. 9.

The Queensland Competition Authority Act 1997 (Qld), under which Queensland Rail's undertaking was assessed, imposes an obligation on an access provider to make all reasonable efforts to satisfy the reasonable requirements of the access seeker. Section 101(2) lists the information an access provider must give the access seeker, which includes information about the access price and pricing methodology, costs, asset values and spare capacity, including the way in which the capacity was calculated. Section 101(3) provides protection to the access provider with respect to the potential disclosure of commercially sensitive information.

FreightCorp and Toll are also concerned with the length of time that the negotiation process may take. It is noted that the New South Wales regime provides for the reporting to the responsible Minister of negotiations that take in excess of three months. FreightCorp and Toll propose that indicators of length of negotiation should be developed (for example, average length of negotiations and number of negotiations that exceed three months) and that ARTC should be required to report on actual performance against these indicators of negotiation.

Commission's position

Negotiating in good faith

The Commission considers that operators' concerns on the lack of obligation on ARTC to make a reasonable attempt to negotiate with access seekers have been dealt with in amendments to the original undertaking. These amendments provide as follows:

- clause 3.1 has been changed from a position where ARTC would "not seek to frustrate the negotiation process" to ARTC will "negotiate with the Applicant in good faith"; and
- in clause 3.2, the list of factors that describe the framework for negotiation has been expanded to include a provision for "both ARTC and the Applicant to negotiate in good faith".

The obligation on ARTC to negotiate in good faith should allay concerns about ARTC not making reasonable endeavours to comply with a request for access as well as seeking to unnecessarily prolong the negotiation process. Many of the concerns that led to stricter provisions on negotiations in other regimes stemmed from the fact that in those jurisdictions, vertically integrated providers operated in a network characterised by relatively high levels of capacity utilisation. This is not the case with ARTC, which is vertically separated, has clear incentives to increase traffic in its network and faces a relatively high degree of competition from road transport. These, plus the obligation to negotiate in good faith, should act as an effective restraint on ARTC from seeking to frustrate the negotiation process.

The insertion in the amended undertaking of the obligation for ARTC to negotiate in good faith requires ARTC to be reasonable and have appropriate justification for any decisions it may make in the negotiation process, including whether or not to refuse to negotiate with an applicant. In addition to the dispute resolution procedures, such an obligation could be enforced pursuant to section 44ZZJ of the TPA.

Section 44ZZJ provides:

> (1) If the Commission thinks that the provider of an access undertaking in operation under section 44ZA has breached any of its terms, the Commission may apply to the Federal Court for an order under subsection (2).
>
> (2) If the federal Court is satisfied that the provider has breached a term of the undertaking, the Court may make all or any of the following orders:
>
> (a) an order directing the provider to comply with that term of the undertaking;
>
> (b) an order directing the provider to compensate any other person who has suffered loss or damage as a result of the breach;
>
> (c) any other order that the Court thinks appropriate.

This provision allows the Commission some discretion in matters it may pursue. Therefore, if circumstances were brought to the Commission's attention that ARTC had refused to negotiate with an applicant without good cause the Commission could inform ARTC that a dispute had arisen relating to the obligation in the undertaking to negotiate in good faith, which potentially may be a breach of the undertaking.

Information provision

On the issue of information provision, this is considered one of the issues that might be dealt with in an undertaking (s 44ZZA(1) of the TPA, Note (e)). The Access Undertakings Guide states that in assessing the terms and conditions included in an undertaking against the interests of potential third party users (as required by section 44ZZA(3)(c)) the Commission will take into consideration a range of factors including whether sufficient information is available to users to engage in meaningful negotiation with the prospect of outcomes reflecting Part IIIA objectives.

The Commission considers that the undertaking should incorporate a provision that gives access seekers comfort that ARTC will not refuse reasonable requests for information to facilitate meaningful negotiations. It would be appropriate if the undertaking reflected such requirements for provision of information, subject to ARTC's obligations in respect of confidential information.

As noted in section D2.4 of this report, ARTC has responded to specific concerns from operators about the lack of information on capacity by committing to publish on its web site additional information. The issue of capacity analysis is further considered in section D3.5.

Recommendation

The ARTC undertaking be amended to include a provision obliging ARTC to take all reasonable steps to comply with requests for information that facilitates negotiation.

In other respects, clauses 3.1 and 3.2 are considered to be acceptable to the Commission. These clauses set the basis and framework for negotiations in a way that satisfy the requirement under Part IIIA of the TPA to balance the interests of ARTC, access seekers and the public.

D3.2 Parties to negotiation

Clause 3.3 of the undertaking describes the type of access seekers with which ARTC will negotiate, the conditions and requirements access seekers must observe for ARTC to continue negotiations and situations in which ARTC may refuse to continue negotiations.

ARTC's proposal

ARTC proposes as follows:

- to negotiate with applicants who are not accredited operators but who acquire the services of an accredited operator in providing the services and either the applicant or the accredited operator meet all the terms and conditions of the access agreement;
- to reserve the right to negotiate only so long as operators:
  - comply with the relevant obligations and processes contained in the undertaking; and
- can demonstrate that they meet certain prudential requirements, including that they are solvent and have not been in material default of rail access agreements (whether with ARTC or other track owners) either currently or in the previous two years, where "material default" is defined as:

  > any breach of a fundamental or essential term or repeated breaches of any of the terms of the agreements referred to in clause 3.2(d)(ii);

- to provide written reasons to an operator for refusing to negotiate due to concerns about prudential requirements; and
- to make refusal to negotiate a matter that may be referred to dispute resolution.

ARTC argues that the objective of the undertaking is to encourage the broadest range of applicants to consider rail as a means of transport and thus not exclude any genuine applicant from gaining access.

ARTC claims that the requirements laid down by the undertaking are minimal and will not present any difficulty to a genuine applicant. However, ARTC adds that the effect of the requirements is to discourage frivolous applications and new applications being made by those already in material default of an access agreement.

Views of interested parties

Queensland Rail

QR considers that the provisions in the ARTC undertaking regarding the processes for the initial phase of negotiations and relating to ARTC's ability to "screen" applicants are reasonable.

National Rail

NR argues that the undertaking should be more explicit as to which obligations and processes would be material to a decision by ARTC to refuse to negotiate. It adds that ARTC should also be required to provide reasons in writing within 14 days for its refusal to negotiate.

NR argues that there is considerable ambiguity about which aspects of an access agreement may be negotiated with an end user and which by an accredited rail operator and that the undertaking must be redrafted to remove this ambiguity. It argues that provisions relating to capacity (analysis, allocation and transfer) are clearly relevant only to an access right and could be negotiated either by an end user or an operator. However, it claims that those relating to network transit management (part of haulage arrangements) are clearly most relevant to applicants who are accredited operators.

FreightCorp and Toll

Freight Corp and Toll note that ARTC reserves the right not to continue negotiations if an applicant does not comply with the relevant obligations and processes, and ARTC considers that such non-compliance is material. Freight Corp and Toll argue that if ARTC is to have a right to refuse to negotiate the basis of that right, it should be prescribed clearly. Freight Corp and Toll add that it is not clear at exactly what point this right arises in the negotiation process.

FreightCorp and Toll consider that while the solvency of an applicant is a reasonable criterion to not commence or continue the negotiation process, the burden should be on the ARTC to demonstrate a reasonable apprehension of insolvency. Further, FreightCorp and Toll do not believe that it is appropriate for ARTC to have a right not to negotiate if the applicant is in breach of another access agreement, whether it is with ARTC or another access provider. They argue that this is an intrusive process, made worse by the fact that ARTC is provided with considerable scope to exercise this right.

FreightCorp and Toll also note that it would appear that an access seeker can not refer a matter to an arbitrator in these circumstances. Given the subject matter of this clause, they argue that this is odd. Further, FreightCorp and Toll believe that the matters that an arbitrator must take into account do not include a referral under these clauses.

FreightCorp and Toll add that it is not clear, in the event of ARTC exercising its right to not continue negotiations and the applicant remedying the situation which led to ARTC halting negotiations, whether negotiations can carry on or the process must recommence from the start. It is noted that negotiations may only recommence if the matter is taken to arbitration.

Commission's position

Clause 3.3 of the undertaking is a key clause because it sets out the thresholds for operators that ARTC will negotiate with and conditions upon which ARTC will cease negotiations. So in a sense, the tenor of the entire negotiation process rests on the framework provided for in this clause. Operators generally claim that clause 3.3 has a potentially exclusionary tone which can be in direct contrast to the underlying rationale

for Part IIIA of the TPA which is to establish a right for third parties to negotiate access.

Prudential requirements

ARTC claims that the objective of the provisos and conditions is to "screen" obviously unsuitable operators, that the requirements imposed are minimal and would not affect genuine applicants for access.

Operators, mainly FreightCorp, contend that the conditions are intrusive and burdensome. They also argue that the obligations fall excessively on the side of access seekers. For example, the undertaking does not prescribe factors which provide ARTC the right to refuse to negotiate. Rather, the undertaking simply gives ARTC a blanket right to discontinue negotiations if the applicant does not comply with the "relevant obligations and applicable processes set out in the Undertaking" (clause 3.3(a)).

Overall, the Commission considers that ARTC is entitled to assess whether the access seeker is a genuine provider of rail freight services and is therefore not acting inappropriately in seeking to screen applicants. The issue is whether the screening process is unduly intrusive or onerous to the point where it discourages entry.

One of the prudential requirements proposed by ARTC concerns whether an applicant has been or is in breach of an access agreement. As noted, FreightCorp and Toll do not agree that it is appropriate for ARTC to have a right not to commence or continue the negotiation process if the applicant is in breach of another access agreement whether it is with ARTC or another provider. FreightCorp and Toll recommend the findings of the QCA.

The findings of the QCA are of interest because they dealt with issues which were similar to the provisions contained in the ARTC undertaking. These are outlined below.

In the Draft Decision on Queensland Rail's Draft Undertaking, the QCA stated that it believed that QR's proposed discretion to refuse to negotiate on the grounds of material default could become a major barrier to entry.[18] The QCA believes that defaults of access agreements should be brought within the list of factors relevant to QR demonstrating that an access seeker is not capable, to a material extent, of meeting the terms and conditions specified in its proposed access agreement. The key issue is to balance the need to protect QR's legitimate business interests through specifying key risks, against the potential for this to prevent third-party operators from entering the above-rail market in Queensland.

Queensland Rail's proposed 'material default' definition encompasses repeated failure to comply with the terms and/or conditions of any of the agreements specified in a clause of the draft undertaking or any breach of a fundamental term and/or condition in these agreements.

[18] Queensland Competition Authority, *Draft Decision on Queensland Rail's Draft Undertaking* (Volume 2 – The Draft Undertaking), December 2000), p. 168.

The QCA believes that the first part of this definition relating to repeated breaches is reasonable provided that QR recognises that the breaches are non-trivial and assuming that either party is free to refer the matter for dispute resolution. The distinction between a breach and a 'non-trivial' breach is important. It is possible that an agreement may be breached inadvertently and in a manner that has no material effect on QR. The breach could be the subject of a dispute relating to an existing access agreement and non-compliance may be rectified as soon as it becomes apparent. It would be difficult to sustain the argument that this would be sufficient ground for QR not to enter into future access agreements.

The second part of the definition refers to any breach of a fundamental term and the QCA states that this lacks objectivity. The QCA proposed that defaults of access agreements should be brought within a list of factors relevant to QR demonstrating that an access seeker is not capable of meeting the terms and conditions specified in its proposed access agreement. That is, that QR clearly states what it considers to be significant events of default so the scope for disputes is reduced. Material events of default should be agreed during the access negotiation process rather than being specified in the undertaking. The QCA outlined a non-exhaustive list of factors that could be used by the service provider to demonstrate an access seeker's inability to comply, to a material extent, with the terms of its proposed access agreement. These include:

- the suspension of a rail operator's safety accreditation;
- the safety accreditation of a rail operator or a contractor being cancelled;
- the rail operator failing to maintain insurances required under the access agreement;
- the rail operator failing to comply with a suspension;
- repeated non-trivial breaches in the last two years of existing access agreements with QR, and
- insolvency, in the absence of alternative arrangements, such as security deposits, which protect the service provider's financial exposure.

The Commission does not find it compelling to recommend a highly prescriptive approach to prudential requirement. The combined effect of the requirement to negotiate in good faith plus the obligation to provide written reasons for refusal to negotiate should be sufficient to ensure ARTC do not abuse the prudential requirement provisions. Also, it is noted again that there are different circumstances inherent in the QR and ARTC situations, especially the facts that ARTC is not vertically integrated, and has a network which is under utilised subject to intermodal competition for much of the traffic utilising its tracks.

As for the issue of solvency of applicants, the Commission is of the view that it is appropriate that ARTC take into account the financial circumstances of applicants when considering the provision of access to its infrastructure. As a matter of principle, ARTC should not be required to have a degree of apprehension about the solvency of applicants prior to embarking on inquiries on this matter. Rather, it should be able to do this as part of its normal commercial activities.

Overall, the Commission considers that the prudential requirements contained in section 3.3 are not unreasonably onerous.

Accordingly, the Commission considers that clause 3.3(d)(ii) should not act as a deterrent to access seekers. Should there be evidence that ARTC is using these provisions unreasonably, the Commission may take this into account in any review of the regulatory arrangement upon expiry of the undertaking in five years.

Clause 3.3(a) states that "ARTC reserves the right to negotiate with Applicants who comply with the [relevant obligations and applicable processes] … If an Applicant does not comply with the relevant obligations and processes, and ARTC considers that such non-compliance is material ARTC will not be obliged to continue negotiations regarding the provision of Access for that Applicant".

FreightCorp and Toll suggest that the clause should read as follows:

> ARTC reserves the right to negotiate ***only*** [emphasis added] with Applicants who comply with the [relevant obligations and applicable processes….

FreightCorp and Toll also suggest that "relevant obligations and applicable processes" should be explained to clarify the meanings of the terms. Additionally, FreightCorp and Toll question what "material" is intended to mean.

Moving the word 'only' as contended by FreightCorp and Toll is a drafting matter. However, it will avoid an unintended ambiguity in the operation of the clause. It would be appropriate for the word 'only' to be inserted in the clause.

By requiring an applicant to comply with "relevant obligations and applicable processes" ARTC is imposing a condition upon with whom it will negotiate. It is permissible for ARTC to make the obligations under the undertaking conditional. FreightCorp and Toll's concerns essentially go to the clarity of the phrase, which is primarily a drafting issue. It should be clarified so prospective applicants are aware of the conditions upon which negotiation for access may be refused.

This may be done by clarifying "relevant obligations and applicable processes" to mean "complying with the general obligations set out in this undertaking". It is not necessary to define 'material'. The word should be given its ordinary meaning.

End-users other than accredited operators

The Commission considers that clause 3.3(b) adequately covers the situation where ARTC deals with end-user applicants who are not accredited operators. Essentially, the undertaking provides scope for end users and operators to collaborate on an application without being constrained by an overly prescriptive approach. This degree of flexibility should encourage potential applicants to explore a variety of possible approaches. From ARTC's perspective, its key requirement is that the terms and conditions of the access agreement are observed - it is less important whether the obligations towards ARTC under the access agreement are discharged by the end-user or the operator. The sharing of responsibilities could be a matter for the accredited operator and end-user to agree on.

Refusal to negotiate

On the other hand, it would appear that operators may be justifiably concerned about the way the undertaking gives ARTC the right to cease negotiations. Clause 3.3 (c) provides that ARTC may refuse to negotiate where ARTC considers that the access seeker does not meet the prudential requirements stipulated in clause 3.3 (d). In this case ARTC is required to provide written reasons for its refusal to negotiate. For any other reason, ARTC is not required to provide a written explanation for ceasing negotiations. The Commission considers that this provides ARTC with a degree of discretion in dealing with access seekers that is not consistent with the intent of the provisions of Part IIIA of the TPA. Among other things, it may not engender confidence among prospective access seekers and may discourage applications for access.

FreightCorp and Toll suggest that this clause raises the question as to whether ARTC may refuse to commence negotiations at all. FreightCorp and Toll suggest that if ARTC is to have this right the basis upon which ARTC may refuse to commence negotiations should be clearly stated. In response to this observation, the Commission would note that there may be situations where ARTC would be reasonably expected to refuse to commence negotiations and thus should not be prohibited from taking this course of action. However, it should provide its reasons for doing this.

Accordingly, the Commission is of the view that ARTC should be required under the undertaking to provide written reasons why it may decide not to negotiate with an access seeker.

It is not necessary for the undertaking to be prescriptive about the reasons on which ARTC needs to base a decision not to negotiate. There is sufficient protection for applicants in case of unreasonable refusal. Clauses 3.1 and 3.2 provide grounds for possible enforcement action in case of ARTC mot negotiating in good faith. Further, there is the option of referring the matter to dispute resolution in clause 3.3(f) which states that:

> [i]f the Applicant considers that ARTC has unreasonably refused to commence or subsequently unreasonably ceased negotiations in accordance with clause 3.3, then the Applicant may refer the matter to the arbitrator in accordance with clause 3.11. If the arbitrator determines that ARTC has unreasonably refused to commence or subsequently unreasonably ceased negotiations, ARTC will recommence negotiations immediately.

The Commission notes the advice of expert consultants Resolve who expressed the view that many of the specific references in the undertaking to matters that an applicant could refer to dispute resolution were unnecessary (including in respect of failure to negotiate in good faith). According to Resolve, these would all be caught in the umbrella provision contained in clause 3.11.1. Resolve further contend that most of these specific references relate to the conduct of negotiations rather than issues about which dispute resolution might typically be considered the appropriate option.[19]

[19] Resolve Advisors, *Draft Report on Dispute Resolution Provisions in ARTC Undertaking and Access Agreements*, October 2001, pp. 9-10.

The Commission agrees that the enforcement provisions in section 44ZZJ of the TPA may be an appropriate response to these types of disputes, but considers that it is not inappropriate for the undertaking to provide that access applicants may refer matters about the conduct of negotiation to dispute resolution. As argued already, this represents an alternative to seeking enforcement action from the Commission in respect of possible breaches of the undertaking under section 44ZZJ of the TPA. The Commission considers that there are no grounds under the Part IIIA criteria for arguing that operators would gain by having these specific references to dispute resolution deleted from the undertaking.

FreightCorp and Toll also consider that it is appropriate for the access undertaking to state the consequences of the ARTC's refusal to negotiate (that is, whether the process starts from the beginning again). The Commission is of the view that in the absence of an express provision that the negotiations that preceded an arbitration determination are deemed terminated, it is reasonable to infer that negotiations will recommence from where the parties left them prior to proceeding to arbitration.

Recommendations

Clause 3.3(a) of the ARTC undertaking be amended to clarify that:
ARTC reserves the right to negotiate *only* ***with Applicants who comply with the*** *general obligations* ***set out in this undertaking. If an Applicant does not comply with the*** *general obligations set out in this Undertaking* ***,[and ARTC considers…]***

The ARTC undertaking be amended to include a provision to the following effect: ***ARTC to explain in writing to an Applicant reasons for any refusal to negotiate within fourteen days of a refusal.***

In other respects, the Commission considers that clause 3.3 of the undertaking is consistent with the intent of the legislative criteria in section 44ZZA(3) of the TPA.

D3.3 Confidentiality

ARTC proposal

The confidentiality provisions contained in clause 3.4 stipulate that information exchanged as part of the negotiation of access pursuant to the undertaking is to be kept confidential to the purposes for which the information was required. Clause 3.4 also provides for exceptions when confidential information may be disclosed. The undertaking also allows parties to enter into confidentiality arrangements if required.

Views of interested parties

National Rail

NR notes that confidentiality is a difficult area, as the legitimate commercial interests of the parties to an access negotiation can be in conflict with the expressed desire for transparency. It argues that some principles are required in order to distinguish between these two interests, namely:

- where applicants request it, ARTC and its consultants must be willing to sign confidentiality agreements with respect to the specified information;
- the identity of applicants must not be revealed to third parties during negotiations (for example in disclosure of applications for mutually exclusive capacity); and
- access prices should be disclosed only after commencement of agreements.

FreightCorp and Toll

FreightCorp and Toll note that the confidentiality obligation relates to confidential information exchanged as part of the negotiation for access. They believe that as there is some doubt as to when negotiation commences, the access undertaking should provide that all confidential information must be kept confidential and not disclosed. Further, FCT consider that to ensure that information is used only for the negotiation of access, the undertaking should contain a definition of the purpose for which it is exchanged.

Commission's position

Clause 3.4 of the undertaking deals with confidentiality of information that is exchanged between an operator and ARTC. It operates to impose obligations on ARTC, and to make ARTC's obligations to negotiate conditional on an operator agreeing to accept similar obligations.

The Commission considers that it is important that these obligations of confidence strike an appropriate balance between the legitimate interests of operators and ARTC, and the public interest in transparency of decision making and efficient management of the network.

The Commission considers that it is appropriate for the undertaking to provide at first instance for ARTC and operators to not disclose information given in confidence except in specified circumstances. The Commission considers that clause 3.4(a) serves this purpose.

In other respects, however, the Commission recommends that amendments are made to the undertaking in respect of striking this balance. The Commission considers that the specified circumstances where disclosure is permitted in 3.4(c) should be expanded to permit the following additional disclosures:

- ARTC may publish information that it is obliged to publish by this undertaking;
- ARTC may notify operators that a conflicting access application has been received as required by the undertaking (provided that the identity of the operator is not disclosed);
- applicants may disclose network availability information to end-user customers or accredited operators, or potential customers for the purpose of considering whether or not to accept access as offered by ARTC; and
- where ARTC and the applicant agree that information may be disclosed.

The Commission also considers that it is appropriate for determinations made in arbitration and reasons for them to be published. The Commission notes that the current confidentiality obligations would not restrict it from doing this. However, the Commission will have regard for the confidentiality of information in doing so. This is discussed further in chapter D4 of this report.

The Commission considers that apart from the recommendations listed below, the confidentiality provisions in clause 3.4 are acceptable in terms of the requirements in section 44ZZA(3) of the TPA.

Recommendations

The ARTC undertaking be amended by inserting further sub-clauses into clause 3.4(c) that permits:

- **ARTC publishing information that it is obliged to publish by this undertaking;**
- **ARTC notifying operators that a conflicting access application has been received as required by the undertaking (provided that the identity of the operator is not disclosed);**
- **applicants disclosing network availability information to end-user customers or accredited operators, or potential customers for the purpose of considering whether or not to accept access as offered by ARTC; and**
- **ARTC and the applicant agreeing that information may be disclosed.**

D3.4 Access application and acknowledgment

Clauses 3.5 and 3.6 of the undertaking deal with the submission of an access application by an access seeker and its follow up acknowledgment by ARTC.

ARTC proposal

Clause 3.5 provides that the applicant must apply for access by lodging an access application containing information as set out in Schedule B. The applicant may also seek initial meetings with ARTC prior to submitting an access application.

Following receipt of an application, clause 3.6 provides that ARTC must, within five business days, either acknowledge the application or request additional information if considered necessary to process the application. If additional information has been requested, ARTC must acknowledge the application within five business days of receiving the additional information.

Views of interested parties

Freight Corp and Toll

FreightCorp and Toll note that the ARTC has no obligation, not even a reasonable endeavours obligation, to meet with an applicant within a reasonable time.

Commission's position

The Commission considers that the requirement on ARTC to "negotiate in good faith" should be sufficient to ensure that ARTC does not frustrate the negotiation process with an applicant by not meeting within a reasonable time to discuss the application. The contents Clauses 3.5 and 3.6 dealing with the processes for submitting an application and its subsequent acknowledgment by ARTC achieve an acceptable balance between the interests of ARTC, access seekers and the public, as required under section 44ZZA(3) of the TPA.

D3.5 Indicative access proposal

The terms and conditions pertaining to the contents of the Indicative Access proposal, as well as the processes associated with its submission to the Applicant are dealt with in clause 3.7 of the undertaking.

ARTC proposal

The information set out in the indicative access proposal includes the following:

- whether capacity to accommodate the requests already exists;
- additional works and an estimate of the order of cost should additional capacity be required;
- whether or not there is a conflicting request;
- an estimate of the likely charges (or additional information required to estimate likely charges); and
- an indicative train path.

ARTC argues that in its experience this is the key information required by operators in order to evaluate the potential viability of commencing a new train service. It believes that this information enables an operator to evaluate the feasibility and indicative costs associated with the service and whether or not it is worth pursuing further. The ARTC adds that this information provides the foundation for detailed discussion with ARTC on any aspect of the proposal.

Clause 3.7 also outlines the conditions for referring a dispute about the indicative access proposal to the dispute resolution process. The applicant may request that the matter be subjected to the dispute resolution process where ARTC fails to provide an indicative access proposal within 30 business days of the acknowledgment by ARTC of an application, or, if ARTC requires more than 30 days, within such time as ARTC may have indicated.

Views of interested parties

Queensland Rail

QR argues that, based on its own experience in dealing with requests for access, ARTC's indicative access proposal contains sufficient information and details to enable an access seeker to adequately evaluate the proposal and begin meaningful negotiations.

National Rail

NR argues that both the nature of capacity and the process of capacity analysis are unclear in the undertaking and this can act as an obstacle to initial negotiation. It argues that this is a key issue because if capacity means more than the defined term train path, it gives ARTC the potential to require in its indicative access proposal that an applicant meet the cost of additional capacity. NR claims, therefore, that the undertaking must contain a useable definition of capacity.

NR further adds that as the indicative access proposal does not oblige ARTC to provide access in accordance with specific terms and conditions contained within it, the ARTC has the ability to 'move the goalposts' during the negotiation. NR claims that this issue could be addressed by committing the ARTC to negotiate 'in good faith.' Alternatively, NR argues that the undertaking could specify that the indicative access proposal is a firm offer subject to negotiation, or require that the ARTC provide a firm offer for future negotiation at an early stage in the negotiation (say 30 days).

FreightCorp and Toll

Similarly, Freight Corp and Toll consider that it is appropriate for the access undertaking to contain an obligation on ARTC to be bound by an indicative access proposal for a period of time and to inform applicants immediately if it no longer wants or is no longer able to provide access in accordance with an indicative access proposal. They argue that under the proposed undertaking there is a risk that applicants may engage in negotiations only for ARTC to change the proposal.

Commission's position

Access rights

Clause 3.7(c)(i) states "the results of a Capacity Analysis determining whether there is sufficient Available Capacity to accommodate the requested Access Rights".

FreightCorp and Toll note that 'Access Rights' is not defined. FreightCorp and Toll also suggest words be inserted that state "…if there is not, suggestion as to Access Rights that can be accommodated".

The Commission considers that if it is a separate term 'Access Rights' should be defined. If 'Access Rights' is intended to have the same meaning as 'Train Path', then the term 'Train Path' should be substituted for 'Access Rights'.

Clause 3.7(f) states that:

> [i]n the event that ARTC is unable to provide an Indicative Access Proposal based on the Access Application, ARTC will, if possible, submit to the Applicant an Indicative Access Proposal offering alternative Access which it reasonably believes may meet the Applicant's Access requirements.

It would appear that clause 3.7(f) addresses the concerns raised by FreightCorp and Toll in relation to alternative access rights. FreightCorp and Toll suggest that clause 3.7(f) does not provide a clear statement as to when the indicative access proposal offering alternative access must be provided.

Clause 3.7(a) states that:

> subject to clause 3.7(b), ARTC will use reasonable efforts to provide the Indicative Access proposal to the Applicant within thirty (30) Business Days of the acknowledgment given under clause 3.6.

Therefore, ARTC must us reasonable efforts to provide the indicative access proposal to the Applicant with 30 days, and if unable to provide an indicative access proposal based on that access application, will, if possible, suggest alternative access.

There are two points to note. Firstly, the access seeker could request alternative access rights in its access application should its preferred access rights be unavailable. Secondly, that there is the overriding obligation on ARTC to negotiate in good faith (as per the amended undertaking submitted by ARTC). It is not necessary that clause 3.7(c)(i) be changed.

Indicative access proposal

Two key issues are whether the indicative access proposal (IAP):

- provides sufficient detail and adequate definitions, such as, for example, on capacity, to represent a firm basis on which to commence negotiations and allow operators to assess the IAP; and
- should be binding on ARTC.

ARTC has committed in the revised undertaking to publish more information on capacity than was the case in the original undertaking. As noted in section 2.4 of this report, ARTC has revised the original clause 2.6 of the undertaking and now proposes to publish on its web site the following additional information:

- a graphical representation of committed capacity on the network (excluding track possessions for network maintenance);
- indicative section running times for indicative services by corridor;
- route standards by corridor; and
- the performance indicators.

Clause 3.7(c)(ii) states that:

> in the event the Access Application requires the Applicant to have recourse to Additional Capacity, an outline of the works and an indicative estimate of the cost of such works required to provide the Additional Capacity or an outline of the requirements for an investigation into the provision of Additional Capacity for the requested Access Rights.

"Available Capacity" is defined in the original undertaking as meaning "Capacity that is not Committed Capacity (including Committed Capacity in instances where it will cease being committed Capacity prior to the time in respect of which Capacity is being assessed". "Additional Capacity" means "additions to the Network or other enhancements of Capacity".

FreightCorp and Toll consider that greater definition is required of both Available Capacity and Additional Capacity. FreightCorp and Toll query whether 'enhancement' is intended to mean increased and that it is not clear how this differs from extensions to the track.

ARTC responded to these concerns about definitions of capacity and amended the definition of Additional Capacity in the revised undertaking to: "the capability of the Network to carry additional task". This seems to eliminate confusion surrounding extensions, additions and enhancements to the network in the context of altering capacity

Clause 3.7(c) requires ARTC to include in its indicative access proposal details of a capacity analysis showing whether there is sufficient available capacity to accommodate the applicant's request. The Commission considers that there is now sufficient information available to operators to quantify utilisation of the system independent of information contained in indicative access proposal . But it is questionable whether operators have at their disposal sufficient information to independently determine when the system is approaching full capacity such that further traffic volumes can only be accommodated by increasing capacity. That is, the applicant may not be able to relate utilisation to the system's capabilities on the basis of the information presented by ARTC. The Commission notes in this regard that ARTC claims in a response to comments from operators to its revised undertaking that:

> "Spare capacity may be inferred and calibrated from the graphs provided[20] and this provides an adequate basis for discussion with ARTC."[21]

The Commission invites further comment from ARTC and interested parties on the matter of spare capacity.

It is also noted that matters arising in clause 3.7(c) are not subject to dispute resolution. Given the uncertainties about whether operators can independently assess capacity utilisation, the Commission is of the view that as a safeguard for operators, disputes arising from matters in clause 3.7 should contain a specific reference to the dispute resolution mechanism in clause 3.11.

The Commission notes the concerns of operators that ARTC could walk away from an IAP thus raising uncertainty about the effectiveness of the early phases of the negotiation process. However, the requirement to negotiate in good faith should act as a deterrent on ARTC from failing to "stand by" the IAP. As such, the Commission does not consider it necessary or appropriate for the undertaking to expressly provide for the IAP to be binding on ARTC.

In addition, there are grounds to believe that the indicative access proposal should not bind ARTC even for a limited time in all cases. Firstly, it may have a negative effect on third-party access to the ARTC network. At a general level, it would not be unreasonable to expect an infrastructure owner to be inclined to provide access on less favourable terms and conditions if it is bound by its original offer. An example would

[20] As proposed in the revised undertaking, clause 2.6(b)(viii).
[21] ARTC, (1) *Response to SCT*, p. 1.

be if ARTC built into the IAP a safeguard or buffer against potentially negative effects of unforeseen changes in circumstances during the time the offer is binding.

Further, the notion of a binding offer is inconsistent with generally accepted common law principles. Generally, a person who receives an offer cannot enforce it unless they accept it, by giving consideration or in some cases, by relying on it to their detriment. Until that happens, an offer is not binding and can be withdrawn.

In all, the Commission considers that it does not have concerns with clause 3.6 of the undertaking under section 44ZZA(3) of the TPA.

Confidentiality of applicants

Clause 3.7(c)(iii) states that:

> advice in respect of the existence of other operators who have submitted an Access Application (where negotiations are continuing in accordance with this Undertaking) in respect of Access which, if it were to be provided, would limit the ability of ARTC to provide Access in accordance with the Indicative Access Proposal.

FreightCorp and Toll raise the concern that there is an issue as to how this provision is intended to interrelate with the confidentiality provisions. FreightCorp and Toll suggest that the undertaking should make it clear that the existence only, not the identity of other operators nor the access sought by them, should be disclosed.

The natural effect of this clause, in light of clause 3.4 relating to confidentiality, is that it is implicit that the identity of another access seeker would not be disclosed, merely that there is another access application being considered. As such, it is not necessary to amend this clause.

Standard terms and conditions of access

Clause 3.7(c)(iv) states that the indicative access proposal will set out "… a copy of ARTC's standard terms and conditions of Access".

FreightCorp and Toll query whether "standard terms and conditions of Access" are intended to be the same as the indicative access agreement or different.

If standard terms and conditions of access are intended to be the same as the indicative access agreement then this should be more clearly stated to ensure consistency. If the standard terms and conditions are different these should be stated to ensure that access seekers know the standard terms and conditions.

Progress in preparing indicative access proposal

Clause 3.7(e) states that if the applicant believes that ARTC is not making reasonable progress in the preparation of the proposal (either 30 business days after acknowledgment or time estimated by ARTC) then the applicant may refer the matter to the arbitrator for a determination in accordance with clause 3.11(f). The clause also provides that if ARTC is unable to provide an indicative access proposal based on the access application, ARTC will if possible, submit an IAP offering alternative access.

FreightCorp and Toll again raise the point in response to this clause that they consider it appropriate for the access undertaking to state the consequences of a determination against ARTC. FreightCorp and Toll also consider that it would be appropriate for the access undertaking to provide a process in this instance that can be resolved expeditiously.

If the clause were to be breached, that is, if it were thought that ARTC was not making reasonable progress in preparation of the proposal, there are two options available to either the applicant or the Commission. Firstly, the applicant could have the matter referred to dispute resolution and receive a direction that ARTC must prepare the proposal in a timelier manner. Secondly, the Commission could seek enforcement of the undertaking pursuant to section 44ZZJ of the TPA, ultimately resulting in a court order requiring ARTC to remedy the breach.

Recommendations

The status of 'Access Rights' should be clarified. If 'Access Rights' is intended to have the same meaning as 'Train Path', then the term 'Train Path' should be substituted for 'Access Rights'.

The status of standard terms and conditions of access should be clarified by ARTC, particularly if they are the same as the indicative access agreement.

Disputes arising from matters in clause 3.7 should contain a specific reference to the dispute resolution mechanism in clause 3.11.

In other respects, the Commission considers that the process set out in clause 3.7 of the undertaking for preparing and submitting an indicative access proposal represent an adequate balance of interests as required under section 44ZZA(3) of the TPA.

D3.6 Negotiation

Clause 3.8 of the undertaking deals with processes for an applicant to respond to an indicative access proposal from ARTC. The negotiation period is deemed to commence when the applicant provides a notification to ARTC to the effect that it is willing to proceed with negotiations.

ARTC proposal

Clause 3.8 of the undertaking provides for notification by the access seeker of intention to progress its application for access as indicated in the IAP within 30 business days of receiving the IAP. It also provides for the access seeker to notify ARTC of any concerns it may have about the IAP (also within 30 business days) and for ARTC to modify the IAP if considered appropriate. If the applicant is still not satisfied with the IAP then it has 30 business days to refer the matter to dispute resolution.

Views of interested parties

FreightCorp and Toll

FCT are concerned that the process set out in clause 3.8 is too prescriptive in terms of the time lines imposed on access seekers. In particular, they are concerned that the

negotiation process may be unnecessarily delayed if operators fail to act within the time lines stipulated. FCT argue that there should be no time constraints on operators.

