QR Submission ACCC

Response to ACCC Issues Paper
on ARTC Access Undertaking - Interstate Network
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Introduction

QR appreciates the opportunity to provide comments to the ACCC as part of this assessment of the ARTC Access Undertaking for the Interstate Network (UT).

Whilst, in the main, restricting the comments in this submission to the variations between the June 2007 version of the UT and the December 2007 version of the UT, QR reiterates comments provided in it's previous submission, to the extent that they have not been addressed as QR considers appropriate.

The network covered by the UT is of fundamental significance to the current and future viability of freight movements across Australia. The extent of the network and the characteristics of rail make it clearly uneconomic to duplicate. This places ARTC in a very important position vis-à-vis the public of Australia who are, after all, the customers of the freight operators relying upon ARTC's ability to manage the network with an eye to long term sustainability and competitiveness with other forms of transport. This UT is critical for this reason.

While rail is now seen as forming an important element of the national freight strategy and should have the capacity to exploit its competitive advantage through increased costs on modal competitors due to labour supply constraints and increasing input costs such as fuel. it is however important that the rail industry is in a position to respond to the changing market conditions in a timely manner. In other words, rail should be improving its capacity and service reliability well ahead of when both above and below rail businesses can expect to earn commercial rates of return.

Improving service levels and increasing rail's market share of the national freight task requires considerable investment by both above and below rail operators and the access provider to raise productivity and address service reliability issues. This raises concerns of double marginalisation where total freight charges cannot sustain a commercial return sufficient to support the business case necessary to commit to these investments. Commercial negotiation in such an environment is difficult. QR and other operators have raised concerns about ARTC's take-it-or-leave-it approach to commercial negotiation under the negotiate-arbitrate model of access.

While ARTC's access charges may be substantially below the full economic cost permissible under the pricing principles, ARTC possesses significant market power and as the above rail market becomes more competitive, ARTC will have greater capacity to increase access charges to operators. As another provider of access to a rail network, QR has taken an approach to negotiating access charges that is information based, and considerate of the likely impacts to both the access provider and access seeker, of the access charge and its variation over the term of the access agreement.

Regulation does not necessarily provide a solution to this dilemma. Alternate below-rail funding models, such as the Transport Service Contract, may be more capable of addressing these underlying concerns.

QR's response to changes made by ARTC

1. Capitalisation approach to Regulatory Asset Base (RAB) changed to building blocks approach

The June UT included a regulatory capitalisation model that would enable ARTC to bank foregone economic costs for future recovery. QR considers that the capitalisation approach had advantages in certain parts of the interstate network.

QR recognises that like any commercial infrastructure provider, the viability of an expansion project will be dependent upon the expectation of earning the required return commensurate with the commercial and regulatory risks over the economic life of the asset.

While QR raised issues regarding the potential distortions associated with applying the capitalisation model across the network, there will be circumstances where prices could exceed the pricing limit established under the building blocks model. This is particularly relevant where ARTC's investment decision is underpinned by an expectation that it recovers its original capital investment. QR recognises that the capitalisation methodology remains relevant to any investment in new corridors where the costs are clearly separable.

However, for existing corridors an alternate methodology of achieving this objective within the building blocks framework would be to modify the depreciation profile. Where non-linear volume growth, through increased density and rail productivity, is expected over time on the interstate network then the depreciation profile should parallel the expected long-run demand profile. This approach provides a more reasonable distribution of risk as well as incentives for both below and above rail to improve the commercial performance of the rail industry.

In returning to the building block methodology, QR queries the retention of the RAB 'lock-in' which underpins the concept of financial capital maintenance. As prices are to be reviewed every regulatory period, it is important that the asset value continues to reflect forward looking costs. In the event that replacement costs escalate at a much greater rate than the consumer price index for extended periods of time, then price ceilings under the RAB lock-in will not be a reasonable reflection of efficient costs and the cash flow ARTC requires to replace expiring assets or grow the network. Either the RAB should be periodically revalued, but over a more extended period than 5 years as provided for in the 2002 undertaking or an alternate cost reflective index, such as a Rail Cost Index, is used to roll-forward the asset base.

