



**QR Submission to ACCC  
on  
ARTC Interstate Access Undertaking 2007**

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## 1. Introduction

QR is pleased to have the opportunity to comment on ARTC's proposed Access Undertaking (UT) for its interstate network. QR's participation on this network has grown over the past few years and is planned to continue to grow as QR expands its national freight logistics business.

QR's perspective is that of a relatively recent entrant to the various markets reliant upon access to ARTC's network, and one that is attempting to narrow the gap between its operations and that of the major operator, Pacific National.

QR's perspective is also influenced by its responsibility for the management of below rail services on the QR network within Queensland. In this capacity QR has been involved in the negotiation and implementation of two Access Undertakings under the Queensland rail access regime governed by Part 5 of the *Queensland Competition Authority Act 1997 (Qld)*.

QR has attempted to balance both of these perspectives in providing its response to the ACCC's Issues Paper. Above all, QR's concern aligns with the ARTC aims of encouraging growth of the Australian rail industry, stimulating customer confidence and promoting competition between above rail operators. QR's comments hopefully provide some insight into what it considers ARTC can do to achieve these objectives.

## 2. Overview of Key QR Issues

In order to foster growth in competition within those markets dependent upon access to the ARTC interstate network, the regulatory environment needs to permit multiple operators to meet the market requirements in terms of product delivery and service reliability by offering all operators the opportunity to gain access to equivalent 'services' in terms of length and reliability of transit time, arrival and departure times ('premium' versus 'non-premium' paths), operational protocols and price.

QR considers that this requires a capacity allocation and management framework and a pricing approach that:

- recognises the benefit in allocating one type of path, for instance premium paths, to more than one operator in any particular market;
- provides end customers with the ability to change operator within an access agreement term;
- compensates those operators who, by virtue of network limitations, bear an operational disadvantage vis-à-vis other operators (for instance, those operators of shorter trains on the North-South corridor who, because of the design of the below rail infrastructure and not their own performance, are directed to give way to longer trains in the event of a cross); and
- prioritises an investment strategy that enables more than one operator to adopt the favoured or benchmark operating mode.

In order to foster growth of rail as a competitor in the wider transport market the regulatory environment needs to:

- recognise the role of shipping and road as competitors in the East-West corridor freight transport market and ensure any increases to access charges do not threaten the growth of freight volume on rail; and

- reduce the North-South corridor access charges sufficiently for rail to increase its share of the freight transport volume.

### **3. Specific issues/responses to ACCC Issues Paper**

***a. ACCC Issues Paper ref. 5.1 – Part 1 ‘Preamble’. Question – does the Undertaking provide the basis for outcomes that balance the interests of ARTC, potential access seekers, and the public interest?***

The ARTC UT, relative to the Undertakings of other Australian network providers, including QR, is limited in its prescriptive detail. ARTC has argued that the degree of regulatory intensity is consistent with the level of market power it possesses on the Interstate Network.

QR supports a regulatory framework which is sufficiently transparent and provides both operators and the network owner with reasonable certainty to proceed with commercial negotiation. It is QR's experience that the undertaking should also possess flexibility in order to accommodate practical commercial outcomes that may not be envisaged at the time of drafting.

While ARTC may not possess market power in the sense that it has the capacity to extract monopoly rents, it is still a monopolist in terms of its bargaining position during commercial negotiations.

This power may be particularly acute during negotiations for contract renewal or variations, such as price increases, after a service has been established on a given set of expectations. A network owner may also have an incentive to maximize its short term commercial performance by preferentially dealing with an incumbent operator in a manner that maximizes joint profits.

Therefore, there are aspects of the UT, such as capacity management and price escalation, which should reflect the potential barriers to entry and asymmetry of bargaining power that exist in interstate rail access. These issues are addressed further in our comments below.

Additionally, QR considers that ARTC needs to provide greater certainty through its UT to both current operators and prospective operators on the interstate network in order to encourage growth in the Australian rail industry. In relation to pricing and related capacity management provisions, the ARTC UT provides no comfort to operators of non-Indicative Services vis-à-vis operators of Indicative Services. This is likely to hinder rather than assist an operator wanting to use the interstate rail network for anything other than intermodal traffic.

**b. ACCC Issues Paper ref. 5.1 – Part 1 ‘Preamble’. Question – *is there sufficient clarity about the tracks and other infrastructure that the Undertaking applies to now and will apply to during the term of the Undertaking?***

**Also ref. 5.2 - Part 2 ‘Scope and Administration’. Question – *is the Undertaking sufficiently clear about the difference between extensions to the network and expansions to the network’s capacity?***

The ARTC UT is clear about the fact that it does not cover extensions to the network (except for the Southern Sydney freight line once completed and commissioned) and that ARTC will provide Additional Capacity in the circumstances set out in 6.2 of the UT. The UT defines Additional Capacity as an enhancement or improvement of the infrastructure associated with the Network such that it has the capability to carry additional traffic. The difference

appears to be that 'extensions' to the network increase the physical extent of the network (in terms of track kilometres but not necessarily track capacity), whilst 'expansions' increase the network track capacity but not the physical extent of the network.

QR's Access Undertaking has similar provisions to those in ARTC's UT and in addition deals with ongoing changes to the rail infrastructure such as the addition of new track. As a result, whilst QR's Undertaking sets its scope by reference to infrastructure diagrams included in a schedule to the document, it also has an obligation to update those diagrams so that the scope does not remain static through the life of the regulatory document. In other words, QR has an obligation to keep the infrastructure diagrams of its network updated throughout the regulatory term. On this point ARTC's UT is unclear. If 'extensions' occur, how will ARTC deal with them?

