Australian
Competition &
Consumer
Commission

Draft Decision

Access Undertaking – Interstate Rail Network

Australian Rail Track Corporation

APRIL 2008

CONTENTS

Glossary

2002 Undertaking	The access undertaking submitted by ARTC and accepted by the ACCC in 2002
ACCC	Australian Competition and Consumer Commission
Act	Trade Practices Act 1974
AER	Australian Energy Regulator
Allens	Allens Consulting Group
ARTC	Australian Rail Track Corporation
BAH	Booz Allen Hamilton
CAPM	Capital Asset Pricing Model
CEO	Chief Executive Officer
CPA	Competition Principles Agreement
CPI	Consumer Price Index
DCF	Discounted Cash Flow
December Undertaking	The access undertaking submitted by ARTC to the ACCC on 20 December 2007
DORC	Depreciated Optimised Replacement Cost
ENOC	Excess Network Occupancy Charge
FROG	Freight Rail Operators Group
GSR	Great Southern Railway
GST	Goods and Services Tax
gtkm	gross tonne kilometres
IAA	Indicative Access Agreement
IAP	Indicative Access Proposal
kgtkm	'000 gross tonne kilometres
Kph	Kilometres per hour

KPI	Key Performance Indicator
LOREN	ARTC's cost allocation process for the leased NSW segments
MPM	Major Periodic Maintenance
MRP	Market Risk Premium
NERA	National Economic Research Associates
Network	The interstate network managed by ARTC
NPV	Net Present Value
NMP	Network Management Principles
NSW	New South Wales
NSWMC	New South Wales Minerals Council
PN	Pacific National
PTRM	Post Tax Revenue Model
PWC	PriceWaterhouseCoopers
QR	Queensland Rail
RAB	Regulated Asset Base
Reserve Bank	The Reserve Bank of Australia
RIC	Rail Infrastructure Corporation
SCT	Specialised Container Transport Logistics
SSFL	Southern Sydney Freight Line
Synergies	Synergies Economic Consulting
The Tribunal	The Australian Competition Tribunal
The Act	*Trade Practices Act 1974 (Cth)*
WACC	Weighted Average Cost of Capital

Executive Summary

This draft decision details the Australian Competition and Consumer Commission's (ACCC's) preliminary assessment of the Undertaking lodged by the Australian Rail Track Corporation (ARTC) on 20 December 2007 (the December Undertaking). The December Undertaking covers the terms and conditions ARTC proposes to apply in negotiating access to all traffic on the Interstate Rail Network. The Interstate Rail Network covers the mainline standard gauge track linking Kalgoorlie in Western Australia, Adelaide, Wolseley and Crystal Brook in South Australia, Melbourne and Wodonga in Victoria and Broken Hill, Cootamundra, Albury, Macarthur, Moss Vale, Unanderra, Newcastle (to the Queensland border) and Parkes in New South Wales (NSW).

Broadly, the ACCC's draft decision covers the following issues in ARTC's Undertaking:

- Preamble;
- Scope and Administration of the Undertaking;
- Negotiating for Access and Dispute Resolution;
- Pricing Principles;
- Financial Model;
- Capacity Management;
- Investment, Network Connections, Additions to Capacity and Network Transit Management;
- Performance Indicators; and
- Schedules.

The ACCC reviewed all sections of the December Undertaking and assessed whether, overall, the Undertaking would deliver outcomes that are consistent with the criteria in s.44ZZA of the *Trade Practices Act 1974* (the Act). In making that assessment the ACCC has drawn on:

- ARTC's application and other information it provided to the ACCC;
- submissions from interested parties on the December Undertaking and an earlier version of the Undertaking ARTC lodged with the ACCC in June 2007;
- consultants engaged by the ACCC to review the efficiency of ARTC's operating and maintenance expenditure, cost allocation methodology, and proposed valuation of network assets; and

- the ACCC's own research.

ARTC's Undertaking

If the December Undertaking were accepted by the ACCC, access terms and conditions for all rail services on the interstate network owned or leased by ARTC would be governed by that Undertaking. ARTC would be obliged to negotiate with access seekers who meet minimum prudential requirements. Such negotiations would be supported by the processes defined in the Undertaking, the indicative access agreement (which specifies standard terms and conditions for contracts that involve the supply of indicative services), prices for indicative services that are specified in the Undertaking and additional information provided on ARTC's website. There would also be recourse to dispute resolution processes, including independent arbitration, if negotiation failed.

The Undertaking requires the revenue earned by ARTC to fall within a regulatory floor and ceiling which is based on a standard building block methodology.

There are, however, some unusual features of the rail sector that affect the development and assessment of this Undertaking. Primarily, it is clear that ARTC does not earn sufficient revenue to cover the full economic cost of the rail network, and this conclusion is unlikely to change over the term of the Undertaking. Therefore, in assessing the Undertaking, the ACCC has put less focus on provisions to prevent ARTC from earning monopoly rents and focussed more on the need to provide sufficient certainty for access seekers to confidently invest in above rail services, without undermining ARTC's ability to improve its cost recovery over time.

ACCC Draft Decision

The ACCC has reached a view that it would accept ARTC's Undertaking subject to ARTC addressing a number of issues identified in the draft decision. The following discussion summarises the key issues considered in the draft decision and highlights those areas where the ACCC considers that the current approach proposed by ARTC raises objections under the criteria in Part IIIA of the Act. In a number of cases the ACCC has suggested ways that the ARTC could address the issues identified.

The Preamble

The preamble to the December Undertaking does not contain individual legal obligations *per se*, rather it includes preliminary statements that explain the purpose of the Undertaking and assists in its interpretation. With that said, the ACCC considers that the preamble should be consistent with the legislative criteria and has, therefore, considered areas where this may be of material concern.

In general, the ACCC considers that the preamble provides an appropriate context for access negotiations. Stakeholders expressed some concerns about ARTC's objective to operate as a commercial entity as they felt that such an objective is inappropriate given ARTC's role as a public entity managing essential infrastructure that does not earn a commercial rate of return. After considering these issues, the ACCC concluded that it is possible for ARTC to balance its commercial focus with low levels of cost recovery in a way that is consistent with the criteria in Part IIIA.

The ACCC, however, raises some issues in relation to clause 1.2, the objectives of the Undertaking, as it considers that the objectives should explicitly recognise that a key purpose of the Undertaking is to provide access to the Network. This could be achieved by moving part of clause 1.1 from the introduction into the objectives section of the preamble.

Scope and Administration

Scope

In assessing the scope of the December Undertaking, the ACCC considered whether:

- its geographic coverage is clearly defined;
- sidings and yards should be covered by the Undertaking;
- the provisions relating to the future coverage of the Southern Sydney Freight Line (SSFL) are appropriate; and
- extensions, other than the SSFL, should be automatically covered by the Undertaking.