It is also pointed out that the obligations and responsibilities in clause 3.8 are not equal on ARTC and operators as the time constraints only apply to operators with ARTC, for example, being unburdened by time lines to produce a revised IAP.

Commission's position

Time lines

As noted, the undertaking imposes time limits on the applicant if it wishes to proceed with the negotiation process. Clauses 3.8(a) and (b) impose a 30 business day time limit on applicants to notify ARTC of their intention to progress the access application under the negotiation process set out in the undertaking. The applicant must also notify ARTC of an intention to proceed with negotiations within 30 business days of receiving ARTC's response. If deemed appropriate, the applicant must also seek to commence the dispute resolution process within 30 business days of receiving ARTC's response.

FreightCorp and Toll are concerned that ARTC is seeking to impose such time limits on an applicant's action. FreightCorp and Toll also suggest that if, for some reason, an applicant does not give notice within the specified time frame, the applicant should not have to start the entire access application process from the beginning again. FreightCorp and Toll argue that such time limits do not have regard to the interests of access seekers as required by section 44ZZA(3)(c) of the TPA.

The issue of time limits is an important one for the Commission's assessment of the undertaking. Time constraints can be seen as a necessary element of ensuring that the negotiation process proceeds in a timely and orderly manner. It could be argued that in the absence of time constraints, the negotiation process could become inordinately long and deter demand for access. On the other hand, having crucial steps in the negotiation process subject to time limits creates triggers that could end the negotiation process prematurely if the relevant party does not act within the required time.

The Commission considers that timeliness is an essential ingredient of access procedures in any network industry. The alternative, in an industry where it is important that parties be required to progress matters as efficaciously as possible, is an unacceptable level of delay and confusion with potentially disruptive effects.

The issue with time limits is that it defeats the objective of having them if parties are permitted to act outside them without consequences. Likewise, it appears unreasonable to structure a negotiation process without time constraints at various steps and expect that it would generate acceptable outcomes as expeditiously as possible.

On balance, the effects of not having time limits are probably more detrimental to the effectiveness of the negotiation process than the burden associated with having to abide by them. The issue is what is an appropriate time limit for the various steps of the negotiation process. In the absence of evidence that the time limits stipulated in clause 3.8 of the undertaking are obviously inappropriate, the Commission is not in a position to recommend different time lines in respect of the negotiation process.

Should ARTC also be subject to time constraints? There do not appear to be valid reasons why ARTC should not also be required to act within certain time limits in attempting to balance the interests of ARTC and access seekers. Clause 3.8(c) of the undertaking requires ARTC to respond to concerns from an applicant about the IAP, including preparing a revised IAP, "within a reasonable time". The Commission considers that ARTC should be required to provide a revised IAP (where appropriate) within 30 business days of receiving a notice from the applicant.

Recommendation

Clause 3.8 (c) of the ARTC undertaking be amended to include a provision to the following effect:

***ARTC will respond to these concerns including, where appropriate, the making of revisions to the Indicative Access Proposal,* within 30 business days of the date of receipt of the notice from the Applicant.**

In other respects, the Commission considers that clause 3.8 satisfies the requirements of section 44ZZA(3) of the TPA. The provisions in clause 3.8 provide ARTC and access seekers with processes for negotiations around the Indicative Access Proposal which meet the legislative criteria.

D3.7 Negotiation process

Clause 3.9 sets out the conditions that terminate the negotiation period, how ARTC will deal with mutually exclusive applications for access and a provision for referral of disputes to the dispute resolution process.

ARTC proposal

ARTC proposes that negotiations over access commence when the applicant acknowledges the IAP and that the negotiation period ends when one of the following occurs:

- final execution of access agreement;
- written advice from the applicant that it is withdrawing the application;
- execution of agreement with another operator which reduces capacity to meet the applicant's request;
- expiration of three months from commencement of negotiation period or such period as agreed by ARTC and the operator;
- a determination under the dispute resolution process that negotiations are not proceeding in good faith; or
- evidence that applicant no longer meets prudential requirements.

Clause 3.9 further provides that where there are applications for mutually exclusive capacity, ARTC will grant access to the most favourable proposal as given by the highest risk-adjusted present value of future returns.

Clause 3.9 also provides that disputes that occur during the negotiation period may be resolved subject to the dispute resolution process outlined in clause 3.11. Finally clause 3.9 provides that negotiations may have to recommence as a consequence of another party finalising an access agreement.

D3.7.1 Commencement and termination of negotiation period

The provisions of the undertaking dealing with the commencement and termination of the negotiation period are contained in clauses 3.9(a), (b), (c) and (e).

Views of interested parties

Freight Corp and Toll

Freight Corp and Toll argue that the combination of clauses 3.9 (a), (b), (c) and clause 3.9(e) will force access seekers to proceed to dispute resolution, rather than allow the three months' negotiation period to expire and start the application process again, which is very time consuming. FCT contend that while three months is an appropriate period to try to negotiate an agreement, if negotiations are unsuccessful, negotiations should not be terminated. Rather, according to FCT the objective should be to "treat the access seeker as in dispute with the railway owner"[22] and thus refer negotiations to dispute resolution. Freight Corp and Toll argue that clause 3.9(e) of the undertaking should be deleted and replaced by a provision that acknowledges that if agreement is not reached within three months, either party may refer the matter to dispute resolution.

Commission's position

The Commission considers that it is appropriate that the negotiation period should have a specific termination date to deal with the possibility of negotiations simply being allowed to go on for an unacceptably long time. The expiry of the negotiation period should signal the end of negotiations. To avoid this, an applicant has the option of referring the matter to dispute resolution or to the Commission for possible breach of the undertaking just prior to the expiration of the three month negotiation period if it feels that ARTC is not meeting its obligation to negotiate in good faith.

However, it would be of concern to the Commission if ARTC were in a position to terminate negotiations before the expiration of three months from the commencement date, without prior notice to the applicant and thus without providing the applicant the option of referring the matter to dispute resolution. There are two provisions in clause 3.9 which appear to provide ARTC the right to cease negotiations without prior notice to the applicant. In clause 3.9(b)(iii) the negotiation period ends when there is a reduction in available capacity while clause 3.9(b)(vi) provides that it ends when ARTC receives evidence that the applicant has breached the prudential requirements of clause 3.4(d).

While these events may provide ARTC the right to seek an end to negotiations, the negotiation period should end at the expiration of suitable notification. This would give applicants an opportunity to challenge ARTC and take matters to dispute resolution rather than recommence the application process from the start.

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[22] FreightCorp and Toll, *op.cit.*, p. 18.

Accordingly, the Commission recommends that under clauses 3.9(b)(iii) and (vi) ARTC be required to give applicants 14 days' notice of intent to end negotiations on the grounds of reduced "Available Capacity" and breach of prudential requirements of clause 3.4(d).

Clause 3.9(e) provides for dispute resolution if a dispute arises within the negotiation period. The Commission views this as an option for applicants an alternative to seeking enforcement action on the grounds of a possible breach of obligation to negotiate in good faith. The Commission is satisfied that these options provide applicants with adequate protection from unreasonable negotiation practices by ARTC.

Recommendation

Clauses 3.9 (b)(iii) and (vi) of the ARTC undertaking be amended to include a provision to the following effect:

ARTC gives 14 business day's notice of intent to end negotiation period.

In all other respects, clauses 3.9(a), (b), (c) and (e) do not raise concerns under the assessment criteria in section 44ZZA(3) of the TPA.

D3.7.2 Requests for mutually exclusive capacity

Applications for mutually exclusive capacity are dealt with in clause 3.9(d) of the undertaking. ARTC's approach to requests for mutually exclusive access rights is also set out in clause 5.2(b).

ARTC proposal

Essentially, in the event of there being more than one application for the same time path, ARTC proposes to:

- notify each applicant (without basis for being in breach of undertaking if failure to notify is not wilful);
- grant access to the applicant with the most favourable proposal where the decision would reflect the highest risk-adjusted present value of future returns.

ARTC have stressed that the proposal for granting access to mutually exclusive capacity on the network is not an auction whereby applicants are engaged in a bidding process to determine the highest price each is willing to pay for access. ARTC have described the process as follows:

> Due to the nature of freight traffic demands, it is not unlikely that two or more operators may request the same Access Rights on the network. Under these circumstances ARTC must have a transparent way of dealing with the conflicting demands. ARTC has proposed to do this by assessing the value to ARTC of each of the applications; where value to ARTC is measured in terms of present value of future returns and associated risks, having

> regard to the circumstances including terms and conditions, customer profile and history of each application.[23]

The crucial aspect of assessing conflicting applications may not be access price. While applications may be for the same time path they may relate to entirely different services for which the access charges may differ. In this case, ARTC proposes to grant access to the service yielding the highest net present value. ARTC indicated at the workshop that:

> If in fact it is an 80km/hr freight service for four years against an intermodal service for eight years … then effectively … the NPV of those will be different without going anywhere near an auction on price because the prices are generally published.[24]

Where the applications are for the same time path and the same service, the successful applicant may be determined either by having applicants effectively tender for the access rights or by ARTC giving applicants the same indicative access proposal and allowing applicants to compete for the contract with the end user. This seems to be the process ARTC described at the workshop:

> … our traditional approach has been that if, in fact, both services are bidding for the same contract, which has happened a couple of times, we have indicated to both applicants that the person who is successful with the contract will have the path and we have sometimes indicated to both of them that … if the end user is happy we will give them both an indicative proposal and if they are successful with their contract that there will be a path there … but the mutually exclusive rights provision isn't an (auction), as some have suggested.[25]

Views of interested parties

National Rail

NR argues that the undertaking should require the ARTC to use its best endeavours to accommodate all applicants by flexible adjustment of requested paths. If this is not possible, NR argues that the process by which the ARTC assesses the "most favourable" must be undertaken with transparent criteria.

There is generally insufficient clarity about how mutually exclusive access applications are dealt with. This in part stems from the lack of definition of capacity. But also from a lack of definition of factors and processes for assessing the 'most favourable' applicant. The key is the assessment of risk in quantifying net present value. Also there is no way of an applicant knowing whether he is effectively engaged in an auction while negotiating terms and conditions. ARTC should inform applicants of potentially mutually exclusive access requests.

NR also argues that clause 3.9(d) exempts ARTC from failure to notify applicants of the existence of a potentially conflicting application. There must be an obligation on ARTC to inform each applicant that there is a potential conflict, but not of the identity of the other party. It claims that without this knowledge, subsequent negotiations could (unknown to the applicant) be a complete waste of time and expense.

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[23] ARTC, (2) *Response to Commission Issues Paper*, April 2001, p. 31.
[24] Australian Competition and Consumber Commission, *op cit* (3), pp. 22-23.
[25] *ibid*, p. 23.

SCT

SCT argues that the granting of access on the basis of the highest present value of future returns is not appropriate. SCT states that it is unacceptable that operators who have built their businesses around their train paths face uncertainty following the expiration of these paths. SCT contends that at the very least, those operators require a continuation of these train paths whilst the parties negotiate in good faith on new terms and conditions.

FreightCorp and Toll

Freight Corp and Toll contend that this provision is tantamount to auctioning time paths. They consider that if an auction process is to be considered, the basis upon which it is to be conducted is critical. They argue that the criteria for assessing each bid must be prescribed and must go beyond the "highest present value" and state how that value is determined.

Commission's position

Auctions

The Commission has considered the issue of auctioning scarce capacity in section 5 of this report. Essentially, an auction represents the most efficient way of allocating congested time-space on the network. It ensures that scarce capacity is allocated to users who value it most highly. The Commission has come to the view that the undertaking does not contain provisions for auctions to be used as a means of allocating time paths. In the absence of an auction, the Commission must assess whether the ARTC proposal satisfies the legislative criteria in section 44ZZA(3) of the TPA.

Assessment of competing requests for access

The method chosen by ARTC to grant access in the case of conflicting applications is in principle not inappropriate given the objectives of the legislative criteria. Assessing applications on the basis of a net present value analysis would appear to be an adequate basis for granting access to competing applicants.

The issue is whether the process for allocating scarce capacity is characterised by the necessary clarity and transparency to give operators confidence in the system and encourage access. For example, has ARTC provided sufficient information on how the present value analysis will be conducted? In all, the Commission considers that ARTC has no incentive to award access rights to the applicant with the least favourable proposal. The undertaking does not provide precise details on how the present value analysis will be carried out such that an access seeker would be able to have complete certainty about the methodology employed. Nevertheless, this does not detract from the Commission's view that given the commercial circumstances in which ARTC operates, particularly competitive constraints imposed by road transport, that ARTC is unlikely to award access rights to the operator that represents the most unfavourable outcome.

Exemptions on ARTC

The Commission also notes that the obligation on ARTC to advise applicants of competing access requests may be somewhat constrained by the provision in clause 3.9(d) that:

> Failure by ARTC to provide such notification shall not constitute a breach of the Undertaking where such failure was not wilful and ARTC acted in good faith.

The Commission considers that this provision in clause 3.9(d) is detrimental to the interests of access seekers. It is an exemption that acts as a defence to proceedings that the Commission may otherwise have brought against ARTC for breach of an undertaking under section 44ZZJ of the TP Act. Accordingly, the exemption greatly reduces ARTC's potential liability to an order under s44ZZJ. In the course of these proceedings, a court may compensate an operator who has suffered loss as a result of a breach of an undertaking: in this case, a breach of the notification obligation. In the event such a matter came to court, the Commission would have to prove that the failure to notify was wilful (ie deliberate) or otherwise arose out of bad faith (eg to perpetrate a fraud or further an improper purpose) before the Commission could succeed in any proceeding, and before a person could be compensated in the course of an Commission proceeding for any loss they suffer as a result of not being notified.

The Commission does not consider it appropriate for a person who provides an undertaking under Part IIIA of the TPA to seek to make their obligations conditional in this way. Removal of this exemption from clause 3.9(d) should mean that the provisions of the clause achieve a more appropriate balance of the requirements imposed by section 44ZZA(3) of the TPA.

Recommendation

The following provision be deleted from Clause 3.9 (d):

"Failure by ARTC to provide such notification shall not constitute a breach of the undertaking where such failure was not wilful and ARTC acted in good faith."

D3.8 Matters for inclusion in agreement

Clause 3.10 sets out the key features of the access agreement: the parties to the agreement; the term and conditions that may be covered in an access agreement; and execution of the agreement.

ARTC

In clause 3.10, ARTC provides that the access agreement must be between ARTC and the applicant where the applicant may be either or both an accredited operator and a person which is not an accredited operator. The agreement must be consistent with the indicative access agreement and address at least the matters set out in Schedule C of the undertaking. In clause 3.10(b) of the undertaking, ARTC says that Schedule C does not "provide an exhaustive list of the issues that may be included in an Access Agreement".

Views of interested parties

National Rail

NR argues that the matters for inclusion in an access agreement (which are outlined in Schedule C) are vague. For example, NR claims that a right for the ARTC to vary, remove or review train paths is stated without qualification, while a right for the ARTC to conduct audits does not specify what type of audits it may conduct.

FreightCorp and Toll

FreightCorp and Toll argue that the list of matters in Schedule C is unclear and incomplete and does not represent a reasonable starting point for negotiations. FCT have provided detailed comments on issues that they consider Schedule C should include. Among other things, FCT have submitted that Schedule C should list matters that ARTC considers must be included in an access agreement (ie non-negotiable), matters that ARTC will not seek to include in an access agreement and those matters that ARTC may seek to include in an access agreement.

Commission's position

Schedule C of the undertaking lists a number of matters that ARTC has described as "Essential Elements of Access Agreement". These core elements of an access agreement encompass issues that have the following general characteristics:

- issues that must be dealt with (but without stating commitments or obligations);
- formulae for price variation and measuring under-utilisation of capacity;
- the ability of ARTC to perform tasks;
- the right of ARTC to make demands on operators; and
- obligations on operators to perform tasks or comply with requirements.

Schedule C provides clarity to operators on matters that ARTC considers indispensable in an access agreement. On the basis of items listed in Schedule C, operators should have certainty as to the nature of issues that are not negotiable and without which ARTC will not enter into an access agreement. Schedule C does not present a detailed description of the core elements of an access agreement, so it is not possible to discern ARTC's final position on these issues. While some operators, notably FreightCorp, argue that this is undesirable, Schedule C at least provides a statement of key issues whose presence in an access agreement is considered crucial by ARTC. The detail about many of the matters raised in Schedule C is contained in the indicative access agreement and is subject to further negotiation.

The Commission does not consider that Schedule C, or indeed the undertaking itself, should be so detailed and prescriptive that it would have the effect of reducing the scope for negotiation. Balancing the interests of the infrastructure owner and access seekers is about striking an appropriate balance between certainty of terms and conditions desired by operators and the exercise of discretion by ARTC in the pursuit of its own self-interest. The Commission is of the view that Schedule C of the

undertaking promotes understanding of issues that ARTC considers to be important in providing access to its infrastructure, and enhances certainty and clarity beyond what would be achieved in its absence, without compromising access seekers' ability to negotiate reasonable terms and conditions.

On balance, the Commission considers that the provisions of clause 3.10 of the undertaking do not raise concerns under section 44ZZA(3) of the TPA.

D4. Dispute resolution under the undertaking

In the issues paper, the Commission questioned whether the dispute resolution processes are reasonable, appropriate and adequate.

D4.1 ARTC proposal

Clause 3.11 of the undertaking originally submitted by ARTC provided for a four-step approach to dispute resolution:

- **Negotiation** between the parties;
- **Mediation** by a person appointed by agreement between the parties or by the President of the Law Society of South Australia if the parties can not agree on a mediator;
- **Arbitration** by a person appointed by agreement between the parties or by the President of the Institute of Commercial Arbitrators if the parties can not agree on an arbitrator. The arbitration is to be conducted in accordance with the Commercial Arbitration Act 1986 (SA). The arbitrator must take into account the objectives and principles in Part IIIA of the TPA and the Competition Principles Agreement.
- **Determination by the Commission** in case where one of the parties to the dispute considers that the arbitrator's decision contains a "manifest error". If the Commission finds there has been manifest error, then the parties may refer the matter to another arbitrator or to the Commission for resolution. In making a determination, the Commission is to be bound by Division 3 of Part IIIA, sections 44V, 44W and 44X of the TPA and Division 3 Subdivision D of Part IIIA of the TPA.

The original undertaking provided for a number of notification/grace periods as part of the dispute resolution process such that a period of 100 days could elapse prior to the appointment of an arbitrator.

In response to submissions made to the Commission by operators, and to comments made at the public forum hosted by the Commission, ARTC submitted to the Commission an amended version of the undertaking which incorporated significant changes to the dispute resolution process. The Commission sought from interested parties further comments on these amendments.

The major amendments were that the mediation stage was no longer compulsory, and that the Commission would act as the arbitrator rather than relying on commercial

arbitrators. The option of determination subsequent to arbitration was also removed, although the arbitration would be subject to any rights of appeal granted under the TPA.

The amended undertaking incorporates the following dispute resolution process in respect of disputes arising prior to execution of an access agreement.

Progressive stages in case of unsuccessful outcomes	**Time lapse (calender days)**	**Instigation**
Negotiation Notification of dispute – senior representatives of both parties must meet within **7 days** to endeavour to resolve the dispute.	21 days to resolve	Either party. This is an obligatory step.
Mediation CEO negotiation for **14 days**, then, if no agreement on mediator within a further **14 days,** a mediator is appointed by President of Law Society of South Australia. Mediation is to be conducted under *'Guidelines for Legal Practitioners Acting as Mediators'* of the Law Society of SA.	14 days to resolve, 14 days to appoint then 30 days to mediate. Total of 58 days.	Optional step, only undertaken if agreed by both parties.
Arbitration Refer dispute to arbitration. The arbitrator is the Commission. The Commission is to take into account provisions set out in the undertaking, Part IIIA of TPA and the Competition Principles Agreement.	Indefinite	Either party. Arbitration can be pursued after 21 day negotiation period, or after mediation (79 days after Dispute Notice lodged).
Appeal Commission arbitration subject to any rights of appeal granted under the TPA.	Indefinite	

ARTC states that in the past, operators have stipulated that a dispute resolution should have the following characteristics:

- it should be hierarchical, commencing with attempts by the parties themselves to resolve specific issues;
- it should be inexpensive;
- it should be quick/timely; and
- the use of lawyers and the legal system should be avoided where possible.

ARTC argues that the proposed dispute resolution process has been designed to provide the above features. The process allows a number of opportunities for resolution or escalation meeting the requirement by operators that the process should be hierarchical and cost effective. ARTC also argues that the undertaking provides clear guidelines for matters such as how appointments should be made,

costs are to be borne and criteria by which mediation and arbitration are to be conducted.

ARTC acknowledges that following the original process might result in a wait of up to 100 days before an arbitrator could be appointed. In recognition of this drawback, the amended undertaking has allowed the mediation phase to be passed over in situations where either party considers that it will be ineffectual. ARTC notes that arbitration is a "worst case" scenario, and it is hoped that most disputes could be resolved long before it becomes necessary to appoint an arbitrator.

In relation to enforceability, ARTC argues that at each level of dispute resolution the outcome is either that the parties agree and the issue is resolved or it is escalated to the next level. At its highest, the arbitrator will make a decision which will, in the absence of manifest error, be final and binding on both parties.[26]

ARTC also puts forward the view that timeliness need not be compromised at the expense of efficient and fair outcomes. The process outlined in the undertaking effectively achieves a fair outcome through the use of independent parties, but with a realistic timetable that allows for deliberation of the issues without unnecessary delay of a resolution.

D4.2 Views of interested parties

Interested parties were provided with two opportunities to comment on ARTC's proposed dispute resolution processes. The following comments largely relate to the process specified in the undertaking as it was originally submitted. Following the amendments later submitted by ARTC (as discussed above), the Commission also sought comments on the revised version. Comments on the amendments were generally supportive. Unless otherwise specified, the following summaries reflect the earlier submissions provided.

D4.2.1 Queensland Rail

QR views favourably ARTC's approach to dispute resolution. QR considers it reasonable to include chief executive resolution as the first dispute resolution step. While there are some differences in the dispute resolution procedures proposed by QR and ARTC, both ultimately provide for disputes to be resolved by an independent party. This was a critical issue for stakeholders in relation to QR's undertaking.

QR does not consider it necessary to specify all the issues that may lead to dispute resolution. These are adequately defined as disputes arising under the undertaking or in relation to access negotiations.

[26] The 'final and binding' nature of the arbitration decision is subject to any rights of appeal granted under the TPA (clause 3.11.4(b)(vii) of the undertaking).

D4.2.2 National Rail

NR is satisfied that the approach to dispute resolution taken by ARTC clearly sets out the specific steps to be taken at each stage of the process. However, this results in the process being cumbersome and drawn out. NR argues that the dispute resolution provisions should be reconsidered, with a view to providing a more direct path to arbitration and determination of all unresolved disputes by the Commission.

NR has observed that the dispute resolution process could potentially deter new operators from commencing the process. There should therefore be scope for either party to go directly to arbitration sooner than is currently the case (the QCA has sanctioned a more direct model in relation to the Queensland Rail undertaking).

According to NR, there should be a greater specification of matters an arbitrator should be required to take into account. These include the interests of persons who want access, uniformity with inter-connecting networks and the direct costs of providing access. Furthermore, the arbitrator should be given the power to obtain access to relevant information.

NR also comments about the enforceability of arbitration decisions, suggesting it is sufficient that the undertaking says that the decision of the arbitrator is 'final and binding'.

D4.2.3 New South Wales

The New South Wales Government argues that the proposed dispute resolution process is lengthy and cumbersome. It also notes that arbitration is to be conducted in accordance with the South Australian *Commercial Arbitration Act 1986*, arguing that this jurisdiction may not be suitable to all applicants. It may therefore be better to have some flexibility in this process.

D4.2.4 State Rail Authority of NSW

SRA argues that in the event of a dispute over any issue other than safety, the operator's train paths should continue to be available during the process of resolving the dispute.

D4.2.5 SCT

SCT argues that the dispute resolution processes are flawed because the undertaking does not expressly provide for the arbitrator to take into account the legitimate business interests and investments by operators already using the network where these operators do not have current contracts. SCT adds that the undertaking does not expressly set out the actual standards that an arbitrator must refer to when resolving a dispute.

In commenting on ARTC's amendments to the original undertaking, SCT supports ARTC's proposed changes to the dispute resolution process. SCT adds that in conducting an arbitration, an arbitrator should take into account the legitimate

business interests of the applicant, the binding contractual obligations of ARTC and the reasonable expectations of existing users.

D4.2.6 FreightCorp and Toll

Access seekers have incentives to gain access as quickly as possible to commence operations, and try to avoid arbitration as it is costly and uncertain. FreightCorp/Toll accept compulsory negotiation but not compulsory mediation. Given that it needs to be consensual to be effective, making mediation compulsory is an unnecessary step which simply delays resolution of disputes. As an alternative, FreightCorp/Toll suggest that mediation should not be compulsory but rather an option subject to agreement by the parties or to a determination by the arbitrator as to whether or not mediation is appropriate. Compulsory negotiation should last seven days after which either party may notify the other of intention to proceed to arbitration. The initiating party should be able to assess whether it is appropriate to proceed to an arbitration and, if so, on which issues.

On that topic, FreightCorp/Toll consider that the nature of the issues that may be subject to dispute resolution is unclear. Indeed, it appears that certain matters should be non-negotiable and, accordingly, not subject to arbitration.

FreightCorp/Toll also argue that all determinations of the arbitrator should be published. Publication of determinations is likely to result in fewer disputes over time, as negotiations will not be stalled over matters on which the arbitrator has expressed clear views.

FreightCorp/Toll express a preference for the Commission to be nominated as arbitrator.

In commenting on ARTC's amendments to the original undertaking, FreightCorp suggests that the role of the Commission as arbitrator is uncertain.

D4.2.7 WA Transport

The submission from WA Department of Transport generally covers issues relating to compatibility between the ARTC undertaking and the WA Rail Access Regime.

The submission notes the requirements in the WA regime for an arbitrator to be qualified and acceptable to conduct an arbitration both under the WA Rail Access Code and any other regime affected by the proposed rail operations. It argues that this is an important mechanism for dealing with interface issues, and should be incorporated into the ARTC undertaking.

WA Transport also notes that the decision of the arbitrator is not binding on access seekers in WA: an access seeker is free to reopen negotiations with the track owner if an arbitration determination is not favourable to the access seeker. The ARTC undertaking should also allow for the arbitrator to be able to call on the regulator for expert assistance, as is the case in the WA regime.

D4.2.8 Great Southern Railway

GSR argues that ARTC's proposed dispute resolution process is unwieldy and could be improved and streamlined by ARTC:

- publishing details of all available capacity on the network; and
- accepting any proposal to utilise that capacity from an operator which:
  - fulfilled the criteria in clause 3.3 (d); and
  - agreed to ARTC's standard published contractual terms.

ARTC should also be required to take account of the legitimate business interests of an operator or person seeking access to the network.

D4.3 Consultants' views

To assist in its assessment, particularly in light of ARTC's proposal to incorporate a formal role for the Commission, the Commission engaged consultants, Resolve Advisors (Resolve), to provide advice on ARTC's proposed dispute resolution processes. The draft report and a document providing a summary of the recommendations are available on the Commission's website.[27] This paper provided an analysis and evaluation of the dispute resolution process in Part 3 of the undertaking relating to disputes arising out of negotiations between ARTC and applicants for access to the ARTC network, and also of clause 17 of the indicative access agreement, relating to disputes arising under an agreement.

The key points and recommendations made by Resolve in relation to dispute resolution under the undertaking are summarised below.

In general, Resolve expresses a concern that the process proposed by ARTC is overly long, and that timeliness is a critical concern of the industry in such matters. Furthermore, a distinction is made between *resolution* of a dispute between the parties and *determination* of a dispute by a third party. The former is the preferred outcome and, accordingly, Resolve has proposed an alternative model which attempts to facilitate a consensual outcome while allowing for arbitration to be pursued concurrently should either party consider consensus is unachievable.

Resolve considers its proposal provides a balance of flexibility, choice, clarity and guidance to the parties. The alternative dispute resolution model (for disputes arising under the undertaking) is set out in the table on the following page.

Some of the key differences between Resolve's model and that proposed by ARTC are summarised below.

- The Resolve model does not specify CEO negotiation, since it is unlikely that a dispute resolution process would be initiated unless this avenue had already been explored.

[27] Resolve Advisors, *op. cit*. This report is available on the Commission's website at www.accc.gov.au.

- Rather than specifying mediation and the approach to appointing a mediator, Resolve proposes the appointment of a general 'conflict manager' to act as a facilitator. Mediation may be one process agreed to by the parties, expert determination another.

- Under the Resolve model, the determinative process of arbitration can be initiated by either party at any time after a meeting with the conflict manager has occurred. This can be run in parallel with any other processes agreed between the parties for resolving some or all of the aspects of the dispute.

- Resolve considers that the Commission is a more appropriate arbitrator than commercial arbitrators in relation to negotiating access, since the arbitration is likely to involve a broad discretionary, and policy-related, component. Were the Commission to be nominated in this role, it would be inappropriate to make reference to the Commercial Arbitration Act (SA).

Resolve: Recommended Dispute Resolution Process for Access Undertaking

MEDIATION	BINDING EXPERT	ARBITRATION
Dispute Notice 7 days		
CEO's meet with Conflict Manager 7 days		
By agreement in a resolution contract	By agreement in a resolution contract notice for **Binding expert evaluation without reasons unless otherwise agreed** 7 days	With or without agreement in a resolution contract
Appointment of Mediator 7 days		**Notice to Arbitrate** 7 days
Mediation 14 days	**Appointment of Expert** 14 days	**Appoint Commission arbitrator (Commission or Commission appointee)** 14 days
Termination of Mediation Max: 25 days from Notice of Dispute	**Submissions to Expert** 14 days	Arbitration to be conducted by Commission on time frames directed by arbitrators (see also clause 2.3.5.1 of this report)
	Termination: **Binding Decision** Max: 49 days from Notice of Dispute	↓
		Award ↓ Appeal

Resolve argues that the model provides flexibility for dealing with disputes while the parties are committed to a consensual outcome, but certainty of time-frames and processes in the event the consensual approach breaks down.

The role of the conflict manager is central to Resolve's model. The conflict manager has no decision-making power but is simply a facilitator, tasked with assisting the parties to agree on a process for resolution of the dispute. Resolve suggests that this person should be either selected from a panel approved by the Commission or, failing this, by the Commission itself. Resolve lists the attributes of the conflict manager as being a person or body whom:

- understands the rail industry and the needs of industry participants;
- is familiar with ADR processes and their strengths and weaknesses;
- is purpose appointed;

- is capable of either conducting any mediation process themselves or assisting the parties in the selection of a suitable mediator;
- would have the skill and knowledge to dovetail all ADR processes where appropriate and disseminate information on the processes available to ARTC and industry generally;
- should also have knowledge of and access to appropriately qualified persons to appoint as arbitrators or experts if the parties agree to a determinative process.[28]

In addition to proposing an alternative model, Resolve notes the potential for parties other than the access seeker and the access provider to have an interest in a dispute arising under the undertaking. Given this possibility, Resolve suggests amending the undertaking to allow for such parties to be notified of the dispute, and to join if deemed appropriate by the arbitrator.

D4.4 Commission's position

In its Access Undertakings Guide, the Commission indicated that effective dispute resolution procedures are an essential component of an access undertaking. More specifically, the Commission needs to be satisfied that the undertaking:

- identifies a dispute resolution body or outlines a process for the selection of a dispute resolution body;
- clearly defines the powers, functions and jurisdiction of the dispute resolution body; and
- clearly describes the dispute resolution process which will govern any dispute, including the definition and ambit of matters which may be resolved pursuant to the undertaking.[29]

The guide also comments further on the Commission's expectations that dispute resolution processes only eventuate after genuine attempts at negotiations have been made by both parties to the dispute. As noted earlier, the fact that ARTC has committed to negotiating in good faith places an onus on ARTC to make reasonable endeavours to negotiate an access arrangement. Clauses 3.11.1 and 3.11.2 specifically extend the requirement to act in good faith to situations where a dispute has arisen. In addition, clause 3.11.3 of the undertaking requires negotiation between CEOs as the first stage of the mediation process. A seven-day period of compulsory negotiation was supported in the FreightCorp/Toll submission.

The Commission has had considerable experience in relation to arbitration of access disputes in the telecommunications industry. In light of that experience the Commission's submission commenting on the Productivity Commission's draft report into telecommunications competition regulation made several recommendations as to haw the process could be improved.[30] One of these recommendations deals with increased transparency of information through the publication of arbitration decisions. This is designed to encourage commercial negotiations. Another recommendation is to

[28] *ibid*, p. 33.
[29] Australian Competition and Consumer Commission, (2) *op cit*, p. 22.
[30] Australian Competition and Consumer Commission, (4) *Response to the Productivity Commission Draft Report: Telecommunications Competition Regulation*, June 2001.

allow the arbitrator to join related arbitrations and share information between such disputes.

Given its potential involvement, the Commission has considered ARTC's proposed dispute resolution process very closely and, as already mentioned, sought external advice on possible alternative dispute resolution models. While the process proposed by ARTC displays the features listed in the Access Undertakings Guide, the Commission has some concerns that there are potential difficulties with the approach. That said, the difficulties should not be insurmountable.

D4.4.1 Timeliness of dispute resolution process

The amended undertaking, while allowing mediation as a voluntary step, appears to treat mediation and arbitration as mutually exclusive processes. Potentially, this gives rise to difficult decisions for access seekers who may be considering mediation, as it is not clear that they would then be in a position to request an arbitration until the specified mediation option has run its full 58-day course. As Resolve have argued, it is not necessary for these processes to be structured in this fashion. The undertaking should clarify whether arbitration can commence prior to the conclusion of a mediation process.

D4.4.2 Negotiations and mediation

The Commission has previously made clear that it considers negotiation an essential precursor to the initiation of a formal dispute resolution process. In this regard, the inclusion of a specific requirement for the CEO's to meet (clause 3.11.2 of the undertaking) is an acceptable starting point. That said, Resolve considers it unnecessary to explicitly specify negotiation as a separate step, as substantial negotiation is likely to have already occurred prior to the lodgment of a dispute notice.

The requirement on the CEO's to meet is, however, consistent with Resolve's recommended dispute resolution model. Similarly, the inclusion of an optional mediation process is consistent. The Commission's view is that ARTC's proposed process could be fairly easily reconciled with the Resolve model through some amendments to clauses 3.11.2 and 3.11.3. The Commission is supportive of the suggestion that the dispute resolution process be facilitated, in the first instance, through a designated conflict manager.[31]

Recommendation

The Commission recommends that the ARTC undertaking incorporate the appointment of a suitably skilled, independent conflict management body to be the initial point of contact for disputes under the undertaking.

The Commission also supports a clear distinction between the body responsible for consensual resolution of disputes (the conflict manager or mediator) and the body

[31] The conflict manager should perform the role, and possess the attributes, as described in the Resolve report.

responsible for the determinative process of arbitration. As the Resolve report notes (albeit in the context of disputes arising under access *agreements*):

> It is most undesirable for the parties to have a decision maker moving from that transparent role where rules of natural justice prevail to a role that has the capacity for one-sided discussions. This is particularly so where s27(2) [of the Commercial Arbitration Act (SA)] permits an arbitrator who has acted as a mediator to return to acting as an arbitrator.[32]

In this respect the approach proposed by ARTC again appears acceptable.