**c. ACCC Issues Paper ref. 5.2 – Part 2 'Scope and Administration'. Question – is the proposed term for the Undertaking appropriate, given the nature of the services covered by the Undertaking and of the industry more generally?**

QR supports the retention of a 5 year term for the ARTC UT given the relative immaturity of rail access regimes in Australia.

**d. ACCC Issues Paper ref. 5.2 – Part 2 ‘Scope and Administration’. Question – are there any aspects of the Undertaking that should be taken into account in considering the objects clause 44AA(b), dealing with a “consistent approach to access regulation in each industry”?**

QR acknowledges the attention regulatory harmonisation has received with the recent introduction of the objects clause in Part IIIA of the *Trade Practices Act 1974* (C'th) (TPA) and the Coalition of Australian Government's (COAG) '*Competition and Infrastructure Reform Agreement*' obligations to achieve nationally consistent regulation of the designated interstate network from Perth to Brisbane.

The efficiency gains from regulatory harmonisation will be greater in instances where there are horizontal interfaces between the interstate and other networks. In this context, ARTC's intention to adopt multiple access undertakings for the interstate network and the Hunter Valley coal network, with varying degrees of regulatory intensity, should be balanced against the need to avoid complex interfaces between the two networks.

In the absence of any detail on the Hunter Valley coal network access undertaking it is difficult to ascertain the likely presence or consequence of any interface issues. Ideally, the interstate network undertaking and the Hunter Valley access undertaking should be considered concurrently to enable interface issues to have been readily identified and addressed.

The various access regimes across jurisdictions have evolved following careful and considered examination of the relevant market characteristics subject to the regime. The main source of difference between regimes relates to the relevant access agreements, which



reflect the desired commercial outcomes the access provider is seeking to achieve on its network. There is likely to be a trade-off with regulatory harmonisation, which may improve administrative efficiency and lower transaction costs but comes at the expense of lower technical and allocative efficiency for the network.

QR understands that a COAG working group has been drafting a possible National Rail Access Code. The apparent delays in developing an acceptable draft to be circulated for industry comment would appear to reinforce the complexity and difficulty in establishing a one-size fits all access model for the various networks.

QR considers harmonisation of access regimes which do not interface, due to technical constraints such as gauge, should only be pursued where there are clear and demonstrable efficiency gains from doing so.

**e. ACCC Issues Paper ref. 5.3 – Part 3 ‘Negotiating for Access’ – Negotiation. Question – is there sufficient clarity and transparency about the method that ARTC proposes to use for choosing among competing access applications?**

**Also ref. 5.5 – Part 6 ‘Management of Capacity’. Question – is there sufficient clarity about ARTC’s proposal for awarding access rights in the case of applications for mutually exclusive train paths?**

The ARTC UT, including the Track Access Agreement for Indicative Services (TAA), permits ARTC a level of discretion in the allocation of mutually exclusive capacity.

The importance of premium paths to an operator's competitive position on the interstate network is clear and has previously been acknowledged by the ACCC through its creation of the East-West Starters' Kit. Given the importance of premium paths to the competitiveness of an above rail operator, and the importance that vigorous competition bears to strengthening the Australian rail industry, QR considers it critical that ARTC's path allocation method ensures capacity is appropriately and transparently allocated, particularly when more than one operator wants the capacity in question.

Under paragraph 3.10(d) and clause 5.3 of the UT where there is more than one party seeking access with respect to mutually exclusive access rights, ARTC is entitled to finalise an access agreement with the party who agrees to terms and conditions, including charges, that are considered by ARTC to be the most favourable to it. It goes on to say whilst ARTC's discretion in this regard is not limited, it would ordinarily make such a decision based on "the Access Agreement that represented the highest present value of future returns to ARTC after considering all risks associated with the Access Agreement."

QR considers that limiting capacity allocation to 'the highest net present value of future returns after considering all risks associated with the Access Agreement' may not represent the terms and conditions most commercially favourable to ARTC. For example, Pacific National currently holds the access rights to all premium, maximum length paths on the North-South corridor. The ability for operators, through the TAA, to seek to renew access agreements in relation to scheduled train paths, in combination with the test for determining which party will be allocated contested capacity could entrench Pacific National's position on this corridor, and potentially prevent effective above rail competition.

There are likely to be spill-over benefits associated with achieving effective and sustainable competition on parts of the interstate network which would translate into operator investment and innovation, and improvement in rail performance and service reliability. Ultimately, ARTC's commercial performance would benefit through increased modal share and volume growth which would otherwise not have been reflected in the net present value of access revenue associated with an entrant's proposed access agreement.

As a result, QR appreciates the need to expressly provide that ARTC's discretion is not limited in this regard. There is a question, however, about the appropriateness of the broad consideration guiding ARTC's discretion – namely, access agreement terms and conditions that in ARTC's opinion are most favourable to it.

QR's Undertaking, for instance, is based upon a similar capacity allocation premise as ARTC's – namely, first in first served, and when there is competition for scarce access, it will go to the party able to offer the best deal to the infrastructure manager. Significantly, the test in QR's Undertaking expressly refers to the 'commercial' performance of below rail services.

QR's Undertaking also includes a queuing mechanism that attempts to make the capacity allocation process more transparent by detailing some of the considerations that go towards QR's determination of the most favourable commercial performance for below rail services.

Leaving aside both of these undertakings, however, perhaps a clearer way to describe the goal of infrastructure managers in this circumstance is to say that they seek to maximise the commercially efficient use of the rail infrastructure over the long term for the benefit of users of that infrastructure and their customers. This

means that the immediate commercial impact of the capacity allocation may not be the sole or the determining factor in the decision.