In analysing these issues the ACCC notes that first, the Undertaking is voluntary and, therefore, the ACCC can only justify requiring the inclusion of current or future infrastructure if it is clearly demonstrated that coverage is essential to a workable undertaking. Second, the Undertaking needs to have sufficient transparency and certainty to enable it to meet the interests of access seekers and for it to be enforceable and not unduly encourage disputes.

Consistent with these principles, the ACCC concludes that it does not have sufficient information to require ARTC to include sidings and yards, or future extensions of the infrastructure in the December Undertaking. It also concludes that the provisions in the Undertaking covering the inclusion of the SSFL do not raise any objections under Part IIIA of the Act.

The ACCC's preliminary view is, however, that further clarity is needed on the definitions of the Undertaking's scope in Schedule E, and that maps of the network should be attached to the Undertaking.

Administration

Administration of the Undertaking includes its commencement, duration and review, how existing contracts are protected, and the requirements for parties to hold insurance. In this draft decision, the ACCC looks in detail at the timing of the commencement of the Undertaking, the term of the Undertaking, ongoing review of the Undertaking, the rights to renegotiate expiring contracts and the obligations on access seekers and ARTC to hold insurance.

Overall, the ACCC considers that the Undertaking's triggers for ceasing the Undertaking and the arrangements for protecting existing contracts, renegotiating expiring agreements, the changes to the amount of insurance ARTC and access seekers are required to hold, and the proposed ten-year term are reasonable. In considering the

ten-year term, the ACCC notes that there are potential benefits for access seekers and ARTC in longer term certainty in access arrangements. Many of the concerns raised by interested parties have been considered by the ACCC in other areas of this assessment and a ten-year term would not undermine national processes for developing more uniform access arrangements. There may, however, be benefits in ARTC reviewing the operation of the Undertaking after five years.

In addition, the ACCC notes that when an undertaking expires there are no statutory protections for access seekers between the expiry of one undertaking and the execution of a new undertaking, unless an access seeker applied for, and obtained, declaration of the service provided by ARTC's network. The resulting 'gap' between undertakings can be considerable and can contribute to industry uncertainty. The ACCC considers, having regard to the objects of s.44ZZA(3) of the Act, that the Undertaking should include provisions that reduce uncertainty during 'gap' periods.

The ACCC has, therefore, recommended some changes to administration processes in the Undertaking.

First, it is recommended that the Undertaking be amended so that, consistent with the Act, it takes effect 21 days following approval by the ACCC, rather than the 30 days currently specified.

Second, that the Undertaking specify that three months prior to its expiry ARTC would submit to the ACCC a written statement outlining whether or not it intends to submit a new voluntary Undertaking to the ACCC for its consideration, and if ARTC intends to submit such an Undertaking it would also apply to the ACCC for an extension of the expiring Undertaking, pursuant to s.44ZZBB of the Act.

Third, the ACCC considers that ARTC should formally review the effectiveness of access arrangements, including whether the Undertaking continues to meet the needs of access seekers, after the December Undertaking has been operating for five years. Such a review would involve consultation with industry, but it would not be subject to any ACCC assessment.

Negotiation of Access and Dispute Resolution

The arrangements for negotiating access and resolving disputes are essential to effective access arrangements. ARTC's negotiation framework includes:

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

Negotiation Processes

The ACCC's preliminary conclusion, after analysing ARTC's proposal, is that the approaches to information provision, confidentiality of information, the process for submitting and acknowledging access applications, the allocation of train paths between competing access seekers, and the ability of accredited and non-accredited rail operators to negotiate access are all appropriate.

There were several areas where access seekers raised concerns about the negotiation processes proposed by ARTC.

First, there was considerable concern among access seekers that the prudential criteria proposed by ARTC are not balanced and are overly onerous as they allow ARTC to refuse to negotiate with an access seeker who is in material default of any access agreement, not just one negotiated with ARTC, and that ARTC can refuse to negotiate with an operator who cannot demonstrate that they have a legal ownership structure with a capital base and asset value to meet the actual or potential liabilities under an access agreement.

The ACCC considers that ARTC should not be obliged to negotiate with an access seeker that is not genuine about gaining access to its network or does not have the capacity to meet the obligations of an access agreement, and it is appropriate for ARTC to 'screen' applicants. The ACCC's preliminary view is that it is legitimate for ARTC to consider an access seeker's performance in other rail access agreements when assessing the risk to ARTC of an access seeker breaching its access agreement, and that the use of criteria, such as the legal structure of the organisation, is appropriate in considering whether that organisation is capable of meeting its long term access commitments.

Second, stakeholders felt that the Undertaking's timeframes may provide ARTC with more time than necessary to respond to access seekers and with an opportunity to exploit the timeframes to hinder access. The ACCC recognises that timeframes are necessary to ensure that the negotiation process is timely and orderly. In the absence of any timeframes, negotiation could become protracted and act as a barrier to entry. Overall, the ACCC believes the nominated timeframes are an upper limit (except in exceptional circumstances), and the requirement for ARTC to 'act in good faith' should ensure it seeks to meet its obligations expeditiously. ARTC's proposed timeframes are also largely consistent with those in similar regimes.

Finally, interested parties were concerned about the role and effect of the current available market terms and conditions published on ARTC's website. The ACCC's preliminary view is that these market terms assist the transparency of Undertaking and do not undermine the status of the Indicative Access Agreement (IAA). The IAA is part of the Undertaking (Schedule D), ARTC should be obliged to make the terms in the IAA available to access seekers seeking to operate the indicative service and it cannot be amended without the ACCC's agreement. Current available market terms and conditions, however, may cover services other than the indicative service and would assist access seekers to determine what has been agreed between ARTC and other users of the network.

The ACCC recommends that the Undertaking be amended in the following areas.

The Undertaking specifies the conditions under which ARTC may cease access negotiations, including allowing it to cease negotiations if it receives evidence that the applicant no longer satisfies the prudential requirements. Given that the prudential criteria in the December Undertaking has been strengthened considerably, the ACCC considers that there needs to be transparency in their application, to inform negotiation processes. The ACCC's preliminary view is, therefore, that the December Undertaking should be amended to require ARTC to provide written reasons to an applicant if ARTC decides to end negotiations because ARTC believes the applicant no longer meets the prudential criteria.

While ARTC has informed the ACCC that it intends to offer the IAA to an access seeker where the access seeker is seeking access to the indicative service, the Undertaking does not explicitly specify this obligation. As a result, the ACCC's preliminary view is an amendment is required to the December Undertaking to ensure that ARTC is obliged to offer the IAA. This would create certainty regarding the status of the IAA.

Dispute Resolution

The dispute resolution processes include negotiation, meditation and arbitration, in which the ACCC hears disputes that are referred to arbitration.