The Commission has some concerns, however, with ARTC's proposed mediation process, primarily relating to the manner in which the mediator is appointed. Clause 3.11.39(c) stipulates that, if the parties cannot agree on a suitable mediator, one shall be appointed by the President of the Law Society of South Australia. This appears unnecessarily time-consuming, and has the potential to result in the appointment of mediators not suitably skilled or qualified to act in the role.

The proposed role of a conflict manager is closely linked to the function of mediation of disputes. In many circumstances it is likely that mediation will closely follow the formal meeting with the conflict manager, and in some cases be conducted by the conflict manager her/himself. It is likely, however, that the demands of mediation will require the appointment of a number of suitably qualified mediators, rather than a single body. For this reason, the Commission considers that ARTC should include in the undertaking a provision committing it to assembling, and publishing details of, a panel of suitably qualified, independent persons to conduct dispute resolution services. In addition to the explicit function of mediation under the undertaking, this panel might perform other dispute resolution services where the Commission is unable to act (for example, disputes under access agreements[33]), or considers that another person should act. It should be emphasised though, that the panel must be independent.

The appointment of a panel has a number of advantages. The panel is likely to quickly develop an understanding of the industry through practical experience. Having a number of paths to choose from allows for more timely commencement of mediation processes.

The Commission notes, however, that it may be the case that the panel is unable or unwilling to act in particular cases or at particular times. In these circumstances, it may be appropriate to allow for the appointment – by mutual agreement - of a person other than those on the panel, in order to provide a greater degree of flexibility to accommodate the needs of access seekers. Where parties cannot agree on the appointment of a mediator, however, a third party such as the Commission or the President of the Law Society of SA) should be limited to appointing a member of the panel.

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[32] Resolve Advisors, *op. cit*, p. 27.

[33] Dispute resolution under access agreements is discussed in more detail in chapter D4 of the draft decision.

Recommendation

The ARTC undertaking should include a provision committing ARTC to appointing a panel of suitable skilled, independent mediators to, unless otherwise agreed by the parties, undertake mediation under the undertaking (and under access agreements) or where the arbitrator considers another party should act in relation to a dispute.

One further issue raised by Resolve relates to indemnifying the neutral parties to the dispute resolution process. The Commission considers that ARTC should undertake that they will indemnify the person providing dispute resolution services, and that operators be required to do the same before ARTC's obligations to submit to dispute resolution apply in respect of a particular dispute. To this end, the onus is on ARTC to ensure the willingness of the selected parties to act in the roles described in the undertaking. From a public policy viewpoint, the Commission also notes that a person should not be indemnified against 'wilful negligence or dishonest conduct'. The Commission considers that the particular wording of such a clause should be addressed by ARTC.

D4.4.3 Arbitration

In the event that a party to negotiation is unable to satisfactorily resolve a dispute through the earlier stages of the formal dispute resolution process, the matter may be referred to arbitration. This is broadly consistent with the process applicable to services declared under Part IIIA of the TPA. As such, the Commission considers the inclusion of arbitration provisions appropriate, provided the process can be initiated in a timely fashion.

D4.4.4 Commission as arbitrator

There may be sound reasons for having a single arbitration body rather than allowing a variety of arbitrators, as would have been the case under the undertaking originally submitted by ARTC. A single arbitrator will have a better understanding of the issues and parties likely to be interested in a particular dispute if it has been handling all such disputes. 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 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.[34]

A further advantage relates to the current market environment in the inter-state rail industry. Inconsistencies in access regimes across state boundaries are currently a

[34] Resolve Advisors, *op. cit*, p. 18.

significant impediment to improved performance of the rail sector.[35] The Commission is well placed to overcome this difficulty. Furthermore, the submissions have been supportive of the Commission taking on this role.

Accordingly, the Commission sees some benefit in acting as the arbitrator, as ARTC has proposed in its amended undertaking. That said, the acceptance of the role in this particular case does not imply that the Commission always expects, nor will be always willing, to adopt an arbitration role under access undertakings.

D4.4.5 Transparency of arbitration determinations

Recommendation

The Commission notes that all references in the ARTC undertaking to "Subdivision D of Part IIIA" should be amended to refer to "Division 3 Subdivision D of Part IIIA".

In relation to arbitration determinations, one issue of concern is that of transparency. Clause 3.11.4(b)(vi)(D) of the amended ARTC undertaking stipulates that in conducting an arbitration, the Commission must comply with the procedures described in Division 3 Subdivision D of Part IIIA of the TPA. In that context, the Commission notes that s44ZD of the TPA requires arbitrations to be conducted in private. The Commission is of the view that this section may preclude it from publishing details of its determinations or providing reasons for them. The Commission considers that such an outcome would be inappropriate and that it is in the public interest that this information is published so that all operators are aware of the Commission's attitude to particular issues. This is emphasised by the potential for the same or similar types of dispute to arise between operators and ARTC.

As in the case of telecommunications, the Commission is of the view that transparency is an important element of a dispute resolution model. While the Commission is encouraged by ARTC's commitment to publish the prices for which access has been granted [clause 2.6(b)(iv)], it may be that the decision reached by an arbitrator is based on particular principles which the arbitrator believes should be widely available to the industry. For these reasons, the Commission has a preference for arbitration decisions to be publicly released, subject to the requirement that, in releasing its decisions, the arbitrator have regard to the potential commercial sensitivity of the material. Commercially sensitive information could be protected through the inclusion in the undertaking of a clause based on s44ZL of the TPA, which relates to the treatment of such information provided to the Commission during the course of an arbitration. This clause would need to be modified to deal with the potential for broader public release of information.

It should be noted that Resolve makes a similar recommendation in its report to the Commission (p. 19).

[35] See Productivity Commission, *Progress in Rail Reform*, Report No. 6, August 1999, p. XXVII.

Recommendation

Clause 3.11.4(b)(vi) of the ARTC undertaking be amended to allow the arbitrator discretion to publish arbitration determinations.

Commercially sensitive information be dealt with through the introduction of an additional provision based on s44ZL of the TPA, but modified to deal with the potential for broader public release of information, into clause 3.11.4 of the ARTC undertaking.

Clause 3.11.4(b)(vi)(D) also appears to preclude the Commission from notifying or joining other parties to an arbitration, through its reference to s44ZD of Part IIIA of the TPA. More specifically, it acts to preclude the joining of separate arbitration to expedite the process. This may waste both time and resources as creates the potential for separate, private bilateral arbitration that in other respects are very similar. Possible options to avoid such situations could be through allowing access seekers to lodge joint dispute notices or allowing the arbitrator to join parties where it considers appropriate. Given that the former option assumes a commonality of interest and knowledge on the part of access seekers, and that such an assumption may not be appropriate, the Commission has a preference for the latter approach.

The Commission considers that the undertaking should contemplate a limited discretion to join arbitration where there are common issues to be resolved, or to join additional parties to an arbitration.

In reaching the view that this discretion should be limited, the Commission is mindful that joining a party to the arbitration of a commercial dispute has the potential to delay its resolution. Accordingly, it would not be in the public interest for the undertaking to provide a general discretion to join any person who may wish to participate.

The Commission considers that only those persons who could clearly demonstrate that they are in a position to assist an arbitration based upon their specialised knowledge of the matters in dispute should be permitted to join an arbitration. It would not be appropriate that a person be permitted to join an arbitration simply because they may anticipate a potential for the determination to in some way affect its own commercial interests in future.

Recommendation

Clause 3.11 of the ARTC undertaking be amended to allow the arbitrator limited discretion to join related arbitrations, and to allow the arbitrator limited discretion to notify other affected parties of arbitrations as it considers appropriate.

This recommendation is consistent with the findings of Resolve. In its report to the Commission, Resolve argues that the arbitrator should have the power to join interested parties, noting that if "the like for like provision is to be retained, the lack of a procedural mechanism through which the interests of incumbent operators can be

represented is…a significant concern".[36] Resolve suggests that this should be incorporated into the undertaking in two ways. Firstly, ARTC should have an obligation to invite affected or potentially affected non-parties to participate in resolving the dispute. Secondly, the arbitrator should have the power to join non-parties to an arbitration.

D4.4.6 Criteria for arbitration

In light of the Commission's willingness to accept the role of arbitrator under ARTC's undertaking, it is appropriate to provide some further guidance on the principles it might apply in making arbitration determinations. In this respect, the Commission is guided in the first instance by the terms of the undertaking, provided the terms are consistent with the Commission's powers and functions under the TPA.

The amended undertaking provides criteria which an arbitrator must take into account in making its determination. Clause 3.11.4(b)(vi)(C) requires the Commission to take into account the matters referred to in s44X of the TPA. Over and above this, clause 3.11.4(b)(v) lists a number of specific factors which the arbitrator must take into account in resolving disputes. On this point, Resolve notes that while the two clauses are broadly consistent, the criteria in sub-paragraphs (F) and (G) of 3.11.4(b)(v) may establish a more limited field of consideration than the criterion of paragraph (c) of s44X(1) of the TPA.

> The former appears to allow the decision maker to consider the interests of those who have current contractual rights in relation to the service, while the latter appears to contemplate that the decision maker should also be able to consider the interests of those with rights other than other under contract, for example rights that arise under the Act.[37]

In general, these two definitions are likely to substantially overlap. Given the objectives of Part IIIA, however, on this issue the Commission has a preference for the ability to broaden the scope for consideration as per the wording of s44X(1). The Commission considers that the criteria specified by ARTC should therefore be modified to eliminate any possible inconsistency between the two clauses.

Recommendation

Clause 3.11.4(b)(v)(F) and clause 3.11.4(b)(v)(G) of the ARTC undertaking be amended to make them consistent with s44X(1)(c) of the TPA.

The Commission notes that s44X does not explicitly list as a criterion the interests of access seekers. However, it should be noted that in considering the interests of potential third party users in relation to access undertakings, the Commission has stated that it "will consider the extent to which access arrangements generate real benefits to final consumers and the community in general".[38] Given that s44X addresses both the public interest and the interests of all persons who have rights to use the service, the Commission considers that the interests of access seekers will, in practice, be

[36] Resolve Advisors, *op. cit*, p. 21.
[37] *ibid*, p. 17.
[38] Australian Competition and Consumer Commission, (2) *op. cit*, p. 7.

considered. Accordingly, it does not seem necessary to explicitly stipulate a separate criterion in clause 3.11.4(b)(v) of the undertaking. That said, the inclusion of such a clause would be consistent with the other applicable criteria.

Clause 3.11.4(b)(v)(K) of the undertaking and s44X(2) of the TPA also grant the Commission the power to take into consideration any other matter that it considers appropriate. In general, the Commission would exercise this discretion on a case by case basis. The Resolve report suggests one additional matter that might be relevant in the case of ARTC is consideration of the interests of operators with rights to use an interconnecting rail network.[39] The Commission's views on interface issues are discussed in more detail in section D2.1.3. In general, the Commission considers that interface considerations can be adequately dealt with on a case by case basis, rather than as a formal criterion applicable to all arbitrations.

Other than with respect to the above clauses, the Commission considers the proposed criteria which should be taken into account in conducting an arbitration under the undertaking are acceptable.

D4.4.7 The Commission's approach to arbitration under the undertaking

If the Commission accepts the ARTC undertaking and, in particular, the role of arbitrator, it may be called upon to approve or determine a price for a particular service. It is therefore appropriate to provide some guidance as to the approach the Commission would adopt in making such determinations. Providing guidance is not intended to limit the outcomes of commercial negotiations, although it may assist parties to negotiations by limiting the boundaries for those negotiations.

It is important to note that the Commission's approach does not preclude variations to price that might be negotiated between ARTC and an access seeker, nor is it intended to prevent ARTC from varying its charges to take account of the factors listed in clause 4.2 of the undertaking.

The arbitrator will be bound by the undertaking. Clause 3.11.4(b)(A) stipulates that the arbitrator must take into account the principles, methodologies and provisions of the undertaking in deciding a dispute. An important consequence of this requirement is that it requires the arbitrator to have regard to the indicative access charges when making a determination on prices [clause 4.2(b)]. That is, the indicative access charge acts as a reference tariff. This is discussed in more detail in chapter D5. Where ARTC's proposed charge differs from the indicative access charges, the arbitrator would also be required to have regard to the other factors listed in clause 4.2. These include the particular characteristics of the service and the commercial and logistical impacts on ARTC's business.

Given that the indicative access charge only applies to a specific service category, however, it is important to consider what 'having regard to' means in the context of determining charges for train consists not explicitly included in the undertaking. A number of such services are currently provided by ARTC. In these cases, the factors listed in clause 4.2(a) and 4.2(c)–(f) are likely to be relevant in the context of an

[39] Resolve Advisors, *op.cit*, p. 18.

arbitration determination. Among these factors are the opportunity cost to ARTC and the market value of the train path sought.

Given the general nature of such criteria, the Commission has considered further how these factors might be applied should it be called upon to make an arbitration determination for a non-standard service. As noted in chapter D5, the Commission is of the view that the market prices prevailing at the time of this draft decision are not unreasonable charges for those services. While the Commission would consider any pricing dispute referred to it for arbitration in light of its particular circumstances, it also considers that, where a train consist is not explicitly described in the undertaking, the prevailing market prices are a general indication of differences in both the market value of certain types of services and the opportunity costs (to ARTC) associated with them.[40] Proper application of the opportunity cost and market value criteria would thus involve some consideration of these prices. These prevailing charges are listed in the table on the following page, for the train consists defined in terms of maximum speed, axle loading and train length.[41]

As already noted, the approach the Commission intends to adopt does not preclude ARTC from differentiating its charges on the basis of the other criteria it has listed in clause 4.2. Indeed, in specific cases the opportunity cost to ARTC and/or the market value of the train path may require consideration of additional information. The Commission considers that such differentiation is acceptable provided prices fall within the levels defined by the revenue limits specified in clause 4.4 of the undertaking.

[40] An example of such prevailing market prices is the indicative access charges contained in the undertaking.

[41] These prices are based on the schedule of charges prevailing at the time of this draft decision (currently cited on the ARTC website).

Table 4.1: Reference Tariffs for Arbitration[42]

	Units	**Adelaide-Parkeston**	**Crystal Brook-Broken Hill**	**Pt Augusta-Whyalla**	**Adelaide-Pelican Point**	**Adelaide-Melbourne**	**Melbourne-Albury**
Variable Charges	*per '000 gtk*	$2.262	$2.558	$3.996	$3.557	$2.602	$2.372
Flagfall Charges							
Super Premium	*per train per km*	$-	$-	$-	$-	$-	$2.665
Premium	*per train per km*	$3.306	$2.085	$2.079	$2.451	$2.061	$1.877
High	*per train per km*	$2.865	$1.807	$1.808	$2.109	$1.942	$1.680
Standard	*per train per km*	$2.424	$1.526	$1.537	$1.767	$1.690	$1.250
Low	*per train per km*	$2.204	$1.387	$1.386	$1.596	$1.632	$1.250

Table 4.2: Service Characteristics

Service Category	**Maximum Train Speed**	**Maximum Axle Loading**	**Maximum Length**
Super Premium	130 km/h	20t	N/A
Premium	115 km/h	20t	N/A
High	110 km/h	21t	Corridor-standard maximum
Standard	80 km/h	23t	Corridor-standard maximum
Low	Off-peak train paths		

[42] The prices currently listed on the ARTC website, and from which the figures in Table 4.1 are based, are quoted exclusive of GST. Clause 4.6 of the undertaking, however, makes no mention of whether prices are inclusive or exclusive of GST. For the purposes of this draft decision, the Commission has assumed that the prices are inclusive of GST, and that the relativities are as described in the table. This should be clarified by ARTC. At a minimum, GST-inclusive prices should be specified in the undertaking.

D4.4.8 Review of arbitration decisions

The Commission notes that clause 3.11.4(b)(vii) states that arbitration determinations under the undertaking would be subject to any rights of appeal granted under the TPA. The Commission understands that this is intended to allow for review of an arbitration decision. The Commission considers that the rights of appeal that will lie in the event of the Commission making arbitration determinations will be in the nature of judicial reviews. The undertaking does not provide for merits review, or re-arbitration, of disputes by a body such as the Australian Competition Tribunal ('the Tribunal'). Strictly speaking however, there are no rights of appeal under the TPA. Accordingly, the Commission recommends that this clause be amended.

Recommendation

Clause 3.11.4(b)(vii) of the ARTC undertaking be amended to remove the words "under the TPA".

It is questionable whether, even if ARTC wanted to provide for such a re-arbitration in its undertaking, it would be within the scope of the Tribunal's jurisdiction to perform a function or provide it a power that an undertaking purports to provide it with.

In this context, the comments of WA Transport should be noted. In the Western Australian regime, an arbitrator's decision is not binding on an access seeker; rather, the access seeker is able to re-open negotiations in the event it is dissatisfied with the arbitrator's decision. By contrast, clause 3.11.4(b)(vii) stipulates that the determination of the arbitrator shall be final and binding on the parties. Given the provisions of s44V(2), in making an arbitration determination the Commission has the power, should it consider it appropriate, to enforce acquisition of the service. The Commission considers that, given it is the intention of Part IIIA of the TPA, such discretion is not inappropriate.

4.4.9 Compliance with arbitration

Clause 3.11.4(b)(vi)(D) of the undertaking requires the Commission to comply with the procedures described in Division 3 Subdivision D of Part IIIA of the TPA. Section 44ZG of the TPA provides the Commission with particular powers for the purpose of arbitrating an access dispute, including the right to give directions necessary to determine the dispute. The Commission has some concerns that the undertaking as it is currently drafted does not adequately allow for the enforcement of directions that may be given by the arbitrator to an access seeker or ARTC. Clause 3.11.4(b)(ix) of the undertaking allows ARTC to cease negotiations with an applicant if the applicant does not comply with the determination of the arbitrator, but does not refer to directions given during the course of making that determination. Failure to comply with directions is likely to significantly limit the ability of the arbitrator to reach an appropriate decision.

Recommendation

Clause 3.11.4(b)(ix) of the ARTC undertaking be amended to allow ARTC to cease negotiations in the event that an applicant does not comply with the directions or determination of the arbitrator (subject to any rights of appeal).

The Commission also notes that there is no corresponding clause requiring the compliance of ARTC with the directions and determination of the arbitrator. Again, this may give rise to problems of enforcement. Accordingly, the Commission considers that express provision to this effect be made by ARTC in the undertaking. Failure to comply with the directions or determination of the arbitrator would thus represent a breach of the undertaking.

Recommendation

Clause 3.11.4(b) of the ARTC undertaking include a provision expressly requiring ARTC to comply with the directions or determination of the arbitrator (subject to any rights of appeal).

4.4.10 Prevalence of disputes

The Commission's experience in telecommunications suggests that the ARTC undertaking contains features which should lessen the likelihood of disputes proceeding to the point of arbitration. A significant cause of the large number of arbitrations in the telecommunications industry is the private, bilateral nature of the arbitrations, and associated uncertainty over the pricing outcomes generated by arbitration. As already argued, this can be alleviated by increased transparency. An important aspect of transparency relates to pricing principles. In the absence of principles to guide access seekers' price expectations there is a higher probability of disputes arising and being brought to arbitration.

The Commission has found that the publication of pricing principles for telecommunications services has expedited the process of commercial negotiation. For example, when the Commission released its draft pricing principles for GSM mobile services in December 2000, there were six GSM arbitrations in progress. Further information regarding the implementation of those principles has since been published. As a consequence, five of those arbitration notices have been withdrawn. Similarly, in relation to local carriage services (LCS), the Commission released final pricing principles in November 2000. Since then, the Commission has engaged consultants to provide an assessment of the quantum of inputs into the methodology recommended in the pricing principles paper. This was completed in August 2001. Since this time, two LCS arbitration have been withdrawn. While there are other factors that are likely to have contributed to the withdrawal of these disputes, it is arguable that the release of pricing principles and the final results of the consultants' study have contributed to their resolution.

It should be noted that the Commission does not consider the publication of principles alone as reason for these outcomes, but publication in conjunction with guidance as to their application. This, too, is addressed in the ARTC undertaking, through the

commitment to publishing agreed access prices. As discussed earlier, the Commission recommends that this transparency be extended to allowing the arbitrator to publish arbitration decisions. Transparency is also improved through the assessment of the access undertaking itself: in reaching this draft decision, the Commission is presenting its views on ARTC's pricing principles and approach and its views on how it would interpret them in the context of arbitration of a dispute. The assessment of pricing principles is detailed in chapter D5 of the draft decision. The telecommunications examples suggest that a combination of clear pricing principles, a published assessment by the Commission of ARTC's approach to pricing, and the publication of arbitration decisions will help to facilitate the process of commercial negotiation and to minimise access disputes.

4.4.11 Costs of arbitration

In the event the Commission is required to make an arbitration determination in relation to a declared service, it is empowered by s171A of the TPA to charge a fee for its services. Fees relating to the notification and conduct of an arbitration are set out in paragraphs 2.6C and 2.6F of the Trade Practices Regulations.

There is no corresponding provision in the ARTC undertaking as to how the Commission is to be compensated for adopting the role of arbitrator. Given that the Commission is accepting additional responsibilities under ARTC's proposal, it considers that the inclusion of a clause stipulating how an arbitration is funded is a necessary element of the undertaking. This might be worded similarly to, or make explicit reference to, the clauses in the Trade Practices Regulations.

It should be noted that the undertaking is a commitment made by ARTC. To ensure that parties *other* than ARTC (ie access seekers) are obligated to make appropriate payments for the costs of arbitration, the access undertaking will require careful drafting.

Recommendation

The ARTC undertaking include provision for the Commission to charge fees in relation to the performance of its duties in relation to arbitration of disputes.

4.4.12 Summary

As noted in the Access Undertakings Guide, the Commission will generally accept a dispute resolution role only if an appropriate alternative is not readily available. On balance, however, the Commission is prepared to accept a dispute resolution role under the ARTC undertaking provided the process is revised to address the concerns indicated above. The Commission notes that the reasons behind its preparedness to accept a role in this particular case include:

- having a single arbitrator is more likely to ensure consistency of arbitration determinations over time;
- access disputes may require a significant consideration of competition policy, which represents an inappropriate role for commercial arbitrators;

- the ARTC undertaking is the first operational rail access arrangement which spans state boundaries, and involvement by the Commission may assist the facilitation of a nationally consistent approach to rail access;[43]
- the ARTC undertaking contains provisions which should ensure the transparency of access pricing agreements and, if suitable revisions are made, arbitration decisions;
- the ARTC undertaking contains explicit pricing principles which are assessed in this draft decision: such transparency has been shown to facilitate commercial negotiations in the telecommunications industry;
- the ARTC undertaking contains an explicit reference tariff, and this draft decision sets out further explicit prices which the Commission would consider in conducting an arbitration; and
- the Commission considers that inter-modal competition will significantly limit the extent to which ARTC is able to price in a fashion that would breach the revenue limits specified in the undertaking.

The Commission anticipates that the combination of a number of these factors should minimise the number of disputes that are progressed to arbitration. Should it become evident over time that this is not the case, and that commercial negotiations are being hindered by either the terms of the undertaking or by the dispute resolution process itself, ARTC may consider modifications to the undertaking. The Commission notes that the term of the undertaking is limited to five years, at which time the provisions will no longer apply. At the outside, such difficulties could be taken into account in evaluating an appropriate framework beyond this 5-year term.

The Commission accepts the role of arbitrator under the ARTC undertaking provided the undertaking is refined to address the concerns indicated above.

The Commission has a strong preference for access agreements to be reached through a negotiated, consensual outcome rather than through the determinative approach implied by arbitration. For these reasons, the Commission would like to see implemented a dispute resolution process that most effectively pursues genuine agreement between the parties. The expert advice provided to the Commission is designed to achieve this aim and, accordingly, the Commission strongly encourages ARTC to adopt a dispute resolution process along the lines proposed by Resolve.

The Commission considers that, as presently drafted, clause 3.11 does not fully meet the requirements of section 44ZZA(3) of the TPA. Most particularly, the Commission is not convinced that the proposed dispute resolution process is sufficiently timely to meet the interests of access seekers. Ultimately, this lack of timeliness comes at a cost to consumers and the community in general.

[43] The Darwin to Tarcoola rail access regime has been certified by the Minister but is not yet operational.

Recommendation

Clause 3.11 of the ARTC undertaking be amended to broadly reflect a dispute resolution model along the lines proposed in the *Draft Report on Dispute Resolution Provisions in ARTC Undertaking and Access Agreement*[44], provided the amendments are consistent with the assessment and recommendations set out in this draft decision. In particular, it is recommended that the undertaking make provision for:

- **the appointment of a conflict manager;**
- **the appointment of a panel of mediators;**
- **the commencement of arbitration at any time beyond the initial meeting of the parties with the conflict manager;**
- **transparency of arbitration determinations;**
- **discretion for the arbitrator to notify parties of, and join to, arbitrations; and**
- **the Commission to charge fees for making arbitration determinations.**

4.4.13 Implementation - appointment of a conflict manager

Adoption of a model along the lines proposed by Resolve raises the question of how a conflict manager is to be appointed. Resolve suggests that the appointment could be made by either an industry body, ARTC or the Commission. Given that the submission of an undertaking is a voluntary decision on the part of ARTC, however, the Commission does not consider it appropriate for the regulator to impose upon the industry.

The Commission notes that the electricity industry has in place a similar model to that proposed by Resolve.[45] That said, the structure of the electricity market is quite different to the rail market under consideration. There, the National Electricity Code Administrator (NECA) has a central role in the operation of the market. The appointment of a dispute resolution advisor in that industry can therefore be coordinated via NECA rather than by a particular participant in the market.

The Commission's preference is for ARTC to make an explicit commitment in the undertaking to appointing, within a specified timeframe, an independent, suitably skilled party to the role. A failure to meet this obligation would then constitute a breach of the terms of the undertaking. The process might seek endorsement of the appointed party by the Commission as a final step. In assessing any proposed process, the Commission's main concerns will be to ensure that the appointed conflict manager is independent and impartial, and appropriately skilled. The Commission seeks feedback from interested parties on the proposed approach to establishing such a model.

[44] Resolve Advisors, *op. cit*.
[45] Proposed changes to the dispute resolution provisions in the National Electricity Code are currently under review by the Commission.

D5. Pricing principles

Part 4 of the undertaking sets out the principles used by ARTC to derive access charges. ARTC argues that its objective is to apply access charges which achieve a practical balance between the legitimate business interests of ARTC, the interests of third party access seekers, and the interests of the public.

Access charges are structured as a two-part tariff comprising a fixed and a variable component. The fixed ('flagfall') component is levied on the basis of the length of the train path, irrespective of whether the path is actually utilised. The variable component is levied on the basis of gross mass and distance, and is charged only when the path is utilised.

Indicative access charges for each segment of the network are included in the undertaking. The indicative access charge is effectively subjected to a price cap in the undertaking, which means it cannot be increased by more than the greater of two-thirds of the percentage increase in CPI or the percentage increase in CPI less 2% in any one year.

The indicative access charge applies to services having the following characteristics:

- axle load of 21 tonnes;
- maximum speed of 110 km/h and average speed of 80 km/h; and
- length not exceeding 1500 metres east of Adelaide and 1800 metres west of Adelaide.

This service effectively acts as a 'standard' service, which ARTC is committing to providing at the indicative access charges. Where an access seeker requests a service different to this standard (a 'non-standard' service), the undertaking sets out the considerations ARTC will take into account in formulating the charges for that service. The undertaking also constrains ARTC from differentiating charges either on the basis of the characteristics or identity of the applicant, or - where users are operating within the same end market - from discriminating charges for services that are alike.

The extent to which ARTC can vary the charges for access for these kind of non-standard services is limited by a requirement to have regard to the indicative access charge when setting prices, and by the floor/ceiling revenue limits defined in the undertaking. The floor/ceiling limits restrict the amount of revenue ARTC can recover from a segment or group of segments, and act as an overall constraint on the prices ARTC can charge. The floor limit is defined as the amount of revenue required to cover the *incremental* cost of a segment. The ceiling limit is defined as the amount of revenue required to cover the *economic* cost of a segment. These concepts are discussed in more detail in section D5.3.

A number of issues were raised in relation to ARTC's proposed access pricing principles during the course of the Commission's public consultation process. This chapter addresses these issues under four broad headings. First, the general approach to access pricing is discussed. Second, issues relating to the proposed pricing and structure are discussed. These issues include competition considerations, the level and

structure of the indicative access charges, and the efficiency implications of ARTC's approach. Thirdly, a cost-based assessment of ARTC's floor/ceiling limits is conducted. This section addresses issues in relation to asset valuation, depreciation, rate of return and operating expenditure. The final section provides a specific assessment of the clauses in Part 4 of the undertaking in light of the preceding discussions.

D5.1 General approach

In the Issues Paper, the Commission questioned whether the general approach to access pricing achieves the undertaking's stated objective of striking a balance between the business interests of ARTC, access seekers and the general public.

D5.1.1 ARTC proposal

ARTC is of the view that the pricing principles are generally balanced in favour of the access seeker. Essentially, ARTC believes it manages an asset that is significantly under-utilised in various parts and at various times. As such, the volumes currently available in the market will not generate sufficient revenue to recover the full economic cost of the asset where access is charged so as to make rail inter-modally competitive. Given this spare capacity, and the constraint placed on pricing by inter-modal competition, ARTC sees growth in volumes as the primary means by which the asset can become sustainable in the long term. In the shorter term, however, it is essential that sufficient revenue be generated to cover incremental cost. ARTC argues that, in order to price access in a way that makes rail competitive, it must take some long term commercial risk, which it is seeking to mitigate by growing its markets and revenues.

Specific features of ARTC's pricing policy which it claims are designed to promote market growth through the encouragement of competition, resulting in wider community benefits, include:

- Operators competing in the same market environment and operating under like terms and conditions of access are not price differentiated.
- Indicative charges and terms and conditions are published, as well as any prices associated with deviations from the indicative terms and conditions, providing prospective users with guidance, and some certainty, with respect to access pricing.
- ARTC charges are levied in two parts, being a variable usage related charge and a fixed flagfall charge. The relativity of charges results in revenue collected from the fixed flagfall charge being only around 33% of total revenue. In addition, the flagfall component is only 'fixed' to the extent that the path exists. The only risk to the operator is that if the path is not sufficiently utilised, it may be withdrawn.
- Infrastructure maintenance is currently outsourced and managed under maintenance contracts entered into on commercial terms as a result of a competitive tender process. ARTC argues that it has adopted this practice with a view to ensuring that its cost structure reflects efficient infrastructure maintenance practice, and access pricing is efficient and competitive.

- Valuation of the infrastructure asset base reflects an optimised network so as to ensure that revenue collected does not inefficiently recover the costs of redundant assets.

- The annual increase in the indicative access charge is limited to the greater of CPI less 2% or 2/3 of CPI. ARTC argues that this implies an annual real reduction in access pricing of up to 2% may be made available to users, as well as the possibility that pricing may not be increased at all, offering the possibility of even greater real reductions to users.
- In addition to real falls in access pricing, ARTC argues that strategic investment in the infrastructure, together with improved asset management practices at lower unit cost, has given users the opportunity to make significant yield improvements in above rail operations. For example, the operation of longer trains, increased wagon loading and better train loading potentially further reduce effective access charges.

D5.1.2 Views of interested parties

National Rail

NR argues that, provided a number of network pricing issues that it raises are fully addressed[46], the undertaking strikes a balance between the business interests of ARTC, access seekers and the general public.

Given that most prices are in fact the indicative access charges, the floor and ceiling revenue diminish in importance. Instead the 'X' in CPI-X becomes critically important.

New South Wales Government

The NSW government supports the floor/ceiling approach, but notes that the NSW approach to access pricing may impose more constraints on pricing than the approach adopted by ARTC. For example, the NSW regime does not allow the inclusion of formation value of assets such as cuttings and embankment in the estimate of asset valuation. Given the gap between indicative charges and the price ceiling, however, it may not be necessary to impose such a rigorous methodology.

Transport WA

Transport WA notes some differences between the ARTC undertaking and the WA Rail Access Regime, including the ability of ARTC to charge more than the ceiling (ie monopoly rent) with the consent of the access seeker and to charge less than the floor (ie cross subsidisation) at its discretion; and the absence of a mechanism for adjusting for over or under recoveries.

SCT

SCT argues that the ARTC undertaking does not properly take into account the interests of existing users of its network. The undertaking does not properly

[46] These are outlined below.

differentiate between existing operators and prospective users. SCT also considers that the undertaking lacks transparency. Operators are not in a position to know whether the access price has been calculated in accordance with the undertaking. Furthermore, operators cannot be certain whether some operators and not others have benefited from price and non-price conditions.

State Rail Authority of NSW

ARTC is only setting out an indicative access charge for one class of train, which is significantly different from Countrylink XPT passenger services. Previously, ARTC has published a schedule of prices for different categories of train. SRA believe that the undertaking should provide an explanation of pricing treatment for trains that differ from the 'standard' specification.

Queensland Rail

ARTC pricing limits should have a combinational test to ensure there is no cross-subsidisation between individual train services or combinations of train services. By not using a combinational test, ARTC is adopting an average cost methodology, which results in a lower ceiling limit and a higher floor limit than under more typical constrained market pricing approaches.[47] This produces a narrower band and reduces the scope for price differentiation.

ARTC is not in a position to charge monopoly rents. Its pricing is significantly below its allowable revenue limit. The pricing regime contains sufficient incentives for ARTC to continue to seek to improve the market value of its business. It is not necessary to enhance incentives through regulatory measures.

Pricing in rail should be set in a manner that will promote efficient utilisation of the network, ensure the appropriate sharing of risk and allocate volume benefits in an appropriate manner. Rail systems are characterised by the potential for substantial cost trade offs between the provision of rail infrastructure and the operators of services on that infrastructure. Optimisation of the performance of rail infrastructure does not necessarily result in optimisation of the performance of the logistics chain. It is therefore necessary for access pricing to provide appropriate signals to both infrastructure owners and operators in terms of the need for additional investment.

FreightCorp and Toll

While price discrimination between competing access seekers is necessary and desirable, price discrimination on the basis of demand factors can lead to distorted outcomes if applied subjectively. This creates uncertainty about pricing outcomes. To address this uncertainty issue, ARTC should indicate how it intends to take account of demand factors.

FreightCorp/Toll argue that the floor/ceiling band proposed by ARTC is so wide that price certainty is difficult to achieve. The only other indication of future pricing is the

[47] The Commission's views on the distinction between average, marginal and incremental cost are discussed in section D5.2.4.

CPI-linked price escalation formula, which is unlikely to achieve the desired balance between the interests of ARTC, access seekers and the public. Accordingly, this should be replaced with either a commitment to maintain constant nominal prices, or if an index is to be adopted, that index should be related to interstate general road freight pricing. FreightCorp/Toll suggest that the fact that most assets are gift funded shows that the Government wants to improve rail's viability versus road, rather than to make commercial investments.

D5.1.3 Commission position

In its Access Undertakings Guide, the Commission notes that the criteria by which it must assess access undertakings are fairly general. The criteria largely involve balancing the interests of the access provider, access seekers and the public. Clauses 1.2(c) and 4.1 explicitly state balancing these interests as one of ARTC's objectives in lodging the undertaking.

Submissions to the Commission expressed a range of views in response to this issue. For example, National Rail and the NSW government expressed the view that the undertaking was able to achieve a balance between the interests of various parties; while on the other hand SCT argues that the legitimate interests of users of the network are not properly taken into account. Similarly, the FreightCorp/Toll submission suggests that the proposed pricing principles would be unlikely to achieve the desired balance between the interests of ARTC, users and the public.

