Submission to the Australian Competition and Consumer Commission

Issues Arising from Revised ARTC Undertaking

1. Overview

1.1 The Revised Undertaking

Toll has been invited by the Australian Competition and Consumer Commission ("**Commission**") to provide comments on a revised undertaking which has been submitted by the Australian Rail Track Corporation ("**ARTC**") to the Commission. The revised undertaking has been submitted by ARTC following extensive submissions by a wide range of parties on the initial undertaking and a workshop organised by the Commission on the undertaking. Following an extensive consultation process and widespread acceptance of a number of key failings in the undertaking, Toll would have anticipated significant changes being proposed to the undertaking. In fact, the amendments which have been made by ARTC to its undertaking are extremely limited in scope and fail to address most of the issues which have been raised in submissions made by rail users in submissions to the Commission and most of the issues which were identified and debated at length at the Commission's workshop on the undertaking. Toll is extremely disappointed at the lack of responsiveness of ARTC to the issues which have been raised.

In a number of significant respects, the revised undertaking represents a step backwards from the current access arrangements which Toll has negotiated with ARTC to a position which is significantly more favourable to ARTC as service provider. Toll finds it surprising that this would be the outcome of a review process under Part IIIA of the *Trade Practices Act, 1974* ("**TPA**").

The purpose of this submission is not to repeat the matters which have previously been dealt with at length in the submissions of a number of rail users and particularly the previous combined submission of FreightCorp and Toll dated 13 June 2001. This submission seeks instead to provide a summary of the key failings in the revised undertaking with particular emphasis on the changes which have been made in the revised undertaking.

1.2 The Lack of Focus on Efficiency

If Toll were to encapsulate its concerns with the revised undertaking in a single notion it would be that the undertaking is not designed to encourage efficiency in operations, administration or the structure of charges and indeed much of the undertaking works against efficiency being achieved either by train operators or by ARTC.

More specifically the areas of concern to Toll are:

(a) the application of an access charging regime which pays no regard to the use which is to be made of the track access and therefore to what is being transported, whether passengers, bulk freight or general freight;

(b) the absence of any incentives for efficiency or efficiency improvements, either for track owners or train operators;

(c) the inappropriate capital base used by ARTC given the book value of the relevant assets and the way in which those assets were acquired by ARTC;

(d) the inappropriateness of a CPI escalator when the environment created by the undertaking should be one in which decreases to access charges are possible;

(e) the inadequacy of quality of service obligations on ARTC in relation to the track;

(f) the ambiguous relationship between this undertaking and:

(i) any further undertakings submitted by ARTC in relation to "Other Track"; and

(ii) other access regimes particularly those which apply to east-west rail traffic.

2. "Non-discriminatory Access Charges"

2.1 Pricing Natural Monopoly Services for Different Classes of Users

Clause 1.1(e) of the revised ARTC Undertaking reads:

> *As a vertically separated provider of access, ARTC operates in a competitive environment where competitive pressure from other modes of transport (particularly road) place constraints on rail transport and access pricing…"*

The change to this clause was designed to reflect that the undertaking covered passenger services as well as freight services. This brings to the fore a concern which Toll has with the approach to access charges which applies to the entirety of the undertaking but is exacerbated in its application to passenger services.

In setting access prices for track access, it must be recognised that track access operates with declining average costs and with marginal costs lower than average costs. The optimal level of output is achieved where the access provider provides access to all access seekers willing to pay at least the marginal costs of production. If all access seekers pay only the marginal costs of production, the access provider will fail to recover the capital costs associated with the provision of access. Therefore, some mechanism needs to be found which will enable optimal utilisation but also enable the access provider to recover more than just its marginal cost.

Price discrimination is the obvious tool to enable this to occur. Price discrimination recognises that different users place different values on services which are provided and this is almost always a reflection of the market places within which those users themselves provide services. The revised undertaking seems to assume that there is something inherently inefficient in price discrimination and that price discrimination leads to anti-competitive behaviour. There is a fundamental distinction between price discrimination to achieve efficient outcomes and price discrimination which is designed to prefer one user over another. 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. This result is not consistent with many of the objectives in the ARTC undertaking but will be an inevitable consequence of the operation of the undertaking as currently formulated.

Such an approach will have significant consequences for general freight. Either:

(a) the track access charges for general freight operators will be as high as those of bulk freight operators, in which case freight forwarders moving general freight by rail will not be competitive with freight forwarders using road linehaul; or

(b) those transporting bulk products will enjoy track access charges which enable them to earn super-normal profits.