In assessing the December Undertaking, the ACCC identified only one issue in relation to the earlier stages of the dispute resolution process — negotiation and arbitration. ARTC did not include in the December Undertaking explicit reference to parties being able to appoint a conflict manager to assist in resolving disputes. The option of using a conflict manager was explicitly recognised in the 2002 Undertaking. While some submissions commented on this change, there were no objections raised, and the ACCC considers that the exclusion of a conflict manager does not raise any objections under the Part IIIA criteria.

There were, however, a number of issues raised by stakeholders about the arbitration processes in the December Undertaking. First, clarity in the arbitration provisions was an important issue for interested parties. For example, in earlier versions of the Undertaking there was some confusion about the references to dispute resolution and arbitration outside the general dispute resolution processes in cl.3.12.1(a). In the December Undertaking, however, it appears clear that such references clarify how dispute resolution processes would be applied in certain circumstances.

Overall, the ACCC considers that, while it may be possible to simplify the arbitration provisions in the Undertaking, they are currently sufficiently clear to allow for effective arbitration processes and, therefore, do not raise objections under Part IIIA of the Act. In addition, the arbitration provisions of Part IIIA, adopted by ARTC in the December Undertaking, are appropriate as they are generic enough to cater for the specific issues and circumstances that are likely to surround the variety of possible disputes.

A number of parties also expressed concerns about whether the ACCC has the power to arbitrate disputes over non-indicative services and whether in arbitrating such disputes it is constrained to accepting any price that is below the Undertaking's regulatory ceiling. It is the ACCC's view that it can arbitrate on the substance of any dispute arising under the Undertaking, including indicative and non-indicative price and non-price terms and conditions of access. In addition, s.44ZZA(6) of the Act requires the

ACCC to resolve disputes in accordance with the Undertaking. However, the ACCC believes compliance with s.44ZZA(6) involves more than simply examining ARTC's compliance with its obligations in its Undertaking. Rather, the Undertaking provides for the ACCC to consider a range of factors in deciding a dispute. These include the objects of Part IIIA and the economically efficient operation of the network. Therefore, in arbitrating a dispute, the ACCC is not obliged to conclude that a disputed price is acceptable just because it complies with the Undertaking and is below the ceiling.

Finally, there was some concern among stakeholders about whether the requirement to fund the costs of arbitration would discourage its use.

In response, the ACCC notes that arbitrating disputes under a voluntary access undertaking is not one of its legislated functions. Therefore, it is not unreasonable for the ACCC to have the option to charge for conducting an arbitration. However, the ACCC also has discretion on when it charges costs and how those costs are apportioned, and can take into account the incentives and impact on access seekers and the access provider in making such decisions. For example, if the actions of one party lead to unreasonable delay or a party asks for the consideration of matters that are outside the scope of what could normally be expected in an arbitration, then the costs for this additional period of arbitration could be apportioned to that party by the ACCC. The ACCC considers that its discretion to charge and apportion costs should overcome the concerns expressed by interested parties.

Pricing Principles

The Undertaking sets out ARTC's framework for all price negotiations. For indicative services, ARTC commits to offering these services at the indicative access charges in the Undertaking. The Undertaking does not prescribe prices for other services, but commits ARTC to negotiate access prices for non-indicative services having regard to a range of factors, including the charges for indicative services.[1]

Pricing issues analysed in the draft decision broadly fall into four groups:

- price negotiation, including indicative charges and price differentiation;
- the level and structure of prices;
- price escalation; and
- the introduction of a excess network occupancy charge.

Price Negotiations

While all access agreements are subject to negotiation, those negotiations are guided by the indicative prices specified in the Undertaking and subject to provisions that limit the level of price differentiation.

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[1] The indicative service broadly equates to intermodal freight, that is, general non-bulk freight (for example manufactured goods) that is transported from its origin to destination using two or more modes, such as road and rail and accounts for about 60 per cent of ARTC's revenue. Non-indicative services cover all other freight including steel, minerals, passenger services and grain.

Generally, there were few concerns about the specification in the Undertaking of prices for indicative services. Many interested parties, however, argued that similar price guidance should be provided for other, non-indicative, services. The ACCC's analysis of ARTC's approach to negotiating non-indicative prices assessed whether:

- the December Undertaking strikes the appropriate balance between certainty for access seekers and flexibility for ARTC to negotiate prices; and

- if it is appropriate to constrain ARTC's flexibility, are the constraints in the December Undertaking sufficient.

The ACCC's preliminary view is that the benefits to access seekers of certainty, and the practical difficulties obtaining all the theoretical benefits from unconstrained price flexibility, mean that ARTC's capacity to set prices should be constrained. There are, however, already provisions in the Undertaking that limit ARTC's capacity to set prices, namely:

- ARTC must have regard to indicative prices in setting non-indicative prices, meaning that there should be an identifiable link between these prices and that indicative prices should provide a benchmark for non-indicative prices;

- the 'like with like' provisions limit ARTC's capacity to exercise unconstrained price discrimination. Price discrimination is constrained to differentiating between broad product categories such as inter-modal freight, bulk freight (grain steel and minerals) and passenger services;

- operators are protected by the dispute resolution provisions in the Undertaking. The ACCC notes that it could arbitrate on prices for non-indicative services, even if the disputed price is below the regulatory ceiling; and

- the December Undertaking requires ARTC to publish prices for non-indicative services on its website, guaranteeing transparency, and making it easier for operators to determine if ARTC has breached the Undertaking's 'like with like' provisions or whether they have a legitimate dispute over the prices they have been offered.

The ACCC's preliminary view is that the constraints in the December Undertaking are sufficient to link the negotiation and arbitration of non-indicative services to indicative prices and to provide sufficient transparency for operators to judge whether ARTC has breached its obligations in the Undertaking.

The Undertaking also limits the extent to which ARTC can differentiate access prices. ARTC commits that its access charges will not differ on account of the identity of access seekers and that it will not price differentiate where the characteristics of the services are alike and the access seekers are operating in the same end market. Discrimination is still possible when the characteristics of the service differ or the applicants operate in different markets. Overall, limiting price discrimination is strongly supported by all interested parties and the ACCC has concluded that it does not raise objections under the Part IIIA criteria.

Price Level and Structure

The ACCC conducted a high level assessment of ARTC's price level and price structure. That analysis confirms that while revenues in the final year of the Undertaking are estimated to more than cover operating and maintenance costs and to contribute to a return on capital on some lines, they are unlikely to reach the regulatory ceiling on any major line segment. The ACCC reviewed the assumptions ARTC used to predict revenue growth and considers it very unlikely that any errors in the estimates would be large enough to change this conclusion.

This assessment is based on a global evaluation. The ACCC has not assessed prices for individual non-indicative services and this conclusion does not mean that in an arbitration the ACCC would necessarily conclude that any individual price is appropriate simply because it falls below the revenue ceiling.

ARTC currently sets market based, rather than cost based prices. Given this approach to pricing, and the fact that revenues are well below the regulatory ceiling, the ACCC has not conducted a detailed assessment of ARTC's price structure based on cost. It did, however, conduct a high level review, primarily to highlight whether there are issues that may need to be addressed going forward.