QR considers that the capacity allocation principles should continue to provide ARTC with sufficient flexibility in allocating new or resumed capacity. QR considers it appropriate for ARTC to have this discretion given ARTC's charter to encourage growth in the rail industry, stimulate customer confidence and promote competition in the above rail market. QR considers that there may be a clearer way of expressing the goal that ARTC seeks to achieve in exercising this discretion.

**f. ACCC Issues Paper ref. 5.3 – Part 3 ‘Negotiating for Access’ – Negotiation. Question – do operators have sufficient certainty about prospects for the long-term utilisation of the network and their on-going access to train paths when re-negotiating existing train schedules? Does ARTC have sufficient flexibility when re-negotiating existing contracts to encourage above rail competition?**

In relation to existing contractual agreements, 2.5(b) of the UT provides that with both parties' consent, expiring agreements may be extended in place of renegotiation of a new agreement. The effect of this is unclear without reference to 2.9 of the TAA for indicative services. That provision clarifies that an access holder cannot entrench provisions under a previous regulatory instrument by simply extending an expiring agreement rather than negotiating a new agreement. QR considers that this clarification would add value in the body of the UT itself.

With respect to the goal of encouraging above rail competition, there is a balance to be struck between the rights of an incumbent

access holder, the interests of other operators seeking access to train paths, and the interests of ARTC as infrastructure manager. On the face of it, if ARTC had an incumbent access holder seeking to renew its contractual entitlement to scheduled train paths, and a new party seeking to negotiate an access agreement in respect of those same train paths, ARTC would resort to its rules for dealing with multiple applicants for mutually exclusive access rights. QR has commented on these rules above.

In terms of practicalities, however, there are questions about process. An incumbent must notify ARTC that it wishes to renew its agreement not less than 120 days before its existing contract is due to expire. If another party lodges an access application with ARTC around that time, the UT provides a process for notifying both parties and ultimately granting access in accordance with 5.3 of the UT. The UT is unclear, however, on how ARTC will manage the receipt of access applications received prior to that time in respect of the scheduled train paths in question. Will ARTC notify the incumbent that another party is interested in securing the paths?

By way of illustration, QR's Undertaking contains provisions relating to capacity registers, which serve a number of purposes. One purpose is to record the details of parties with an interest in access rights and notify such parties in the event that QR receives an access application that would utilise the relevant access rights after the expiration of an existing access agreement. QR considers that these provisions provide additional confidence to both incumbents and new access seekers regarding the process that will be followed in respect of mutually exclusive capacity. ARTC's UT may be improved by the addition of similar provisions.

**g. ACCC Issues Paper ref. 5.4 – Part 4 ‘Pricing Principles’.**

***Questions – various***

***Access Charges and Charge Differentiation***

QR has a number of concerns with the pricing aspects of the proposed UT and TAA. Firstly, QR considers that any changes to prices need to be justified to ensure that prices balance the needs for commercial infrastructure investment against the realities of operating rail services in the various markets.

With the goal of growing the Australian rail industry, ARTC’s pricing approach should aim to grow the “pie” that is the market for rail freight services, rather than seeking to attain, for itself, a larger share of a smaller “pie”. In other words, QR would consider it inappropriate for ARTC to increase its access charges if that were to result in a reduction in rail’s market share, irrespective of whether such increases result in greater revenue for ARTC.

QR disputes ARTC’s apparent assumption that access charges for the East-West corridor can be substantially increased without adversely impacting upon the ability of rail operators to compete in this transport market. QR considers that both road and shipping present viable competitors to rail for this market, and ARTC has failed to take adequate account of this fact in proposing a significant increase in East-West prices.

It is understood that rail on the East-West corridor has lost some market share in the last couple of years as a result of significant price increases from the incumbent rail operator. Any increase in access charges will have the same impact to the detriment of current rail market share.

In addition, and contrary to ARTC's express intended outcome, the rate changes proposed for the North-South corridor do not represent a decrease in North-South prices by 10%. On QR's assessment the overall effect is a 6.17% rise to current expected corridor access costs, with the actual increase for ARTC sections being greater than that (as there are non-ARTC sections included in the corridor). QR considers that this negative effect is likely to be more significant for its operations than for Pacific National because of QR's use of shorter trains. QR acknowledges that ARTC propose to offer a 10% rebate of the Indicative Access Charges with on the North-South corridor for 2 years from the introduction of the revised access charges. The details concerning this rebate are not included within the ARTC UT however.

QR's analysis is annexed to this submission (**Annexure A – marked CONFIDENTIAL**). It indicates that on a TEU (twenty foot equivalent unit) basis, 1500m trains on the North-South corridor receive an access charge that is 3.55% less than the access charge for 1200m trains on the same corridor. In a situation where one operator, Pacific National, owns all of the train paths that accommodate 1500m trains, QR finds this discrimination both unfair and inconsistent with the price differentiation principles in 4.3(b).

Whilst ARTC made a small change to the access charges it proposed in its second industry consultation draft of the UT, the effect of which is to decrease the access charges for shorter trains, the change to the pricing structure actually increases the disparity between the 1500m and 1200m train access charges. Under the previous price structure the disparity between the different length trains was 2.68%. It is now 3.55%, in favour of the longer train.

This bias in the pricing structure towards longer train paths could be justified were its purpose to improve industry productivity by encouraging longer trains. However, such a pricing structure

introduces inefficiencies where the availability of these paths becomes capacity constrained. Network utilisation can be improved where price structures for non-premium paths encourage growth in this market. The limit of price differentiation between premium and non-premium paths should be the point where operators of premium train services would consider transferring from the premium to the non-premium market.