Given the inherent difficulties in employing a cost reflective index for RAB roll-forward in a post-tax nominal environment where the real-rate of return is employed to avoid the double counting of the capitalised inflation, an extended period of asset revaluation would appear more appropriate. To the extent that access revenue for most segments would appear to be well below the maximum allowable revenue permissible under the building blocks framework then an extended interval between valuations would not appear to distort prices and would minimise the transaction costs associated with performing DORC valuations. In addition, the longer interval would provide greater certainty regarding potential access charges for an extended period of time as is ARTC's intention with the 10 year access agreement.

2. 10 year term for UT – QR continues to support a 5 year term in preference over a 10 year term

ARTC has sought to increase certainty to operators by extending the term of the UT from a period of 5 to 10 years.

QR does not believe a 10 year access undertaking is appropriate at this point in time. The implementation plan for the Competition and Infrastructure Reform Agreement (CIRA) includes commitments relating to clauses 3.1 and 3.2 which could lead to the development of a National Rail Access Code modelled on the ARTC UT. QR considers that this process creates an environment of increased regulatory risk to all stakeholders which may not be addressed through an increase in the term in the UT. Where an Access Code is developed and applied to the interstate network, including parts of the network not owned or managed by ARTC, a ten year undertaking would not meet the objective of national consistency, an objective ARTC has long advocated.

For example, subsection 44ZZA(7) allows for the access provider to vary the access undertaking at any time, but only with the consent of the Commission. The Commission must have regard to the matters in subsection 44ZZA(3) which includes whether the undertaking is in accordance with an access code that applies to the service. ARTC has alluded to this process in Box 2 of the issues paper with reference to amending the UT.

The greater the uncertainty associated with demand projections beyond five years the greater the justification to locking in a capped price-path (or to capture the full benefit of productivity gains from above rail investment) for a period of 10 years.

As acknowledged by ARTC, the access provider is willing to enter into an access agreement with an operator for a period up to 10 years. ARTC also notes that the greater risk of providing long-term certainty to access terms and conditions lies with ARTC. It is not clear that all operators should be exposed to this risk and that this long-term certainty to a particular operator should be priced at a premium to reflect the value of this risk to ARTC.

3. Prudential Criteria – revised prudential criteria in 3.4(d) UT

The changes proposed by ARTC fail to address the concerns expressed about the prudential requirements in the June UT. If anything, the revised criteria is worse than that previously proposed by ARTC. By taking out the 'reasonableness' limit upon ARTC's discretion in relation both to an access seeker's ability to meet the prudential criteria and establish what the prudential criteria are, ARTC appears to have greater discretion to refuse to negotiate with a particular party.

QR also considers that there should be a less time consuming and costly process nominated to resolve disputes about an ARTC decision to refuse to negotiate with a particular access seeker.

Issues not dealt with at all by ARTC or not dealt with sufficiently by the December UT.

4. Requirement to offer Indicative Access Agreement (IAA).

The changes that ARTC has made in this area do not address the real issues of concern.

The inclusion of an obligation to make reference, in an Indicative Access Proposal (IAP) to the IAA and the current market terms and conditions as published on ARTC's website does not seem to serve any purpose other than to point out what ARTC already does. The issue for operators is that what ARTC already does in respect of non-indicative train services is inadequate.

Even if the market terms and conditions published on ARTC's website covered all of the relevant information that an access seeker might require in order to fully assess their exposure under an access agreement, which they do not appear to do, the fact that these details are published on a website provides no certainty to access seekers that ARTC will, at the very least, offer them access on these terms and conditions.

QR considers that in respect of non-indicative services, the ARTC UT needs to be clearer about the basis on which it will contract for these services. Schedule C is inadequate in this respect.

5. Variations to capital expenditure

Whilst QR is generally in support of the UT provisions in this regard, it considers the 20% buffer that ARTC wants with respect to over-expenditure on capital expenditure on the network for any one year, to be too generous. A much lower percentage would require ARTC to put more rigour into the cost management of its capital expenditure and would be a more appropriate figure.

6. Publication of prices for non-indicative services

As noted above in point 1, the publication of prices for non-indicative access services on ARTC's website, whether or not required by the UT, does not in isolation, address QR's concerns regarding access for non-indicative access services. In order to assess the costs and risks associated with running a non-indicative service, an operator needs the terms and conditions under which access will be provided, not just the starting price. Such a price may mean very little if in fact, the ability of ARTC to review that price is broad and discretionary.