Overall, the ACCC observes that for most key segments of ARTC's interstate rail network, revenue from variable charges is considerably higher than variable costs. While, with the exception of Adelaide to Kalgoorlie, revenue from the flagfall is less than fixed costs (excluding a return on capital). Over the term of the Undertaking, the gap between variable access charges and average variable costs on most segments increases.

The data indicate that there may be a question about whether the structure of ARTC's access charges appropriately matches cost drivers and revenue sources, given the heavy reliance on the variable charge. That said, the ACCC's analysis is preliminary only and, as the levels of cost recovery improve, a more detailed investigation is needed before it could be concluded that ARTC's price structure is inappropriate. Overall, the ACCC considers that the structure of ARTC's prices warrants further investigation over time and suggests that when ARTC considers future changes to indicative prices that it should also look at whether it is appropriate to re-balance the price structure.

The ACCC also considered whether there should be greater variation in the prices charged for indicative services to more closely reflect the characteristics of different types of trains. It concluded, however, that such an approach would reduce the effectiveness of the provisions in the Undertaking that restrict price discrimination and would have high administration costs. Its preliminary review is that such costs would outweigh the benefits of changing the approach to pricing indicative services.

Price Escalation

Three key issues arise from the price escalation formula proposed by ARTC. One, the methodology used for price increases, including the ability to bank or accumulate price increases and to increase prices more than once a year. Two, the absence of an efficiency discount factor. Three, the exclusion of prices for non-indicative services from the control on price rises.

On these issues the ACCC has reached the following conclusions. First, the ACCC's preliminary view is that the cumulative price increase component of the price escalation formula is not inconsistent with Part IIIA of the Act. It provides ARTC scope to benefit from price increases forgone in previous years while operators are protected by the overall CPI cap and the five-year time constraint.

The ACCC has concluded, however, that ARTC's proposal to increase prices as often as ARTC considers appropriate could affect rail operators' contractual agreements with their customers.

The ACCC has, therefore, recommended that given the costs to above rail operators and limited evidence that the freedom to increase prices more than once a year has significant benefits for ARTC, the ACCC's preliminary view is that the escalation formula should be modified so that prices can only be increased once a year.

Second, there was considerable criticism among interested parties about ARTC's failure to include a discount factor in its price escalation formula. Many argued that, as a result, the Undertaking fails to provide sufficient assurance to operators that ARTC is committed to lowering costs and improving service levels. In assessing whether a discount factor of zero is appropriate in the context of the December Undertaking the ACCC notes that:

1. while a discount factor may be used in cost based undertakings where prices are near the ceiling to smooth the price path so that revenues approximate costs at the end of the regulatory period, because ARTC is below the ceiling, it is not necessary to use the discount factor to match revenue and cost changes over the term of the Undertaking;

2. a discount factor is often used to share the benefits of efficiency improvements between the regulated firm and its customers, but given that the rail network is operating so far below cost recovery there is justification in this case for ARTC to retain a greater proportion of its cost reductions to improve the financial viability of the network; and

3. there is no need to design a discount factor as an incentive to improve efficiency because, as ARTC is below the regulatory ceiling it can keep any cost reductions it achieves, it therefore retains the full financial benefit of efficiency improvements and has strong incentives to improve efficiency.

The ACCC's preliminary view is that in this case, an X of zero within a CPI-X price cap would be appropriate given the circumstances of the December Undertaking. The ACCC stresses, however, that this conclusion would not necessarily apply to other rail networks nor would it necessarily hold for the interstate network in the future.

Third, many interested parties were critical that the price escalation formula does not cover non-indicative services. Non-indicative services include products such as bulk minerals and steel, which are the traffics for which the practical alternatives to transport by rail are most limited. The impact on access seekers of unrestrained increases in non-indicative prices is potentially significant, and the ACCC considers it inappropriate for ARTC to be unrestrained in its capacity to raise non-indicative prices.

In practice, however, even though non-indicative prices are not covered by the price escalation formula, the ACCC considers there are still constraints on ARTC's capacity to increase such prices. The commitment in the Undertaking to set non-indicative prices having regard to the prices charged for indicative services includes having regard to how prices increase over time. Again, this commitment creates a connection between the indicative and non-indicative prices, so that indicative service prices are a fundamental factor to be taken into account by ARTC when negotiating access for non-indicative services and by the ACCC in arbitrating any relevant disputes.

Excess Network Occupancy Charge

The excess network occupancy charge (ENOC) is a new charge proposed by ARTC in the December Undertaking. This charge applies to trains where the travel time that has been agreed in the contract is longer than that normally expected for the relevant section of track. The excess travel time is calculated as the time in excess of reasonable allowances for section run times and for other network utilisation needs (dwells for crossings and other operational activities) for the applicable train service type. It is levied irrespective of whether the contracted path is used. The ENOC is only applied when an access seeker requests a contracted train path that allows additional run time, it is not a charge for late trains.

ARTC argues that the purpose of the ENOC is to encourage efficient utilisation and rationalisation of capacity.

The ENOC recognises that there are costs associated with slower services, which can delay faster trains and reduce the capacity available for services whose presence on the network is within the 'reasonable allowance.' The ACCC therefore considers that there may be a justification for ARTC to seek to levy a charge like the ENOC but the charge also needs to be clear and applied in appropriate circumstances. Given the changes ARTC has made in the December Undertaking, the ACCC's preliminary view is that the quantum and basis for calculating the ENOC is now clear.

There are, however, residual concerns with the nature of ARTC's commitments on the ENOC. ARTC stated in its explanatory guide to the December Undertaking that it does not intend to apply the ENOC when a contract with a better path cannot be offered because such a path is not available. Also, ARTC included in the IAA a provision committing not to apply the ENOC if ARTC is unable to provide the contracted path or an agreed substitute path. Neither of these commitments are in the Undertaking. The ACCC considers that both commitments should be set out in the Undertaking. This would protect users by formalising ARTC's pledge in legally enforceable commitments and avoid possible confusion about ARTC's intentions in the event of a dispute.

Financial Model

ARTC's financial model is the framework that supports the regulatory approach in the Undertaking. To establish an appropriate regulatory framework it is necessary to:

1. define how the boundaries on the revenue earned by the regulated firm will be set — in this case this involves setting the floor and ceiling tests;

2. set the capital costs that feed into that framework appropriately, including valuing the asset base and defining how the return on and the return of capital will be calculated;

3. allocate costs between the different segments of the network appropriately; and

4. ensure that other costs that feed into the framework — in this case operating and maintenance costs — are not inflated.

Floor Ceiling Tests

ARTC has modelled its network on a segment by segment basis, each with its own revenue ceiling and revenue floor, for each calendar year of the Undertaking. ARTC proposes not to generate revenue on a segment or group of segments that is lower than its revenue floor (unless otherwise agreed by ARTC) or higher than its revenue ceiling.