Neither is an efficient outcome.

2.2 Markets for track services v freight markets

Within the freight task, ARTC has made much of the fact that it "*competes in the intermodal and bulk freight transport markets. Both are in direct competition with road and sea*." In its original application, ARTC set out seven primary rail operators including Toll Rail and a number of smaller specialist rail companies. It then stated:

> "*The services ARTC provides to these operators compete directly with road haulage companies to numerous to list*."

Fundamental to the pricing methodology which has been used by ARTC is the notion that road and rail are directly competitive. Whilst it is true that non-bulk transport operators can use a range of modal solutions to deliver a customer's requirements, that does not mean that access to rail track is in the same market as access to roadways. Similarly, because in the functionally distinct market of freight forwarding, there is intermodal competition for non-bulk or general freight, does not mean that in the upstream market for the provision of access rail track services compete directly with road services.

As outlined earlier, the price which can be paid by a user of rail track will depend upon the market in which that user provides service. The ability of a general freight transport operator to pay for track access is significantly less than that of a bulk operator such as those which operate moving coal in the Hunter Valley and the ability of the operator of a passenger service is likely to be quite different again. The ARTC Undertaking operates on the assumption that all providers who gain access to services provided by its infrastructure operate in markets where pricing is constrained by transport using other modes. This leaves ARTC to state in paragraph (f) of section 1.1 of the Undertaking that:

> "*ARTC will not discriminate price on the basis of the identity of the customer, the commodity being transported.*"

Clause 4.1 of the Undertaking provides that ARTC will develop its charges with a view to reaching an appropriate balance between:

(a) the legitimate business interests of ARTC;

(b) the interests of the public; and

(c) the interests of applicants wanting access to the network.

Clause 4.2 sets out a number of factors to which ARTC will have regard in setting its charges including indicative access charges which are set out in clause 4.6. Clause 4.3 imposes limits on charge differentiation. Paragraph (b) of clause 4.3 provides that ARTC will not differentiate between applicants in circumstances where the characteristics of the service are alike and the applicants are operating within the same end market. This appears to be a more limited notion of "non-discrimination" than appears elsewhere in the undertaking and is inconsistent with other statements that access charges will be determined without regard to the commodity being transported. If this is designed to address the notion of like service, then it involves fundamentally different considerations from the broad principle of "non-discrimination" described elsewhere.

This approach is not consistent with structuring an efficient pricing mechanism reflecting the ability of different users to pay depending on the market which is being serviced. Unless this issue can be rectified it will have flow on difficulties for the operation of the undertaking.

2.3 Differing Performance Requirements of Different Users

In addition, it fails to take into account the fact that the different services which are operated by different rail users will often have different performance requirements. For example, passenger operations, in many respects, have limited ability to pay in excess of marginal costs. However, passenger operations usually have high demands on the speed which can be achieved over relevant track. These are issues which are relevant to determining the access charges of users carrying on different activities on the relevant track. ARTC's proposed undertaking simply ignores these issues.

3. Capital Base

Toll refers the Commission to the report by NECG dated 12 June 2001 which was Annexure 1 to the previous combined submission of FreightCorp and Toll dated 13 June 2001 where this issue is addressed in detail.

4. CPI Escalator

4.1 No Scope for Review of Increases

The undertaking proposes a continual escalation in the Indicative Access Charge through a CPI mechanism. The structure of clause 4.6 of the revised undertaking is that ARTC determines if an increase is to be made to the Indicative Access Charge. If ARTC determines to effect an increase, the increase in the Indicative Access Charge is mandated to be the Indicative Access Charge multiplied by the greater of:

(a) CPI less 2%;

(b) 2/3 thirds (sic) of CPI.

There is no scope within the undertaking of the Indicative Access Agreement for there to be a review of either the appropriateness of a decision to effect an increase or the size of any increase. It is no longer (to the extent it ever was) usual to find a CPI price escalator especially where, as in the present case, a CPI escalator does not bear any clear relationship to ARTC's costs.

4.2 ARTC's Costs to Decrease

A CPI escalator is particularly in appropriate, where, as here, ARTC predicts its costs will decrease. The undertaking is therefore proposing a pricing structure not designed to be cost reflective or designed to enhance efficiencies. ARTC is proposing that, notwithstanding that its costs will be decreasing it should be entitled, in its absolute discretion with no review rights available to the access seeker, to increase price annually.

Instead of the current structure there should be one which provides for a review of the Indicative Access Charge on an annual basis but that review should be one which is determined having regard to efficient costs and ARTC's actual cost savings.