QR's concern in this regard is heightened by the operational bias that longer trains receive on the North-South corridor. This operational bias stems from the status of the below rail infrastructure. The existing infrastructure was designed predominantly for shorter length trains, and whilst all passing loops on the network can accommodate smaller train lengths, only a proportion can provide for maximum length trains (1500m).

As a consequence once a maximum length train is on the network train control gives it priority simply because it is not possible to hold a maximum length train in the majority of passing loops. This priority is given regardless of the actual performance of the respective trains.

This operational advantage, combined with the pricing advantage, and the scarcity of premium paths, creates the greatest dilemma for QR as a rail freight operator trying to compete against Pacific National on the North-South corridor.

### ***Pricing Floor Limit***

ARTC has proposed to retain the floor limit definition from the approved 2002 Access Undertaking. Earlier consultation documents circulated by ARTC prior to lodging the UT canvassed an alternate concept of a floor limit more consistent with ARTC's objective of a sustainable economic approach to access pricing.



Access regimes across various jurisdictions have different interpretations for the relevant floor price. In regards to the TPA objects clause this may be one area where there is benefit to achieving a consistent approach to access regulation.

The ARTC floor limit definition specifically excludes depreciation and return on capital costs. Accordingly, the approach is more consistent with the concept of short run marginal cost pricing (SRMC). However, the benefits in terms of improved network utilisation provided by SRMC may be offset by excess demand for the service and inefficient network expansion.

Where the network is experiencing sustained growth in volumes and is undergoing expansion, then economically efficient pricing would require that users are faced with the capital costs associated with the renewal or expansion of the infrastructure required for their continued and extended use of the service, or the long run marginal cost (LRMC). In this context, the definition of incremental cost in QR's Undertaking is more compatible with this concept:

*'Incremental Costs means those costs of providing Access, including capital (renewal and expansion) costs, that would not be incurred (including the cost of bringing expenditure forward in time) if the particular Train Service or combination of Train Services (as appropriate) did not operate, where those costs are assessed as the Efficient Costs and based on the assets reasonably required for the provision of Access.'*<sup>1</sup>

Applying a more forward looking pricing concept such as LRMC to determine the floor price on the interstate network could however

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<sup>1</sup> 2005 QR Access Undertaking, p.105

lead to potentially perverse outcomes for particular parts of the interstate network which will be subject to significant capital upgrades. For example, the resultant floor limit on some line segments on the North-South corridor could exceed existing access charges which would result in a breach of the floor limit.

In addition, the LRMC will differ between types of services with a higher LRMC attributable to services which are driving ARTC's investment program. Therefore, for some services the LRMC will coincide with the SRMC which is adequately captured under QR's incremental costs definition.

While a LRMC floor limit approach may be relevant for some parts of the interstate network its application would require specific dispensation arrangements for other parts of the network.

In order to avoid introducing unnecessary complexity to the ARTC undertaking QR recommends that the ACCC accept the proposed floor limit definitions. However, there may be scope for reviewing this issue in subsequent determinations once the Productivity Commission's proposed road freight infrastructure pricing reforms have been fully implemented and there are similar service standards across the interstate network.

### ***Price Escalation***

QR has some concerns regarding the amended price escalation provisions in the draft 2007 UT and would prefer retention of the 2/3<sup>rd</sup> CPI annual escalation formula contained in ARTC's 2002 Undertaking.

QR supports pricing arrangements which improve the performance of both above and below operations in the interstate freight market. Improvements in ARTC's profitability will be an important stimulant

of further below-rail investment which should translate into improvements in service quality and transit times. However, QR has concerns with the access provider's capacity to fully comprehend the impacts of such price changes on above rail operators given the relevant information asymmetries.

The recent Productivity Commission report on road and rail freight infrastructure pricing suggested that cross-price elasticity for road and rail is quite low and that moderate increases in road user charges would produce only a marginal shift on modal transfer to rail.

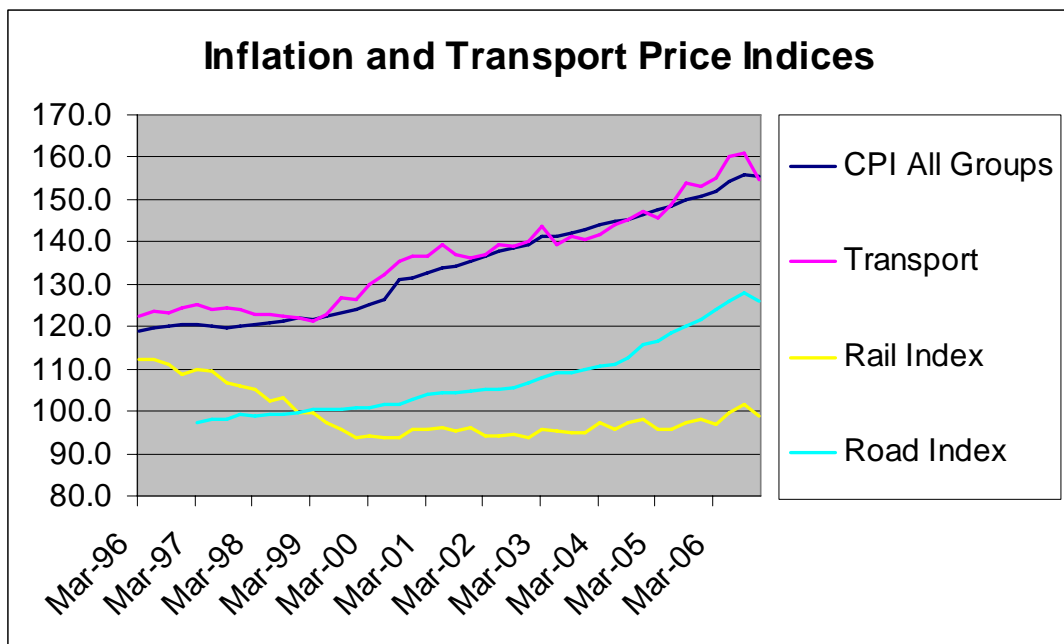
However, the elasticity conclusions within this report contained a number of caveats which precludes their reliability for estimating modal transfers in response to price movements in the respective modes. In this context, commercial negotiation for haulage agreements by QRNational indicates that modal cross-elasticities are more significant than indicated by the Productivity Commission's summary.