The remainder of this chapter discusses in detail the Commission's views on the implications and appropriateness of ARTC's proposed approach to pricing, and provides an assessment of the proposed principles against the criteria of s44ZZA of the TPA. In summary, the Commission is of the view that Part 4 of the undertaking is acceptable, subject to some refinement of the wording. The Commission considers that the undertaking provides users with a substantial degree of certainty, as well as protection against any market power that ARTC currently holds (or could hold in the future), while allowing ARTC to pursue its intended growth strategy over the five-year duration of the undertaking. In so doing, it should further the interests of the public, through providing falling real access charges[48] and facilitating increased intra and inter-modal competition.

D5.2 Proposed prices and structure

D5.2.1 Intra-modal / inter-modal competition

The Issues Paper sought comments on the likely effect of the proposed access pricing approach on intra-modal and inter-modal competition.

ARTC proposal

ARTC argues that its approach to pricing promotes intra-modal competition. In particular, ARTC believes that its pricing regime will encourage the entry into markets

[48] Falling real access charges are a direct consequence of clause 4.6 of the undertaking. This is discussed in more detail in section D5.2.4.

of newer operators. Such operators can enter the market with confidence that they will be able to compete on an even playing field with incumbent carriers, and certainty as to the level of access pricing which will be made available to them.

Concerning inter-modal competition, ARTC argues that it faces competition (to varying extents) from road and sea transport in all the markets it serves. Therefore, access price negotiation must consider the competitive position of rail in the end markets. Both ARTC and the operator lose revenue if rail is unable to compete in the markets.

For this reason, ARTC argues that it has endeavoured to tailor its approach to pricing to facilitate the growth of rail volume in these markets, whilst still retaining as much flexibility for commercial negotiation as possible. ARTC argues that the indicative access charge enables rail to compete effectively in East – West markets, while the structure of access charges provide incentive for operators to improve yield from both their own above rail assets, as well as from usage of the track.

Views of interested parties

SCT

In considering variations to charges, ARTC should be required take into account the effect of an increase in charges on inter-modal competition. Furthermore, the uncertainty in relation to the pricing principles and the application of non-price conditions will hinder competition.

National Rail

NR indicates that it believes the ARTC undertaking will provide a continued balance between stability for existing rail operators and ease of new entry.

Freight Australia

Freight Australia expresses the concern that while ARTC is compelled to act in a commercial manner there is no corresponding obligation on road transport, rail's primary competitor. Freight Australia proposes that one of the objectives of the undertaking should therefore be rail access charges that are competitively neutral with road access charges.

FreightCorp and Toll

The FreightCorp/Toll submission suggests that automatic linkage of access prices to CPI will limit rail's ability to compete with road and coastal shipping.

Commission's position

A number of submissions commented on the possible effects of the undertaking on inter-modal competition. Generally, the suggestions were that the effect of pricing on inter-modal competition should be a formal consideration within the ARTC undertaking. The Commission's view is that the inclusion of such a clause is unnecessary, as competition provides a constraint on ARTC's behaviour regardless of the inclusion of formal provisions. Indeed, the inclusion of such a clause may result in wasteful disputes as to whether ARTC has taken the effect on competition into consideration in its pricing.

It is widely accepted that vigorous and effective competition normally provides the best means of promoting economic efficiency, a competitive economy and the welfare of consumers. Competition is a *process* which centres on the active efforts of firms to keep ahead by reducing costs, developing new products and enhancing the quality of their services. It is a process which forces businesses to offer "more for less" by improving quality and/or lowering prices. At a broader level competition also helps to ensure that the community's scarce resources are used in the most valuable way now and through time.

Prices in competitive markets reflect the marginal costs of production. This allows all consumers who value the good/service above marginal cost to obtain that good/service, and consequently for social welfare to be maximised. In a market where there is a monopoly provider of infrastructure, this is not the case, and society suffers associated welfare losses. The monopolist is said to hold 'market power', which is generally manifested in prices above marginal cost and consequently lower output than the socially optimal level. The loss associated with the lesser use of the service is termed allocative inefficiency.

Competition is characterised by **substitutability**; that is, users of a service can either seek an alternative kind of service (demand side substitution) or an alternative service provider (supply side substitution) in the event that they are dissatisfied with their current provider. 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, supply side substitution options are limited.

The fact that freight (the major above-rail market on the ARTC network) can be transported using alternative modes, however, suggests that there is a high degree of demand side substitutability in the market for rail track services. In general, a profit-maximising monopoly provider sets prices at levels that are higher than the socially optimal level. However, where users have the option of utilising a different service, such as road transport, even a single provider of rail network infrastructure will face limitations on the extent to which it can increase its charges. A significant proportion of ARTC's business appears to be operating in this kind of environment.[49] It is therefore unlikely that, for these customer segments, ARTC would be able to significantly raise prices from their current levels, or significantly reduce the quality of service, as this would result in large reductions in rail freight volumes as freight is switched to alternative transport modes such as road and shipping. A similar argument holds for

[49] ARTC argues that "around 60% of ARTC business is priced at the Indicative Access Charge. This business includes most containerised freight that is characterised by a high level of inter-modal competition". ARTC, (2) *op. cit*, p. 17.

passenger traffic. In economic terms, this suggests that a significant proportion of the demand for use of ARTC's track is relatively elastic.[50]

The Commission notes that there may be less competition from road in the market for bulk freight. The term 'bulk freight' generally refers to commodities such as coal and grain. That said, it may be the case that ARTC faces competition in this customer segment from other modes, such as sea transport. Furthermore, as the NCC notes, "the majority of freight transported between Sydney/Melbourne and Perth is non-bulk".[51] Accordingly, while ARTC may hold market power in some more narrowly defined markets, such power is likely to be limited.

The argument that ARTC is constrained in its behaviour by inter-modal competition is supported by the Commission's analysis of the costs of providing rail infrastructure across the ARTC network. In general, ARTC appears to be recovering revenues well below the economic cost of providing services. Such an outcome would be unlikely to eventuate in the absence of competition. Moreover, until recent years, rail's share of the interstate freight market – its largest customer segment – has been declining relative to road, suggesting that relative prices could not be substantially increased without ARTC facing a significant volume impact. Notably, the improved market share performance of rail against road on the east-west corridor in the last few years has occurred at a time when real rail access prices have been in decline.[52]

Under these conditions of competitive constraint, ARTC has strong incentives **not** to increase prices, or at least to limit price increases. Prices negotiated between ARTC and access seekers will therefore generally reflect a competitive outcome. An access seeker will not accept a high access price that prevents it from effectively competing against alternative modes of transport in the long term.[53] Similarly, ARTC has an incentive to negotiate a price which the access seeker finds acceptable, thereby providing ARTC with additional volume and revenue. If ARTC does not negotiate such a price, the business is lost not only to the operator, but to ARTC itself. Thus prices are essentially market based.

The Commission thus disagrees with suggestions that ARTC will ignore the effect of its pricing on competition, or without considering the effect its pricing will have on its downstream customers.

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[50] This is supported by Freebairn, who notes that "elasticity is likely to be high and to increase with higher prices". Freebairn, J., *Access Prices for Rail Infrastructure*, Economic Record, Vol. 70, No. 226, September 1998, p. 289.

[51] National Competition Council, *Specialised Container Transport Applications for Declaration of Services Provided by Westrail: Recommendations*, November 1997, p. 15.

[52] With the exception of increases in July 2001, ARTC's offered prices have been constant in nominal terms since 1995. This equates to a decline of approximately 15% in real terms over a six year period. Changes in real prices approximately equal the change in nominal price less inflation, so constant nominal prices imply falling real prices, unless inflation is negative.

[53] In determining whether an offered access price is acceptable, an access seeker will take into account all other long-term costs of providing rail services and the prices it needs to charge its customers to justify its own investment. Where this involves some level of 'sunk' cost – ie, where the access seeker's investment is specialised and cannot be recovered upon exit from the business – this will be factored in to the access seeker's decision to operate or not operate the service. Thus exit costs will be factored into any decision to introduce a new service, irrespective of whether the access seeker is currently providing above-rail services or whether it is a new entrant.

In this context, it is worth considering whether the fact that ARTC is a vertically separated rail provider has a bearing on the incentives it faces in relation to pricing. In its submission to the Productivity Commission's review of Part IIIA of the TPA, the NCC argued that even a vertically separated firm has incentives to distort competition in dependent markets.

> In effect, a vertically separated upstream monopoly can deal on an exclusive basis with the most efficient downstream firm, precluding all downstream competitors, and extract the chosen downstream firm's rents by means of a two-part tariff. The downstream firm earns zero economic profit while the upstream firm secures whatever rent is available in the dependent market.[54]

While this argument may have some merit, it applies to markets in which the (effectively vertically integrated) entity is not subject to competition. As already noted, the rail market in which ARTC operates *is* subject to a relatively high degree of competition. Accordingly, the extent to which it would be able to extract rents is very limited. That said, there may be some customer segments in which ARTC does hold, or may in future hold, some market power. For these reasons, the Commission considers it important to ensure that ARTC's undertaking does not allow it to earn monopoly rents. This is discussed further in the context of the Commission's assessment of the ceiling limits ARTC has proposed.

While ARTC reserves the right to increase the indicative access charge by the greater of CPI-2% or 2/3 of CPI, this increase is not automatic. Ultimately, the extent to which access charges increase will be determined through commercial negotiation in the context of market realities. Accordingly, the Commission does not consider that the ARTC undertaking will have a detrimental effect on inter-modal competition.

It follows from the above reasoning that a clause explicitly requiring ARTC to take into account the effect on inter-modal competition would be redundant. It may even be the case that such a clause would create increased complexity during access negotiations or in enforcement of the undertaking.

The further issue of whether there exists competitive neutrality between rail and road transport is highly complex and contentious. However, while important to the efficiency of the national transport system, the question is beyond the scope of the Commission's role in assessing ARTC's undertaking. Even if it was clearly the case, however, that the road transport market was competitively 'non-neutral' in the sense that providers of road infrastructure did not operate on a fully commercial basis and/or other distortions existed in the road market, in the Commission's view it would be inappropriate to expect ARTC to factor this into its undertaking. As far as possible, issues regarding competitive neutrality should be addressed directly in the road market rather than indirectly via the rail market.

The Commission notes that the Productivity Commission inquiry into rail reform did find that the road charging system for heavy vehicles under-recovers costs attributable to classes of vehicle which compete directly with railways, thereby conferring a

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[54] National Competition Council, *Legislation Review of Clause 6 of the Competition Principles Agreement and Part IIIA of the Trade Practices Act 1974: Submission to the Productivity Commission*, January 2001, p. 23.

competitive advantage on road transport. A similar finding was reported by the Bureau for Transport Economics (BTE).[55] The BTE concluded that even if both road and rail paid more competitively neutral charges, the freight rates for each would be likely to fall by similar proportions. Thus the *relative* price of rail and road may not be substantially altered, and the market share of rail may continue to decline over time. From the Commission's perspective, though, the important point to note is that ARTC does face significant competitive constraints on its business from inter-modal competition. The Commission seeks comments from interested parties on its initial assessment of ARTC's competitive environment.

Submissions to the Commission contained few comments on the likely effects on intra-modal competition. It should be noted that healthy intra-modal competition is generally likely to contribute towards rail's ability to compete inter-modally. Competition between train operators is likely to place continued pressure on those firms to lower costs and/or increase service quality over time. This in turn is likely to increase rail's competitiveness against road, potentially increasing rail's share of the total freight and passenger markets.[56] Increased intra-modal competition can be facilitated by reducing barriers to new entry in the market. Such barriers include start-up costs and the costs associated with uncertainty.

The Commission considers that the acceptance of an access undertaking will provide potential entrants into the above-rail market a greater degree of certainty than may otherwise be the case. It should be noted, however, that the undertaking commits ARTC to providing like services at like prices, where access seekers are operating in the same end market.[57] In making this commitment, ARTC is effectively limiting the extent to which it can price discriminate between customers. Given ARTC's difficulties in covering the replacement costs of its existing assets[58], it may actually be preferable for ARTC to be charging customers according to their valuation of a particular train path.[59]

That said, the earlier discussion on vertical integration noted the NCC's argument that there may be some incentives for a vertically separated infrastructure provider to distort competition in the downstream market. Furthermore, if competition in the downstream market is imperfect, the welfare losses from monopolistic pricing are potentially greater in the case where the entity has been vertically separated.[60] While the earlier discussion noted that, in relation to ARTC, inter-modal competition is likely to limit the extent to

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[55] Bureau of Transport Economics, *Competitive Neutrality Between Road and Rail*, Working Paper 40, September 1999, p. x.

[56] This point was noted by the Productivity Commission in its inquiry report, *op. cit*, pp. 162-163.

[57] While the definitions of "alike" services and "same end market" are open to some interpretation, these principles have been generally well established under trade practices case law. The Commission does not, therefore, see definitional impediments to accepting these terms.

[58] This is a consequence of the fact that ARTC's revenues do not cover the economic costs of its assets. See sections 4.2.4 and 5.3 for more discussion of this point.

[59] Given ARTC's high proportion of joint and common long run costs, efficient recovery of such costs calls for mark-ups above incremental service costs based on demand-side considerations. Specifically, the mark-up should be inversely proportional to the elasticity of demand for the service (Ramsey pricing). In a regulatory context, however, the informational requirements of implementing such an approach can be very high.

[60] For a more detailed discussion of this issue, see King, S. and Maddock, R., *Unlocking the Infrastructure: The Reform of Public Utilities in Australia*, Allen and Unwin, 1996, pp. 87-94.

which such pricing can be sustained, the Commission's view is that ARTC's inclusion of a commitment to not differentiating charges for users of like services provides a further degree of protection to above-rail operators. If ARTC does have a significant degree of market power (or at some future point comes to have market power), and thus has (or gains) some incentive to distort competition, this 'like for like' clause should prevent ARTC from actually implementing distortionary pricing.

A number of operators have expressed support for non-discriminatory pricing, and ARTC has responded to these concerns in preparing its undertaking.[61] For these reasons, the Commission is not proposing to object to the inclusion of a commitment to pricing like services equally. This issue is discussed further in section D5.2.2.

D5.2.2 Setting access charges

In the Issues Paper, the Commission sought comment on whether the indicative access charge provides a reasonable basis for the setting of access prices, and whether there is sufficient clarity about how ARTC will deal with deviations from the indicative access charge.

ARTC proposal

ARTC argues that the existence of the indicative access charge considerably reduces uncertainty for new applicants. However, where an operator's requirements differ from the indicative terms and conditions, ARTC proposes to formulate an access charge that considers a range of factors including the particular characteristics of the relevant service, the commercial and logistical impact on ARTC's business, the cost of any additional capacity required, and any contribution made by the operator.

In order to provide additional certainty to operators seeking terms and conditions other than the indicative terms and conditions, ARTC has proposed publishing any negotiated access prices, together with related terms and conditions, on its website. The purpose of this is to provide additional guidance to prospective operators as to how their requirements might be priced. ARTC expects that, over time, the high incidence of situations where specific requirements have either been exactly or closely handled in previous negotiations would considerably reduce uncertainty for new applicants.

Views of interested parties

SCT

SCT argues that the indicative access charge does not provide a reasonable basis for the setting of access prices because the manner in which that charge is determined is neither market based nor clear, and the access arrangements are not clear in terms of price and non-price conditions. SCT adds that adopting floor/ceiling limits is not appropriate given that ARTC indicates that the indicative charges are market based rather than cost based.

[61] For example, SCT states that allowing price discrimination between operators "will lead to uncertainty and adversely affect the interests of operators and adversely affect competition". Not all operators expressed this view – for example, Toll expressly argues that a degree of price discrimination should be allowed.

FreightCorp and Toll

The FreightCorp/Toll submission highlights concerns with the indicative access change with respect to the way it is linked to increases in CPI, the excessive weighting given to the flag fall component and the lack of quality of service standards. CPI-linked increases are argued to be inappropriate as general freight prices are not keeping pace with inflation. Such price increases will hinder rail's ability to compete with road and coastal shipping. With regards to service quality, FreightCorp/Toll argue that the absence of quality service standards allows the price-regulated firm to maximise profitability by sacrificing service quality.

Toll

In a separate submission commenting on ARTC's amendments to the undertaking, Toll argues that the undertaking is proposing a price structure that is not designed to be cost reflective. CPI linked price increases should be replaced by a commitment to annual review of the indicative access charge having regard to efficient costs. Toll also argues that the obligations introduced by Part 8 of the amended undertaking (relating to maintaining the network in a 'fit for purpose' condition and publishing performance indicators) are inadequate.

The submission also comments on the subject of non-discriminatory access charges. Toll suggests that the "revised undertaking seems to assume that there is something inherently inefficient in price discrimination and that price discrimination is a form of anti-competitive behaviour".[62] By contrast, Toll argues that:

> Unless the undertaking recognises the differing ability of users to pay depending on the use to which track access is being put by that user, optimal output will not be achieved and rail will be utilised less and less where there are alternate modes available.[63]

Toll suggests that ARTC is failing to take into account the effect of its pricing on downstream markets, and that the access prices that users can afford to pay depends on the market in which that user is operating.

Another point made by Toll relates to consistency within the undertaking. Toll argues that the commitment to not differentiating charges between applicants using like services and operating in the same end market is narrower than the broad principle of non-discrimination described elsewhere in the undertaking.

National Rail

NR suggests that the implied X-value of 2% should be reviewed after two years or, alternatively, that there should be provision for regular review of the reference tariff. NR also adds that the undertaking must fix dates for the application of the CPI-X escalation of the reference tariff.

Great Southern Railways

GSR contend that profit and cashflow figures suggest that track access fees could be lowered by as much as 15% while still generating acceptable returns to ARTC. The fact

[62] Toll Group, *Issues Arising from the Revised ARTC Undertaking*, October 2001, p. 2.
[63] *ibid*, p. 2.

that prices are above the floor on all major line segments indicates there is considerable scope for reducing prices.

Commission's position

Indicative access charge

In a regulatory context, a critical concern is the potential for monopoly providers to charge excessive prices; that is prices which are above the long run costs of production. In the case of ARTC's interstate rail network there has, to date, been no regulatory involvement that has warranted an investigation into the appropriateness of ARTC's charges. It should be stressed that it is ARTC's decision to voluntarily lodge an access undertaking with the Commission which has initiated the first such examination. The Commission's cost based assessment is detailed in section D5.3.

The purpose of a cost-based assessment is as a benchmark against which ARTC's proposed charges can be compared. ARTC has not proposed setting its charges 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. Currently, no such formal limits exist, nor would they exist in the absence of an undertaking. Accordingly, ARTC's undertaking represents a self-induced limitation that would otherwise only be likely to arise in the event that ARTC's rail-track services were declared by the NCC under Part IIIA of the TPA.

In the absence of regulation, the prices for rail track services are essentially market based. That does not necessarily imply that they are efficient; as already mentioned a monopoly provider may be able to sustain pricing above socially optimal levels. However, prices that generate revenues below the economic cost of providing services are generally inconsistent with monopoly pricing outcomes. In those circumstances, the Commission considers it reasonable to assume that prices have been determined on a commercial basis. This appears to be the current situation in the markets in which ARTC is operating, with the limitations on ARTC's pricing stemming largely from inter-modal competition from road and shipping. Inter-modal competition was discussed in more detail in section D5.2.1.

The indicative access prices contained in the undertaking are the same as ARTC's current charges for services classed as superfreighters. This superfreighter service has the same characteristics as the indicative service defined in the undertaking. According to ARTC, the history of these charges dates back to 1995, when they were determined by commercial negotiation between ARTC and above-rail operators in the market at that time.[64] This view of the process was supported by the Toll Group at the Commission's public forum, who noted that the access price reflects "what [ARTC] can get from you".[65] The important point here is that historically, prices for rail track services have not be determined with reference to costs but are essentially market based; ie reflective of prevailing demand. Recent increases in rail volumes and rail's share of the freight transport market on the east-west corridor are consistent with this view.

[64] Australian Rail Track Corporation, (2) *op. cit*, p. 17.
[65] Australian Competition and Consumer Commission, *Transcript of Proceedings, (3) op. cit*, pp. 23-24.

As noted above, from a regulatory perspective the prevention of excessive pricing by a monopoly provider is a major justification for intervention. Where ARTC's revenues remain below the appropriately defined and measured economic cost of providing services, however, the Commission considers that commercial negotiations are likely to provide the most efficient short-run pricing outcomes. Commercial negotiation is likely to award train paths to the party that values the path most highly, and is also likely to provide ARTC with incentives to maintain and expand capacity as it becomes necessary. That said, the Commission notes that the inclusion of a 'like for like' provision may somewhat limit these potential gains.

Indeed, in circumstances where ARTC is constrained by market forces to pricing below the levels necessary to recover the full economic cost of providing services, the Commission has concerns regarding the sustainability of the network infrastructure. If ARTC is not able to generate sufficient cash flow to replace assets as becomes necessary, the longer term viability of the industry is compromised. The Commission notes that in these circumstances, a degree of price discrimination, even between different users operating the same type of service, may be a desirable practice. Such an approach may facilitate the efficient allocation of common costs. That said, this would only be appropriate to the extent that it does not distort competition in downstream markets. ARTC has suggested that its strategy is to reduce its long-run average costs - through productivity gains and volume growth - to the level of its prices.[66] ARTC appears to believe that this strategy can be achieved most readily through a commitment to non-discriminatory pricing. In light of the benefits of promoting competition in downstream markets, the Commission's draft decision does not object to the inclusion of a like for like provision in the undertaking.

In relation to the issue of consistency between clause 4.3 ('Limits on Charge Differentiation') and clause 1.1 (f) of the undertaking, which states that ARTC will not discriminate price on the basis of commodity being transported[67], the Commission notes again that the role of the preamble is to assist in the interpretation of the document rather than imposing a legal obligation on ARTC.[68] Accordingly, the Commission considers that it is clause 4.3 which specifies the obligation upon ARTC. This suggests that the inconsistency does not present a practical problem. That said, it is preferable for inconsistencies to be removed from the undertaking as far as possible.

Service quality

A possible concern that arises when prices are constrained by regulation, however, is the incentives the regulated business faces with regard to service quality. Quality of service measures are an important aspect of the oversight arrangements in most regulated industries - for example, price-capped airports are subject to quality of service monitoring. Potential service quality issues arise in the context of the ARTC undertaking because the ways in which a price-constrained rail track operator can increase its profits are primarily through increasing volumes, or through lowering operating costs. In situations where users of the track cannot elect to use some

[66] That is, ARTC's strategy is designed to move towards a position of full cost recovery.
[67] This issue was expressly raised in the Toll submission in response to the amended undertaking submitted by ARTC.
[68] See chapter D1 of this draft decision.

alternative provider, it may be the case that a monopolist has incentives to cut costs beyond an efficient level, to the point where the standard of service deteriorates to an unacceptable level. In that context, some submissions commented on the absence of service quality measures in ARTC's undertaking.

This does not necessarily imply that a set of service standards is a mandatory component of an access undertaking. A trade-off exists between price and quality, and it may be the case that different classes of access seeker, and even different individual access seekers, want different standards. There can be advantages, therefore, in allowing service quality to be a negotiable term of access. The Commission has indicated, in its Access Undertakings Guide, that service standards will be assessed on a case-by-case basis. The guide also notes that any commitment to particular service standards needs to be complemented by adequate mechanisms for measuring and reviewing service performance.

ARTC's original undertaking contained little in the way of service standards or performance indicators. In the main, ARTC's service standard obligations are more fully laid out in the indicative access agreement. For example, clause 5.3 sets out ARTC's obligations under an agreement; while clause 6.1 commits ARTC to maintain the network to the higher of the standard existing at the commencement of an agreement, the minimum standard required to maintain ARTC's accreditation as a track owner, or some other standard agreed between the parties. Similarly, clause 12 requires all parties to an agreement to comply with minimum safety standards, while clause 2.9 requires the compliance of both the track owner and applicant with negotiated key performance indicators.

In response to submissions and comments made at the public forum hosted by the Commission, ARTC submitted on 14 September 2001 an amended undertaking to the Commission. This amended undertaking includes an explicit commitment by ARTC to maintain the network in a fit for purpose condition (clause 8.1), and a commitment to regularly publish specified key performance indicators. These indicators are discussed in more detail in chapter D9.

The Commission considers that the circumstances under which ARTC has lodged its undertaking are relatively unusual. As noted in section D5.2.1, ARTC faces a significant degree of inter-modal competition from road and shipping in a number of its customer segments. Just as the existence of such competition is likely to constrain the extent to which ARTC can increase its prices, competition will limit the extent to which ARTC is able to decrease service quality. As noted earlier, competition is characterised by substitutability; users of a service can either seek an alternative kind of service (demand side substitution) or an alternative service provider (supply side substitution) in the event that they are dissatisfied with their current provider. This dissatisfaction may be the result of high prices for a certain service, or poor quality of service for a given price. Given the demand side substitution possibilities (such as road transport) available to users of the ARTC infrastructure, ARTC is likely to face limitations on the

extent to which it can run down service quality at given price levels. Customers who find service levels unacceptable may choose to use alternative modes of transport.[69]

In light of this relatively high degree of inter-modal competition, the Commission is of the view that explicit service standards are not an essential component of the ARTC undertaking. Indeed, it may be the case that the inclusion of universal standards creates unnecessarily high prices, thereby limiting access. Furthermore, the inclusion of particular performance indicators in the indicative access agreement (the effect of which is discussed in chapter D10) means that, unless an operator agrees that there should be no such indicators, ARTC will be obliged to maintain a standard of service in accordance with those indicators. On balance, the Commission considers that specific service standards can be left open to negotiation between ARTC and access seekers, with the "fit for purpose" clause acting as a safeguard against provision of inadequate services by ARTC. This can be monitored over the term of the undertaking through examination of appropriate performance indicators. ARTC's proposed indicators are discussed in chapter D9.

Non-standard services

The Commission's Access Undertakings Guide notes that access pricing arrangements are a necessary element of any access undertaking. The form in which these arrangements are specified can, however, vary. Some possible approaches include the specification of a list of prices, specification of a range of possible prices, specification of reference prices for a reference service, or specification of a price menu allowing different combinations of fixed and variable charges.[70] The ARTC undertaking adopts a combination of these approaches, allowing for a range of allowable prices (the floor and ceiling limits) as well as effectively including a reference tariff for the superfreighter-type service. This reference tariff is the indicative access charge.

As noted earlier, the indicative access charge relates to a particular service with defined characteristics. In the event that the undertaking is accepted, ARTC becomes bound to offer those services at the indicative access price (adjusted over time in line with CPI increases). For services other than the indicative service, ARTC is bound by clause 4.2(b) to have regard to the indicative access charge, amongst other criteria, in formulating its charges. Over and above this, ARTC is expressly constrained by the revenue limits set out in clause 4.4. Prices for these other services are therefore not directly limited by a CPI-linked cap. ARTC currently publishes a schedule of prices which covers the majority, if not all, of these services.

There are certain implications of ARTC's decision to select a single customer segment as an indicative service with accompanying indicative prices, rather than including all its major service categories. In theory, this allows ARTC greater flexibility to meet operators' needs and vary prices for those services, with the specified revenue limits acting as an overall constraint. Indeed, for these reasons ARTC points out that "it

[69] This may be mitigated somewhat by the exit costs faced by above-rail operators. That said, exit costs will have been factored in to an operator's decision to provide the service. See footnote 53 for further discussion of exit costs.

[70] For more discussion on these types of approach, see Australian Competition and Consumer Commission, *(2) op. cit*, pp.29-30.

considers it important not to be too prescriptive in price setting at other than the Indicative Access Charge".[71] In practice, though, the limitation introduced by clause 4.2(b) will require ARTC to justify any departures from the indicative access charge.

That said, in the Commission's view, the current schedule of charges appears reasonable. Although differentiated between services, these prices appear to be well within the revenue ceiling (see chapter D5.3) and, as already noted, are likely to reflect prevailing demand conditions in the market. Relativities between the level of charges across different service categories are therefore likely to be reflective of generally different competitive constraints upon the service typically provided within each category, and the relative opportunity costs to ARTC of offering such services. For example, passenger services, which mainly fall within ARTC's premium category, would be subject to different competitive constraints than the freight services provided using superfreighters. Furthermore, the different types of service may have different effects upon ARTC's ability to accommodate other network users, and thus upon ARTC's revenues from those other users. In this sense, there are likely to be generally different opportunity costs to ARTC of accommodating different types of service. These differences - ability to pay and opportunity cost - would be expected to largely explain the different charging levels currently observed between the premium and superfreighter categories.

Furthermore, as noted in chapter D4.4.7, both opportunity cost and the market value of the train path sought are factors which must be taken into account in making an arbitration determination.[72] Proper application of these two arbitration criteria would thus involve some consideration of the full schedule of ARTC's current prices. The Commission's approach to arbitration of disputes arising under the undertaking is discussed in more detail in chapter D4.4.7.

It should also be noted that only the indicative access charge is expressly price-capped by clause 4.6(c) of the undertaking. However, an attempt by ARTC to increase charges for its other services by more than the variation allowed by clause 4.6(c) would appear to be inconsistent with to the notion of 'having regard to' the indicative access charge. Thus clause 4.6(c) may have the effect of capping the indicative prices for those other services currently covered by ARTC's pricing schedule.[73]

The Commission has considered the relative merits of ARTC's approach to this issue against possible alternatives such as including indicative prices for all major customer segments, or excluding indicative prices altogether. The decision represents something of a trade-off for an access provider between offering customers a reasonable degree of price certainty and retaining the ability to vary prices across different types of service (although, in the case of ARTC, not between different operators depending on their relative willingness to pay). In this instance, it appears that ARTC has elected to offer increased certainty primarily to its largest customer group, which provides around 60% of ARTC's business.[74] Given the Commission's stated position on what it considers 'having regard to' means in the context of the undertaking, however, the practical effect

[71] ARTC, (2) *op. cit.*, p. 17.
[72] Market value of the train path is likely to be representative of a user's ability to pay.
[73] The price cap is discussed in more detail in section D5.2.4.
[74] ARTC, (2) *op. cit*, p. 17.

of ARTC's commitment to take the indicative access charge into account in formulating charges for services other than the indicative service may be to imply a broader range of indicative prices than is actually specified in the undertaking. This is perhaps also broader than ARTC intended in submitting its undertaking. That is, the effect of clause 4.2(b) is similar to the position that would eventuate if ARTC had specified its full set of access charges and associated service categories. The Commission seeks comment from ARTC and other interested parties on its interpretation of the undertaking.

Deviations from the indicative access charge

The indicative access charge does, however, allow for some further negotiation by access seekers over terms and conditions of access, and associated variations to price levels and structure. These negotiations will be conducted with reference to the indicative access charges, as clause 4.2(b) of the undertaking expressly provides. In general, the specification of appropriate revenue limits may well be a sufficient level of price specification. The inclusion of indicative access charges thus adds a further constraint on ARTC, and offers further protection and certainty for rail track users. The Commission does not, therefore, consider that a more detailed schedule of indicative charges in the ARTC undertaking is necessary to achieve a workable outcome for ARTC, access seekers and the Commission.

D5.2.3 Fixed and variable components of access charges

In the Issues Paper, the Commission questioned whether the fixed and variable components of the access charge are set reasonably.

ARTC proposal

ARTC argues that the relativity of the fixed and variable component of access charges has resulted in revenue from the fixed charge representing around 33% of total revenue. ARTC contends that, as it is generally accepted that a significant proportion of rail infrastructure costs are fixed, the structure of access charges places market risk on ARTC. ARTC argues that it has taken this market risk in order to grow rail's market share. The strategy is based on reducing the relativity of fixed charges for access (a potential barrier to new entry) and thereby encouraging intra-modal competition.

ARTC adds that, where possible, it seeks to attribute as much expenditure to specific pricing segments as possible. ARTC has sought to allocate other costs using methods commonly employed in the rail industry. Unattributable infrastructure maintenance expenditure has been allocated 60 percent with respect to gtks and 40 percent with respect to track kilometres, while all other operations and management expenditure has been allocated on the basis of train kilometres. ARTC argues that it has sought to allocate costs so that any operator pays a fair share of expenses which reflect the costs incurred by its operation.

Views of interested parties

Queensland Rail

QR argues that the assessment of incremental cost for incorporation in a multi-part access charge is not a simple exercise, and the extent of incremental costs will

potentially vary over time, particularly in the event of significant changes in train operations or volume. QR therefore believes that it may be appropriate to enable ARTC to review the two part tariff if it becomes apparent that the tariff structure is leading to inappropriate pricing signals. QR argues that such a review may be appropriate if, for example, the tariff is leading to perverse decisions by operators for the purpose of minimising access charges, or if the operating paradigm on a system changes to such an extent that the cost elements are no longer reflective of future incremental costs.

SCT

SCT argues that it is inappropriate for the flagfall component to be charged irrespective of whether a train path is utilised. It claims that the undertaking should provide that cancellation fees will not be imposed when an operator does not use a scheduled train path.

SCT argues that the allocation of non-segment specific costs is not soundly based and would not contribute to efficient outcomes.

FreightCorp and Toll

The weight placed on the flagfall component should be considered carefully. There are already some incentives to operate long trains; however, this incentive should not be too strong as there are costs of being constrained to operating only long trains. These costs include a loss of flexibility and increased terminal costs. FreightCorp/Toll argue that, ultimately, terminal costs and terminal size constraints will determine maximum train lengths, irrespective of access price signals. FreightCorp and Toll consider the reliance on flag fall rates is too heavy and that there should be an opportunity to negotiate a more flexible balance.

National Rail

NR considers the fixed and variable components of ARTC's indicative access charges appropriate.

Commission's position

The ARTC undertaking specifically stipulates a two-part tariff, comprising a variable charge based on actual usage of a train path ($/kgtkm basis), and a fixed flagfall component charged irrespective of whether a train path is utilised ($/km basis). The Commission estimates that across the various geographic segments of the ARTC network, the fixed charge represents around 20-40% of charges for freight-type services and around 45-60% of charges for passenger services, on average.

In its Access Undertakings Guide, the Commission has previously encouraged the use of two-part tariffs in undertakings. Two-part tariffs may have the advantage of allowing an asset owner a reasonable rate of return on investment without constraining capacity in an undesirable way. By allowing for short-run marginal cost pricing, it can provide an approach to recovering common costs while minimising allocative efficiency losses.

One concern associated with two-part tariffs is the potential for a uniform up-front fee to exclude some users from access despite such users being prepared to pay an access price above marginal cost. For example, this may occur in circumstances where the

fixed charge is determined as an average of (fixed) facility development costs. The discussion in sections D5.2.1 and D5.2.2 argued, however, that ARTC's proposed charges are essentially demand determined. One consequence of this is that the fixed charge is not uniform; rather, it varies across different service categories.

In the context of rail access, the entry fee (the flagfall component of ARTC's charges) is an input cost in the downstream train operator market. In deciding whether to enter the above rail market, an operator will take into account all the costs associated with providing its service, and the charges the market will allow it to levy. As a consequence, from an end-user's perspective, a revenue-neutral two-part tariff and a single price charge will result in similar price-quantity outcomes for using rail transport (as opposed to rail track) services.

Freebairn argues that a two-part tariff may actually have detrimental effects in the downstream market.[75] That is, it may result in a relatively inefficient train operator market because of the way it affects operators' market entry and exit decisions. Since the flagfall charge is fixed per entrant, the minimum efficient scale for operators is higher than it would be if only a variable charge applied. Operators will have incentives to run fewer, heavier trains than may be desirable. The resulting market will therefore be characterised by fewer, larger operators than may be socially optimal. For these reasons, it may be desirable to allow an access provider to discriminate the level of fixed charges between different users of the infrastructure in order to facilitate entry. In ARTC's case, this is enabled through clause 4.5(c) of the undertaking, which expressly provides for negotiation over price structure.