7. Excess Network Occupancy Charge (ENOC)

QR remains concerned that a charge such as the ENOC will favour operators who have established non-ARTC network infrastructure that facilitates more efficient usage of ARTC network. For instance, if an operator has a terminal that is large enough to accommodate shunting of full length trains, it will arguably not require as much network occupancy time as an operator who has smaller terminals and has to rely on network infrastructure to carry out some of its operations. From one perspective, a distinction between two such operators is justified. However, the reality of land availability, in metropolitan regions particularly, means that existing operators have strategic advantage over smaller and newer operators by virtue of the fact that their assets cannot be replicated irrespective of the amount of money a party might be prepared to spend. QR queries whether it is reasonable for such operators to be further disadvantaged by having to pay the ENOC as well as standard access charges.

This concern regarding favouritism is heightened by the ARTC's explicit exclusion in the December UT of 'yards and sidings' from the scope of the UT.

QR considers that ARTC's amendments to the IAA should be incorporated into the UT if, as ARTC claims, the ENOC applies only to the contracted train path sought by operators and not operators' actual usage. The IAA would appear to be a more appropriate place to deal with the consequences of an operator not performing in accordance with a contracted train path. Without inclusion in the UT, QR would remain concerned that ARTC may arbitrarily alter the parameters of the ENOC.

8. Price escalation for indicative train services

QR notes that the revised escalation provisions in the UT, in particular the proposal to accumulate price increases over a 5 year period, fail to reasonably address the issue of possible roll forward of escalation during the regulatory period. For instance, during the maximum 5 years period within which ARTC may accumulate price increases, if the only limit is the cumulative CPI increase over the 5 year period, operators potentially face a huge price increase in year 5 as ARTC tries to recover as much as it can from the previous 4 years. For example, if CPI increases at 5% for each of the 5 years in the relevant period, but ARTC does not pass through the full CPI increase in years 1-4, but rather chooses to pass through a 3% increase, there is in theory nothing preventing ARTC from imposing a 13% increase in year 5.

In addition to the comments QR provided to the June 2007 issues paper on the proposed tariff escalation rules, QR questions the capacity of ARTC to evaluate the prevailing market conditions. ARTC has previously noted[1] its difficulty in applying Ramsey pricing principles due to its separation from the end market where end-user elasticity of demand drives demand for rail access. This raises concerns regarding the capacity of ARTC to 'match pricing variation' to prevailing market conditions where the mechanism by which ARTC obtains this understanding is unclear. As ARTC's predominant source of information regarding the market is obtained ex-post through the invoiced gross tonne kilometres, ARTC is in effect stating is that it will apply cyclical peak pricing by passing through larger increases in periods of higher demand. Such an intention requires an understanding of the operators cost function with changes in volume.

In an environment of increasing volumes, service level improvements and increasing network density, operators could reasonably expect that access charges should incorporate a volume discount in the escalation formula. In part, service level improvements and growth will be facilitated by ARTC's below rail investment and ARTC should be entitled to share in the economic benefits this investment will deliver. However, price escalation by the full CPI amount may lead to an increase in ARTC's real revenue and a capture of the benefits that would accrue to above rail operators which would otherwise provide the required return on above rail investors. In this context, ARTC has not demonstrated with any reasonable degree of robustness the demand forecasts and its revenue projections over the regulatory period.

[1] David Marchant's presentation at the 2007 Australian Rail Summit made reference to ARTC not being in a position to Ramsey price when explaining charge structure.

The somewhat discretionary nature of the price escalation formula will require operators to manage this risk through their end customer contracts. QR questions whether this escalation approach introduces additional cost and risks which would otherwise be limited under an assumed price path derived from transparently assumed volume forecasts. Rail customers are also likely to have a better understanding of cost pass-through relating to below-rail contracts linked to CPI in a transparent and predictable manner.

The Issues Paper makes reference to the UT committing to publishing regularly a "state of play' with information on the permitted variation based on transparently assumed inflation forecasts. QR cannot identify within the UT where ARTC has made this commitment. QR considers the 'state of play' would be of greater assistance to operators where it includes escalation forecasts and the basis for those projections as most operators will already have their own estimates of forecast inflation. It is also likely to be beneficial where the 'state of play' is developed in consultation with operators.

9. Capacity reservation fee (CRF)

QR supports the ARTC decision to remove the exemption from the charge differentiation obligations in respect of the CRF. However, QR still considers that the valuation and calculation of the reservation fee is problematic. The ceiling placed on the fee is, by all reasonable accounts, high, and there is still a great deal of discretion left to ARTC to determine what an operator should pay to 'reserve' capacity.