The revenue floor is set to reflect the costs that would be avoided if that segment was removed from the network. The ceiling is set at full economic cost, including segment specific costs, a return on and a return of segment specific assets and a return on and a return of a share of non-segment specific assets.

Overall, the post tax revenue model proposed by ARTC uses a standard building block methodology to calculate the regulatory ceiling. This model is consistent with standard regulatory practice. The ACCC considers that the model should generate appropriate incentives for ARTC to invest in the rail network and it does not raise any objections under the criteria in Part IIIA of the Act.

There were, however, several issues of detail that have been considered in the ACCC's draft decision.

First, the main issue for the revenue ceiling is whether gifted assets should be excluded from the regulatory asset base and whether ARTC should be able to generate a return on (that is a depreciation allowance) those assets. The ACCC's preliminary view is that it is appropriate for gifted assets to be included in the asset base and for ARTC to generate a return *of* capital on both non gifted and gifted assets. This should allow ARTC to maintain these assets in the long term. But, as reflected in the Undertaking, ARTC should only be allowed to earn a rate of return on non gifted capital. Overall, the ACCC considers that ARTC's revenue ceiling definition is appropriate.

Second, there was some debate about the costs that should be included in the revenue floor. While some operators argued that the floor test should be based on the cost of running an extra train on the line, the ACCC considers that such an approach is not sustainable in the long run as it would not necessarily recover all the costs needed to maintain the line. The ACCC's preliminary view is that ARTC's proposal to base the floor test on the avoidable cost of the segment means that each segment should earn at least enough revenue for it to remain viable and should not give incorrect incentives to close viable segments.

Capital Costs

Three components of capital costs have been considered by the ACCC in the draft decision — the valuation of assets, the return on assets and the return of assets (depreciation).

ARTC's December Undertaking valued the interstate rail assets using a depreciated optimised replacement cost (DORC) asset valuation methodology. ARTC's proposed asset valuation includes a valuation of the recently leased NSW rail network and a revaluation of the South Australian and Victorian assets. ARTC has committed to not revaluing existing assets in future regulatory periods.

Given the specialised nature of railway assets, the ACCC engaged PriceWaterhouseCoopers (PWC) and Hi-Mark rail engineering consultants to independently evaluate ARTC's asset valuation.

The questions that arise for the analysis of the regulatory asset base include:

- Is DORC the appropriate valuation methodology?
- Should assets be revalued for this Undertaking and if so, should they then be locked in going forward?
- Are the asset valuation proposed for the NSW network reasonable and, if revaluation is allowed, is the revaluation for the non NSW network reasonable?

The ACCC's preliminary view is that DORC is a well accepted valuation methodology and is therefore appropriate in the context of the December Undertaking. However, the ACCC considers that revaluation should not normally be allowed under a DORC framework, because it creates unnecessary uncertainty, may encourage gaming and increases regulatory costs. However, the ACCC recognises that revaluation was explicitly anticipated in the 2002 Undertaking and, therefore in this specific case, it does not object to ARTC revaluing its assets prior to locking in the asset base going forward.

Finally, based on the results in the PWC report (which concluded that, overall, the Booz Allen Hamilton (BAH) valuations undertaken for ARTC appear reasonable), the ACCC's preliminary view is that the DORC valuation proposed by ARTC does not raise any objections under the criteria in Part IIIA of the Act.

ARTC's allowed return on capital was estimated using a weighted average cost of capital (WACC), which reflects the return investors could expect to earn by investing in the next best investment of equivalent risk. ARTC proposes a vanilla WACC and, using ARTC's methodology, the ACCC estimated the WACC would equal approximately 11.60 per cent, using the proposed gamma of 0.30.

The ACCC examined each of the input parameters to the WACC methodology ARTC used and determined, on balance, that ARTC's proposed WACC method is broadly reasonable. This is particularly the case given that ARTC's expected revenue levels are significantly below ARTC's proposed revenue ceilings on every segment over the entire duration of the Undertaking. However, the ACCC does not accept the proposed

gamma of 0.30 because it would result in segment revenue ceilings that are above what is reasonable, given current studies on the value of imputation credits, and would overcompensate ARTC for the present value of the tax it would incur, if it was operating at its revenue ceilings.[2]

ARTC is seeking a return of capital (depreciation) on signalling and communications assets but not on rail infrastructure assets, which it considers have an infinite economic and physical life due to the use of major periodic maintenance to prevent deterioration in these assets. Depreciation charges on signalling and communications equipment are calculated by applying straight-line depreciation to the optimised replacement cost values of the assets, and are allocated to segments on the same basis as operating costs. Because depreciation is only applied to signalling and communications equipment it is a relatively small component of costs, approximately $4.2 million in 2007-08.

The ACCC analysed the approach to depreciation, drawing on independent consultant advice, and concluded that, given that the cost of major periodic maintenance includes a charge for asset replacement, ARTC's approach to not charging depreciation on rail infrastructure assets is appropriate. To do otherwise would mean that users would be paying twice for the cost of replacing assets. In addition, based on the PWC report and its own analysis, the ACCC's preliminary view is that the level of major periodic maintenance and the approach to depreciation does not appear unreasonable in the context of this Undertaking.

Cost Allocation

ARTC provided the ACCC with a financial model for the period 2007-08 to 2017-18, which includes its operating and maintenance costs and a methodology to allocate those costs to ARTC's individual rail lines. ARTC's financial model separates its operating and maintenance expenditures into those attributable to individual rail segments (direct costs) and those attributable to the entire network (indirect costs).

Indirect costs include, for example, the labour costs associated with path scheduling, train control and contract management, and the costs of ARTC's executive functions such as management, finance and procurement. ARTC allocates indirect costs via a three-step process. Firstly, costs are defined by their division, for example finance and procurement. Secondly, costs are tagged with either a gross tonne kilometre (GTK) or a train kilometre allocation method, depending on the division to which they are allocated. Lastly, costs are allocated to different parts of the network by a process called LOREN.

PWC was engaged by the ACCC to independently review the reasonableness of the cost allocation methodology used by ARTC in the December Undertaking. PWC concluded that ARTC's methodology is reasonable, as: it is consistent with the principles of good allocation processes; the sophistication of the cost allocation is appropriate for the complexity of ARTC's business; and the cost allocation process

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[2] While ARTC's other WACC inputs are broadly acceptable in the context of the ARTC Interstate Access Undertaking, it should be noted that the ACCC is currently conducting a review of WACC in conjunction with the AER due to be completed in 2009.

does not over allocate costs across the various rail segments. The ACCC's preliminary view is that ARTC's allocation process is reasonable.