These arguments were reflected in submissions to the Commission, although a range of views on the appropriateness of ARTC's proposed structure was presented. National Rail endorsed the weighting specified in the undertaking, while the FreightCorp/Toll submission suggested that the fixed component was too high. SCT went further again, arguing that the fixed charge should be zero.

The issue of two-part tariffs should be considered in the context of potential competition. As noted in section D5.2.1, the ARTC network faces significant competition from alternative transport modes. This is likely to affect the incentives faced by ARTC in relation to negotiating alternative fixed/variable price structures. For example, if a potential entrant to the train operator market finds the level of the fixed charge too high, it may be deterred from entering the market, and the business may be transferred to the road transport sector. Under these conditions, ARTC has an incentive to negotiate an alternative price structure. Indeed, the different levels of competitive constraint across different types of service is likely to be one reason ARTC's current fixed charge does vary between them.

ARTC may also have incentives to negotiate alternative structures if the potential entrant is seeking to win business from incumbent operators. Section D5.2.1 noted that increased intra-modal competition will over the longer term increase rail's ability to compete against other transport modes. Accordingly, it may be in ARTC's interests to facilitate new entry as expeditiously as possible.

[75] Freebairn, J., *op. cit*., pp. 293-294.

The ability of ARTC to price in this manner is constrained, however, by it undertaking to offer like prices for like services, and to offer to include in its access agreements ongoing rights to operators to renegotiate prices previously agreed in light of new pricing decisions. It can be expected from this that ARTC's pricing decisions for a given service would be relatively consistent over the term of the undertaking. In the course of negotiating with a potential entrant, ARTC will be mindful of the fact that all the current users of that service would have a right to access on the basis of the newly negotiated price structure. It is conceivable that this may actually undermine ARTC's incentives to negotiate an outcome that might otherwise be acceptable to it. That is, it may be that the lost revenues to ARTC from incumbents switching to the new pricing structure are greater than the revenues it gains from the new operator. That said, if the negotiated outcome facilitates a greater volume of train services over time, the price-volume trade-off may ultimately increase ARTC's profitability. The incentives would therefore appear to be appropriate, in that sustainable pricing outcomes should be achieved through negotiation.

In summary, the Commission has some concerns that the adoption of a two-part tariff, particularly in conjunction with a commitment to provide like services at the same price, may act as a barrier to entry for some smaller train operators. This may be the case even where those operators are prepared to pay access charges that are above the short-run marginal cost of the service.

Furthermore, the like service provisions may constrain ARTC in the degree to which it is prepared to negotiate alternative proportions of the fixed/variable charges. Nonetheless, the proportions remain open to negotiation. In general, the Commission considers that, provided price levels are not set at a point that represents an abuse of market power, price structure is most appropriately decided through commercial negotiation, augmented by the availability of arbitration.

The Commission acknowledges that the effects of locking in a two-part pricing structure remain to be fully explored. It also notes that the ARTC undertaking has a five-year time horizon. If, over time, it appears that potential entrants are being frustrated in their attempts to gain access to the ARTC network, then this could be taken into account in evaluating an appropriate framework beyond the current 5-year period. The Commission considers that such an approach is preferable to undertaking a review of the tariff structure part-way through the term of the undertaking. Such a review of prices may have the effect of increasing regulatory uncertainty, thereby counteracting the objectives of lodging an undertaking in the first place. On balance, the Commission considers that the concerns of operators are largely addressed in the undertaking, particularly given the fact that price structure is open to negotiation. The Commission does, however, seek further comments from interested parties on its initial assessment of ARTC's proposed two-part tariff.

The above discussion has not touched on the potential issue of congestion. In the event that volume growth leads to congestion problems at certain peak times in parts of the network, the ARTC undertaking has separate provisions which could be brought into play. Accordingly, the Commission does not consider that potential congestion problems are necessarily dealt with through changes to the price structure provisions of the undertaking. Congestion pricing is discussed in more detail in section D5.2.4.

D5.2.4 Efficiency considerations

In the Issues Paper, the Commission questioned whether the pricing principles contained sufficient incentives to promote efficient use of tracks by operators and efficient maintenance and investment in infrastructure by ARTC. The Commission also questioned whether, if access prices are only approximately set on the basis of costs, ARTC has little incentive to seek efficiencies and reduce costs over time.

ARTC proposal

ARTC argues that incentives to promote the economically efficient use of the asset by operators are embedded in equitable two part pricing. This provides a level playing field for above rail competition, encouraging maximum path utilisation to minimise the cost of access. The use of DORC is argued to provide efficient investment incentives, provided it recognises capacity enhancements.

Furthermore, ARTC claims that irrespective of whether prices are directly linked to costs, the inability of the access provider to achieve full CPI escalation (with any productivity allowance) means that the provider has incentive to seek greater efficiencies and reduce costs over time. ARTC adds that the contestable nature of infrastructure maintenance also provides incentive to maintenance providers to achieve cost efficiencies over time.

Views of interested parties

Queensland Rail

QR accepts that revenues to the rail track provider should not exceed the ceiling limit based upon the DORC valuation and efficient operating costs. Where this maximum revenue can not be attained, QR considers that the railway manager should be able to charge any price within the determined floor and ceiling limits, providing it does not distort competition. QR argues that in situations where a business is not recovering a return on its full asset value (as appears to be the case with ARTC), there is a strong incentive for it to seek efficiencies and cost reductions. QR adds that it is not necessary to attempt to enhance this incentive through regulatory measures.

National Rail

NR argues that to give incentive for productivity gains, the implied factor X should share benefits from provider efficiency gains between access provider and users. The X-factor is a constant 2%, which is broadly in line with historical experience. The X needs to be reviewed to ensure that if efficiency gains are consistently greater than 2% then the X is adjusted upwards to ensure that operators can share in the benefits of efficiency improvements. Thus there should be a review of the X after around two years to ensure that it is not understating the underlying assumption about actual efficiency gains.

SCT

SCT argues that it is not clear whether access costs reflect the efficient provision of infrastructure by ARTC. It adds that the access undertaking does not refer to the standard to which the network must be maintained, nor refer to the manner in which the

maintenance will be managed and in particular, whether a competitive tender process will be employed.

The undertaking should impose requirements on ARTC to demonstrate efficiency improvements by:

- introducing key performance indicators;
- comparing these to agreed targets; and
- reporting results of actual performance compared to targets.

SCT adds that it is not sufficient for the annexed access agreement to make reference to certain key performance indicators.

SCT also suggests that the undertaking does not ensure that access costs do not reflect the cost of maintaining sub-standard infrastructure and that future higher standards should not result in higher access prices unless operators directly benefit and past neglect is not an issue.

SCT argues that section 4.3 of the undertaking allows ARTC to unfairly discriminate between operators when pricing train paths. As an example, SCT states that ARTC may determine that two train paths are not alike because the duration differs between access agreements.

The undertaking has no provision that ensures that cross-subsidisation across different segments does not occur. The undertaking should expressly prohibit cross-subsidisation of other rail segments.

SCT notes that the undertaking does not allow for the access price to be regularly reviewed so as to require ARTC to reduce access prices in circumstances where ARTC has achieved benefits from increased rail usage.

State Rail Authority of NSW

SRA argues that the ARTC undertaking imposes no obligations on ARTC to ensure the integrity and longevity of infrastructure. SRA understands that ARTC considers itself accountable to its customers through its executed access agreements, but SRA does not believe that access agreements allow any single customer to ensure that the infrastructure is adequately maintained.

Commission's position

X-value

ARTC has made a commitment to capping the indicative access charge for a particular class of service. Price caps are usually specified in terms of allowing increases in line with CPI-X inflation, where the X-value represents a productivity component. Users of the indicative service are thus guaranteed to receive prices that, in real terms, are falling over time. One of the advantages of a price-cap approach in a regulatory setting is the incentives it provides to regulated businesses. Because prices are not linked to actual costs over the duration of the price cap, the business can increase profits by reducing

the costs of providing its services. Similarly, by only restricting price, the business also benefits from any increase in volumes, since these translate into increased revenues and profits.

Clause 4.6(c) of the undertaking effectively specifies the X-values, which in practice amount to a range between 0-2%.[76] The undertaking does not provide for these parameters to be revisited during the five-year tenure of the undertaking. The Commission considers this to be an acceptable approach, given the rationale behind having price caps at all. If the X-values were open to regular review, the incentives provided to the regulated business would be undermined. Efficiency gains would not accrue to the business that generated them, thereby removing any incentive for the business to pursue those gains in the first place.

An important further point to note is that the 'variation' articulated in clause 4.6 is an *option* to increase prices, not a commitment to actually increasing prices. It follows that, should ARTC be likely to lose significant amounts of business through increased charges, it would be unlikely to exercise its option to do so. The inclusion of this clause thus specifically prevents price increases above a certain level rather than guaranteeing any actual increases.

The Commission notes that ARTC has provided little justification for its choice of a 'greater than two-thirds CPI or CPI-2%' value for its price cap. Typically, an X-value might be chosen to reflect anticipated productivity gains. In the case of ARTC, where recovering the full economic cost of its business appears to be problematic (see section D5.3), it might be chosen such that ARTC reaches a point of full-cost recovery by a specified time. That said, it may be that this latter approach is not feasible given the nature of the market in which ARTC is operating. The Commission's assessment of ARTC's financial modelling tends to support the view that full cost recovery is unlikely to be achieved over the five-year term of the undertaking. Accordingly, there seems to be no reason for limiting price increases any further than ARTC has proposed; for example, to require ARTC to hold nominal prices constant over the next five years.

As noted in section D5.2.2, the indicative access charges only apply to the indicative service. Nonetheless, the Commission notes that clauses 4.5(a) and (b) of the indicative access agreement provide for a similar escalation for prices negotiated between ARTC and access seekers. Furthermore, clause 4.2(b) of the undertaking expressly requires the indicative access charge to be taken into account by ARTC when formulating charges for other services. Accordingly, the price capping approach is likely to have broader implications than just for users of the indicative service.

Incentives for investment

An important question that arises as a consequence of the price bounds ARTC has proposed relates to ARTC's incentives to operate and maintain the rail track infrastructure. Rail infrastructure is characterised by economies of scale and scope that

[76] Clause 4.6(c) specifies the allowable price increases as "the greater of CPI less 2%; or two-thirds of CPI". This means there is not a fixed X-value, although the *maximum* is 2%. In practice X will nonetheless be positive (in the specified range), and provide real reductions in prices to users of the indicative service.

mean it is productively more efficient to have a single provider of the service than multiple providers. A further characteristic of such a market, however, is a divergence between average costs and marginal costs of production given the level of market demand.[77] In general, marginal cost is lower than average cost in these markets (compared to competitive markets where the two values are generally the same). This has implications for pricing; for example, if a single provider is constrained to pricing at marginal cost, then in the long run it will not recover the full costs of providing the service, and ultimately will cease operations (assuming a profit-maximising firm). Conversely, if prices are set at the level of average cost, at the margin there will be users whose valuation of the service exceeds the marginal cost of providing the service but who are unwilling to pay the full average cost of the service. These users will be priced out of using the service and allocative efficiency losses to society result.

The Commission's analysis of ARTC's costs (chapter D5.3) suggests that ARTC is in a difficult position. Pressure from inter-modal competition appears to constrain ARTC from pricing at a level sufficient to cover the long-run average cost of providing rail track services. (ARTC's 'economic cost' concept is effectively equivalent to long-run average cost.) As a result, the Commission has some concerns regarding ARTC's incentives to continue providing the service over a longer time horizon. That said, as was noted previously, ARTC are pursuing a strategy designed to move, over time, to a position of full cost recovery. The Commission considers that, in the case of ARTC, pricing which is below these levels does not represent a misuse of market power. Rather, it reflects competitive pressure imposed by the strong competition from road. Full cost recovery is unlikely to occur during the term of the current undertaking since, given the limitations on pricing imposed by the undertaking, the volume growth required to achieve it is very high.

Pricing at levels below the full economic cost of the infrastructure also has implications for ARTC's incentives to *increase* capacity or quality through new investment. In general, a service provider is unlikely to have an incentive to invest where it cannot recover its economic cost of making that investment. This may give rise to *dynamic* inefficiency – the loss of future welfare resulting from investment falling below efficient levels. That said, the ARTC undertaking applies primarily to the existing infrastructure: clause 2.1(c) expressly excludes any extensions to the [existing] network from the scope of the undertaking.[78] The Commission considers that new investment in the existing network, should it become necessary for the provision of certain services, can and should be adequately dealt with by negotiation between ARTC and the party or parties who benefit from the investment. The Commission also notes that this stage, it is not apparent that network capacity is a major issue.

Accordingly, despite some concerns about the economic sustainability of the infrastructure, the Commission has no objections to ARTC's proposed approach in relation to the incentives for investment. In stating this view, the Commission notes that such concerns have not dissuaded ARTC from voluntarily submitting its undertaking.

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[77] Costs include the opportunity cost of capital. This is measured with reference to the DORC valuation of ARTC's assets (see section D4.4.3).

[78] If ARTC becomes the provider of rail services using track that is not part of the network defined in the current undertaking and previously owned by a government or government authority, clause 2.1(d) commits ARCT to lodging a separate access undertaking in respect of that track.

The Commission would not in general *require* such an approach to be adopted in voluntary undertakings from access providers.

Incentives for use of the ARTC network

A positive aspect of the competitive constraint faced by ARTC, however, is the implications it holds for users of the ARTC network. Constrained pricing means a greater number of users find it economically viable to use the ARTC track. Accordingly, allocative efficiency losses are significantly lower than may be the case in other infrastructure markets. ARTC's market is thus characterised quite differently to most 'monopoly' markets, one in which productive and allocative efficiency are not the primary concerns. Rather, the main economic concerns relate to dynamic efficiency.

Associated with this problem is the possibility of government funding to accommodate investment needs. Such funding is potentially distortionary in an efficiency sense.. If new investment in rail infrastructure cannot be funded through increased revenues either from additional volume or increases in price, then the shortfall presumably represents government funding. The investment might still be justified, provided it passes a more strict 'global' cost-benefit test; ie the total social benefits exceed the total social costs of the investment. These social costs would include any distortions arising as a consequence of the manner in which the government funds have been raised.

However, provided prices are not set to a level *below* marginal cost, welfare losses should be minimised by allowing prices to be determined competitively; ie by what users are prepared to pay. In practice, it is unlikely (in the absence of community service obligations [CSOs] that prices would fall below marginal cost, as additional users at these price levels will reduce ARTC's profits.

It should be noted, though, that ARTC's floor limit is defined by reference to *incremental* cost rather than marginal cost. This distinction is important: "marginal cost of a service is the additional cost that would be incurred in order to supply an additional unit", while "incremental cost of a service is the cost per unit of service necessary to provide the entire service…given all the other services supplied".[79] Marginal cost is thus like a unit incremental cost. The Commission is not convinced that ARTC's description of 'incremental cost' reflects the definition given here. ARTC's definition distinguishes between geographic segments rather than services, and might be more appropriately described as an avoidable cost methodology.

Nonetheless, the floor limit as it is currently defined is likely to achieve the objectives for which it has been included. In the Explanatory Guide to the undertaking, ARTC suggests that the floor limit is designed to 'ensure that unprofitable parts of the rail network are not cross-subsidised by highly profitable parts of the network'.[80] ARTC argues that this is similar to 'combinatorial' tests used in other access regimes. The Commission notes that the incentives for a vertically separated access provider to cross-subsidise certain services or segments is limited. Accordingly, the Commission has no particular objections to the principles which ARTC has adopted for formulating

[79] Kessides, I.N., and Willig, R.D., *Restructuring Regulation of the Rail Industry for the Public Interest*, World Bank Working Paper 1506, September 1995, p. 32.

[80] Australian Rail Track Corporation, (3) *Draft Access Undertaking: Explanatory Guide*, February 2001, p. 8.

a floor limit. However, the definition contained in clause 4.4(b) might be clarified to better express this principle. The undertaking could be amended to remove any potential ambiguity as to the definition of the floor limit and how it is calculated.

Congestion

Part 4 of the ARTC undertaking does not make any specific mention of pricing in the event of congestion on the network. While in general it seems likely that there exists sufficient capacity to cope with demand, particular time slots are more highly sought after than others.[81] It may be the case that a number of access seekers are competing for the same train path.

In these circumstances, it would generally be appropriate for the price of the sought after path to increase. In an unconstrained market, price would increase until all the access seekers *except* the one who values the path most highly are unwilling to pay the asking price. This is an efficient outcome, as the path is allocated to the user who values it most, at a price below that user's valuation of it (otherwise the user would not have agreed to that price). Such an outcome might be facilitated through an auction of the train path. Indeed, this approach has been encouraged by the Productivity Commission.[82]

An auction mechanism has the advantage of simultaneously dealing with the related question of price and allocation of a particular path. Such an approach also allows the market outcome to reflect demand-side considerations, rather than just mandating supply-driven concerns. The Commission notes, however, that auctioning of train paths is a complex exercise, and almost certainly not feasible to implement for the purposes of the current undertaking. It should also be noted that the use of auctions does not guarantee efficient outcomes; in a number of situations the use of auctions can lead to unsatisfactory outcomes.

One of these situations is the case of a natural monopoly. For this reason, the Commission has closely examined ARTC's proposed approach to allocating capacity between competing users. Clauses 3.9(d) and 5.2(b) of ARTC's undertaking reserve to ARTC the right to negotiate and allocate a train path which is the subject of competing requests to the access seeker which ARTC considers to provide the highest present value of future returns to ARTC.[83] This does not mean, however, that ARTC is able to award the path to the access seeker which is prepared to pay the most for it. The constraints on pricing introduced under clauses 4.2, 4.3, 4.4 and 4.6 would continue to apply. Rather, the 'highest present value' criterion is likely to allow ARTC to award the scarce capacity to the applicant which is seeking the longer path, is prepared to enter

[81] The Commission received few comments suggesting that capacity on the ARTC network was significantly constrained. ARTC does note, however, that "due to the nature of freight traffic demands, it is not unlikely that two or more operators may request the same Access Rights on the network" , ARTC, (2) *op. cit.*, p. 31.

[82] Productivity Commission, *op. cit.*, pp. 180-185. This report also argued that an auctioning system should be supported by some allowance for secondary trading of allocated train paths to be fully efficient.

[83] The present value of future returns might involve a consideration of non-price terms and conditions. For example, it may be that one access seeker is prepared to enter a longer-term agreement than others.

into a longer term agreement with ARTC, or in some other way offer ARTC a more attractive commercial proposition. ARTC's undertaking thus precludes it from conducting a genuine auction.

SCT argues that auctioning of train paths will reduce competition in the above-rail market because auctioning favours larger companies.[84] The Commission does not agree with this view. Rather, the path would go to the user which values the path most highly; if this is a larger company, then it is likely that its higher valuation of the path reflects the fact that there are some economies of scale in the above-rail business. It does not necessarily imply that the auction mechanism itself is problematic. It should be noted, though, that allowing ARTC to capture scarcity rents in the short term – by levying higher charges for paths at congested times - might actually translate into a monopoly rent in the long term, as ARTC is in a position to create congestion by restricting capacity. That said, the competitive constraints discussed earlier limit the extent to which this would be likely to occur.

In light of this discussion regarding the allocation of scarce capacity, the Commission considers ARTC's proposed approach has merit. The main concern that might arise here is the extent to which this approach might allow ARTC to engage in pricing practices that generate monopoly rents. In this context, the Commission's view is that the ARTC undertaking contains sufficient safeguards to prevent such outcomes materialising. Specifically, clauses 4.3 and 4.4 – relating to the limits on pricing and price differentiation – would continue to apply. The rights granted by clauses 3.9(d) and 5.2(b) are of a general nature that can be applied subject to the specific constraints of Part 4 of the undertaking.

Even without the limitations set out in Part 4 of the undertaking, the extent to which ARTC would be able to raise charges at congested times will have some limitations. These include the inter-modal competition from road (demand-side substitution) and the ability of access seekers to substitute the preferred path for an alternative path at a time where congestion is less of an issue (supply-side substitution). While the Commission recognises that some times are strongly preferred by users, it is not inappropriate for charges at these times to be higher than those for off-peak times. Indeed, ARTC might offer a discount to users prepared to utilise the network during off-peak periods.

It should also be noted that ARTC's commitment to publishing capacity and service quality measures should provide a degree of transparency to the process of determining whether or not congestion does, in fact, exist.

Other efficiency considerations

ARTC's incentives in relation to service quality were discussed in chapter D5.2.2. For the reasons detailed in that section, the Commission considers that ARTC faces appropriate incentives to maintain and improve service quality. That discussion also noted that detailed service quality standards are not an essential component of ARTC's undertaking, given the inclusion of a 'fit for purpose' clause in the undertaking.

[84] SCT *Submission*, p. 11.

The above discussion refers to possible distortions that may arise given the potential for government involvement in the rail industry. Furthermore, a number of submissions have suggested that the extent of government funding of the ARTC network should be taken into account in determining access charges.

ARTC's status as a government-owned entity is not unique: government ownership often coincides with industries subject to regulatory oversight. In this context, paragraph 13.2(4)(b) of the Competition Principles Agreement notes that independent prices oversight of government business enterprises should have as its prime objective efficient resource allocation. Accordingly, the Commission considers it appropriate to assume that ARTC, being a corporatised entity, faces the same commercial incentives as privately owned businesses. In practical terms, an example of this approach is the fact that the Commission accepts a DORC valuation of the ARTC network rather than historic cost (which some submissions have argued for).

D5.3 Assessment of cost based model

D5.3.1 Floor/ceiling test

In the Issues Paper the Commission questioned whether the definitions of "floor" and "ceiling" revenues are appropriate, and whether the ceiling limit was defined in such a way that ARTC cannot exercise market power.

ARTC proposal

ARTC proposes 'combinatorial' floor and ceiling tests to the revenue it could extract from the network. That is, prices must be such that the total revenue extracted from a segment or group of segments on the network must be no less than the incremental cost (costs avoided if the segment or group of segments were removed from the network), nor greater than the full economic costs of the segment or group of segments. ARTC argues that a similar test is used in most other existing rail regimes in Australia.

The undertaking allows for revenues to be higher than the ceiling limit, or lower than the floor limit, but only where agreed by the operators and ARTC respectively. The floor limit for revenues on a segment is the cost that would be avoided if the segment (or group of segments) were removed from the network. The ceiling limit for a segment is the full economic cost of the segment (or group of segments).

A portion of infrastructure maintenance expenditure has been directly identified with segments. ARTC argues that as information systems improve over time, this portion could be expected to increase. Depreciation and return are also directly identified with segments. Remaining maintenance expenditure as well as contract management, train control, operations management and system management have been allocated to segments in accordance with the cost allocation rules identified in the undertaking.

ARTC argues that the floor and ceiling revenues are effectively set so as to ensure more profitable parts of the network do not 'cross-subsidise' unprofitable parts. In other words, revenues would be maintained so as to lie between the floor and ceiling limits on any segment. ARTC argues that, in most cases, revenue extracted for each segment lies between the floor and ceiling limits. ARTC notes that this is certainly the case on

ARTC's key 'trunk' segments between Albury/Broken Hill and Parkeston. As such, ARTC considers that there is no cross-subsidisation between parts of its network.

ARTC states that the nature of its business (where significant inter-modal competition exists in ARTC's downstream business) does not permit ARTC to have 'market power' despite it controlling a monopoly asset with respect to some customers.

In addition, ARTC argues that its objective to grow the rail freight market is contradictory to the use and abuse of market power. ARTC considers that the definition of ceiling revenue limits as proposed has little bearing on the commercial negotiation of access pricing in such an instance. The ceiling limits serve more as revenue targets for future market growth.

Views of interested parties

New South Wales Government

The New South Wales Government supports the floor/ceiling approach to pricing taken by ARTC, noting that this approach has also been taken in the New South Wales rail access regime.

Queensland Rail

QR argues that ARTC's "floor" and "ceiling" approach varies in some aspects from the generally accepted constrained market pricing limits. Under QR's proposed methodology, revenue limits are applied to both the individual train service and to any combination of train services (for example, all services operating in the system in which that individual train service operates). QR argues that it therefore,undertakes both a combinatorial test and an individual test to ensure there is no cross subsidisation between individual train services or between combinations of train services.

QR states that by contrast ARTC's proposed pricing methodology does not make provision for both an individual test and combinatorial test to determine pricing limits. Under ARTC's definitions, the floor limit means the charges which, if applied to all operators on a segment or group of segments, would generate revenue for ARTC sufficient to cover the incremental costs of that segment or group of segments. QR notes that similarly ARTC defines the ceiling limit to mean the charges which, if applied to all operators on a segment or a group of segments would generate revenue for ARTC sufficient to cover the economic cost of that segment or group of segments. QR contends, therefore, that the price limits for individual services are determined by an average cost methodology which would result in a lower ceiling limit and a higher floor limit than under the more typical constrained market pricing approach used by other railway managers.

QR recommends that ARTC incorporate a more typical constrained market pricing approach. QR not only considers such an approach to be more economically sound, but also believes that it has the added benefit of facilitating consistent pricing principles across various rail access regimes.

National Rail

NR argues that the definitions of floor and ceiling revenues are appropriate. It believes it is not necessary to have a combinational test because it is unlikely ARTC will have significant scope for price discrimination. This is not surprising given the relatively homogenous and competitive market served by ARTC. The market power of ARTC is constrained by competition from road transport.

SCT

SCT notes that the calculations used to arrive at the floor and ceiling revenues have not been provided in the undertaking. In particular, the DORC approach to asset valuation is not an appropriate measure of economic cost. It adds that there is no evidence to suggest that the ceiling revenues have been defined in such a way that ARTC cannot exercise market power.

Great Southern Railways

GSR expresses concern that the floor/ceiling approach is not the best available as it is subjective and reliant on potentially arbitrary assumptions. Furthermore, in ARTC's case, the bands are so far apart that they do not set meaningful constraints on ARTC's indicative prices.

FreightCorp and Toll

The FreightCorp/Toll submission notes that the floor/ceiling limits are consistent with economic tests to ensure the track owner's market power is not being misused. However, the distance between the two measures in the case of ARTC means that they provide negligible price certainty to track users.

South Australian Independent Industry Regulator

SAIIR notes that the ARTC undertaking provides minimal detail on the principles and methodologies underlying the definition of stand-alone economic cost or avoided cost.

Commission's position

The Commission considers that the inclusion in ARTC's proposed undertaking of floor and ceiling revenue limits provide one form of constraint on ARTC's pricing. Clauses 4.2 and 4.6 introduce further such constraints, and it will often be the case that it is these constraints with which a particular operator will be primarily concerned. Nevertheless the floor and, particularly, ceiling revenues are important for forming views as to the competitiveness and viability of the service provided by ARTC and for the determination of charges for new services.

The proposed undertaking ties the revenue floor to the concept of incremental cost. ARTC's undertaking contains the following definition of incremental costs:

> For the purpose of this clause, incremental costs means the costs that could have been avoided if a Segment was removed from the Network excluding Depreciation and a return on assets employed, such return being an amount determined by applying to WACC to the DORC associated with the assets. (Clause 4.4(b)).

The financial model ARTC provided to the Commission provides a better description of what is included and what is excluded from the definition. Examples of items included as incremental costs are:

- contract maintenance for the track and signalling and communications assets;
- train control and communications;
- contract management costs (in part);
- train planning and administration (in part);
- corporate, finance and administration costs (in part);

Examples of items that are not included as incremental costs are:

- maintenance of facilities and buildings that are dedicated to the particular segment;
- depreciation;
- return on capital.

In choosing an avoidable cost approach as a floor, ARTC has focused on ongoing cash costs, such as commitments under contracts. Whether such costs represent an appropriate floor is not strictly a question that the Commission is best placed to answer. The Commission notes however that, in the longer term, there is a lack of incentive to invest in assets that do not earn an economic return. Further, there is a risk that prices struck at below economic cost may encourage inefficient entry into the downstream market. In shorter time periods however it may be efficient to price below cost if the result is that demand is established that will eventually provide an economic return.

The floor chosen by ARTC appears designed to ensure that ARTC can meet the immediate cash commitments associated with providing the service, although ongoing revenues at this level may not allow for financing or replacement of the assets providing the service. Bearing this in mind the Commission prefers to leave decisions regarding pricing below economic cost to the discretion of the asset owner or to be negotiated between the asset owner and users. As such the Commission does not object to ARTC's methodology for determining a revenue floor for its segments. The Commission does, however, take the view that ARTC's undertaking should refine its definition of incremental costs to more clearly express what is included and what is excluded.

In determining a ceiling for revenues ARTC has adopted a definition of "Economic Cost". The meaning of economic cost in the context of the undertaking is defined by example in Clause 4.4(d). Economic cost includes:

- costs specific to a segment;
- the costs of additional capacity;
- depreciation;
- return on segment-specific assets; and

- an allocation of overhead costs.

Essentially, economic cost is defined to include all costs that are attributable to the provision of a service over a segment. Such an approach is comparable with the "building block" approach endorsed by the Commission in its Draft Regulatory Principles (DRP).[85] The adoption of a cost-based "building block" methodology to arrive at a revenue ceiling or "cap" is an appropriate approach to constraining an asset operator to charging levels that could be expected in the presence of competition. Revenues at this level also allow the asset owner a return on assets and to allow an efficient asset base to be maintained. ARTC's application of the DORC asset valuation, the cost of capital and operating costs are explored elsewhere in this draft decision.

Within the proposed undertaking, "additional capacity" is a defined term. Additional capacity as defined would appear to exclude excess capacity. A further constraint on pricing for excess capacity is provided by the DORC valuation process which limits returns on assets to those required for future growth.

The commitment to prices reflected in the indicative access charges essentially means that ARTC can only achieve its ceiling revenues through the annual price changes and/or growth in the volume of traffic carried. Further, the undertaking's proposal to not price discriminate between services that are alike combined with the commitment to publish new prices that may be negotiated appears to restrain ARTC from moving beyond its revenue ceiling except through volume growth in the short to medium term. The Commission's position is therefore that it does not object to the approach that ARTC has used to derive a ceiling for revenues. The Commission has analysed ARTC's application of the approach and has recommended that ARTC make some refinements to calculation methodology.

Regarding the "combinatorial" test, the Commission is of the view that ARTC's description could benefit from greater clarification. The term "...the Charges which, if applied to all Operators on a Segment or a group of Segments" is uncertain. For example, does it mean that if a new price is struck for a new service an a particular segment, then that price is notionally applied across all existing services regardless of which indicative category they fall into in order to test whether the revenue floor or ceiling is breached?

Finally, the Commission is concerned about the possibility of prices leading to revenues that fall outside the bands. Although interested parties have not expressed concerns with ARTC's approach, and the "right of veto" may theoretically protect users from pricing above economic cost, it seems possible that in a case where downstream competition is less than perfect users may agree to the higher prices even where they breach the revenue ceiling. Such a situation would have potentially adverse consequences for allocative efficiency.

The Commission also invites comment from interested parties as to whether users or access seekers would be in a position to establish where ARTC's revenue limits actually lay on any particular segment.

[85] Australian Competition and Consumer Commission *(1) op. cit.*

Setting revenue limits is a forward-looking exercise and there are some circumstances where the Commission expects that actual revenues could exceed predicted revenues. An example of this occurs where actual traffic or volume levels exceeds those forecast. Such a phenomenon should however be allowed for such that on average and over the medium term the firm does not set charges that exceed the stand alone cost of providing the service.

D5.3.2 Use of DORC

In the Issues Paper, the Commission raised the question as to whether ARTC's use of DORC to value is assets was the most appropriate methodology.

ARTC proposal

ARTC is of the view that the DORC methodology is appropriate in the case of its infrastructure assets. The ARTC believes that a major advantage of DORC compared to other methodologies is that it replicates the asset valuation outcome in a competitive market. In particular, ARTC argues that it provides a disincentive to the infrastructure operator to 'gold plate' its asset base by not allowing redundant or excessive assets and technologies to be included in the asset base (an efficient outcome which would result in a competitive market). In addition to adjustments for depreciation and optimisation, ARTC supports the requirement that the valuation should be 'forward looking' and take into consideration reasonably forecasted demand for the infrastructure with respect to volumes, service levels and performance.

A further benefit seen by ARTC of adopting a DORC valuation is that such an approach would result in some consistency in regulatory asset valuation throughout Australia. This will benefit the interstate rail freight industry, which represents a dominant portion of ARTC business.

The ARTC notes that it has adopted an independent, transparent valuation approach and outcome as part of its application. The report 'ARTC Standard Gauge Rail Network DORC' prepared by independent transport economics consulting group Booz Allen & Hamilton (BAH) has been included in documentation supporting the undertaking application. The ARTC argues that this has been done to reduce uncertainty and any lack of transparency surrounding the calculation of revenue floor and ceiling limits. ARTC claims that the methodology employed by BAH is similar to that used in previous valuations.

ARTC argues that the BAH assessment understates the value of the network in that it does not fully address the current and future demand characteristics of businesses using the network. ARTC claims that improved capability and performance is being extracted from assets that have been in place for some time and have previously operated at a lower standard, with the same or higher ongoing maintenance cost. ARTC argues that by taking a narrow view of future demand in a DORC valuation, as has been done, only the existing assets are considered sufficient to meet current demand and growth (despite being previously considered insufficient without capital investment). It states that there is no incentive for the infrastructure operator to seek ways of improving capability and performance of the existing asset base. In fact, if the infrastructure operator can achieve this at a lower cost of maintenance, it is penalised via a lower access price. On the other hand, investment in the current asset base to achieve the

same end is rewarded via an increased valuation, whether or not such an approach is the most efficient means to achieve that end.

ARTC therefore proposes that a wider view of current and future 'demand' should be taken in assessing the asset requirement to meet existing capacity. Where higher demand with respect to asset capability and service performance has been met through the extending existing engineering capability at no additional operating cost, the asset base for valuation purposes should include the alternative (higher) cost of investment that might have been made to achieve the same capability and performance had the existing asset not been 'sweated'.

Without any adjustment to account for the narrow view taken by BAH in the valuation of ARTC's assets, ARTC would consider the valuation very conservative.

The depreciated component of asset life is generally measured in terms of asset age or asset condition. The choice of method often depends on the observability of condition, availability of information and the extent to which asset condition is maintained over time. Where assets are maintained with a view to significantly extending useful life, an asset condition assessment is more appropriate. In the assessment carried out by BAH, information with respect to the current condition of the asset was used where appropriate and where data was available and useful. This applied with respect to a major proportion of the asset base. Detailed information regarding the methodology employed, sources of information, and conclusions drawn is provided in the BAH report.

In its application, ARTC has proposed to annually increase the regulatory asset base by CPI during the term of the undertaking, for the purpose of ceiling revenue limit calculation. This has been so as to merely allow for the increased replacement cost, as originally contemplated, of the original optimised asset base and recognises the forward-looking nature of the initial valuation in terms of an allowance for growth only, as has been assumed in the BAH valuation.

Views of interested parties

Queensland Rail

QR agrees that the DORC valuation methodology provides the most appropriate initial capital base for calculating revenue limits for rail infrastructure, provided the optimisation is conducted in an appropriate manner.

DORC is the appropriate asset valuation methodology for use in the rail industry.

PTM

PTM Strategies, however, argues that the use of DORC as the asset base on which ceiling prices are determined should not be accepted. PTM strategies contends that the asset base on which a return should be based should be the owner's actual investment in the facility. PTM Strategies' supplementary submission adds that, to the extent that infrastructure is leased, then there is no "owner's investment." DORC is not consistent with the concept of 'owner's investment'. Ceiling revenues should only include assets

actually owned. For leased assets, only the lease cost should be included as a valid expense.