Furthermore, there is no discussion about how the fee will be reconciled, assuming it is paid up front, and then reduced and partially/fully refunded once ARTC takes all relevant factors into account. This process seems to be completely within the discretion of ARTC.

10. Renegotiation of existing access rights

QR supports ARTC's decision to amend Schedule C as proposed. QR considers that the other issues it raised in its submission on ARTC's June UT in regard to capacity remain relevant. In particular, QR queries why

ARTC does not consider it necessary to at least acknowledge the issue of customer initiated capacity transfers. QR accepts that whilst such an issue may not be particularly topical for intermodal traffics (i.e. the indicative train services) for non-indicative train services such as those carrying bulk minerals, such a provision may be very relevant.

11. Additional capacity sought by ARTC

A significant constraint on QR developing the national intermodal freight business is the access to premium paths to deliver a comparable service to the incumbent operator. As a result, QR fully supports the ARTC revisions concerning Additional Capacity for the benefit of the rail industry. It is anticipated that some stakeholders will raise issues regarding the impact on their existing contractual rights. QR considers that any concerns regarding these new provisions will relate primarily to the practical application and that these views should not detract from the underlying concern of incumbency advantages. QR notes that where 6.3(b) includes the matters that the ACCC must have regard to in making an access determination, then this is sufficient protection for ARTC and existing and future access seekers. Specific issues raised in the consultation process can be addressed at the time of ARTC's application.

12. Certainty beyond proposed regulatory period

QR would welcome a commitment from ARTC that it will seek to maintain an approved access undertaking beyond the proposed term. QR recognises that regulatory determinations are a complex process and may not be completed within defined timeframes. However, for the period of expiry of the 2002 ARTC UT to the expected approval of the 2008 ARTC AU, access seekers are required to negotiate with ARTC in an environment without access to formal dispute resolution procedures. This is not an acceptable position in which to leave commercial operators to whose business the cost and certainty of access to the interstate rail network is fundamental.

13. Definition of prudent capital expenditure

QR supports the ARTC revisions.

14. *Definition of "associated facilities"*

The exclusion of 'sidings or yards' from the coverage of the UT begs the question of how this infrastructure will be dealt with by ARTC.

Will ARTC take an approach similar to wayside detection equipment, and negotiate separately and outside any regulatory constraints, in a manner that leaves operators with no choice as to the terms on which it must acquire these services given their essential relationship to the services covered by the UT?

This leaves access seekers in a position where it may be necessary to seek declaration of services necessary for the operation of a Train Service, while the majority of the infrastructure is covered by a voluntary undertaking. Notwithstanding this is a voluntary undertaking by ARTC, QR questions the value of providing an undertaking that 'picks and chooses' which services and infrastructure it chooses to cover, whilst remaining silent on how it will deal with other services and infrastructure essential to the operation of activities as envisaged by the undertaking. Surely, such an approach hinders the smooth provision of access.

15. *Gifted/contributed assets*

ARTC has not addressed concerns regarding the treatment of capital contributions. The primary source of capital contributions for the interstate network is likely to be received via the Auslink program. As this program provides one-off capital contributions for specific projects, there appears to be no on-going funding stream to support the sustainability and replacement financing of the asset. Therefore, where the intention of the Auslink funding is to provide benefits to the rail industry and the broader community without an expectation of recovering a financial return on capital invested it is appropriate for the building blocks to include the depreciation of that asset. . However, it is recognised that in the absence of government contributions, ARTC's cash flows may not be capable of attracting the necessary private capital to expand the network. Ultimately, the Government is the financier of last resort and whether it earns a return on that investment is at the discretion of the contributor. Nevertheless, QR sees merit in the Undertaking explicitly recognising capital contributions where the intention of the contributor is to provide price discounts for users of the service.

16. Possession Planning

QR considers that further detail needs to be included in the IAA around the process by which ARTC will consult and determine the timing of possessions of the network for the purposes of repairs, maintenance, new works and upgrades. QR considers that the best outcomes can be achieved through consultation between all the affected parties – access provider, maintenance provider, operators etc – and the provision of minimum notice of changes to scheduled times.

Conclusion

Track access is a fundamental part of the rail industry, and being able to gain access in a way that efficiently supports commercial operations is fundamental to the industry's success. QR therefore looks forward to a satisfactory conclusion to the development of this current undertaking.