ARTC's explanatory paper includes freight market pricing analysis which would appear to indicate a difference between rail and road unit rates for long-haul intermodal that provides a reasonable basis for increasing below-rail access charges. However, this analysis does not examine the factors driving current market pricing. Given the sustained level of price differentiation between road and rail unit rates on the east-west corridor, it would be difficult to believe that operators on long-haul markets do not make rational pricing decisions and are not fully extracting the economic value of the service. A more rational hypothesis is that rail is significantly price squeezed by customers who are responsive to relative differences in cost and service reliability. The competition between road, rail and sea modes on this route provides limited capacity for negotiating price increases.

The constraints on modal transfer to rail and market growth are also influenced by lower service standards and reliability. In addition, rail freight must also compete with the relatively low unit rates offered by non-time sensitive sea-freight. Any suggestion that rail will be capable of improving pricing performance following a revision of the heavy vehicle pricing determination, when there is now an expectation that B-double charges will be increased, needs to be moderated against the inability of rail pricing to correlate increases with road charges and the consequences of further road productivity gains associated with adoption of performance based standards and development of the national B-triple network.

QR is supportive of ARTC being able to escalate access charges to improve below rail performance where operators have the capacity to fully pass those costs on to freight-forwarders or customers. However, as evident in the inflation and producer price indices in Figure 1, the rail industry has not been able to maintain prices in real terms.

**Figure 1**<sup>2</sup> Source: Reserve Bank of Australia: Table G02 ABS.6427.0 Producer Price Indices, Australia



<sup>2</sup> CPI and the Road-Rail Price Indices have different base years for the purpose of graph clarity.

QR does not consider that the escalation formula proposed by ARTC represents an acceptable balance of interests between above and below rail. Maintaining access charges in real terms which operators cannot pass through to customers will erode operator margins. In an environment where operators are contemplating significant investment in rollingstock and intermodal terminals, uncertainty over future returns will have an adverse impact on investment incentives.

Until road freight infrastructure pricing is based on forward looking pricing principles which recognise the social welfare benefits of rail over road, the problem of double marginalisation is one that is likely to persist in the intermodal rail freight industry for a considerable period of time.

QR considers the long term performance of ARTC is intrinsically linked to growth in rail freight volumes and gains in market share. Achieving sustainable revenue adequacy will be dependent more on growing volumes so that in the long term, rail can be competitive and achieve long-term sustainability of its asset, rather than price increases. For example, ARTC's 2005-06 annual report predicts that the significant works proposed for the North Coast Line will achieve reliable track access for operators, and are expected to more than double rail's market share over the next 10 years between Sydney and Brisbane.

Discretionary price escalations will increase operator uncertainty and unnecessarily increase the risk of investments which will leverage off ARTC's below rail investments and improve industry productivity and reliability<sup>3</sup>. Operator investments are a critical element in achieving a doubling of rail's market share along the North-South corridor.

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<sup>3</sup> Uncertainty increases the risk premium required for above-rail investments.

As a result, QR would prefer an escalation method that involves an annual calculation and increase/decrease in access charges. Reasonable demand forecasts should be attainable such that a price path for access charges is available for specific services over the term of the 2007 Access Undertaking. For this reason, QR would support retention of the 2/3<sup>rd</sup> CPI annual escalation formula in the previous ARTC UT.

Any diversion from this formula could be an issue for commercial negotiation but in the absence of a framework whereby ARTC and the network users undertake a joint market analysis of the needs of the industry as a whole, including the relevant coordinated above and below rail investment plans and the cash flows necessary to support those investments, it is difficult to see how a mutually acceptable resolution might be reached.

### ***Excess Network Occupancy Charge (ENOC)***

The rationale for the application of an excess network occupancy charge may be sound. To the extent that an operator is seeking a service which does not align with a menu of service offerings and the provision of that service involves an opportunity cost in terms of reducing network capacity, then the operator should be exposed to the cost of providing that service. Similarly, QR agrees that this cost should not be passed on to an operator in the event that excessive transit times are due to unavailability of a better path.

The difficulty lies in determining what should be included within the 'access charge' and what should be subject to an additional charge. Then there is the issue of quantum.

It is unclear how ARTC intends to calculate the quantum of the ENOC. The opportunity cost will differ across various parts of the interstate network. In circumstances where the network is not

constrained, the non-standard service may actually impose no additional costs. Additionally, it is not apparent how ARTC will ensure that operators do not 'game' the ENOC provisions by, for instance, purchasing a standard path but operating outside that path.

The consequence is a proposed charging mechanism which is not transparent, is potentially subjective and increases operator uncertainty as to the likely below rail access charge. Without a clear and understandable methodology as to how the charge will be calculated and what the quantum of any ENOC payable will be, QR cannot support the charge.