SCT

DORC should not be used to value assets. SCT argues that in calculating DORC, it is not appropriate to assign a value to an asset for which the ARTC incurred no cost in acquiring or constructing. It states that a depreciated actual cost methodology would be appropriate. SCT similarly contends that where assets have been built as a result of government grants, no costs should be attributable to these assets.

SCT takes issue with BAH's argument that the cost of investment to raise standards will be allowed into the asset base once the raised standards are in place. SCT contends that this should not be the case unless those higher standards directly benefit operators and they are not the result of past neglect.

NSW Government

The New South Wales Government argues that its approach to rail access pricing would appear to contain more constraints on pricing than that of ARTC. In ARTC's DORC valuation of assets, ARTC has included formation value such as earthworks (which includes cuttings and embankments) while the NSW regimes valuation of assets does not.

National Rail

NR argues that DORC is an appropriate asset valuation methodology in the rail industry.

NR comments on the annual revision of DORC in line with CPI. It strongly supports ARTC's recently released network audit, which proposes new investment of $507 million in the rail network, of which approximately quarter is in the rail network that is the subject of this undertaking. It believes that a 'CPI-X' approach to DORC (where CPI has no logical relationship to future investment and where X = zero) is an arbitrary and unsatisfactory way to make up a shortfall in notional future network investment. It contends that a more acceptable approach to this issue would be to:

- upscale the DORC valuation to take account of the portion of the proposed investment program which applies to the ARTC's network; and
- formally review the DORC at the end of 2004, to incorporate any other actual or planned investment in the ARTC network.

Freight Australia

DORC is not the appropriate valuation approach, it is not a reflection of the 'owner's investment' as provided for in Part IIIA. Valuations should be restricted to the actual dollars invested by the owner. Alternatively, any increase in value arising as a result of the DORC valuations should be considered part of the earnings of the access provider.

FreightCorp and Toll

FCT argue that:

> ARTC's asset base is largely "gift-funded" by the Commonwealth. That is the case both historically and with respect to ongoing investments. Arguably the Commonwealth's intention is to donate assets to ARTC to improve rail's viability versus road, rather than to make commercial investments in a business which is earning less than 2% return on (DORC-valued) assets.[86]

While not criticising the use of DORC of itself, FCT argue that the resulting distance between the floor and ceiling revenues makes the exercise "...nearly useless as a means of creating price certainty for rail traffics".[87]

Advisers to FCT, NECG, also raise concerns regarding ARTC's application of the DORC methodology. Specifically, NECG question the inclusion in the regulatory asset base of assets that have been financed by the Commonwealth. NECG also note that "...the majority of infrastructure investment was and continues to be funded by Commonwealth grants".[88]

Commission's position

The Commission's view, expressed in the DRP, is that DORC is an appropriate methodology for the economic valuation of infrastructure assets as it represents a measure of forward-looking, long-term replacement cost. In raising the appropriateness of DORC as an asset valuation in its Issues Paper the Commission was interested in possible reasons why DORC may be unsuitable for ARTC's particular circumstances.

A number of parties have raised concerns regarding ARTC assets that were funded through Government grants. Infrastructure that has been financed by the Commonwealth may be considered separately as existing infrastructure that has been financed by Commonwealth grants in the past and future infrastructure development that will be financed by ongoing Commonwealth grants. Regarding existing, or "sunk", infrastructure, any adjustment to DORC to allow for a previous imbalance between the historical level of cost recovery on road freight versus rail freight would at best involve a very difficult measurement process. Additionally, going forward, any such adjustment would become less relevant given that existing revenues are currently significantly below the ceiling and charges for road use have been subject to some adjustment with the introduction of the New Tax System.[89]

Regarding ongoing Commonwealth grants, the Commission sees merit in NECG's view that such funding needs to be taken into account in determining floor and ceiling

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[86] Freight Rail Corporation and Toll Rail, *op. cit.*, p.25.
[87] *ibid.*
[88] *ibid.* p.44.
[89] The Commission understands that under the New Tax System introduced from 1 July 2000, rail transport businesses can claim a 100% rebate for Federal excise paid on diesel fuel. Rebates on diesel excise for road transport businesses are limited to 18.51 cents per litre (out of a current Federal excise of 38.143 cents per litre).

revenue limits. This view is consistent with that of the NCC in its Final Recommendation regarding the Darwin to Tarcoola rail line.[90]

The Commission recommends that ARTC set out how it intends to allow for the value of expenditure on infrastructure which is refunded by Government.

A number of submissions raised the issue of the "owner's investment" and argued that ARTC's charges should relate only to those assets that it owns outright. The concept of "owner's investment" arises in Part IIIA of the TPA in relation to access disputes over declared facilities. Part IIIA provides that in making a determination on an access dispute the Commission must, among other things, take into account "...the legitimate business interests of the provider, and the provider's investment in the facility".[91] Another consideration the Commission is bound to have in the determination of an access dispute is "...the economically efficient operation of the facility".[92] Consideration of the s.44X criteria is not relevant to the Commission's decision on whether to accept ARTC's proposed undertaking, which is based on the criteria in s.44ZZA.[93] This notwithstanding, the Commission is of the preliminary view that criteria provided in s.44X would not restrict prices to those based on the historic cost of amounts invested by the access provider, particularly where the result of doing so may lead to operation of the facility that is not economically efficient.

The Commission employed cost consultants Currie & Brown to review the DORC valuation carried out for ARTC by BAH. A copy of the Currie and Brown report is available from the Commission's web-site. The report largely supports BAH's valuation and concludes that, using benchmarked costs, the ORC value "...could be approximately 10% too low". The Commission does not therefore object to the DORC value of the assets used by ARTC as a starting point.

From this starting point, ARTC has proposed to index the DORC value going forward using CPI. Explaining this approach, ARTC's David Marchant commented:

> (the CPI) was put against the reference service price to provide certainty, clarity and capping so that the market could actually have a transparent base to deal with against the indicative access service agreement so on the second issue, then, relates to the DORC with regard to the CPI and the DORC actually comes from a slightly different angle with regard to those issues. It is quite simply dealt with a CPI minus X basis - a CPI basis I should say and is not there again as a surrogate for the productivity.[94]

The Commission understands that applying an indexation factor to DORC can have the effect of providing an approximation of a service provider's DORC at points in time between valuations. Leaving aside for one moment optimisation and depreciation the change in DORC over a period of time for a given set of assets could be expected to

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[90] National Competition Council *Australasia Railway Access Regime – Application for Certification under Section 44M(2) of the Trade Practices Act 1974 – Final Recommendation* February 2000. The NCC's decision was to allow the regulator of the Darwin to Tarcoola track discretion to adjust the DORC valuation of assets to account for government-contributed assets and other government financial assistance.

[91] S.44X(1)(a) of the *Trade Practices Act 1974*.

[92] S.44X(1)(g) of the *Trade Practices Act 1974*.

[93] See, however, the discussion regarding access disputes in chapter D4.

[94] Australian Competition and Consumer Commission, (3) *op. cit.*, p.20.

vary by the rate of inflation and the rate of technological change. By indexing DORC by CPI, ARTC is assuming that advances in technology will have no significant effect in reducing the cost of replacing the asset. The Commission notes however that ARTC claims to have assumed some future efficiencies in its Major Periodic Maintenance.

The Commission does not object to ARTC indexing its asset base.

ARTC's comments regarding the degree of optimisation assumed in BAH's DORC valuation and the potential disincentive for ARTC to seek asset efficiency is more a question of benefit sharing than DORC itself. It is difficult to see how ARTC's incentives are adversely affected when current prices are currently set below those that would recover the full economic cost of the service provided. It is noted that Currie & Brown support BAH's view of allowance for future demand.

D5.3.3 Depreciation

ARTC proposal

ARTC has opted for a straight line method of depreciation applied to the DORC value of the asset base. In calculating an annual depreciation charge, ARTC has taken into account both the useful life and the economic life of its physical assets bearing in mind the economic life of businesses using the infrastructure and technological obsolescence. The useful life of ARTC's assets is kept at a "steady state standard in perpetuity" through regular maintenance which is expensed and passed on to operators as part of the access charge. As the assets do not decay, the component of the depreciation charge which is intended to reflect the gradual erosion of the assets' physical capabilities is zero. As for the economic life of the asset base, ARTC considers that neither loss of rail freight business nor technological changes are likely to render the tracks "stranded". As such, track assets are deemed to have an infinite economic life and thus no depreciation is required. However, some assets are deemed to have a limited economic life due to the possibility of technological obsolescence, viz signalling and train control assets, communications equipment and cabling. A depreciation charge of $6.8 million is included in the revenue ceiling limit in respect of these assets.

ARTC has proposed to differentiate certain components of its asset base with regard to the characteristics of the decline in the economic value of these assets. Specifically, ARTC has chosen not to depreciate its track, formation and structures related assets for the purposes of inclusion in the ceiling revenue limits. It was also concluded that, because railway tracks are generally maintained to a steady-state standard through the application of expensed Major Periodic Maintenance (MPM), the physical assets have a perpetual useful life. For these reasons, no depreciation with respect to track assets has been included in revenue ceilings to avoid any possibility of double counting MPM in operating expenses and as a depreciation charge.

ARTC has also chosen to depreciate its signalling and communications assets over the estimated technological (economic) life. The BAH report estimated the useful economic life of the various asset types owned or leased by ARTC. BAH assumed an economic life of 30 years with respect to signalling assets, and 15 years (radio equipment) and 20 years (cabled communications backbone systems) with respect to

communications assets, consistent with other assessments it has made. Modelled depreciation determined for these assets simply applied these lives on a straight-line basis to the optimised replacement costs for these assets determined on a segment by segment basis.

ARTC has proposed to depreciate its depreciable assets on a straight-line basis. ARTC favours this method on the basis of its ease-of-use and transparency. ARTC notes that the use of the straight-line method of depreciation has been employed in access regulation for a number of other industries.

Views of interested parties

Queensland Rail

QR argues that ARTC is best placed to determine the nature of its own assets and the asset life that best represents their character. However, QR considers that the assumption of an infinite track life would be inappropriate to QR's rail infrastructure.

QR notes that the adoption of straight line depreciation is consistent with the approach that will be incorporated in QR's undertaking.

Straight line depreciation is consistent with the approach incorporated in other rail access regimes, including the assumption of infinite track life.

Commission's position

ARTC has assumed the "steady state standard in perpetuity" for the majority of its assets, representing 93% of DORC. In such circumstances the levelised MPM becomes a proxy for depreciation in that, by any name, the resulting revenue "building block" represents a funding of asset refurbishment, renovation and/or replacement. Therefore, a relevant question for the regulator is whether the level of MPM is greater than a notional depreciation charge.

The Commission employed cost consultants Currie & Brown to review ARTC's assumption of "steady state standard in perpetuity" and its relationship to the level of MPM. Currie & Brown noted the relationship of the MPM charge to ARTC's 15-year rolling Asset Management Plan and described the approach as "reasonable"[95].

A further check on the reasonableness of the level of the MPM charge can be made by comparing the implied depreciation charge for the "steady state" assets in the 2001 financial year to the 2001 MPM charge. ARTC's MPM charge for 2001 is $15.5 million compared to assets with an ORC value of $2,329.1 million[96], which implies a weighted average useful life of approximately 150 years. This may be compared to an estimation of a weighted average useful life using the BAH (Table 15) ORC values and depreciation rates drawn from the BAH report and ARTC's 2000 Annual Report. Based on this information the Commission derived an estimation of approximately 105

[95] Currie & Brown, *Report on Review of ARTC's Access Undertaking Submission to Commission*, October 2001, available from the Commission web-site at http://www.accc.gov.au.

[96] The ORC figure of $2,329.1m is the result of removing the ORC value of the depreciating assets (Signals and Train Control, Communications) from the total ORC value of $2,514.5m. The MPM charge of $15.45m excludes MPM for assets associated with Signals and Train Control, and Communications.

years.[97] This suggests that ARTC has not developed an MPM charge that would allow a faster return of capital than an engineering assessment of useful life would estimate as being appropriate.

For those assets that are assumed to depreciate, representing approximately 7% of DORC, ARTC has adopted the useful lives as in the BAH report of:

- Signalling, train control and safe working – 30 years;
- Communications (radio equipment) – 15 years;
- Communications (cabled backbone systems) – 20 years.

Currie & Brown comment that BAH's approach to determining depreciation formed a "reasonable basis".

The Commission's conclusion is therefore that the depreciation charges and the assumptions regarding the "steady state" assets included in ARTC's proposed undertaking form a reasonable basis for determining a rate of return of capital.

D5.3.4 Weighted average cost of capital

The weighted average cost of capital (WACC) indicates the risk-adjusted rate of return to be earned by debt and equity capital providers. The rate of return reflects what these investors could be earning by committing their funds to an alternative project of similar risk; that is the opportunity cost of capital.

ARTC bases its approach to WACC on a report resulting from an independent assessment of ARTC's WACC by investment banking consultants, Equity & Advisory (E&A). E&A have utilised the capital asset pricing model (CAPM) in order to establish WACC.

The submissions and the Commission are supportive of the use of the WACC/CAPM model. The contentious issues concern the appropriateness of the parameters used to build up the WACC. These are discussed below.

Risk free rate

ARTC proposal

Equity & Advisory argues that bond rate maturity should match asset lives. Whilst in this case, the average life is longer than ten years, the markets for very long term bonds are not very liquid and hence volatile. Therefore ARTC adopts the yield on 10 year government bonds for the risk free rate assumption. The rate adopted for the undertaking is 5.46%.

[97] The Commission based its estimation on the ORC values in the BAH report and the following depreciation rates for each category: Track (including rail, sleepers and ballast) – 90 years; Earthworks – 250 years; Structures – 100 years.

Views of Interested Parties

Fundamental issues in relation to the selection of the appropriate risk free rate are not raised in submissions. However, National Rail raises the issue of what date the bond rate will be taken for the purposes of the undertaking. It suggests that the date should be stated explicitly in the undertaking. It states alternatively, that the date for fixing this parameter value to be used in the CAPM quantification of WACC should be the date of approval of the undertaking.

Commission's position

Two major issues associated with the risk free rate assumption have emerged in the regulatory context. One is the appropriate bond maturity. The other is how to select the rate given the chosen bond yield.

The issue of bond maturity concerns the selection of the appropriate term of Commonwealth bond as the basis for the risk free rate assumption. The debate on this issue generally revolves around whether the 5 year bond or 10 year bond is most suitable.

The Commission has stated a preference in several decisions for the use of the 5 year bond due to the higher inflation risk premium embedded in the 10 year bond, which is unjustified in frameworks designed to ameliorate this risk. In the case of ARTC, the review period of 5 years means that ARTC's exposure to inflation risk is limited to that extent.

Therefore the Commission considers that the use of the government bond of 5 year maturity as the basis for the risk free rate assumption to be most appropriate.

As stated in past decisions, the Commission has supported the use of short-term averaging of yields in order to smooth out the effects of financial markets volatility. The 40-day moving average approach is therefore adopted.

The date at which the risk free rate will be calculated and incorporated into the WACC will be the Wednesday of the week before the Commission's decision is announced.

The risk free rate assumption is taken from the 40 day average yield of the 5 year government bond rate[98], which as at 8 October 2001 was 5.28%.

Inflation

The expected inflation rate is used to convert nominal rates of return, such as the nominal WACC, into real rates of return.

ARTC proposal

In converting nominal rates into real rates, ARTC applies the Fisher formula using an inflation assumption of 2.5%.

[98] Since the exact 5 year rate is unknown the Commission calculated it using extrapolation procedures on the yields of July 2005 and June 2011 series government bonds.

Views of interested parties

Submissions do not raise the inflation assumption as an issue.

Commission's position

The Commission considers that the use of market-based inflation expectation is the most appropriate measure of expected inflation. As in other Commission regulatory decisions, a market expectations inflation measure can be inferred by deriving the implied expectation of inflation existing between nominal and indexed bonds of the same maturity and term. In this case, it means calculating the difference between the chosen nominal 5-year bond yield and the yield on indexed bonds of corresponding maturity.[99] The Fisher equation is then applied to the two yields to arrive at the inflation figure.

Although there are many respected sources providing inflation forecasts, the Commission considers that the use of market-inferred inflation forecasts is most consistent with the view that the WACC is a forward-looking market-based number, in concept and in regulatory practice.

The Commission has decided to again adopt the market-inferred method of deriving inflation, as implied by difference between nominal and real bond rates.

At the time of this decision, the 5-year-equivalent real bond rate is 3.02%. Using the Fisher equation, this implies an expected inflation rate of 2.19%.

Cost of debt

The typical practice in determining a company's future cost of debt capital is to nominate a debt risk margin over and above the risk free rate, which is assumed to reflect what a firm of similar credit risk could be expected to obtain.

ARTC proposal

ARTC assumes a 1.2% debt margin over and above the risk free rate. Its consultants arrived at this figure by estimating the rate at which ARTC is expected to be able to borrow over the relevant term. The 1.2% estimate is based on recent negotiations with major banks, and the regulatory decisions in the following table:

Decision	Date	Debt Margin
IPART final decision - Wagga Gas	March 1999	1.2%
IPART final report - NSW Rail Access	April 1999	1.0%
Commission final decision - Victorian Gas Transmission	December 1999	1.2%

[99] These were extrapolated from the yields on August 2005 and August 2010 series capital indexed bonds

Views of interested parties

Submissions do not raise the cost of debt as an issue.

Commission's position

The experience in Australia suggests that a 1.2% debt margin is not an unreasonable benchmark for companies with similar debt risk characteristics to ARTC. The Commission therefore does not propose to amend ARTC's proposed debt margin.

Cost of equity

In evaluating a firm's cost of equity capital, or required rate of return to equity, it is usual regulatory and corporate financial practice to apply the widely known and accepted CAPM model.

The CAPM stipulates that a firm's cost of equity (R_e) is given by the following relationship:

$$R_e = R_{fr} + \beta_e * MRP$$

where R_{fr} = risk free rate of return, MRP (market risk premium) = $R_m - R_{fr}$, and β_e = equity beta.

In the CAPM context, the two variables of note involved are the beta and MRP.

Beta

The purpose of a beta is simply to measure the sensitivity of the return on an individual investment to changes in returns for the market as a whole.

More formally, the beta of any entity (project or firm) is defined as the covariance between its return R_j, and the market portfolio's return, R_m divided by the variance of the market return:

$$\beta_j = \frac{Cov(R_j, R_m)}{Var(R_m)}$$

Under standard econometric assumptions it coincides with the slope coefficient of the line of best fit in a regression of the entity's return with that of the market; that is:

$$R_j = a + bR_m + e_j$$

where a is the intercept, and e is a mean zero residual uncorrelated with R_m.

Being specified in this way, beta then captures the *systematic* risk component of the *total* risk of a company's returns. Also called "non-diversifiable risk", it is that type of risk that cannot be eliminated by diversification, so that the expected systematic returns have an 'unavoidable' correlation or co-variation with market returns.

One of the risks associated with holding risky assets is financial risk; that is, the risk arising from how the underlying assets are financed. In this regard, the beta referred to thus far is known as an equity beta, to distinguish it from an *asset* beta. The latter is the

beta that would apply if the company were 100% financed by equity, thereby eliminating the effect of leveraging. The equity beta takes account of the effect of mixing equity and debt. A higher level of gearing, *ceteris parabis*, increases the risk to equity-holders, and hence the equity beta, since it is debt holders who are compensated first out of the firm's revenues, and in the event of insolvency. However the risk associated with an asset's cash flows is given irrespective of the financing used in purchasing the asset. The conversion from an equity beta to an asset beta attempts to divorce the risk arising to the *entity* purely due to financing arrangements, from the inherent risk of the underlying assets' cash flows. More meaningful comparisons between companies on the basis of systematic risk can be made once the layer of financial risk is removed.

ARTC proposal

E&A recognises the difficulties associated with determining an appropriate beta where an entity, such as ARTC, is not listed. E&A employs a comparison approach to estimating ARTC's beta. It compiled (equity) betas of listed railway companies, road transport companies, infrastructure funds, and decisions on regulated infrastructure. Citing similar systematic risk characteristics to rail, and more developed regulatory environments, E&A places greater weight on the betas quoted for listed infrastructure funds and regulatory decisions. It concludes that a range of equity beta of 0.90 – 1.0 is appropriate.

ARTC points out that although this is higher than those used with respect to the regulated coal businesses of other operators (0.76-0.85), it is lower than the mixed, but bulk commodity dominated freight business in WA.

> Given the highly competitive nature of most of ARTC's business, and linkage to overall domestic economic activity, compared to the regulated business of other operators, many of which are well placed in diversified international markets, ARTC considers an equity beta higher than that considered reasonable to other rail regulated businesses, to be appropriate….In addition, ARTC has taken on higher exposure to such risks brought about by its approach to pricing, which is weighted towards market growth...

Views of interested parties

Queensland Rail

QR makes general comments on risk which imply that the assumed beta is perhaps too low:

> QR believes it is critical that it be recognised that the rate of return being established at this time reflects only the risks associated with existing assets with a proven demand. On this basis, QR believes that in the event that a railway manager constructs significant new assets, a separate analysis of the project risk should occur to identify whether a different rate of return should apply. For example, in relation to recent major rail projects, it is clear that the investment community is seeking higher returns than would be derived through the ARTC's proposed approach.

Commission's position

E&A's approach appears to be reasonable given the well-known difficulties of determining beta for unlisted utility companies. The comparators used are likely to

display similar risk characteristics to rail infrastructure providers. However the Commission questions why equity beta was used as the basis for comparison. Closer comparison can be achieved by "de-levering" the equity betas into asset betas. As explained above, this process effectively removes the financial risk (due to gearing) component embedded in equity beta. Asset betas thus enable ready comparison of betas between companies of varying gearing levels. Once the appropriate asset beta has been selected, it can then be re-levered into an equity beta consistent with the financial structure of the business.

Given the advantages of comparing and assessing companies using asset betas, the Commission has considered ARTC's proposed equity beta under the guise of an asset beta. The asset beta implied by an equity beta of 0.95 (ARTC's mid-point), as well as ARTC's gearing assumption, is calculated to be 0.58.

The Commission's survey of asset betas in utility industries suggests that an asset beta of 0.59 appears to be at the upper end of a reasonable range of asset beta for companies with systematic risk characteristics typically characterising infrastructure.

In this regard, while the 0.58 assumption compares favourably to the 0.60 – 0.75 asset beta range applied to airports, it is perhaps generous in comparison to gas and electricity decisions (0.40-0.45). A recent study by the Australian Graduate School of Management calculated the equity beta for the infrastructure and utilities sector to be 0.81.[100]

A higher asset beta accorded to rail infrastructure than to energy utilities could be justified as reflecting possibly higher sensitivity of rail transportation to movements in the national economy than is the case with demand by households and firms for energy sources. Consequently, the returns of the railway entities may arguably fluctuate more with the returns available in the market generally than might the returns of more stable utilities.

The Commission does not propose at this stage to make an adjustment to ARTC's implied asset beta of 0.58, but seeks comments on it from interested parties. The 0.95 mid-point equity beta assumed by ARTC is therefore accepted for this draft decision.

Market risk premium (MRP)

The *MRP* is the compensation required by equity investors for assuming the extra risks (systematic volatility) associated with providing funds to a diversified basket of "risky" assets (such as a stock portfolio) over risk-free assets.

ARTC proposal

ARTC assumes a mid-point *MRP* of 5.75%.

[100] Australian Graduate School of Management, *Risk Measurement Service*, September 2000.

Views of interested parties

Queensland Rail

QR argues that the market risk premium (*MRP*) range assumed by ARTC is conservative. QR questions ARTC's use of the *MRP* of 5.5% - 6%, considering a higher figure to be more realistic. In proposing a "low" *MRP* there is the underlying assumption that the *MRP* has declined over the last decade. However, QR considers there is little empirical evidence to support this view. The history of Australian (and US) *MRP* shows high volatility, particularly when measured over five or ten year periods. This high volatility means that it is very hard to argue that the *MRP* measured over the last decade is not simply reflecting volatility. QR believes it would be a brave argument to suggest that there has clearly been a reduction in *MRP* .

> Based upon Dr Bishop's advice, QR believes that the MRP is best represented as a range between 6% and 8%. If a point estimate were used, QR believes that 7% is a reasonable assumption to apply, given the potential costs associated with discouraging investment in rail infrastructure.

SCT

In respect of rate of return, SCT argues that there is negligible risk in the duplication of certain segments and thus little risk of competition for ARTC.

Commission's position

The Commission acknowledges the various complexities and uncertainties involved in the estimation of this parameter.

The adoption of a *MRP* has difficulties not unlike those associated with deriving beta, in that it will typically involve an estimate of an historical variable for use as a proxy for a forward-looking ex ante variable.

Since the market risk premium is a parameter that does not vary according to the company in question, the Commission will apply its standard value that it has used in CAPM estimation across its regulatory functions. That value is 6%. For further discussion, see past decisions such as the Sydney Airport Aeronautical Pricing Proposal and the DRP.

Gearing

In order for an entity's WACC to be determined, its gearing levels must be specified. Gearing refers to the use of debt and equity capital in the financing of a firm's assets. The entity's debt and equity proportions are then used in the calculation of equity beta, the debt margin, and the weights applied in the WACC.

ARTC proposal

E&A assumes a gearing level (debt as a percentage of debt plus equity) for ARTC of 45% (mid point), compared to assumed gearing of 50-55% it observed for other rail infrastructure operators. ARTC states that this has been done to recognise the higher commercial risks faced by ARTC compared to those facing the regulated business of other operators.

Views of interested parties

No views were expressed in submissions on the gearing assumption.

Commission's position

The tax deductibility of debt interest payments means that the WACC will generally decline with increasing leverage. The Commission considers that a benchmarked approach to the gearing ratio has advantages both in efficiency and simplicity. In past decisions on the WACC of infrastructure entities, the Commission has applied a 60% gearing assumption as a benchmark. Therefore, the Commission's decision is to adopt this gearing ratio to apply to ARTC's WACC. The Commission notes, as it has in other decisions, that varying the adopted gearing assumption does not have significant impacts on the ultimate calculated WACC figure, given the offsetting channels provided by the equity (levered) beta and the favoured tax treatment of debt.

Financial Model

ARTC proposal

ARTC uses a pre-tax building block model with which to calculate its allowable revenues. In adopting a pre-tax framework, ARTC require a tax parameter with which to convert a post tax WACC into its pre-tax equivalent. For the purposes of the analysis, ARTC assumes that its effective tax rate equates to the corporate tax rate of 30%, and therefore uses a 30% assumption to "gross up" its post tax WACC.

Commission's position

The Commission has expressed a clear preference across its regulatory functions for a post tax framework, where tax is treated as a cost in the expected cash flows, rather than compensated for in a higher "grossed-up" return. The adoption of a post tax approach is driven largely by the difficulty of determining the long-term effective tax rate as is necessary in the pre-tax approach.

ARTC's use of a pre-tax model and 30% for the grossing-up assumption overlooks the importance under a pre-tax approach of accurately estimating the long-term effective tax rate. The effective tax rate must be estimated through financial modelling of the entity's tax position throughout the term of the revenues.

The Commission conducted modelling of its own in order to determine ARTC's maximum allowable revenues on a post tax basis. Revenues were generated over 6 years using a post tax building block model, which matches the modelling period adopted in ARTC's pre-tax model. This process enabled comparison with ARTC's modelled "ceiling" revenues, as well as with ARTC's forecast actual revenues. The results of the post tax analysis were that ARTC's maximum allowable revenues were somewhat *below* ARTC's estimate of its ceiling revenues, while being significantly above ARTC's forecast actual revenues. Therefore, while the Commission does not support ARTC's use of a pre-tax model with which to determine revenues, it is satisfied that allowable revenues generated using a post tax approach still lie significantly above proposed actual revenues.

Imputation factor

The dividend imputation system in Australia compensates investors for the tax paid out of company earnings through the distribution of franking credits, recognising that tax paid at the company level effectively represents the pre-payment of personal tax. These franking credits have value in the hands of investors, and accordingly are accounted for in the determination of allowable revenues. The extent to which they are of value is captured by the gamma factor.

ARTC proposal

ARTC proposes to adopt a range for gamma of 0.40 to 0.50, based on past regulatory decisions and studies.

Views of interested parties

Queensland Rail

QR understands gamma to "represent the value that an organisation's shareholders gain from each dollar of dividends that is covered by an imputation credit". QR believes that ARTC's proposed gamma of between 0.4 and 0.5 may be too high:

> A recent working paper by Cannavan D, Finn F and Gray S, "The Value of Dividend Imputation Credits" November 2000 indicates that the value of imputation credits is significantly lower than this. It is acknowledged that the results of this paper are significantly different to previous studies. The reasons for these differences are:
>
> - it incorporates the 45 day rule (introduced in 1997) which takes away the ability to trade the imputation credits and therefore decreases the value that can be attributed to those credits; and
> - it takes a different econometric approach which allows for a larger sampling and tighter confidence intervals. [101]

On this basis QR recommends that the valuation of ARTC's gamma be reviewed to take account of these new findings.

Commission's position

The gamma parameter, like the market risk premium, is a parameter used across the regulatory areas of the Commission. The current practice of the Commission is to adopt a 0.50 gamma assumption.

Summary

ARTC proposal

ARTC submits a pre-tax real WACC (mid-point) of 7.20%.

[101] Queensland Rail, *Submission Responding to QCA's Draft Decision on QR's Draft Undertaking*, April 2001, p. 35.

ARTC considers that the resultant WACC under-estimates ARTC's cost of capital in that the assessment has not fully addressed the market risk faced by the company. ARTC points to several factors in support of this contention.

- It operates in a commercial environment where strong inter-modal competition exists in almost all markets and such markets are closely linked to economic activity.
- The WACC noted in recent regulatory assessments in the rail sector are generally similar to that assessed by E&A.
- These decisions have been primarily concerning rail providers serving bulk freight (coal & minerals, ores, grains etc).
- ARTC's dominant businesses are subject to stronger inter-modal competition than faced by bulk commodity movements.
- Coal movements derive stability from contractual ties and/or economic advantage (end users have made financial commitment to supporting infrastructure). Whilst bulk commodities do face some inherent risks (price risk, climate), volumes are generally reasonably reliable.
- A credit assessment carried out by Access Economics[102] with respect to QR's below rail coal business found the risk profile to be 'above average to excellent compared to the business of QR's Network Access as a whole'. This 'reflected its low risk as a natural monopoly business and the stability of its revenues given stable growth and a very low volume and price volatility to which it is exposed'.
- ARTC would expect the movement of agricultural products (facing both price and climate risk) to be more volatile than coal and minerals business.
- ARTC's approach to pricing and relatively few direct customers, where seven major operators account for approximately 91% of business. Its major customer National Rail and another smaller customer FreightCorp are expected to be privatised within the next 12 months. ARTC expects that a new commercial operator could seek to rationalise unprofitable operations and improve operating efficiency generally, further increasing revenue risk to ARTC.
- ARTC also produces a comparative table that it considers indicates that the assumptions made by E&A with respect to the various parameters incorporated in the WACC calculation are reasonable.

Commission's position

The Commission's use of a post tax financial model meant that the pre-tax real WACC determined by ARTC was not relevant. Rather a post tax real "vanilla" WACC is required. Essentially, this involves a WACC that is built up using pre-tax return on debt, and a post tax return on equity. This reflects the fact that returns to debt holders (interest payments) are received before company tax is paid, while equity holders are

[102] Queensland Competition Authority, *Draft Decision on QR's Draft Access Undertaking*, December 2000. Working Paper 4 – The Estimation of Queensland Rail's Below Rail Coal Network Expected Rate of Return.

compensated once tax is paid on profits. Applying the parameters as discussed, the Commission arrived at a post tax real vanilla WACC of 6.70%.

The Commission considers that the WACC/CAPM framework provides appropriate compensation for capital providers of ARTC for the systematic risks facing the enterprise. The factors argued by ARTC to contribute to the riskiness of its business are primarily specific and diversifiable. Whilst ARTC's inter-modal competition may be stronger than what prevails in bulk commodities, it is not necessarily the case that this increases systematic or beta risk of the entity. Rather, this is a specific risk of investing in that sector of the industry. Similarly, ARTC's relatively few customers and approach to pricing are aspects specific to ARTC and may therefore be diversifiable factors.

The Commission considers that the WACC applied to ARTC is consistent with the Commission's access undertaking pricing principles enunciated in Chapter C3.

The WACC ensures that expected revenues imply a normal commercial expected return (Principle 1) on efficient investment is being earned. The WACC methodology is designed specifically to arrive at a risk-adjusted forward-looking market-based return recognising the investor's opportunity cost of providing capital.

The second principle is that access prices should provide ARTC with incentives to provide services efficiently and to undertake efficient investment. The WACC applied to ARTC is considered to give effect to these goals. A return somewhat below that implied by the chosen WACC may jeopardise ARTC's incentives to provide efficient service and to undertake timely and sufficient investment. Similarly, an over-compensated return may lead to inefficient investment being undertaken.

Principle 3 states that access prices should provide incentives for efficient use of rail track infrastructure. This relates to the notion of allocative efficiency. The WACC accorded to ARTC should help ensure that prices reman close to the commercial costs of service provision. The WACC ensures that a commercial return is being earned by the operator, and prevents pricing that takes advantage of any market power. The outcome is that competitive prices and quantities should be supplied to users.

The WACC parameters proposed by ARTC and those accepted by the Commission are set out in the following table.

Table D5.1: WACC Parameters

WACC parameters	ARTC proposal (mid-point)	Commission draft decision
Inflation rate, %	2.50	2.19
Debt, %	45	60
Equity, %	55	40
Nominal risk free rate, %	5.50	5.28
Real risk free rate, %	3.00	3.02
Market risk premium, %	5.75	6.0
Asset beta	-	0.58
Debt beta	-	0.12
Equity beta	0.95	1.27
Debt Margin, %	1.2	1.2
Nominal cost of debt, %	6.70	6.48
Franking credit utilisation – gamma	0.45	0.50
Post-tax cost of equity (CAPM), %	10.98	12.99
Post tax real WACC (Vanilla), %	**-**	**6.70**
Pre-tax real WACC, (%)	**7.20**	**-**

D5.3.5 Operations and maintenance expenditure

ARTC proposal

ARTC's routine maintenance work is carried out under private sector maintenance contracts tendered on a competitive basis. ARTC has adopted this practice with a view to ensuring that its cost structure reflects efficient practice. ARTC also provides measures to support its claim that current and expected future infrastructure maintenance unit costs compare favourably with national average and 'world's best practice' for freight operations over the last decade.

Where contract maintenance expenditure has been identified directly with a particular Segment (usually labour), this expenditure is reflected in Segment costs. Expenditure not directly identified with a segment (mainly materials, overheads, margins) have been allocated to segments on a gtk (60%) and track kilometre (40%) basis.

A further area of costs that represents around 6% of ARTC's total operating expenditure outlined includes the train control, transit management and consist data processing functions. These functions are resourced internally at one location for the entire Network. ARTC has presented information that compares its unit cost performance for train control functions with national average and 'world's best practice' for freight operations over the last decade.[103] ARTC claims that rationalisation of this function between 1998/99 and 2000/01 resulting in "...significant productivity improvements".

[103] ARTC, (2) *op. cit*., p.11.

Finally, ARTC sets out a range of costs broadly categorised as Other Management Functions. It includes:

- **Maintenance contract management** (administration, accounting, project management and maintenance planning) representing around 5% of total ARTC operating expenditure.
- **Operations and safety management** function includes long and short term service planning, service quality control and safety management. This function (included in above train control comparisons) represents around 2.5% of total ARTC operating expenditure.
- **System management and administration** function includes IT, property management, security, accounting, insurance, strategic management and executive. This function represents around 12% of total ARTC operating expenditure.