Operating and Maintenance Expenditure

Over the ten-year term of the Undertaking, ARTC proposes to spend approximately $987 million on maintenance and $1,075 million on operating expenditure for the Interstate Network. Maintenance expenditure is work that preserves the condition of existing rail lines, for example re-sleepering or replacing signals and control infrastructure. Operating expenditure is work associated with the physical operation of the network and the fulfilment of contracts, including scheduling trains and train paths, negotiating contracts with access seekers and ARTC's executive functions.

PWC was also engaged by the ACCC to review the reasonableness of operating and maintenance expenditure. PWC concluded that, although the reasonableness of ARTC maintenance costs is a subjective judgement, it has no reason to believe that ARTC's forecast maintenance costs are unreasonable. PWC cited several reasons for their view, including that ARTC maintenance costs forecast for the December Undertaking are significantly less than the costs incurred over the 2002 Undertaking and that ARTC's costs are expected to fall to approximately the middle of the benchmark range for similar Australian rail networks.

On operating costs, PWC noted that ARTC's costs in NSW are much higher than the rest of the network and 41 per cent higher than operating costs on the Forrestfield to Kalgoorlie lines owned by Westnet. PWC also noted, however, that ARTC's operating costs in NSW, and its capacity to reduce those cost, is driven, to a large extent, by its lease contract with the NSW Government. PWC, therefore, concluded that operating costs on the NSW network are reasonable. For the non-NSW segments PWC noted that, though higher than in the 2002 Undertaking, operating costs are still well below the Forrestfield to Kalgoorlie benchmark, and therefore concluded that these costs are also reasonable. PWC also noted that real operating costs will decrease slightly by the conclusion of the December Undertaking, increasing the case that they are reasonable.

The ACCC's preliminary view is, consistent with that of PWC, that ARTC's operating and maintenance costs are reasonable, but it considers that there should be a strong focus on reducing those costs, particularly in NSW.

Capacity Management

Part 5 of ARTC's Undertaking sets out the capacity management provisions relating to the analysis, reservation, allocation, and transfer of available train paths. The Undertaking's capacity management provisions are based on administrative mechanisms, that is, rules as opposed to market mechanisms (such as auctions).

Capacity Analysis

The first step for an access seeker in securing access to network capacity is its negotiation with ARTC for access to specific train paths. As part of assessing an applicant's indicative access proposal, ARTC undertakes a capacity analysis to ascertain whether there is sufficient capacity available on the network to meet the applicant's requirement. If ARTC believes complex capacity analysis is required, the Undertaking allows it to recover the reasonable costs of carrying out this analysis.

The main concern raised by interested parties was whether ARTC should be able to charge the access seeker if the required capacity analysis is complex. The ACCC's preliminary view is that there are cases where more costly and complex capacity analysis is necessary and that it is appropriate to charge the applicant requiring that analysis directly, rather than spreading the cost across all above rail operators. The ACCC also considers that the section in the Undertaking allowing ARTC to seek agreement to levy a capacity analysis charge is quite specific and, therefore, it is unlikely that ARTC would be able to use this provision to inappropriately extend the application of the charge.

Capacity Reservation

Operators who are negotiating freight contracts will often need to reserve capacity on the rail network in advance, so they have the certainty needed to enter into those contracts and to make any necessary above rail investments. The December Undertaking proposes that ARTC can levy a capacity reservation fee on access seekers wanting to execute an access agreement more than six months prior to commencing the service. ARTC argues that the capacity reservation fee allows it to recover the opportunity cost of setting aside network capacity and prevents capacity hoarding by operators.

Overall, while the ACCC recognises that there are benefits to access seekers from the ability to reserve capacity, it has concerns about the imposition of a charge for this reservation. The charge has benefits in that it may discourage capacity hoarding but the ACCC still questions the extent to which there is an opportunity cost to ARTC of reserving capacity across all train paths and whether the charges would discourage, rather than encourage, new entrants.

The ACCC also notes the analysis of a similar issue by the Queensland Competition Authority, which concluded that a capacity reservation fee could discourage access seekers to enter into early contracts, inhibit competition and result in a windfall gain to the infrastructure owner if capacity constraints are not evident.

The ACCC's preliminary view is that while there may be a theoretical justification for a capacity reservation fee in situations in which capacity is scarce, ARTC's proposed methodology is much broader and is likely to result in the fee being imposed where there is little or no opportunity cost of reserving capacity and the costs of capacity hoarding are minimal. Therefore, the ACCC considers that the fee, as currently proposed by ARTC, does not satisfy the statutory criteria and should be deleted from the Undertaking.

Capacity Allocation

While there has been a lot of debate and discussion about benefits of different methods of allocating capacity, including market based mechanisms (which promote economic efficiency by allocating capacity to the operators who value them most), the rail industry, including ARTC, tends to rely on administrative mechanisms to allocate capacity. Administrative mechanisms set rules that govern capacity allocation and are administered by the infrastructure provider. Such mechanisms tend to minimise transaction costs, allow greater control by the infrastructure provider and may provide greater certainty to operators in their long-term service planning. While the ACCC

recognises the benefits of market based mechanisms, it considers that the administrative mechanisms adopted by ARTC to allocate capacity do not raise objections under Part IIIA.

Two key issues have, however, arisen in relation to ARTC's approach to capacity allocation.

- the allocation of mutually exclusive train paths; and
- the proposal to move away from flexible train paths in NSW and require operators to pay the fixed charge for unused paths unless they moved away from using scheduled paths and rely on *ad hoc* paths instead.

Train paths are allocated through the process of negotiating and agreeing on an access contract. When two or more applicants seek access to mutually exclusive access rights, ARTC finalises the terms and conditions for the access agreement that, in ARTC's opinion, is most favourable to it. ARTC makes this decision based on the access agreement that represents the highest net present value of future returns to ARTC, taking into account relevant risk. Some stakeholders raised concerns about the transparency of ARTC's approach to allocating mutually exclusive train paths. The ACCC considers, however, that an allocation process based on net present value is appropriate.

The December Undertaking provides for two types of train paths — scheduled and *ad hoc*. Scheduled train paths are designed for regular services with a planned origin and destination. They can be routinely timetabled and are suited to the inter-modal traffics that use the interstate network. However, bulk traffic (such as coal, grain and minerals) may require intermittent or less regular services, which cannot be readily timetabled. The December Undertaking caters to these types of train services through *ad hoc* train paths. All scheduled paths attract a fixed charge, whether they are used or not.

This is a significant change from the previous approach in NSW where operators could hold a scheduled path which they may only use periodically and which was only paid for when used. The ACCC considers that replacing unused scheduled train paths with *ad hoc* train paths, and encouraging rail users to rationalise their use of the network, would improve the allocation track capacity and make investment more efficient by avoiding unnecessary investment in additional capacity.

The ACCC recognises that there may be some significant adjustment costs associated with the change to the pricing of flexible train paths, and that some operators are still uncertain how the changes proposed by ARTC will affect some of their traffics. The ACCC's preliminary view is, however, that the long term benefits of combined scheduled and *ad hoc* train paths outweigh the short term costs.