### ***Cost of Capital***

The Issues Paper asks whether ARTC's proposed parameters and the assumptions that have been used to derive the components of the WACC are appropriate. QR notes that in most regulatory proceedings, gamma and the market risk premium continue to be the most subjective and difficult to estimate parameters in the Capital Asset Pricing Model.

QR does not intend to add to this debate as it considers the consultation document prepared by Synergies Economic Consulting, on behalf of ARTC, adequately summarises the empirical evidence and academic debate around these parameters.

As the ACCC is not bound by the prescriptive rules that limited the AER from considering stakeholder comments on gamma and the MRP<sup>4</sup>, QR recommends that the ACCC review these parameters independently of previous regulatory decisions. QR considers there is reasonable justification for adopting a value for gamma less than

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<sup>4</sup> For example, the 2007 Powerlink Revenue Cap Decision

the currently accepted 0.5 and that there is no compelling evidence as to why the MRP should be set lower than that determined from the long-term historical averages.

### ***Regulatory Asset Base***

The Depreciated Optimised Replacement Costs (DORC) methodology is well understood and widely accepted as the relevant benchmark for establishing network charges. The use of replacement costs ensures prices remain forward looking and capture technological change.

Prices established on replacement costs minimises market distortions associated with excessive levels of demand and the inefficient allocation of capital and ensures the business earns sufficient revenue to renew or replace existing assets than would occur if prices reflect actual costs.

QR acknowledges that a model such as the economic loss capitalisation model submitted by ARTC may have advantages for application on lines subject to significant capital expenditure which are not supported by revenues in the short to medium term. It is noted that the model has similarities with the Speculative Investment Fund provisions in the Gas Code.

However, QR is concerned that the proposed model could eventually produce an unrealistic RAB that is of limited value for line segments where there is no reasonable expectation of the RAB aligning with the floor limit in the foreseeable future. For such line segments, the effect of compounded economic losses would result in prices established under the future RAB bearing no relationship with replacement costs. The consequence of this would be that without sufficient volume growth, network utilisation and density,



prices would be at an inefficiently high level and could distort modal choice.

The longer term consequences of the RAB roll-forward are likely to be divergent across the network. Those parts of the network where ARTC is able to price close to the ceiling will have a lower RAB than parts of the network where ARTC is pricing closer to the floor. This has the potential to distort the pricing signals between the various corridors.

QR notes that where a RAB lock in methodology has been applied it has generally accepted the initial DORC valuation and included all future expenditure at cost<sup>5</sup>. As indicated by the ACCC in the issues paper, this provides an opportunity for the business to earn a normal return on its assets. The subsequent roll forward of CPI is generally considered to be consistent with the principle of financial capital maintenance.

If the intention is to allow ARTC to earn a normal return, it has not been made apparent why it was necessary to revalue the DORC value undertaken for the 2002 Undertaking, especially where there has been no optimisation or errors identified in the original valuation. If ARTC is eventually able to capture the compounded economic losses, then the revaluation would amount to earning an abnormal return and would represent a windfall gain.

QR has some misgivings around the 'lock-in' principle. The QCA has indicated that it will only review the asset base where the demand for the service declined to levels where prices would reach an unsustainable level. Aside from the point that for QR to maintain prices at an unsustainable level is commercially irrational, the optimisation risk is asymmetric.

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<sup>5</sup> For example, AER RAB roll-forward model

As below rail infrastructure does not necessarily experience rapid technological change, movement in the value of the asset base is likely to represent changes in the unit rates. Where the replacement costs increase at a substantially higher rate than CPI, then the RAB may be kept artificially low and encourage excessive levels of demand and inefficient capital expenditure. Unless there is a forecast perpetual demand for the service the asset stranding risk is magnified.

In regard to future movements in the RAB for the interstate network, ARTC can be relatively confident that it will face a long term stable demand for any investment made in response to demand at current price levels. Therefore, the case for any further periodic revaluation is not as strong as where the future demand profile would result in residual and redundant assets.

The 2006 DORC valuation has also resulted in a substantial increase in the value of signalling, train control and communications. The ACCC should ensure that the capitalisation of the renewals work does not lead to double-counting where some of that renewals work was included in major periodic maintenance costs. Under the proposed RAB capitalisation model contribution to economic costs is at the bottom of the hierarchy of costs included in access charges. In effect, the contribution to economic costs is a residual once all other costs, including major periodic maintenance, have been met.

### ***Efficiency Incentives***

The 2002 Undertaking included a CPI-X framework; however it is not clear that this framework was intended to be consistent with incentive regulation or whether it was aimed at capping access charges for the purpose of promoting growth in freight volumes. The Economic Regulatory Authority's (ERA) final report on CPI-X

indicates that the X-factor provides incentives for the regulated firm to engage in cost-reducing productivity improvements in the future.

QR considers such a regime is unnecessary where access charges are substantially below the level which would allow ARTC to earn revenue consistent with the RAB floor limit. As previously discussed, provided operators have the capacity to pass through escalation in access charges, ARTC has an incentive to improve its profitability by increasing real revenue yields through efficiency gains.

### ***Capital Contributions***

ARTC has been and will be the beneficiary of a significant level of Government contributions through the AusLink framework. Establishment of the RAB by regulators has typically included an evaluation of previous capital contributions to ensure the network provider does not make a windfall gain through the recovery of capital costs from users for an asset that they did not finance.

The QCA's approach to contributed assets, which is supported by QR, has typically been that it is dependent on the intentions of the parties when the contribution was made. In this regard, the AusLink White Paper did not provide any certainty as to the Australian Government's intentions. For instance, should ARTC be able to recover the full capital costs, just the depreciation or no capital costs?