5. Inadequate Service Obligations on ARTC

Since ARTC lodged its initial undertaking with the ACCC rail operators and users have commented on the absence of any meaningful service or performance indicators being imposed on ARTC. ARTC has sought to address this by the inclusion of Part 8 in the

undertaking. Part 8 is, however, an inadequate response. It contains only one substantive obligation and a number of reporting obligations.

The substantive obligation is a commitment by ARTC "*to maintain the Network in a fit for purpose condition for the duration of the Term.*" The difficulty with this obligation is that it is so broad as to be meaningless and unenforceable by any individual rail operator. Fitness for purpose can only properly be assessed by reference to the specific characteristics of the services provided by the infrastructure in question. One can consider a range of possible uses against which fitness for purpose may be tested:

(a) Is a rail track fit for purpose if any train (whether carrying passengers, general freight or bulk) can physically operate on the track?

(b) Is a rail track only fit for purpose if a train of certain characteristics can travel at specified speeds on the track or over certain routes on the track?

(c) Does a fit for purpose obligation carry with it an assurance that the condition of the track is not such as to cause damage to any train which runs an authorised service on that track under the terms of an access agreement with ARTC?

Unless the fit for purpose obligation has some substantive content, it does not progress the matter at all and is likely not to provide any meaningful performance obligation on ARTC

The balance of the obligations which have been imposed in Part 8 are reporting obligations as to reliability` transit time and track condition. 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. The reporting obligation in relation to track is "Track quality measured by index". Standing alone such a requirement is meaningless an not likely to provide any reliable data for train operators.

The issues of performance obligations on ARTC remains a critical issue which has not been addressed in any meaningful way by ARTC in its revised undertaking.

6. Dispute Resolution

6.1 Qualifications of Arbitrator

Clause 17.4(b)(i) of the Indicative Access Agreement provides for an arbitrator to be agreed on by the parties or appointed by the Institute of Commercial Arbitrators. There is nothing in the revised undertaking or in the Indicative Access Agreement as to the necessary qualification of the proposed arbitrator. This is a critical issue and Toll would suggest that the Indicative Access Agreement needs to include a provision to the effect that the arbitrator:

(a) be appropriately qualified to determine the most appropriate means of determining and calculating fees for access to rail infrastructure services;

(b) not be an interested party to any access agreement with either the Operator or ARTC;

(c) have a detailed understanding of and experience in dispute resolution practice and procedures; and

(d) have an understanding of the rail industry in Australia.

6.2 Appropriate Jurisdiction

The dispute resolution provisions in the Indicative Access Agreement provide for the mediation and arbitration to be by reference to South Australian legislation and South Australian procedures. There is no logical reason why this should be the case given the

jurisdictions in which access is provided. The only reason would appear to be administrative convenience of the ARTC. In Toll's submission that is not a sufficient or indeed an appropriate reason, when track covered by the arrangements includes track in Western Australia, Victoria and South Australian and may include track in New South Wales.

6.3 Application of Part IIIA Pricing Principles

Following submissions, ARTC has proposed that the pricing principles and limitations on arbitrated terms and conditions of access contained in Part IIIA should be applicable in relation to the establishment of an initial access price but not in respect of any disputes arising under an access agreement once in place. ARTC has said:

> *ARTC has also agreed to make amendments to align this clause with the dispute resolution clauses (including amendments described above) in the Undertaking, specifically those relating to the factors to be considered by the arbitrator. With respect to the Undertaking, a dispute relates to the negotiation of an agreement to access the Network whereas with respect to an agreement the dispute relates to the specific terms and conditions negotiated and agreed between the parties. To recognise this difference in circumstance, factors to be considered by an arbitrator with respect to a negotiated agreement should only include the specific terms and conditions of that agreement first, and only when the dispute cannot be resolved on this basis, should include the 'wider' factors delineated in Part IIIA of the TPA and the Competition Principles Agreement (as contemplated in the Undertaking).*

This approach does not recognise that pricing principles may well not be incorporated into an access agreement. Indeed, the Indicative Access Agreement does not provide for the inclusion of any pricing principles. If the approach advocated by ARTC is to have any validity it should expressly include the pricing principles from Part IIIA of the TPA and the Competition Principles Agreement which are incorporated into the revised undertaking in the Indicative Access Agreement. If that were to occur, then to the extent that the parties specifically sought to vary them in the negotiation of an access agreement it would be appropriate for the arbitrator to be bound by those principles as specifically set out and agreed. ARTC's current approach leaves open the possibility that an arbitrator be expected to determine pricing principles by some process of reverse engineering from the access charge which the parties ultimately agreed. There is no substantive reason advanced by ARTC as to why explicit pricing principles of the type contained in the Undertaking should not be expressly incorporated into the revised undertaking.