The ACCC also considers that efficient use and operation of the network has been strengthened by the removal of 'grandfathering' train path provisions. Grandfathering rights detract from efficient utilisation of the network as they guarantee that incumbent operators have absolute security in their access to sought after train paths, and those rights cannot be acquired by other entrants. This change is balanced against the extended time (120 days) that is now allowed for existing operators to renegotiate their

contracts. The ACCC considers that the new provisions appropriately balance existing operators' need for certainty with the benefits of flexibility that can facilitate competition from new operators.

Capacity Transfers

The ability to transfer capacity rights is crucial to the efficient use of and investment in a rail network. As previously noted, market based mechanisms theoretically provide efficiency benefits, but raise practical problems. Given the practical constraints on more competitive market based mechanisms, the ACCC considers that ARTC's approach to allow for the transfer of train paths does not raise objections under the Part IIIA criteria. While administration processes for transferring and relinquishing capacity will always be cumbersome, the ACCC's preliminary view is that the Undertaking does provide for such transfers and therefore does not raise objections against the Part IIIA criteria.

In particular, the ACCC notes that the Undertaking allows end-users who do not operate above-rail services to acquire capacity rights, which may then be sub-contracted to an above-rail operator. This has the potential to promote efficient use of and investment in the network in two key respects. First, it gives end users more service choice and, therefore, increases competition and the pressure on above-rail operators to lower costs and improve efficiency, including putting pressure on incumbent operators by allowing end users to source above-rail services from new operators. Second, it provides more direct indications of network capacity demand and of the value placed upon network capacity by the users of above-rail services.

Network Transit Management

Part 7 of the Undertaking outlines the principles ARTC will use to manage train transit onto, off and within the network. The intention of the network transit management principles is to ensure that a service meeting its specified timetable will exit on time, while services that suffer above-rail incidents need to be managed so that further delays are minimised.

In the December Undertaking, ARTC's network management principles, including train decision factors (which determine train priority) and the rules that govern ARTC decision matrix, are all specified in some detail in Schedule F. These rules set objective decision making criteria that facilitate consistent application of the principles and assist industry understanding of network management processes. The ACCC, therefore, considers that the rules proposed by ARTC for network management are clearly specified, complete and able to be understood by industry, and are consistent with the criteria in Part IIIA of the Act.

In addition, the ACCC notes submissions calling for more coordination in the operation of network management principles between rail networks and greater industry consultation. It considers that coordination issues could be effectively managed through the national processes looking at rail access issues and that there is scope for ARTC to refine its network management principles through ongoing industry consultation.

Investment, Network Connections, Additions to Capacity

The ongoing efficiency of the rail network depends on the overall approach to managing new investment and the interaction between ARTC's network and private infrastructure that connects with that network.

Investment is affected by a range of provisions in the Undertaking. Schedule H and clause 4.4(e) specify planned capital expenditure and the conditions under which the level of that expenditure can change. Clause 6.1 specifies the arrangements for providing connections to the network, while clauses 6.2 and 6.3 specify the arrangements for providing additional network capacity and incorporating that investment in the regulatory asset base (RAB).

Part 6 of the December Undertaking outlines ARTC's approach to network connections and to the provision of additional capacity.

In considering ARTC's approach to network investment and connections the ACCC has reviewed:

- ARTC's proposed investment program; and
- The provisions in the Undertaking on network connections and additions.

ARTC's Proposed Investment Program

Schedule H of the Undertaking outlines ARTC's proposed capital expenditure for the financial years 2006-07 to 2011-12. Given the difficulty in reasonably forecasting capital expenditure over a ten-year period, ARTC proposes to submit forecast capital expenditure for the financial years 2012-13 to 2016-17 to the ACCC by 31 December 2011.

The ACCC conducted a high-level review of the capital expenditure program proposed by ARTC in Schedule H. This review focused on the processes used to generate the scope, standard and cost of ARTC's proposed capital expenditure. The ACCC concluded that the processes and criteria adopted by ARTC to evaluate and determine the scope, standard and costs of capital expenditure appear to be robust and in accordance with industry practice and, therefore, are likely to promote reasonable and prudent capital expenditure.

In reaching this assessment, the ACCC analysed among other things, whether ARTC's processes for determining the scope of its capital expenditure are likely to favour particular types of train services or operators. It concluded that, to some extent, unintended capital biases will emerge as result of ARTC's intention to accommodate standard train lengths that have increased from 1,500 metres to 1,800 metres. However, there is no evidence that ARTC has deliberately sought to engage in capital expenditure projects related to extended train lengths that would result in the exclusions of shorter trains from the network.

In addition, the ACCC has also considered ARTC's approach to industry consultation. While ARTC has engaged in a series of processes that involve providing information to or requesting feedback from industry, stakeholders are still critical of the effectiveness of consultation processes and cited examples where their views have been requested by

ARTC, but they are not confident that those views have being taken into account or they do not know the reasons why their views have been rejected or why ARTC has chosen its preferred option. There concerns are primarily about the effectiveness of consultation, rather than extent of consultation.

Overall, the ACCC considers that there is at least an industry perception that there are deficiencies in ARTC's consultation processes. Furthermore, the consultation process is somewhat opaque in that even if stakeholders are provided with the opportunity to provide their views on particular capital expenditure strategies, ARTC provides no public reasoning as to why it may consider the views of stakeholders to be inappropriate or invalid.

The ACCC's preliminary view is, therefore, that an obligation for ARTC to conduct transparent consultation on its capital expenditure program should be built into the Undertaking. This has potential benefits in that it would clearly establish the obligation to consult effectively, increase industry confidence in the consultation process and improve the transparency of the outcomes of that consultation.

Finally, the ACCC considered the provisions in the Undertaking that allow ARTC to increase its capital expenditure but imposes a 20 per cent cap, after which it must seek ACCC approval. The ACCC's preliminary view is that a 20 per cent cap is appropriate as it balances the need for ARTC to respond to legitimate unforseen circumstances with an obligation to ensure that increases in capital expenditure are not unreasonably high.

Network Connections and Additions

The provisions on network connections and additions cover a range of situations where capacity is either expanded or connected with other networks. These include:

- the conditions under which ARTC will agree to another rail network being connected to its network;
- additions to capacity sought by applicants; and
- additions to capacity sought by ARTC.

The December Undertaking states the conditions that ARTC would impose before it agrees to physically connect the interstate network to another rail network, which is operated and maintained by another infrastructure provider. The other infrastructure provider must agree to bear the costs of the connection and the resulting connection should not result in a fall in the capacity of the interstate network as a whole.

The ACCC's preliminary view is that it would appear reasonable to argue that, given the desirability of increasing traffic on its network, ARTC does not have a strong incentive to deny approvals for connections, and that the issues raised in submissions are unlikely to cause significant practical difficulties.