QR notes comments made by ARTC Chief Executive Officer and Managing Director, Mr David Marchant, to the Productivity Commission public hearing<sup>6</sup> held in Melbourne as part of the

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<sup>6</sup> On 13 November 2006.

Productivity Commission's enquiry into Road and Rail Freight Infrastructure Pricing:

*"The Commonwealth is contributing \$750 million (to ARTC's \$2billion investment between Melbourne and Sydney, Sydney and Brisbane).....we're not seeking a return on the \$750 million. We will depreciate it....but we're not seeking a leverage cost of capital return...."*

Given this statement, QR would expect the DORC to be adjusted accordingly. In any event, clarification around the treatment of government contributions in the RAB would provide considerable certainty to stakeholders regarding future access pricing under the proposed RAB capitalisation model.

***h. ACCC Issues Paper ref. 5.5 – Part 5 'Management of Capacity'. Question – is there sufficient clarity about the rationale for the reservation fee and how the reservation fee policy would be applied?***

The reservation fee is expressed as the opportunity cost foregone, with reductions to take account of any other utilisation during the intervening period.

From an infrastructure owner/manager perspective, the idea of a reservation fee (linked to opportunity cost), particularly in capacity constrained areas, seems reasonable. In a sense, the concept of a reservation fee aligns with the UT provisions relating to capacity resumption in the event of under-utilisation of contracted capacity. Those provisions target 'hoarding' behaviour on the part of operators. The reservation fee concept not only compensates the infrastructure owner for opportunity foregone, but it also ensures that an operator is not seeking to tie up capacity simply for the sake

of denying other operators the chance of acquiring that capacity. There is a risk that without reservation fees operators will seek to secure capacity further out from commencement of operations than they might otherwise simply because they can and because it is free.

From the perspective of an operator, ARTC's proposed reservation fee is simply another potential cost of providing a service on the interstate network. The method for calculating the quantum of that cost is largely uncertain, and accordingly, the quantum is not easily calculable. Without some transparency in how ARTC intends to determine reservation fees QR cannot support this specific reservation fee proposal.

In addition, ARTC's decision not to limit price differentiation for reserved capacity exposes operators further. QR does not understand ARTC's rationale for this decision.

QR tried to include a reservation fee provision in QR's Undertaking during its last regulatory assessment. QR's proposal was that it would agree to execute access agreements up to 2 years out from the commencement of operations, and that a fee would apply in respect to access agreements executed more than 6 months out from the commencement of operation. QR proposed a reservation fee for each month during the period between the commitment date and the commencement date equivalent to 5% of the access charges that would have been payable had the operator being operating as planned.

QR excluded coal traffic in the Central Queensland Coal Region from the reservation fee provisions on the grounds that it would provide a perverse incentive for coal-related access seekers not to enter into access agreements more than six months prior to the

commencement of services. QR considered that such behaviour would have a negative impact on our ability to plan their operations.

ARTC may wish to consider how it will manage to encourage infrastructure investment discussion with operators using its network in circumstances where a reservation fee will be charged.

The QCA accepted that QR should execute access agreements for train services up to 2 years prior to their commencement. However, the QCA refused to allow QR to charge a reservation fee for this service.

***i. ACCC Issues Paper ref. 5.5 – Part 5 ‘Management of Capacity’. Question – are the provisions dealing with cancellation of paths in the event of underutilisation (“use or lose” provisions) appropriate? Are the current “use or lose” provisions appropriate for all traffics?***

Whilst the threshold test for initiating a resumption of access rights for underutilisation is the same under QR’s Undertaking as it is under the ARTC UT, QR’s Undertaking provides a more extensive process for dealing with the removal of scheduled train paths than that detailed in the ARTC UT.

By and large, QR’s process provides more avenues through which an access holder might challenge the decision by QR to resume their access rights. These additional obligations aim to comfort an access holder that such fundamental action as removal of access rights will not be undertaken without weighty consideration and the opportunity for appeal. Operators of seasonal traffics have found particular relevance in this additional security.

### ***Capacity Transfer***

Paragraph 5.4(c) of the ARTC UT currently includes reference to customer initiated transfers of train paths; however the definition of “Customer” clarifies the fact that such transfers are actually by the operator or access holder, not the customer of those entities.

In contrast, the QR Undertaking provides for customer initiated transfers where they are either the sole end customer or collectively constitute one hundred percentage points (100%) of the customers, in respect of any train services operated by the access holder pursuant to the access rights.

Until such time as the network contains sufficient capacity to enable a potential third party entrant to offer a premium service, an incumbent operator may in effect act strategically to limit above rail competition by staggering its haulage agreements and its access agreements. As a consequence, when the customer is considering the service offerings from competing operators, the incumbent has a significant competitive advantage.

In practice customer initiated transfers are unlikely to occur due to the various customers which may be serviced by a particular train service. However, a specific customer may have sufficient volumes that would justify a renegotiation and reallocation of train paths by the access provider.

As a result, QR considers that ARTC’s UT would be improved by the inclusion of similar provisions to those contained in QR’s Undertaking. In the long term this will provide an avenue through which a competitor might replace an incumbent operator notwithstanding the incumbent holds the access rights to critical paths on the network.

QR considers that, following its market enquiries into competition on the East-West route associated with the Toll and Patrick merger, the ACCC is well placed to understand the relevant competition barriers. The ACCC may also be adequately informed to be capable of recommending principles, consistent with the Competition Principles Agreement, which could overcome those barriers.

**j. ACCC Issues Paper ref. 5.6 – Part 6 ‘Network Connections and Additions to Capacity’. Question – Are the Undertaking provisions on ARTC’s commitments in respect of additions to capacity fully funded by an access seeker appropriate? Is there sufficient clarity about how capacity funded by an operator would affect that operator’s access charges?**

QR supports the ability of a network provider to recover all reasonable costs associated with providing network extensions which accrue economic benefits solely to an individual customer.