Views of interested parties

SCT

SCT notes that the undertaking does not ensure that the access provider's costs do not reflect the cost of maintaining sub-standard infrastructure. The additional component of current maintenance costs that arises from past decisions to reduce maintenance resources should not be borne by parties currently granted access.

Commission's position

In its work on behalf of the Commission, Currie & Brown reviewed the level of ARTC's operating costs and compared them to available benchmarks.[104] Noting the difficulties of comparing costs for ARTC's network with other rail networks, Currie & Brown nevertheless considered ARTC's routine maintenance costs to be "low".

Currie & Brown generally regard as reasonable the cost allocation rules used by ARTC.

The Commission notes SCT's concern that future maintenance costs may be higher as a result of asset degradation that may have occurred in the past. However, the Commission's view is that ARTC's low operating costs compared to other rail networks tend to reduce the risk that maintenance costs are excessive. The level of MPM costs has been discussed in the DORC section, above.

The Commission does not object to the level of operating costs that ARTC has incorporated into its calculation of revenue limits.

D5.4 Specific assessment of pricing principles

The discussions contained in sections D5.1-5.3 deal primarily with the economic principles behind the various aspects of ARTC's draft undertaking. The Commission is broadly satisfied that these principles will give rise to outcomes that are consistent with the objectives and principles specified in Part IIIA of the TPA. However, since an

[104] Currie & Brown, *op. cit.*, pp.15-17.

undertaking is a court-enforceable document, for the undertaking to be acceptable to the Commission the specific words of the undertaking must articulate those principles in a sufficiently clear and unambiguous manner. Accordingly, this section presents a clause by clause evaluation of Part 4 of the ARTC undertaking, in light of the views articulated earlier in this chapter.

D5.4.1 Objectives

Clause 4.1 of the undertaking states that ARTC will develop its charges in line with the principles set out in section 1.2(c). These are discussed in more detail in chapter D1 of this draft decision. Clause 4.1 of the undertaking also states that the charges are developed with a view to stimulate customer confidence and market growth in the rail industry and promote efficient use and investment in the network.

The objectives specified in clause 1.2(c) are very similar to the words of s44ZZA. Clause 4.1 serves as some additional detail as to ARTC's interpretation of such words. The Commission considers this interpretation reasonable.

The Commission considers that clause 4.1 meets the requirements of section 44ZZA(3) of the TPA.

The Commission accepts the provisions of clause 4.1 of the ARTC draft access undertaking.

D5.4.2 Charge differentiation

Clause 4.2 of the undertaking specifies the criteria by which ARTC will use to formulate its charges. These include the particular characteristics of the relevant service, the indicative access charges, the commercial and logistical impact on ARTC's business, contributions by applicants to ARTC's costs and the cost of any additional capacity.

Sections 4.4.7 and 5.2.2 detailed the implications of requiring access charges to be formulated 'having regard to' the indicative access charge. In those discussions, the Commission noted that the practical effect of such a requirement may be to effectively cap the prices for a range of services, not just the indicative service. Beyond this limitation, the remainder of clause 4.2 of the undertaking sets out a range of factors which ARTC may take into account in setting its charges. These factors essentially represent the usual range of commercial considerations a business would consider in setting its prices. Given the limitations on ARTC's pricing introduced by both the indicative access charge and the revenue limits specified in clause 4.4 of the undertaking, the Commission considers these a reasonable set of criteria for ARTC to have regard to in setting its charges. This is consistent with the suggestion in section 5.2.2 that, given the competitive constraints ARTC is operating under, some degree of price discrimination may be desirable.

The Commission considers that clause 4.2 meets the requirements of section 44ZZA(3) of the TPA.

The Commission accepts the provisions of clause 4.2 of the ARTC draft access undertaking.

D5.4.3 Limits on charge differentiation

Clause 4.3 of the undertaking specifies limits on the extent to which ARTC can differentiate its charges. These exclude differentiation on the basis of identity and ownership of the applicant, or differentiation between like services where access seekers are operating in the same end market.

Clause 4.3 effectively represents a 'like for like' clause requiring ARTC not to discriminate charges for similar services. Clause 4.3(b) also reserves ARTC the right to determine whether two services are alike. As discussed in section D5.2.2, the Commission does not consider a commitment to pricing like services equally as a necessarily essential component of an undertaking, given that ARTC is not a vertically integrated business. The Commission has some concerns, however, that there may be some incentives for ARTC to distort competition in downstream markets. It is also apparent from submissions to the Commission and comments at the public forum, that rail operators wants such a clause in place. Accordingly, the Commission has no objections to its inclusion, nor to the fact that it is ARTC which, in the first instance, determines whether two services are alike.

In the event that ARTC does not act reasonably in its evaluation of whether services are alike, the issue could be assessed either in considering whether ARTC has acted in accordance with its undertaking, or in the course of resolving a dispute that is notified under the undertaking or under an access agreement.

The Commission considers that clause 4.3 meets the requirements of section 44ZZA(3) of the TPA.

The Commission accepts the provisions of clause 4.3 of the ARTC draft access undertaking.

D5.4.4 Revenue limits

Clause 4.4 of the undertaking specifies limitations on the revenue recoverable by ARTC. This clause limits the revenue ARTC can generate from a segment or group of segments to fall within the floor and ceiling limits, unless ARTC agrees to charges that generate revenues below the floor, or an applicant agrees to charges which generate revenues above the ceiling amount.

The floor limit is defined with reference to the revenues sufficient for ARTC to cover the incremental costs of a segment or group of segments. The ceiling limit is defined with reference to the revenues sufficient for ARTC to cover the economic costs of a segment or group of segments. The Commission invites comment from interested parties as to whether users or access seekers would be in a position to establish where ARTC's revenue limits actually lay on any particular segment.

Economic cost is defined as the costs specific to a segment, the costs of additional capacity, depreciation, return on segment specific assets and an allocation of non-segment specific costs. Clause 4.4(e) specifies the basis by which the non-segment specific cost allocation will be made, while clause 4.4(f) specifies the method by which ARTC's required rate of return is estimated.

Recommendation

- **Clause 4.4(b): The Commission recommends that ARTC refines the definition of incremental costs to more clearly express what is included and what is excluded.**
- **Clause 4.4(b): The Commission recommends that, regarding the "combinatorial" test, ARTC's term "...the Charges which, if applied to all Operators on a Segment or a group of Segments" could benefit from greater clarification.**
- **Clause 4.4 (g): This clause needs to be re-ordered or re-numbered.**
- **Clause 4.4 (d)(i): The Commission's view is that the term "costs specific to a segment" would benefit from greater clarification. For example, "operating costs specific to a segment".**
- **Clause 4.4 (e): This clause refers to itself when it appears that it ought to refer to the previous clause.**
- **Clause 4.4 (i),(ii),(iv): This clause needs to be re-numbered.**

D5.4.5 Structure of charges

Clause 4.5 of the undertaking specifies the structure of access charges as having a fixed (flagfall) component ($/km) and a variable component based on distance and gross mass ($/kgtkm). The flagfall component is charged irrespective of utilisation of the train path. Section D4.5 notes that both elements of the charge are open to negotiation.

In light of the discussion contained in section D5.2.3, the Commission considers that the specification of fixed and variable charges in the undertaking is not unreasonable. In particular, the Commission notes that clause 4.5(c) allows access seekers to negotiate over price structure.

The Commission considers that clause 4.5 meets the requirements of section 44ZZA(3) of the TPA.

The Commission accepts the provisions of clause 4.5 of the ARTC draft access undertaking.

D5.4.6 Indicative access charge

Clause 4.6 of the undertaking specifies the indicative access charges by segment, for a service specified as having the following characteristics:

(i) axle load of 21 tonnes;

(ii) maximum speed of 110 km/h and average speed of 80 km/h; and

(iii) length not exceeding Adelaide 1500 metres east of Adelaide and 1800 metres west of Adelaide.

Clause 4.6 also specifies the maximum variation to the indicative access charges over the term of the undertaking; that maximum being the greater of:

(i) CPI less 2%; or

(ii) two thirds of CPI.

As discussed in section D5.2, the Commission considers that the indicative access charges proposed by ARTC are not unreasonable. The indicative charges, in conjunction with the specification of an indicative service, provide access seekers with a degree of certainty in relation to track access that would not be the case in the absence of the undertaking. Furthermore, given the limitations on ARTC's ability to differentiate charges for like services, access seekers are unlikely to be disadvantaged in the event that they wish to be provided with services with different characteristics.

The indicative access charges are consistent with the Commission's assessment principles outlined in chapter C3. The indicative access charges are on average well below the efficient long run costs (including a normal commercial return on investment) of production, they provide incentives for ARTC to provide services as efficiently as possible and lower costs over time, and provide incentives for above rail operators to use the ARTC network efficiently.

The Commission does, however, have some concerns in relation to the wording of clause 4.6 of the undertaking. While these do not relate to the material content of the undertaking, the Commission would expect these to be presented in a manner that removes potential ambiguities. The Commission also notes that, while the prices quoted on the ARTC website (of which the indicative access charge appears to be a subset) are expressly GST-exclusive, no mention of GST is made in the undertaking.[105] The Commission notes that the prices specified in the undertaking would generally be assumed to be inclusive of GST. The Commission considers that, at a minimum, GST-inclusive prices be included in the undertaking.

It is also not clear whether the variations allowed under clause 4.6(c) are automatic – that is, whether the indicative access charges are increased *every* year by the greater of the percentage increase in CPI less 2% or two-thirds of the percentage increase in CPI – or whether the increases by amounts up to this level are at the discretion of ARTC. If ARTC's intention is to allow the latter, then it should clarify whether the price cap will apply to the level of charges in any one *particular* year or whether it is cumulative. That is, the undertaking should clarify whether a decision by ARTC not to increase the indicative access charge in one year precludes it from implementing increases in later years which take into account inflation in the earlier year.

[105] The indicative access agreement contains a clause (4.10) explicitly related to GST; however, this is not reflected in the undertaking itself.

Specific recommendations are detailed below.

Recommendation

- **clause 4.6(a)(iii) of the ARTC undertaking be amended to omit the first reference to 'Adelaide';**
- **clause 4.6(b) should, at a minimum, specify GST-inclusive prices;**
- **clause 4.6(c) of the ARTC undertaking be amended to clarify whether the allowed variation is a maximum or whether it is an automatic increase, and that the variation is based on the percentage change in the CPI over a specified time-frame;**
- **clause 4.6(c) should clarify whether the annual variation allows for increases to allow for cumulative inflation; and**
- **clause 4.6(c)(ii) should omit one of the references to 'thirds'.**

The above recommendation might be addressed, at least partially, by re-wording clause 4.6(c) along the lines of clauses 4.5(a) and 4.5(b) of the indicative access agreement.

The Commission considers that clause 4.6 meets the requirements of section 44ZZA(3) of the TPA, subject to the above amendments being made.

Subject to ARTC satisfactorily re-drafting the clause along the lines of the above recommendation, the Commission accepts the provisions of clause 4.6 of the ARTC draft access undertaking.

D6. Management of capacity

Clause 5 of the undertaking sets out the processes by which the ARTC will deal with capacity issues, such as assessing capacity, allocating capacity, transferring capacity and cancelling capacity. A key aspect of managing capacity is assigning access rights where multiple applicants seek access to mutually exclusive access rights. The basic dimension of capacity is a "train path" – defined as the "entitlement of an Operator to use the Network between the times and locations as specified in the Access Agreement".

ARTC's proposal

ARTC proposes to undertake a capacity analysis to determine whether there is sufficient capacity to accommodate the requirements being sought by the applicant or whether additional capacity can be justified. Where two or more applicants have applied for access to mutually exclusive access rights, ARTC will allocate access on the basis of the proposal that ARTC considers the most favourable (see section D3.7.2 for a discussion of mutually exclusive requests for access). ARTC intends to assign access rights to the proposal that yields the highest net present value of future returns, adjusted for risk.

ARTC proposes to reserve the right to withdraw train paths allocated to an operator under an access agreement in the event that the operator has under-utilised its capacity entitlement. Such a course of action would be subject to the dispute resolution provisions of the access agreement.

Also, ARTC has proposed that an operator may cancel train paths or assign them to third parties (subject to approval of ARTC).

ARTC argues that its intention is to offer the applicant the range of available alternatives that most closely match the applicant's request. ARTC notes that currently, in most instances adequate capacity can be established in this way and the applicant avoids a conflicting train path and the need to enter into negotiation for the construction of additional capacity. However, if the needs of the applicant cannot be met through an alternate option, ARTC will then need to consider how additional capacity of the nature required by the applicant might be met and seek a costing to achieve the given outcome.

ARTC argues that in managing capacity it must maintain the safety and integrity of the network for all users, and so there may be instances where individual operators' requests for access cannot be met. ARTC considers that assessment of capacity will often involve an exercise of subjective judgement. ARTC is however willing to publish information that will allow operators to make their own assessment of network capacity.

Views of interested parties

Queensland Rail

QR argues that ARTC has not provided as much detail on capacity management issues as QR did in its own draft access undertaking. It argues that it provided more information on:

- the provision of capacity, for example master and daily train plans;
- access to mutually exclusive access rights; and
- the resumption and transfer of access rights.

QR argues that its own undertaking process has demonstrated that the infrastructure owner must publish enough information to allow operators to feel confident that the railway manager is managing the network in the most effective manner, and that capacity is managed in a fair and consistent way for all users. It argues that stakeholders have sought a greater level of detail on issues such as the resumption and transfer of access rights than is proposed in the ARTC undertaking. QR acknowledges, however, that ARTC provides a substantial amount of information through informal channels.

QR notes that it and ARTC have similar proposals to cover cases where there are applications for mutually exclusive time paths. However, in response to concerns from operators, QR has agreed to include in its own undertaking a requirement that the operator must demonstrate that the end user wishing to use its train services is

agreeable to the execution of the access agreement or that there is a contractual arrangement with the operator.

National Rail

NR argues that there is not sufficient detail in the undertaking on how ARTC proposes to assess capacity. It argues that there is need for a detailed description of the factors and processes involved in assessing capacity.

It believes that the undertaking should include a detailed description of the factors and processes involved in assessing capacity. NR argues that the identification of the factors, including constraints, which affect the capacity of corridors at specific times of the day is required.

NR argues that the term 'under-utilised' is not defined in the undertaking. It argues that paragraph 5.3 should be amended to include criteria and a transparent process for assessing 'under-utilisation.'

It adds that the process for assessing whether certain time paths are under utilised is not transparent in the undertaking. ARTC should not be able to remove a particular time path before dispute resolution (although its decision to remove it is subject to dispute resolution).

The undertaking should also provide for the operator to have the right to renew long term contracted train paths to achieve consistency with the standard track access agreement.

FreightCorp

FreightCorp argues that the 'use or lose' provisions in relation to allocated capacity are not warranted unless ARTC can show that there is an applicant ready and waiting to pay more for the non or under utilised entitlement.

FreightCorp adds that the basis on which ARTC proposes to assess capacity and how mutually exclusive access is granted should also be made clear.

Commission's position

Capacity assessment

Defining and measuring capacity is a key aspect of negotiations on access applications. Operators are concerned that the undertaking is not explicit about the way ARTC defines capacity and the factors that it takes into account in measuring capacity. Operators claim that this lack of knowledge about capacity complicates negotiations about an additional time path as they have no alternative way of carrying out an independent analysis of the capacity actually available. Operators also expressed their concern about the means for allocating capacity.

As noted in sections D2.4 and D3.5, ARTC has amended the original undertaking and have responded to these concerns by proposing to publish additional information on capacity, viz:

- a graphical representation of committed entitlements on an operator by operator basis;
- section running time information for indicative services on each corridor; and
- route standards on each corridor.

According to ARTC this should be sufficient information for operators to make a "reasonable assessment of available capacity" (ARTC correspondence, 4 September, 2001).

The Commission considers that a commitment to publishing this additional capacity information represents a significant improvement on the provisions in the original undertaking. The Commission considers that this information provides a useful base from which operators can gauge utilisation but has concerns that operators may not have sufficient information to to relate this to a measure of absolute capacity and assess availability of spare capacity in the ARTC network. The Commission therefore would welcome further comments on this issue.

Requests for mutually exclusive capacity

This matter was dealt with in section D3.7 of this report in the context of assessing clause 3.9 of the undertaking. Clause 5.2(b) also sets out ARTC's proposal in respect of applications for mutually exclusive capacity.

The last sentence in clause 5.2(b) provides as follows:

> Failure to give notification in accordance with this clause 5.2(b) will not constitute default under this Undertaking or invalidate or prejudice any Access Agreement which may have been entered into by ARTC provided such failure was not wilful and ARTC has acted in good faith.

This has the effect of providing ARTC with a defence to a failure by it to notify an operator in the event of mutually exclusive applications. This issue was also considered in section D3.7 of this report. There the Commission concluded that this provision amounted to an exemption from ARTC's obligations which was not acceptable in terms of the assessment criteria and recommended its deletion. For similar reasons, the Commission considers that the exemption in clause 5.2(b) is also unacceptable and recommends that it also be deleted.

The Commission also notes that ARTC's proposed approach to resolving disputes over access rights awarded in these circumstances, that is, where ARTC failed to notify on the existence of competing requests and ARTC goes on to finalise an access agreement with one of the competing applicants (incorporated in clause 5.2(b)) is not appropriate. Such a dispute should be resolved in accordance with general legal principles. ARTC's proposal in this regard would not be a resolution that a court would reach in all cases.

Withdrawal of time paths

The undertaking provides in clause 5.3(a) for ARTC to be able to withdraw time paths if operators do not fully utilise them. The withdrawal of capacity entitlements which are not fully utilised by operators with access agreements in place, prevents operators hoarding time paths which may be used by new seekers. As such, it is a useful

safeguard against barriers to entry into downstream rail services. Accordingly, the Commission does not have an in-principle objection to the provision relating to the withdrawal of under-utilised capacity.

Operators are concerned that the undertaking does not define "under-utilisation" and thus provides ARTC with discretion on when particular time paths might be declared under-utilised and withdrawn. The Commission notes that Schedule C of the undertaking, setting out essential elements of the access agreement, provides that "contracted capacity not utilised seven out of twelve times may be withdrawn by ARTC", that is, when a majority of twelve consecutive contracted train paths is not used. The Commission notes that this rule was not the subject of adverse comments from operators.

The Commission considers that in the absence of evidence that this rule is obviously inappropriate for this purpose, the test of under-utilisation that has been proposed by ARTC contained in schedule C of the undertaking does not raise concerns. The Commission considers that it strikes an appropriate balance between the private rights of an operator to use the network, and the public interest in ensuring that other operators can access the network when it would otherwise go unused.

The Commission considers that it is appropriate for the circumstances in which time paths can be varied, or the procedures that are to be followed in varying or withdrawing time paths, are best left to operators to negotiate with ARTC. The Commission notes that unless the parties otherwise agree, these matters will be dealt with in accordance with the terms contained in clause 9 of the indicative access agreement. The Commission considers that this clause represents an appropriate position should the parties, negotiating in good faith, be unable to negotiate terms tailored to the particular circumstances of the access application.

Operators have also expressed concern that the withdrawal of time paths in the event of confirmation of under-utilisation, is unwarranted if there is no demand for that time path from another operator. While the undertaking does not set out obligations on ARTC to demonstrate that another operator has requested a particular time path before it is withdrawn, it would appear contrary to ARTC's own interests to withdraw a path in the absence of an application from another access seeker, particularly as the incumbent operator is being charged the fixed component of the access charge irrespective of use. The Commission does not consider that the undertaking should require ARTC to demonstrate the existence of alternative demand for a time path before withdrawing it on the grounds of under-utilisation. The details on how access rights to a particular time path are actually withdrawn, are appropriately dealt with in an access agreement where parties are able to negotiate mutually acceptable processes. Details may include issues such as the period of notice and the conditions for resumption of access rights, if any, in the event that a time path has been deemed under-utilised.

In all, it is considered that by removing the exemption in clause 5.2(b), the provisions in this clause achieve a more acceptable balance of interests as required by the legislative criteria in section 44ZZA(3) of the TPA. As noted, however, the Commission would welcome further feedback from interested parties on the matter of spare capacity.

Recommendation

The last sentence of clause 5.2(b) of the ARTC undertaking [Failure to give notification …] be deleted.

D7. Network connections and additions to capacity

Clause 6 of the undertaking sets out the ARTC's processes where additional capacity is necessary to meet the demands of an access seeker or where owners of other tracks seek to connect to the ARTC's network.

ARTC's proposal

In clause 6.1, ARTC proposes to consent to connections to its network provided certain conditions are met: relevant government approvals; the connection does not reduce capacity; the connection complies with ARTC's interface, safety, engineering and operational standards; ARTC's train control directions are observed by operators using the connection; and the construction and maintenance costs associated with the connection is met by the owners of connecting track.

In clause 6.2, ARTC consents to the provision of additional capacity if:

- it is commercially viable to ARTC;
- the applicant agrees to meet the cost of additional capacity, either directly or through increased charges; and
- the extension to the network is, in the opinion of ARTC, technically and economically feasible, consistent with the safe and reliable operation of the network, will not impact on the safety of any user of the network, does not reduce capacity, meets ARTC's engineering and operational standards and does not compromise ARTC's legitimate business interests.

Views of interested parties

New South Wales Govt

The New South Wales Government notes that these provisions of the undertaking are very general. For example, clause 6.1 provides that ARTC will consent to other owners of track connecting to its network where, among other things, other track owners ensure that users of such track comply with the directions of ARTC's train controllers regarding entry to and exit from ARTC's network. The New South Wales Government argues that the provision is not clear on how the changeover among the train controllers is to be managed. It adds that the provision is unlikely to reflect how things work in practice, which New South Wales understands involves a more co-operative approach between train controllers of track owned by different owners.

State Rail Authority of NSW

SRA notes that in the past it has invested significant amounts in capital equipment and refurbishment to ensure that Victorian facilities supported its operations (although not

in relation to ARTC infrastructure). SRA suggests that the undertaking disclose how the use by parties of infrastructure funded by a particular operator is to be treated.

National Rail

According to NR there is insufficient detail on how ARTC proposes to determine the need for additional capacity. This is related to the lack of definition of the term capacity. It is unclear what "extensions to the network" means in the context of "additional capacity". In other words, there is no objective way of distinguishing between the need for additional capacity to accommodate an individual operator's needs and to cater for the entire system's requirements. There is also concern about a lack of clarity on the interaction between ARTC and "other Track Owners". The undertaking should be clear about how the ARTC network will interface with other networks to ensure "seamless access" to the entire interstate rail network. It argues that the interaction of different track owners is essential to providing efficient access arrangements. It contends that clear procedures and protocols must be established in relation to other track and the relationships between track owners with a view to meeting this requirement.

SCT

SCT notes that there is no requirement for ARTC's existing interface arrangements, engineering and operational standards, and costs associated with constructing and maintaining the connection to be reasonable. It notes that if ARTC improperly hinders a company from connecting to a network, the number of operators connecting to a network would be reduced, with a consequential reduction in competition.

The undertaking should place an obligation on ARTC to ensure that the initial and continued cost of constructing and then maintaining the connection are reasonable. ARTC should be prevented from hindering a company's ability to connect to the network. Capacity should not be a factor in determining whether or not a connection should be allowed. Since by definition a connection will reduce capacity, capacity measures should not be used as the main deciding factor. Further, the undertaking provides no requirement to ensure that ARTC's existing interface arrangements and engineering and operational strategies are reasonable.

FreightCorp & Toll

FreightCorp and Toll (FCT) have questioned the meaning of "commercially viable" and "economically feasible" in the context of the provision of additional capacity. In the absence of an elaboration of the meaning of these concepts, FCT claim that operators would remain uncertain about the significance of these provisions. Clarification is also required in the undertaking in respect of the payment/recovery of cost associated with increasing capacity. In particular, it seems unfair that one operator may be required to fund an expansion of capacity that may benefit a number of operators.

Commission's position

Clause 6 provides the general framework for how ARTC intends to deal with requests from access seekers for extensions to the network and expansions of capacity.

Assessing effects of connections

Connections to the network enable operators and end-users to have access to the network where, for example, key infrastructure, such as, storage and loading facilities, are not sufficiently close to tracks in ARTC's network to overcome logistical difficulties. The legislative requirement to have regard to the interests of access seekers and the interest of encouraging competition in related markets would suggest that connections to bottleneck infrastructure are desirable. Such connections represent a solution for an access obstacle that could otherwise prevent desirable entry and diminish intra and intermodal competition.

The issue would appear to be whether the conditions and safeguards in clause 6.1, intended to protect the interests of ARTC, are reasonable, or do they unnecessarily discourage connections and thus access to the network. The provisions in clause 6.1 pertaining to network connections require compliance with the operational, engineering and safety standards applicable to ARTC's network. Connections to the network are also conditional on the capacity of the network not being reduced.

Clearly, ARTC, in the pursuit of its own interests (and interests of existing users), considers that these conditions are essential to maintain the technical integrity of its network as well as ensuring that the connection does not compromise the available capacity for existing business. It would appear reasonable to argue that ARTC is entitled to asses the effects of any connection on the integrity of the rest of the network. The key seems to be how ARTC will assess the impact of a new connection on the system's capabilities. The undertaking does not provide guidance on this and largely leaves this matter to ARTC's discretion. This is the essence of the concerns raised by SCT in its submission.

So the question is: what restraints are there on ARTC's discretion on this matter? It would appear reasonable to argue that given the desirability of increasing traffic on its network, ARTC does not have an incentive to deny approvals for connections. This incentive, which acts as a constraint on its discretion, is derived from the effects of under-utilisation of its network in the face of competitive pressures from road transport. Another source of comfort for operators is the obligation on ARTC to negotiate in good faith. If an operator felt that ARTC was unreasonably withholding approval for a connection without a reason provided for in clause 6.1, the Commission could be requested to consider enforcement action for possible breach of the undertaking.

The Commission considers that competitive constraints on ARTC and the obligation to negotiate in good faith may be sufficient to prevent abuse of discretion in this regard. This is further supported by the scope to refer the matter to dispute resolution under clause 3.11(1). Nevertheless, to provide additional comfort to operators, it is considered appropriate to also recommend that ARTC be required to at least demonstrate that capacity is reduced by a proposal to construct a connection to the network in writing. Accordingly, it is recommended that:

Recommendation

Clause 6.1(b) of the ARTC undertaking be amended to include a provision for ARTC to specify in writing reasons why a connection reduces capacity.

Train controllers

The Commission does not consider that it is unreasonable for ARTC to propose that the owners of the extensions should ensure that users of the track comply with the traffic flow directions of ARTC's train controllers. This is not considered inappropriate as a base case. The undertaking does not preclude negotiations over a more cooperative approach.

Neither does the Commission consider that the undertaking be so prescriptive as to stipulate rules for managing changeover among train controllers. As with other aspects of the undertaking, this issue is about achieving an appropriate balance between certainty inherent in a prescriptive approach and the desirability for flexibility to enable participants to deal with a variety of situations, case by case.

Additions to capacity and connections

Some operators, principally National Rail, have indicated that the undertaking is unclear about how the need for additional capacity is determined and how it is differentiated from extensions to the network. According to National Rail, this partly stems from the absence of a workable definition of capacity.

The Commission is of the view that with the amendments in the revised undertaking, there is sufficient clarity on these issues and that the undertaking now represents an adequate starting point for further negotiations. In the definitions of "Network" and "Additional Capacity" in clause 9.1, ARTC differentiates between changes to the configuration of the railway lines depicted in Schedule E (extensions to the network) and the ability of the existing network to handle greater traffic volumes (additions to capacity). The former would seem to be physical extensions to the network which alter the origin-destination configuration, while the latter augments the capacity of the existing network structure. ARTC proposes in clause 2.1(c) that the undertaking does not apply to extensions and connections to the network, but, by inference, does apply to additions to capacity.

In plain terms, the Commission considers that clause 6.2 provides as follows:

- ARTC will approve additions to capacity if in its opinion, the addition to capacity is "commercially viable".
- If the addition to capacity is not commercially viable in ARTC's opinion, it will still give its approval if the applicant agrees to meet the cost and the addition to capacity satisfies the criteria in clause 6.2(a)(iii), including that ARTC considers the addition to capacity "technically and economically feasible".

As with clause 6.1 dealing with extensions, the key issue in clause 6.2 is the degree of discretion available to ARTC in deciding whether to approve a request for additional capacity. On one hand, ARTC is entitled to ensure that the addition to capacity does not compromise the integrity of its network. But by applying overly onerous criteria, ARTC could be restricting efficient entry. As noted in other sections of this report, ARTC would appear to have few incentives to abuse the discretion available under clause 6.2 and behave in an obstructionist manner. However, the Commission

considers that the application of the dispute resolution processes by virtue of clause 3.11(1) will provide a further disincentive to ARTC acting capriciously.

At a more general level, it is relevant to note that the approval of additions to capacity will ultimately depend on ARTC's opinion on whether or not the additions are either "commercially viable" or "technically and economically feasible". These provisions give ARTC scope to exercise discretion subject to the requirement to negotiate in good faith. To counterbalance this, the Commission considers that it is warranted to recommend that ARTC should be required to give written reasons for its decisions in respect of additions to capacity.

The Commission is of the view that clause 6.2 contains sufficient clarity regarding the financial burden associated with adding to capacity under this clause. The Commission considers that the practical effect of this clause is that in requesting an addition to capacity an operator may be asked to contribute to ARTC's costs in providing that capacity, either in whole or in part, on terms agreed between ARTC and the operator. The Commission notes that clause 4.2 of the undertaking contemplates an increment to the access charge for the net cost incurred in increasing capacity at the operator's request. The Commission considers that clause 6.2 does not provide for the possibility of ARTC being solely responsible for the costs of additions to capacity, but appears not to preclude it either.

It also appears that clause 6.2 may not provide for situations where additions to capacity constructed to satisfy the requirements of an applicant have flow-on benefits to other operators. This is not difficult to envisage in a network industry such as rail, where there are significant levels of joint usage, and a given investment often benefits a number of operators. This may occur where, for example, a passing loop constructed to accommodate the requirements of an operator, enhances the efficiency of all traffic flows in the part of the network where the loop was constructed.

This does not present difficulties where a new applicant considers that the expenditure on the addition to capacity is desirable given its own commercial requirements, irrespective of the fact that others may benefit from this expenditure. This "free rider" aspect may not necessarily affect efficient investment decisions as long as the other "unintended" beneficiaries are not direct competitors of the applicant paying for the additional capacity. In this case, the requesting applicant may decide to go ahead with the investment, if it deems it commercially desirable.

But it is not clear from clause 6.2 how ARTC would deal with requests for additional capacity where the new investment has clear benefits for and requires contributions from other existing and future operators. As noted in the discussion in chapter D5 of this report, the CPI-2% price cap and the "like for like" provision in the undertaking limit the discretion for ARTC to fund new investments from increases in access charges to future operators. To the extent that there are similar provisions in current contracts, ARTC would face similar constraints in respect of existing operators.

For example, there may be situations where an investment in additional capacity may be in the interests of the applicant as well as other operators, but the requesting operator cannot afford the full cost of the investment by itself. This is an example of a desirable investment that could be undertaken by ARTC and funded from operators over time.

However, the investment may be precluded from taking place if the required increase in charges to future and existing operators exceeds the limit imposed by the CPI escalation factor. The options for ARTC would appear to be to delay seeking contributions from existing operators until the expiry of existing contracts and/or lodge another undertaking specifically covering the new investment (or alternatively amend the present undertaking).

ARTC anticipates the possibility of submitting another undertaking in its response to the Commission's Issues Paper:

> ARTC is of the view that where an operator has requested additional capacity, they should be obliged to meet the costs of creating and maintaining that capacity…. Such capacity could be the subject of a separate undertaking such that ARTC or another operator gaining benefit through utilisation of that capacity would be required to pay for the benefit through a contribution to the capital cost.[106]

Paying for Additions to Capacity

Clause 6.2(b) provides that where the additional capacity is funded by ARTC, ARTC's costs can be reimbursed by the applicant either as and when incurred by ARTC or through increased charges or by periodic payments. The option to apply the latter is at the discretion of ARTC subject to ARTC being satisfied that the risk is commercially acceptable.

The effect of this clause is similar to that of clause 3.3(d) dealing with prudential requirements ARTC proposes for applicants before negotiating access. The provisions in clause 3.3, unlike those in clause 6.2, are subject to dispute resolution. The Commission considers that there is no fundamental difference in the way the two clauses operate and that the provisions of clause 6.2 should also be subject to the dispute resolution mechanism in clause 3.11. This would provide operators with protection from unreasonable use of discretion by ARTC in assessing the risk of operators failing to pay for the cost of the addition to capacity through increased charges.

Recommendation

Clause 6.2 of the ARTC undertaking be amended to provide for ARTC to give reasons in writing for its decisions on applications for additions to capacity.

In all, the Commission considers that clause 6 of the undertaking is generally appropriate. It provides for the construction of connections to and additions to capacity in ARTC's network.

While some operators are concerned by the degree of subjectivity reserved to ARTC in respect of refusing applications on the basis of feasibility, safety issues, or capacity and engineering considerations, the Commission considers that in this instance it is appropriate for the undertaking to be structured in this way. In reaching this view, the Commission considers that ARTC's commercial interests are in accommodating

[106] ARTC,(2) *op. cit.*, p. 33.

additional users to the network and so would be unlikely to exercise this discretion capriciously.

Some operators were also concerned about a lack of procedural detail. The Commission does not consider that the undertaking needs to be prescriptive about procedural issues arising in the course of negotiating increasing network capacity. The Commission again notes that if an operator considers that insufficient progress is being made on an application, it can seek to further its application by way of the dispute resolution mechanisms (in the case of applications for additional capacity, as recommended) or by applying to the Commission for enforcement action on a possible breach of the undertaking in respect of the obligation to negotiate in good faith. The Commission noted in section D2.1.3 of this report that ARTC is inconsistent in its ability to optimise interface with other networks. Nevertheless, it was observed that within these constraints, the undertaking achieves an adequate level of interface with interconnecting networks.

In other respects, the Commission does not consider that clause 6 raises concerns under section 44ZZA(3) of the TPA. The Commission is satisfied that with the amendments proposed by the Commission, this clause will achieve an acceptable balance between the interests of ARTC and access seekers. The public interest is promoted by adding safeguards that ensure that efficient entry is not hindered.

D8. Network transit management

Clause 7 of the undertaking sets out the ARTC's transit management procedures. In the Issues Paper, the Commission questioned whether the Network Management Principles (NMPs) were clearly stipulated and likely to be well understood by operators.

ARTC

ARTC states that the NMPs ensure that in essence those services that meet the timetable will generally exit on time, while those that suffer operator incidents will frequently be delayed and exit the network later than their scheduled arrival time.

ARTC argues that these principles have been in use since its inception and are widely supported by operators as being fair and reasonable. Operators, the ARTC claims, support the NMPs because they make users accountable for their performance on the network. Further, the ARTC argues that the nature of the NMP's is such that to the extent possible, users who manage their services effectively are insulated from the flow on effects in terms of delays from poor performers. ARTC contends that application of the NMPs gives greater certainty of track performance to those companies managing their above rail activities reliably replicating what would occur in a non-dynamic environment.

Views of interested parties

National Rail

NR argues that the network management principles are well set out, have been in use for some time, and are understood and accepted.