7. The NSW Track and recent HoA

The Deputy Prime Minister has announced that the Commonwealth and New South Wales governments and ARTC have executed a Heads of Agreement envisaging the long-term lease of at least some NSW track to the ARTC. It is not clear the extent of the NSW track to which this will apply. Clearly, this is an important development in terms of the Commission's considerations and indeed, the views of interested parties. However, there is no information available on the relationship between the ARTC's current proposed undertaking and access arrangements for its envisaged operation of the NSW track. It seems to be contemplated that this will be the subject of a separate access undertaking : see clause 2.1(d) of the current revised ARTC undertaking. There is nothing to indicate whether the "separate" undertaking is required because of technical legal issues or whether it is intended to be different in substance.

This raises a number of serious concerns, not least of which being:

(a) the potential for different approaches to access arrangements for different parts of interstate track (inconsistencies here would constitute a serious setback, particularly given the efforts of train operators and others to try to ensure regulatory compatibility on the interstate track). At a minimum, there should be a commitment

by ARTC that the same terms would apply to any undertaking submitted by it in relation to "Other Track";

(b) the possibility that different track uses in NSW, especially in relation to bulk commodity transport, would compromise access arrangements for interstate train operators, particularly given the ARTC's commitment to non-discriminatory pricing (regardless of efficiency and equity implications);

(c) the likelihood that ownership and regulatory interface issues between ARTC and non-ARTC track are likely to be more pronounced in NSW than in other states.

It would seem sensible to Toll that the arrangements contemplated by the Heads of Agreements should be given effect to and ARTC's undertaking incorporate all of this relevant track rather than dealing with the issue in separate undertakings. The case for this is particularly strong given that the undertaking will not apply to any existing access arrangements between operators and ARTC. Clause 2.5 of the revised undertaking expressly provides that:

> *Nothing in this Undertaking can require a party to an existing Access Agreement to vary a term or provision of that agreement.*

If the Commission were not minded to take this approach, at a minimum ARTC should commit that any undertaking submitted by it in respect of "Other Track" would be on the same terms as that accepted by the ACCC in respect of the network the subject of the revised undertaking.

8. Timing of the Process

As you know, the sale of National Rail and FreightCorp is proceeding on a very short timetable which runs over the next 3-4 months. Toll is part of a consortium bidding for these businesses with Lang Corporation and is engaging with the Commission in relation to that sale process.

All parties interested in rail reform recognise that the NRC FreightCorp sale is a crucial development in the rail industry in Australia, and that the new owner will have a keen interest in national track access arrangements and may be in a position to express views and provide information on track access arrangements that could not be provided earlier. It will be important that these views are taken into account and that a major track user not be prejudiced by the timing of the Commission's consideration of this undertaking.

Toll recognises that the Commission's consideration of the ARTC's undertaking should be concluded as soon as practically possible. However, Toll considers that it is even more important that sufficient time be taken to fully consult all interested parties, take account of relevant developments, facilitate appropriate amendments to the proposed undertaking and ensure national access arrangements are as well designed as is feasible. At this stage, Toll considers that this outcome is unlikely.

Toll notes that the Commission recently suspended consideration of EAPL's access arrangement for the Moomba to Sydney pipeline under the National Gas Pipeline Access Code because another relevant process, the NCC consideration of an application to revoke coverage under the Code of that pipeline, might have implications for the design of the current access arrangement. Toll believes that similar issues arise in relation to the Commission's consideration of the ARTC undertaking. Further changes to the undertaking are needed and more are likely as a consequence of new track operating arrangements in NSW and the NRC/FreightCorp sale. In addition, the current process risks being compromised by ineffective consultation with interested parties as a consequence of uncertainties in relation to these developments.

The Commission should suspend its deliberations on the ARTC undertaking until arrangements for the lease of NSW track to the ARTC and the sale of NRC and FreightCorp are concluded and arrangements for the lease of NSW track to the ARTC are publicly available. All of the rail operators who have been active in the Commission's consideration of the ARTC undertaking except SCT are committed to the NRC/FreightCorp sale either as a bidder or vendor. Until completion of the NRC/FreightCorp sale process, none of these parties will be in a position to meaningfully assist the Commission's further deliberations.