However, QR has considerable concern regarding the potential above rail competition impacts where the full costs of providing additional capacity are sought solely from the incremental access seeker. In addition, ARTC is proposing to leave itself enormous discretion as regards the determination of access charges payable by an incremental access seeker.

The provision and pricing of additional capacity which has common use characteristics, i.e. there is nothing unique about the service for which the expansion is required, has been scrutinised by other rail regulators in Australia. For instance:

- o The QCA rejected QR’s request to impose pre-conditions on mainline expansions for the purpose of increasing capacity in



the Central Queensland Coal Region, citing concerns about competition between mines; and

- ERA's review of the Western Australian Rail Access Code recommended that:

*'It is proposed that section 9.2 (b) of the Code be amended to require the railway owner, in forming its opinion under section 9.2 (b)(ii), to give consideration to implementing cost sharing arrangements which are set equitably between all users based on a combination of relative current usage and economic benefits where this is commercially possible'.*

ARTC provided the following response to the ERA recommendation when first discussed in the draft report:

*'ARTC was concerned the incumbent user may have to pay for a share of capacity expansion that is higher than the benefit it could currently, or in the future, extract from that expansion in order to achieve equity with the access seeker may result in a loss of economic efficiency. ARTC believed that if the access seeker is required to pay a higher charge for the surplus of cost over benefit to itself and incumbent users, then this is a commercial decision for the access seeker'*

ARTC's view that any loss of economic efficiency associated with recovering the costs from all users rather than the user requiring the additional capacity does not recognise the opportunity costs of the

existing capacity. Kahn summarises the situation neatly when discussing the demand of two operators A and B<sup>7</sup>:

*‘true, it is the increase in B’s purchases that precipitates the additional investment; but the additional costs could just as well be saved if A reduced their purchases as if B refrained from increasing theirs. So A’s continuing to take the service is just as responsible, in proportion to the amount they take, for the need to expand investment as B’s increasing needs, and A should therefore be forced just as much as B to weigh the marginal benefits of the capacity to them against the marginal costs they impose on society by continuing to make demands.*

*Even though B’s demand is ‘marginal’ in the temporal sense, both groups are marginal in the economic sense. Both should be forced to match the higher capacity costs against the satisfaction they derive from continuing to use the service.’*

This concept is particularly relevant to an infrastructure provider who does not recover the full economic cost of its existing capacity. In this context, where an incumbent operator’s charges are less than stand alone cost, and the expansion costs would lead to higher access rates to the entrant, the access provider could increase its commercial return by reassigning the incumbent’s access rights to the entrant and not undertaking the expansion. Alternatively, the expansion, while economic, would be unlikely to proceed because the incremental access seeker could not meet the full expansion costs.

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<sup>7</sup> Kahn, A (1988) *The Economics of Regulation: Principles and Institutions*

This indicates that where additional capacity would be necessary to accommodate the requirements of an access seeker who is providing the same service in the same market as an incumbent operator, then the cost of additional capacity should be borne by all operators to avoid distortions in other markets. However, this should only occur where it is clear that the additional capacity is not specific to the access seeker and the demand for that level of capacity is expected to prevail into the foreseeable future. For instance, where it is clear that the additional capacity would not be necessary if an incumbent operator reduced their current demand by a corresponding amount it is clear the capacity is not specific to the operator. Such an outcome is entirely consistent with clause 6.4(j)(iii) of the Competition Principles Agreement.

Given the above position, QR accepts that ARTC would need to give consideration to the impact that expansion costs would have on overall demand for the network before deciding whether to undertake an expansion.

**k. ACCC Issues Paper ref. 5.8 – Part 8 ‘Key Performance Indicators’**

The types of measures that ARTC’s UT includes are similar to those included in QR’s Undertaking, and appear to be fairly standard across the rail industry. There is a difference between ARTC’s proposed UT and QR’s Undertaking in the comprehensiveness of the performance measures and reporting obligations attached to those measures. In terms of a cost benefit analysis it is impossible to say that the additional administrative burdens imposed on an infrastructure provider by way of a more comprehensive KPI regime are justified. As a result, QR does not consider the KPIs need to be made any more onerous at this stage.

## 4. Conclusions

QR considers that ARTC has the best opportunity of fostering the growth of the Australian rail industry by carefully balancing its responsibilities in relation to reducing the real cost of access to the interstate network and increasing the level of above rail competition on the network.

With respect to the first responsibility, QR considers that ARTC's proposed pricing approach needs significant amendment. In particular, the structure of the access charges results in inappropriate price discrimination between operators of different length trains. This discrimination is worsened by the operational restrictions imposed upon the function of train control, and the negative implications this has for operators of shorter length trains. Furthermore, the quanta of the price changes declared by ARTC are excessive in QR's analysis of the circumstances.

With respect to the second responsibility, QR considers that ARTC's capacity allocation process could be improved by a number of modifications as discussed above. In particular, ARTC must ensure that it recognises the barriers to entry that new competitors face. These barriers include access to premium paths and operational complexities imposed by the network limitations.

Finally, in terms of encouraging growth in the Australian rail industry, QR considers that ARTC needs to provide greater certainty to both current operators and prospective operators on the interstate network. In relation to pricing and related capacity management provisions, the ARTC UT provides no comfort to operators of non-Indicative Services vis-à-vis operators of Indicative Services. This is likely to hinder rather than assist an operator wanting to use the interstate rail network for anything other than intermodal traffic.