New South Wales Govt

The New South Wales Government notes that the network management principles appear reasonable as far as ARTC is concerned. However, the New South Wales Government notes that ARTC does not need to deal with issues of priority for passenger services, which is a legislative requirement in New South Wales.

State Rail Authority of NSW

SRA strongly recommends that a provision granting priority of passenger services be similarly included in the ARTC undertaking.

Freight Australia

The undertaking does not adequately address the requirements of issues dealing with the interface by intrastate networks/traffics. In the case of Freight Australia:

- its network interfaces with the interstate mainline;
- its traffic traverses both its own network and the interstate mainline; and
- it operates interstate services.

Freight Australia's access agreement with ARTC for interstate arrangements is similar to the standard access agreement in the ARTC undertaking. However, the intrastate arrangement is substantially different. The access requirement for an effective and efficient above rail service are very different from the interstate requirements.

The standard access agreement in ARTC's undertaking is based on the typical requirements of scheduled interstate trains running from Perth and Eastern states. These access arrangements would be typified by scheduled paths, planned well in advance of the run dates and used every week of the year. These arrangements have flagfall and "take or pay" obligations. As such, so called "healthy" trains have utmost priority with minimum risk of disruption.

As a minimum, the undertaking should acknowledge the terms and conditions in the interstate agreement with ARTC. Ideally, there should be an integrated approach between the ARTC network and the Freight Australia network.

SAIIR

The ARTC undertaking aims to exit trains according to their contractual exit time. In the case of conflicts between trains in transit, the network management principles which would apply are designed to ensure that there is a focus on "on time" exit and that the train performance by operators is appropriately reflected in the management of trains.

In the case of the Tarcoola-Darwin access code, the regulator will have to establish principles for:

- the conversion of an above-rail service provider's capacity entitlement into specific train paths on a daily train plan; and

- traffic coordination/control aimed at the running of train services and the commencement and closures of track possessions as scheduled in the daily train plan.

The ARTC undertaking only sets out the principles for the latter. That is, there is no obligation on ARTC to produce a daily train plan.

FreightCorp and Toll

FreightCorp and Toll have submitted that the NMP's "were first developed for the early access agreements entered into by the Australian National Railways Commission. Following the introduction of Part IIIA of the TPA and greater use of the network by various operators, it is now appropriate for the existing network management principles to be reviewed to determine whether they are still appropriate."[107] According to FreightCorp and Toll, appropriate network management principles should be developed in an industry forum overseen by the Commission. FreightCorp and Toll submitted that the network management principles should be based on:

- scheduling principles
- train control principles and
- planned maintenance programmes.

FreightCorp and Toll have presented a detailed account of how they considered these principles to operate. The key features of the planned maintenance programme principles are as follows:

1. Objectives
    - Minimise disruptions to train services but maintain integrity of infrastructure.
    - Consistency between maintenance programme and basis for charging access fees.
    - Maintenance of infrastructure to take place at same time as maintenance of rollingstock and of private facilities.
    - Ensure that operators are able to access and use the infrastructure in accordance with the contractual obligations of ARTC under its access undertaking.
2. Planning Process
    - A first draft of the maintenance programme is to be distributed to operators six months prior to the commencement of the maintenance period.

[107] FreightCorp and Toll, *op. cit.*, p. 51.

- Within one month after publication of first draft of maintenance programme, operators must make a submission to ARTC in respect of first draft.
- A second draft of the maintenance programme is to be published not less than four months prior to the commencement of the maintenance period
- The second draft of the maintenance programme is to be discussed at the annual planning meeting chaired by ARTC and attended by operators.
- Not later than one month prior to the commencement of the maintenance period, ARTC must publish the planned maintenance programme.

Queensland Rail

QR recognise the difference between the traffic profile of ARTC and QR and acknowledge that its network management system may not be applicable to ARTC's case.

While ARTC's system is based on the "on time" principle, not all of the train services on parts of QR's network have, as their primary objective "on time" running.

Coal trains may be driven by the requirements of the ports in terms of stockpiles and/or vessel loading commitments. The main requirement is not with "on time" running but rather with a system that is flexible enough to accommodate the ports' requirements for a particular sequence of coal from different mines. An "on time" system may not be appropriate if it results in congestion at a bottleneck in the system and delays the next scheduled service. QR has an obligation to meet operators' contractual "capacity" entitlements. The access agreement specifies the consequences of QR's failure to do this.

Commission's position

The Commission's first concern in assessing network transit management has been to ensure that the proposed rules are clearly specified in advance, complete, capable of being known by operators and applied by ARTC in a consistent an efficient manner. Subject to reasonable confidentiality they should also be transparent. The Commission considers that provided the particular rules meet this test, then operators will be able to structure their operations so as to seek to maximise the utility they derive from their access rights. The Commission considers that the rules proposed by ARTC for network management meet this test.

The Commission also notes that some operators have questioned the suitability of some of the rules that have been proposed. The Commission considers that in a network industry, there will be contention between operators as to the particular access rules that should be applied by the network provider, as each operator may have different interests. The Commission however is satisfied that from the information available to it that the current rules are an appropriate basis for ARTC to handle manage the network.

This is not to say that in future the rules could not be further refined or improved. The Commission would welcome industry considering these rules at appropriate intervals to ensure that they continue to be appropriate.

D9. Performance indicators

In response to written submissions and comments made at the Commission's public forum, ARTC submitted a revised version of the undertaking to the Commission on 14 September. One of the amendments was the inclusion of a new section, Part 8, on performance indicators.

D9.1 ARTC proposal

Part 8 imposes an obligation on ARTC to maintain the network in a fit for purpose condition and to publishing a set of specified performance indicators on its website.

The performance indicators are in two categories. The first relates to service quality performance reporting. These measures include the reliability of the network, transit times and a track quality index. The measures are to be published quarterly. The second category of indicators relates to annual reporting of ARTC's unit costs. These costs are infrastructure maintenance costs (on a $/train km and $/kgtk basis), train control costs ($/train km basis) and operations costs ($/train km basis).

The service quality measures relate not only to the performance of ARTC but, in some cases, to customers. The measures are listed as being the responsibility of ARTC, operators or both.

D9.2 Views of interested parties

The Commission contacted interested parties seeking comments on, among other things, the new section in the undertaking on performance indicators. Submissions were received from Toll, FreightCorp and SCT.

Toll

Toll argues that the "fit for purpose" commitment is so broad as to be meaningless and unenforceable by any individual rail operator. It adds that fitness for purpose can only be properly assessed by reference to the services provided by the infrastructure in question. It believes that unless the fit for purpose obligation has some substantive content, it is not likely to provide any meaningful performance obligation on ARTC.

Concerning the performance measures, Toll notes that there is no obligation on ARTC to seek to improve any of these reported parameters or to have charge structures which would provide it with an incentive to improve performance. It adds that the reporting obligation in relation to track, "track quality measured by index", is not likely to provide any reliable data for train operators.

FreightCorp

FreightCorp is supportive of the development of performance indicators. FreightCorp makes a number of comments about the indicators put forward. These include concerns

over the issue of confidentiality, the lack of indicators relating to either signalling/communications infrastructure equipment or safety and the definition of a healthy train. FreightCorp also expresses a preference for monthly reporting of the indicators.

SCT

SCT suggests that the 'fit for purpose' clause has no corresponding clause in the indicative access agreement. Furthermore, SCT expresses dissatisfaction with reporting of infrastructure maintenance costs as it is unclear whether actual costs are reflective of efficient costs and, if not, what affect this would have on determining access charges or the revenue limits.

D9.3 Commission's position

In incorporating Part 8 into its draft undertaking, ARTC has demonstrated a preparedness to respond to the concerns expressed by operators. The Commission is encouraged by ARTC's willingness to publish performance indicators and its commitment to maintaining the network in a fit for purpose condition.

Issues concerning service quality were previously discussed in section D5.2 of this report. It was argued in section D5.2.1 that ARTC faces significant inter-modal competition from road and shipping in a number of its customer segments. The Commission believes that this competition will limit the extent to which ARTC is able to decrease service quality. Therefore, the Commission concluded in section D5.2.2 that specific service standards can be left open to negotiation between ARTC and access seekers, with the "fit for purpose condition" in clause 8.1 acting as a safeguard against provision of inadequate services by ARTC.

The Commission believes, however, that there currently are impediments to the "fit for purpose condition" clause performing this role. As currently drafted, the clause is quite vague, and therefore would be difficult to enforce. For example, it is not clear what the purpose that the network is to be fit for is, or what the standard to which the network should be maintained is. Accordingly, the Commission considers that what constitutes fit for purpose needs to be defined. In making this recommendation, the Commission is mindful that a "fit for purpose condition" has to act as a safeguard against provision of inadequate services by ARTC, yet not be so prescriptive so as to restrict 'price – quality' negotiations between operators and ARTC.

The Commission believes that the approaches outlined in clause 6.1 of the indicative access agreement could potentially provide a basis for a definition of fit for service in the undertaking. This section of the indicative access agreement defines a standard to which the ARTC must maintain the network.

To further improve the enforceability of the undertaking, the Commission also recommends that ARTC undertake to **the Commission** to maintain the network, rather than to 'commit to operators to maintain the network.'

The Commission also has concerns with the performance measure in Table 1 of clause 8.2, "Track quality measured by index." The Commission believes that it is important to have a reliable measure of track quality. Therefore, it is of some concern to the

Commission that this performance measure is not defined. The Commission requires an explanation of what the track quality index is, how it is measured, and whether it is a widely recognised and accepted measure of track quality. Once this information is provided, the Commission will be able to decide whether "track quality measured by index" is an acceptable performance measure.

The Commission also believes that the performance reporting needs to be strengthened by including further performance measures in Table 1. The Commission considers that performance indicators for safety and service satisfaction are essential and must be included in the table. Safety could be measured by accidents per million train kilometres. It should outline workplace and other fatalities / injuries, and should note freight damage and losses. Service satisfaction could be measured by a register of the number of complaints, the number and duration of disputes, and the number of disputes going to arbitration.

Furthermore, the Commission has some concerns that that there are not sufficient checks on the accuracy of the information to be published. The Commission believes that it is important to ensure that the performance indicators that are published have been independently verified. The Commission therefore recommends that the undertaking must provide for periodic independent auditing of the accuracy of performance indicators.

Finally, concerning FreightCorp's argument about confidentiality, the Commission considers that the information at stake could be readily observed and, as it is not internal to an operator's business, would not appear to be commercially sensitive. It appears, however, that the measurement of some of the indicators – for example, the attribution of delays - requires a degree of judgement on the part of ARTC. While this may present no particular confidentiality concerns if the performance indicators are published on an aggregated basis, if the indicators identify individual operators then, at a minimum, some form of confirmation / verification prior to publication would be essential. The Commission recommends that the undertaking clarify whether the indicators are intended to identify individual operators or not, and if individual operators are to be named, to detail how ARTC will ensure they do not unfairly represent the performance of any particular operator.

The proposed changes to this section are designed to ensure that the commitment to maintain the network in a "fit for purpose condition" is meaningful and supported by the publication of relevant, independently verified performance indicators. These changes are summarised in the following recommendation.

Recommendation

- **clause 8.1 of the undertaking must be amended to define "fit for purpose condition" in a manner that is deemed acceptable by the Commission;**
- **clause 8.1 of the undertaking must be amended to require that ARTC undertake to the Commission to maintain the network, rather than to commit to operators to maintain the network;**
- **clause 8.2 of the undertaking must be amended to provide more detail on the components and measurement of the track quality index;**
- **clause 8.2 of the undertaking must be amended to provide performance indicators for safety and service satisfaction that are acceptable to the Commission;**
- **clause 8.2 of the undertaking must be amended to provide for periodic independent review or audit of the accuracy of the performance indicators and processes for information collection (including attribution of delays for the purposes of defining 'healthy' trains); and**
- **clause 8.2 of the undertaking must clarify whether the performance indicators are intended to identify individual operators or not, and if individual operators are to be named, to detail how ARTC will ensure they do not unfairly represent the performance of any particular operator.**

D10. Schedules

The schedules contain further terms and conditions of access which are pertinent to the assessment of the undertaking. The schedules are the following:

- Schedule A: Access Application
- Schedule B: Information to Accompany Access Application
- Schedule C: Essential Elements of Access Agreement
- Schedule D: Indicative Access Agreement
- Schedule E: Description of Network
- Schedule F: Network Management Principles

The Commission has no concerns with schedules A, B and E. In each case, the schedules contain descriptive information on the access application, information which is to accompany the application and of the rail network. The schedules promote understanding of ARTC's requirements for the provision of access to its rail network and represent an adequate balance of the interests of the various stakeholders. The Commission considers that these schedules satisfy the assessment criteria in section 44ZZA(3) of the TPA. Schedule C was considered as part of the assessment of clause 3.10 of the undertaking regarding the access agreement. The Commission's position in

respect of Schedule C was that it also satisfied the requirements of section 44ZZA(3) of the TPA. Schedule F was considered in the context of clause 7 which dealt with network transit management and in the final analysis the Commission expressed the view that it did not raise concerns under the assessment criteria.

D10.1 Schedule D – Indicative Access Agreement

Schedule D contains the indicative access agreement. The indicative access agreement was the subject of considerable comment from interested parties. In the Issues Paper, the Commission questioned whether it was appropriate for the indicative track access agreement to be part of the undertaking and whether the terms and conditions in this agreement are appropriate and consistent with the access undertaking.

ARTC's proposal

The ARTC states that the indicative track access agreement is incorporated into the undertaking as a guide only. However, ARTC is prepared to be bound by the terms and conditions as presented should an access seeker require use of the track for an indicative service, and the capacity exists to accommodate the specified service. It argues, therefore, that inclusion of the access agreement gives absolute clarity to an access seeker in relation to the responsibilities and obligations of both parties should access be granted.

The ARTC further notes that the access agreement as included is the culmination of extensive consultation over a two year period with numerous industry participants. However, the ARTC argues that while it is prepared to commit to the agreement as included – giving certainty to access seekers wanting standard access, ARTC recognises from views previously expressed by operators that some also wish to maintain a certain level of flexibility and the ability to negotiate. Because of this ARTC has included the agreement as a guide for those access seekers wishing to negotiate outside of the published agreement.

In relation as to whether the terms are consistent with the undertaking, the ARTC argues that they are inherently the same since ARTC has developed the undertaking based on what occurs in practice.

Finally, the ARTC argues that its current practices as encompassed in the undertaking has seen the number of operators gaining access to ARTC's network flourish over the past two years with access being granted to a number of new operators as mentioned above. It argues that this is evidence that the processes and practices utilised are effective and viewed as fair by access seekers notwithstanding everyone in business is constantly seeking "a better deal".

Views of interested parties

National Rail

NR argues that it is inappropriate for the indicative track access agreement to be part of the undertaking, stating that major terms must be in the undertaking to ensure they are enforceable.

NR also contends that the indicative access agreement is weighted strongly in favour of ARTC, particularly in those clauses dealing with:

- track standard;
- indemnities;
- renegotiation of long term train paths;
- track extensions;
- rolling stock standards;
- monitoring equipment;
- flagfall relief;
- security;
- assignment;
- removal of train paths;
- review of access charges; and
- renewal of train paths.

Queensland Rail

QR notes that there are many similarities between ARTC's standard access agreement and its own proposed standard access agreement. However, for legal, technical or operational reasons, there are some significant areas, such as capacity management and interface management, where QR has taken a different approach to ARTC.

SCT

SCT notes that it has been negotiating with ARTC for almost two years in order to secure an appropriate track access agreement. It has highlighted eighteen terms and conditions in the draft track access agreement, including many dealing with procedural and legal issues, that it believes are unsatisfactory.

FreightCorp and Toll

FreightCorp and Toll provid detailed comments on the indicative access agreement. Its comments also point to numerous clauses in the indicative access agreement, dealing with procedural matters, with which they are concerned.

Commission's Position

Schedule D to the undertaking comprises an indicative access agreement. This sets out particular terms and conditions upon which ARTC undertakes to allow an operator to access the network should ARTC and the operator be unable to negotiate an access agreement of their own.

The Commission considers that the inclusion of an indicative access agreement in the undertaking has merit, in that:

- it provides a safety net for operators should they be unable to negotiate terms of access that they may consider more favourable, or should ARTC seek to impose terms that they consider less favourable; and,
- it would tend to minimise transaction costs on ARTC and operators by providing a clear basis from which the operator and ARTC can negotiate.

The inclusion of the indicative access agreement does not seek to displace the primary role of negotiation or to otherwise abrogate the rights of an operator to negotiate an access agreement that differs from it. It is clear that the indicative access agreement is not a prescribed form of agreement, and that an operator and ARTC can negotiate an access agreement that differs to it.

The Commission considers that ARTC would, consistent with its undertaking to the Commission to conduct its negotiations in good faith, be obliged to give due consideration to each request that an operator makes to include in its access agreement a term that differs to that contained in the indicative access agreement.

In assessing the undertaking, the Commission has considered the substantive effect of the terms of the indicative access agreement upon the ability of an operator to gain access to the network. The purpose was to ensure that the indicative access agreement is not inconsistent with the terms of the balance of the undertaking, and to assess it against the statutory criteria of section 44ZZA(3) of the TP Act.

The Commission notes that some operators have raised concerns that are solely about the manner in which the indicative access agreement has been drafted, such as whether or not the agreement could be drafted with more certainty or particular words better defined.

The Commission considers that it is appropriate, in assessing the undertaking, to concentrate on those issues which have a substantive bearing on the ability of an operator to gain access to the network. It is more appropriate that ARTC and operators seek to remedy the particular drafting issues perceived in the agreement that is offered (if any) in the course of their negotiations for access.

Of course, should ARTC wish to address any of the perceived drafting errors that have been notified in the consultation process, it is able to lodge a revised undertaking that incorporates these changes.

The Commission has identified a number of matters in the indicative access agreement about which it may have potential concerns:

- a conditional right of renewal is given to operators, provided they hold a long term (3 year +) contract {clause 2.8};
- ARTC can require a parking surcharge be paid {clause 4.3};
- ARTC can levy penalty charges for overweight rolling stock {clause 10.2};

- indemnities by ARTC and operator {clause 15};
- ARTC can require insurance policies to be maintained by operators {clause 16.1}; and
- the proposed dispute resolution process {clause 17}.

Re-negotiation of long-term contracted paths

Clause 2.8 of the indicative access agreement provides that if an operator has a long-term contract for a particular time path, it can apply for an extension of the contract. ARTC commits in clause 2.8 not to unreasonably withhold its consent for an extension of the time path. FreightCorp and Toll in their joint submission have queried why three years were selected as the threshold for automatic consideration of extension of contracts.

The Commission considers that it may be advantageous to both ARTC and an operator to be able to agree to an extension of a contract, rather than re-negotiate a new agreement subject to the negotiation processes of the undertaking, if both parties are satisfied with existing arrangements. The key issues are, firstly, whether the right to extend an existing contract should be incorporated in the undertaking and second, whether it is appropriate for this right to be available only to operators with contracts with a term of at least three years.

The undertaking does not contain a provision regarding the extension of existing contracts. While it can be argued that such a provision may not be significant in the context of an undertaking, it would nevertheless improve its transparency in respect of this particular aspect. Operators would certainly benefit by knowing this up front.

Making this option available only to operators with long term contracts appears reasonable. An assessment of whether an arrangement works satisfactorily is appropriately made after parties have had an opportunity to put the arrangements to test. Also, it acts as an encouragement to operators to avoid contracts of short duration. Three years appears sufficient time for both ARTC and operators to consider whether they wish to continue the existing arrangement or re-negotiate terms and conditions. The Commission considers that in the absence of any evidence that three years is obviously inappropriate as a benchmark for such a provision, it has no reason to reject ARTC's proposal.

Recommendation

ARTC undertaking be amended to provide for re-newal of existing contracts.

Parking surcharges

Clause 4.3 stipulates that a parking fee is applicable should ARTC and the operator reach agreement on utilisation of the network for parking time beyond normal standing time included in time-path allocations.

The Commission does not have information on the likely incidence or pervasiveness of parking surcharges, nor does the indicative access agreement provide details of how the

charge is to be calculated. The Commission is therefore not in a position to assess the reasonableness of the surcharge or whether the surcharge is material. It is noted, however, that it does not appear to be an issue of concern to operators.

Nevertheless, the Commission considers that the undertaking should contain a provision for the parking surcharge. The provision should provide clarity as to what constitutes parking and an indication of how it may be calculated. This would serve the purpose of informing potential access seekers on the possibility of such a charge. This may require amendments to the definition of charges in the undertaking. If revenues from parking surcharges is considered material, ARTC should ensure that the definition of revenues for the purposes of calculating the ceiling takes this into account.

Recommendation

The ARTC undertaking be amended to provide for parking surcharges.

Security of up to four weeks' charges

Schedule C of the undertaking notes that ARTC may require security from all operators. Clause 4.8 of the indicative access agreement then provides the amount of security, the form of security, when security can be required, and the procedure to be followed in requiring security or releasing it. The indicative access provisions will apply should the parties not agree to vary them. ARTC proposes to make such a request if the operator has defaulted in the payment of any monies owed to ARTC. Security will be released if operator is not in default for a continuous period of three months.

Comments from operators vary. SCT have submitted that it is appropriate for ARTC to request security as provided for in clause 4.8, but point out that the operator should be given the opportunity to rectify the default after receiving written notice of default. [108] SCT are also concerned that any review of the amounts that can be required as security are not subject to the dispute resolution procedures. FreightCorp and Toll in their joint submission expressed the view that it is not appropriate for security to be sought at all.

The indicative access agreement provides that security can be required when an operator does not remedy a default within seven days. There is no requirement to first notify of the default. The Commission does not consider that ARTC should be required to specifically notify an operator that they are in default and that the seven day period in which to remedy has commenced. The Commission considers that provided ARTC has issued invoices stating the amount payable and the date it becomes payable then it is the obligation of the operator to ensure that it makes the payment on the due date, or within the seven day grace period. Similarly the Commission does not consider the review of security amounts to be a matter likely of such contention that it should require ARTC to make the review subject to dispute resolution. The process essentially involves the calculation or a four-week average of charges that have been incurred.

The Commission notes that there is provision in Schedule C, "Essential Elements of Access Agreement", for ARTC to have the right to seek security from an operator.

[108] SCT, *Submission*, p. 20.

The Commission considers that clause 4.8 of the Indicative Access Agreement does not raise concerns under the assessment criteria in section 44ZZA(3) of the TPA.

Penalty charges for overweight rolling stock

ARTC proposes in clause 10.2 of the indicative access agreement to apply a charge for overloading its rolling stock where it is found that an operator has presented a train that exceeds the weight that has been contracted (and paid) for. The penalty depends upon the amount by which the actual weight exceeds the contracted weight, and whether the actual weight exceeds the axle load specification for the particular train. If the actual weight does not exceed the axle load specification then the penalty charge is twice the gtk rate per tonne. If it exceeds the axle load specification then the penalty charge is ten times the gtk rate per tonne.

The Commission considers that it is appropriate for there to be a mechanism by which operators are penalised for presenting trains that exceed the weights contracted and paid for, especially where axle loads are exceeded. In the absence of any submissions to the contrary, the Commission has accepted that the penalty rates proposed are appropriate. The Commission considers that the undertaking itself should note that these penalty charges may be levied by ARTC.

Operators have raised concerns to the effect that they should not be penalised without an opportunity to verify that their train has in fact been presented overweight. The Commission considers that it is appropriate for operators to be given this opportunity, but does not consider that it needs to prescribe particular procedures for verifying weights to be included in the undertaking or to be followed when the charges are levied. The Commission considers that because the levying of penalty charges will be a matter for dispute resolution under the access agreement (unless the parties otherwise agree), that operators will be adequately protected from claims that ARTC could not substantiate in that process.

The Commission is of the view that clause 10.2 of the indicative access agreement does not raise concerns under the assessment criteria in section 44ZZA(3) of the TPA. Nevertheless, the Commission considers that there are merits in providing for overweight charges in the undertaking.

Recommendation

ARTC undertaking be amended to provide for overweight charges.

Indemnities

Operators have expressed concern over the provisions of the indicative access agreement that relate to them indemnifying ARTC for damage or injuries that occur in connection with the services that they run.

The essence of this concern is that they consider that the terms of the indicative access agreement effectively attributes to them responsibility for some injury or damage that would not be attributed to them at law in the absence of those terms. The operators consider that as a result additional risk is placed onto them, and it would be more appropriate for this risk to be carried by ARTC.

The Commission has considered that issue first from the perspective of how readily the relevant clause from the indicative access agreement could be applied, should they be incorporated into an access agreement negotiated between the parties. The Commission considers that it would be contrary to the public interest in having injuries compensated or damage repaired for the terms of an access agreement to lead to dispute about who is responsible for that compensation or damages. The Commission considers that on the whole the relevant clauses meet this test.

The Commission has also considered this issue to gauge the implications that the approach proposed by ARTC may have for operators to access the network. To the extent that additional responsibility is in fact placed on an operator, the Commission acknowledges that additional costs, primarily in the form of insurance premiums, may fall on an operator. In this context, this represents the introduction of an additional cost of access. The Commission does not have available to it any estimates of what effect these clauses would have on an operator's costs. The Commission would anticipate, however, that these additional costs would not be so substantial as to make the proposed clauses unreasonable. In coming to this view, the Commission has been mindful that the direct costs of access to the network are not excessive.

Insurance policies

Clause 16 of the indicative access agreement, provides for both the operator and ARTC to take out public liability insurance policies as well as insurance cover in respect of each party's liability to the other pursuant to the indemnity provisions in clause 15. ARTC proposes that the insurance cover should be for $200 million.

FreightCorp and Toll commented in their joint submission that further information should be sought including whether the cost of such a cover can be justified given that public liability insurance policies are also taken by both ARTC and operators. SCT has queried whether $200 million is an appropriate cover.

On balance, the Commission considers that insurance and its cost can be a substantive issue that may have a bearing on the decision to seek access. As such, the undertaking should provide for the possibility of insurance policies. Having said this, the issues of whether the cost of insurance in respect of each party's liability to the other is justifiable given alternative insurance and whether the cover is appropriate, are best dealt with as part of the negotiation process, on a case by case basis.

While insurance premiums do add to an operator's costs, the Commission considers it in the public interest that comprehensive insurance cover is held by ARTC and by operators, so to ensure that injuries caused in connection with the network can be compensated for, and damage to infrastructure repaired.

The Commission considers that ARTC should expressly undertake to maintain the level of insurance that is referred to in the indicative access agreement for the duration of the term, and that this should be contained in the body of the undertaking. The undertaking itself only provides (at Schedule C) for an operator to maintain insurance and does not oblige ARTC to maintain any insurance. While ARTC would be obliged to maintain insurances in respect of access agreements that it negotiates in the terms of the indicative access agreement, the Commission is mindful that access can be negotiated in terms that differ to the indicative access agreement.

In respect of claims that the level of insurance cover may not be appropriate, the Commission does not object to the level of cover that has been proposed.

Recommendation

ARTC should undertake to maintain the level of insurance that is referred to in the indicative access agreement for the duration of the Term.

Dispute resolution under the indicative access agreement

Clause 17.4 of the indicative access agreement sets out its own dispute resolution process, applicable to disputes arising out of such an agreement. This dispute resolution process in the indicative access agreement, as originally submitted by ARTC, provides for a three-step dispute resolution process:

- **Negotiation** between the parties;
- **Mediation** by a person appointed by agreement between the parties or by the President of the Law Society of South Australia if the parties can not agree on a mediator;
- **Arbitration** by a person appointed by agreement between the parties. If the parties can not agree on an arbitrator, the arbitrator shall be, in the first instance, the Commission or – if the Commission is unwilling or unable to arbitrate – a person appointed by the President of the Law Society of South Australia. The arbitration is to be conducted broadly in accordance with the Commercial Arbitration Act 1986 (SA).

In addition to evaluating the proposed dispute resolution model proposed in the body of ARTC's undertaking, the consulting report provided to the Commission by Resolve Advisors assessed the proposed dispute resolution procedures described in the indicative access agreement. The draft report and a document providing a summary of the recommendations are available on the Commission's website.[109]

The report proposes a dispute resolution model not unlike the one proposed in relation to the undertaking. Some adjustments are proposed to take account of the difference in nature between disputes relating to the negotiation of access to the ARTC network and disputes relating to access agreements already negotiated. The Commission suggests that ARTC give further consideration to the recommendations of that report.

Submissions to the Commission provided few comments on the dispute resolution provisions in ARTC's original indicative access agreement. In relation to the amended version, Toll argued that clause 17.4(b)(i) makes no reference to the necessary qualifications of the proposed arbitrator and that the proposed jurisdiction is inappropriate. Toll also argues that the indicative access agreement does not contain any pricing principles. SCT makes a similar point.[110] In relation to these concerns, the

[109] Resolve Advisors, *op. cit*.

[110] On this point, the Commission notes that price would be expressly specified in any executed access agreement. It is not clear, therefore, what need there is for the additional inclusion of pricing principles.

Commission reiterates that the indicative access agreement is not a prescribed form of agreement, and that an operator and ARTC can negotiate an access agreement that differs to it.

During the course of its assessment, however, the Commission has considered the extent of its powers under the TPA. The Commission notes that it is able to perform functions or exercise powers that are provided in an undertaking that it accepts only to the extent that those functions or powers relate to the undertaking itself. This limitation arises from operation of section 44ZZA(6) and section 44ZZA(6A) of the TPA.

The Commission considers that it does not have jurisdiction to exercise any function or power that an access agreement provides for, or that the undertaking provides for but which relates to disputes arising under an access agreement.

Accordingly, the Commission has previously advised ARTC that it could not act to resolve disputes that occur under an access agreement. The Commission indicated that it should not be specified as an arbitrator of such a dispute on the face of the indicative access agreement that is attached to the undertaking. In response to the Commission's advice, ARTC re-submitted the undertaking with amendments to clause 17 of the indicative access agreement.

The amended indicative access agreement no longer specifies the Commission as an arbitrator. Clauses 17.4(b)(vii) and 17.5 of the amended indicative access agreement do, however, provide for arbitration decisions to be appealed to the Commission in the event that a party to the arbitration considers that the arbitrator has made a manifest error. Clause 17.5 also specifies the provisions under which such an appeal is to be conducted by the Commission.

As noted above, the Commission is able to perform functions or exercise powers that are provided in an undertaking that it accepts only to the extent that those functions or powers relate to the undertaking itself. The Commission considers that it does not have jurisdiction to act in any capacity under an access agreement. Accordingly, the Commission does not accept clauses 17.4 and 17.5 of the indicative access agreement.

Recommendation

The ARTC indicative access agreement should not in any way provide for the Commission to adopt a role under an access agreement.

The Commission notes that the Resolve report endorses the use of commercial arbitrators for arbitration of disputes arising under an access agreement. The report also expresses the view that the indicative access agreement does not specify the criteria for arbitration and that this is appropriate, given that the rights of the parties are identified in the agreement itself.

The Commission notes that the original version of the indicative access agreement submitted by ARTC did not contain any specific criteria which the arbitrator should take into account in making a decision in relation to disputes arising under that agreement. The amended version did, however, include a number of criteria in clause 17.4(b)(vi)(B). These refer to, and largely reflect, the provisions of Part IIIA of the TPA and the Competition Principles Agreement. In light of the advice provided by

Resolve, the Commission queries the relevance of including reference to these further criteria. It may be inappropriate to require such questions relating to public policy to be considered by a commercial arbitrator. The Commission notes again, however, that the terms on which access arrangements are agreed is primarily a matter to be negotiated and agreed between the parties.

Summary

Subject to ARTC addressing the matters raised above the Commission considers that the indicative access agreement would satisfy the criteria in section 44ZZA(3) of the TPA.

D11. Conclusion

ARTC has submitted an undertaking to the Commission in respect of third-party access to the rail network owned and managed by ARTC. The undertaking was submitted pursuant to the provisions of Part IIIA of the TPA. The undertaking contains principles and processes for negotiating access, as well as actual terms and conditions which will form the basis for access to ARTC's network.

The Commission has found that the undertaking generally satisfies the legislative criteria pursuant to which the assessment was carried out and represents an adequate basis for negotiating access to ARTC's rail network. However, the draft decision raises concerns with a number of provisions in the undertaking. Primarily, these concerns relate to principles and processes for negotiating access and resolution of disputes rather than prices charged for access. The Commission also makes recommendations regarding the provisions covering service quality.

In coming to a draft decision on the ARTC undertaking the Commission has formed the view that while ARTC has many of the characteristics of a business expected to hold market power, there may be factors that act as restraints on its ability to take advantage of any such power. Firstly, the Commission considers that competition from road transport for inter-modal freight and passenger services is likely to restrict ARTC from increasing prices to generate excessive profits. Second, the information available to the Commission indicates that the ARTC rail network has the capacity to accommodate traffic growth over the next five years and that ARTC currently earns an inadequate rate of return. This suggests that ARTC should have strong incentives to attract access seekers and encourage use of its infrastructure.

In addition, provisions in the undertaking committing ARTC to ongoing reductions in real prices charged to users and proposing a curb on price discrimination have the effect of further restraining the potential of ARTC to exercise market power through increasing prices.

Nevertheless, in its assessment, the Commission has concluded that the effect of a number of clauses is to provide ARTC with unnecessarily broad scope in its dealings with access seekers. The Commission has made recommendations imposing more stringent obligations on ARTC and/or greater safeguards for access seekers in respect of these clauses. This is necessary in order to achieve a more appropriate balance between the interests of the infrastructure owner, access seekers and the public interest, as required by the criteria in Part IIIA.

Given that it is prepared to act as the arbitrator of disputes arising under the undertaking, the Commission has also made a number of recommendations in relation to the proposed dispute resolution process. These recommendations generally aim to expedite the resolution of disputes and increase the transparency of arbitration determinations. The draft decision also provides some guidance as to the approach the Commission intends to take when making arbitration determinations. This approach is primarily guided by the provisions of the undertaking and the TPA.

As the undertaking does not cover the entire interstate network, it is important that in the interests of facilitating the movement of rail traffic across state borders, it interfaces well with other access regimes. The Commission considered a number of interface issues and concluded that while the level of interface is not optimal, ARTC's approach should provide an adequate level of interoperability with other access regimes. The undertaking itself represents an important step towards improving interstate rail access for train operators. The Commission therefore anticipates that further access undertakings covering other parts of the interstate rail network can use ARTC's undertaking, and the Commission's assessment of it, as a guide.

Final approval of the undertaking is subject to ARTC satisfactorily addressing the concerns raised by the Commission in this draft decision.

D12. Draft decision

For the reasons set out above, the Commission has determined that it is appropriate to accept the undertaking, having regard to the matters set out in subsection 44ZZA(3) of the TPA, subject to ARTC effecting changes as recommended by the Commission in this draft decision.

The draft decision is designed to provide the opportunity for ARTC and interested parties to comment on the Commission's initial assessment of the undertaking. It also provides ARTC the opportunity to address the concerns the Commission has raised with its access undertaking, before the Commission makes a final determination.

ARTC now has the opportunity to amend its undertaking and resubmit it to the Commission for further assessment. Before making a final determination on a revised undertaking the Commission will further consult interested parties. The Commission will consider comments and submissions on its draft decision. Submissions are due by 31 January 2002.

Appendix A: List of Parties providing Submissions

The following parties made submissions in relation to the access undertaking:

- Freight Australia
- FreightCorporation
- Toll Group
- Great Southern Railway
- New South Wales Government
- New South Wales Department of Transport
- National Rail
- PTM Strategies
- Queensland Rail
- South Australian Independent Industry Regulator
- Specialised Container Transport
- State Rail Authority of New South Wales
- Victorian Department of Infrastructure
- Transport WA