The Undertaking also sets the conditions on which ARTC would consider undertaking new investment at the request of an access seeker, consent to an access seeker providing additional capital or augmenting capacity itself and then seeking ACCC approval to vary access charges to cover the cost of such augmentation.

Clause 6.2 allows for an access seeker to fund additional capacity as part of an access agreement. The primary concern of stakeholders with this process was that negotiations take place between ARTC and a single applicant. They argued, for example, that individual access seekers could not afford to fund additional capacity and the clause fails to recognise that it is the activities of all operators that cause capacity constraints and all benefit from investment in additional capacity.

The ACCC agrees that the provisions in clause 6.2 are very limited and it is likely that they would be rarely used. The ACCC does not consider that this is likely to cause significant distortions in the rail market, however, as additional capacity would be funded through alternative mechanisms such as clause 6.3 (providing for ARTC to invest in the network and recover the costs of that investment) or through ARTC's broader investment program. The ACCC, therefore, considers that the Undertaking would be improved by an effective mechanism for operators to negotiate and fund investment in additional capacity, but it does not consider that the concerns raised by clause 6.2 are sufficient to conclude that the outcomes would be inconsistent with Part IIIA of the Act.

Clause 6.3 of the December Undertaking allows ARTC to invest in additional capacity that is worthwhile and beneficial to the rail industry and then apply to the ACCC to have that investment brought into the Undertaking and to recover the costs of that investment through increased access charges. The ACCC considers that clause 6.3 simply codifies processes that are already allowed under the Undertaking and Part IIIA of the Act. It has also reviewed the process proposed for the ACCC to assess if additional capacity should be brought into the Undertaking, and concluded that the proposed process is not inconsistent with the processes normally applied to assess an amendment to an access undertaking under part IIIA of the Act.

Finally, clause 6.4 outlines the conditions by which the reasonable costs incurred by ARTC in providing network improvements or extensions will be payable by an operator if the operator becomes a train operator in accordance with s.10 of the *Transport Act 1983 (Vic)* and ARTC is given a direction by the Director of Public Transport which requires to make timetable changes which interfere with the train paths of existing operators.

ARTC's legitimate business interests are served by clause 6.4, as it allows ARTC to recover its reasonable costs of building additional capacity to compensate for the detrimental effects of a mandated timetable change. Clause 6.4 also serves the interests of access seekers in that it explicitly provides an incentive for ARTC to invest in new capacity to restore reliability and capacity of the network.

The ACCC's preliminary view is that none of the provisions relating to network connections and additions raise any objections under Part IIIA of the Act.

Performance Indicators

Part 8 of ARTC's Undertaking outlines the performance indicators to be adopted by ARTC during the term of the Undertaking. Performance indicators are incorporated in the December Undertaking to ensure information is provided on the industry performance and ARTC's quality of service.

Overall, the ACCC considers that the performance indicators proposed in ARTC's December Undertaking are broadly appropriate. However, as the rail market further develops and ARTC moves closer to cost recovery on some segments, there may be a need for a regime with stronger incentives to drive efficiency. The ACCC may, therefore, need to consider benchmark standards for performance indicators in future undertakings.

Schedules

ARTC's Access Undertaking contains a number of Schedules which provide further information relevant to applying for and negotiating access to the network.

Schedules A and B contain information on lodging an access application. Schedule C details the core elements that must be contained in any negotiated access agreement and Schedule D contains the Indicative Access Agreement. Schedule E details those parts of the network subject to access and Schedule F sets out the principles for managing traffic on the network. Schedule G defines the service quality/key performance indicators and Schedule H outlines ARTC's forecast capital expenditure program for the first five years of the Undertaking. The ACCC has reviewed each of these Schedules and is of the view that ARTC's Schedules A to I, with the exception of Schedule E, as noted above, do not raise any objections under the assessment criteria of Part IIIA.

The main schedule that attracted most comment from stakeholders was Schedule D — the IAA. The IAA is a 'template' or 'pro-forma' contract that can be adopted by any access seeker wishing to provide indicative services. The ACCC's preliminary view is that the Undertaking provides sufficient scope for access seekers to negotiate terms and conditions outside the IAA, but still provides adequate information and guidance to ensure that the costs of negotiation are not excessive.

Finally, the ACCC has considered specific issues operators raised about provisions in the IAA. While most of these have been considered in the relevant chapters of the draft decision, the ACCC also reviewed any remaining issues and concluded that the clauses in the IAA attached to the December Undertaking that affect disputes over monthly invoices, indemnity for damage caused by complying with ARTC instructions and the movement of light engines do not raise any objections under Part IIIA of the Act.

Overview of Application, Submission and Assessment Process

Summary

The ACCC's preliminary view is to accept ARTC's December Undertaking application subject to ARTC addressing a number of issues raised in this draft decision.

This chapter outlines the history of ARTC's Access Undertaking applications, stakeholder submissions and the ACCC's assessment processes. It also sets out the process post-draft decision. That is, should ARTC take the view that it wishes to accept the recommendations contained in the ACCC draft decision and wishes to take the December Undertaking toward a final decision, ARTC must:

- *withdraw the December Undertaking;*
- *amend the December Undertaking in accordance with the issues raised in this draft decision; and*
- *resubmit the amended Undertaking incorporating the issues (recommendations) of this draft decision to the ACCC for a final decision.*

The ACCC has requested stakeholder submissions on this draft decision and will take these into account in preparing a final decision.

Application and Submission Process

The ACCC engaged in an extensive public consultation process in preparing for its draft decision on ARTC's Interstate Access Undertaking application. The following outlines the application and submission process to date.

On 8 June 2007, ARTC lodged an Access Undertaking application (the June Undertaking) with the ACCC for assessment under s.44ZZA of the *Trade Practices Act 1974* (the Act).

The June Undertaking proposed a set of terms and conditions upon which ARTC would negotiate access to rail tracks in South Australia, Victoria, New South Wales (NSW) and Western Australia (the Interstate rail tracks).

Section 44ZZBD of the Act provides that the ACCC may invite public submissions on an access undertaking application if it considers it appropriate and practicable to do so. Hence, on 22 June 2007, the ACCC released an Issues Paper seeking public submissions on the June Undertaking by 20 July 2007. Seven submissions were received from stakeholders in response to the June Issues Paper; the last submission was received on 24 August, 2007.

Drawing on stakeholders' submissions and ARTC's application, the ACCC sought further information and clarification from ARTC on its June Undertaking.

On 15 October 2007, ARTC withdrew its June Undertaking application from consideration of the ACCC and subsequently submitted a revised Access Undertaking (the December Undertaking) on 20 December 2007. The ACCC released an Issues Paper on the December Undertaking calling for submissions by 8 February, 2008. Eight submissions were received, the last submission was received on 21 February, 2008.

All submissions to the June and December Undertakings, as well as ARTC's Access Undertaking applications, were made available to the public on the ACCC's web site at **www.accc.gov.au**.

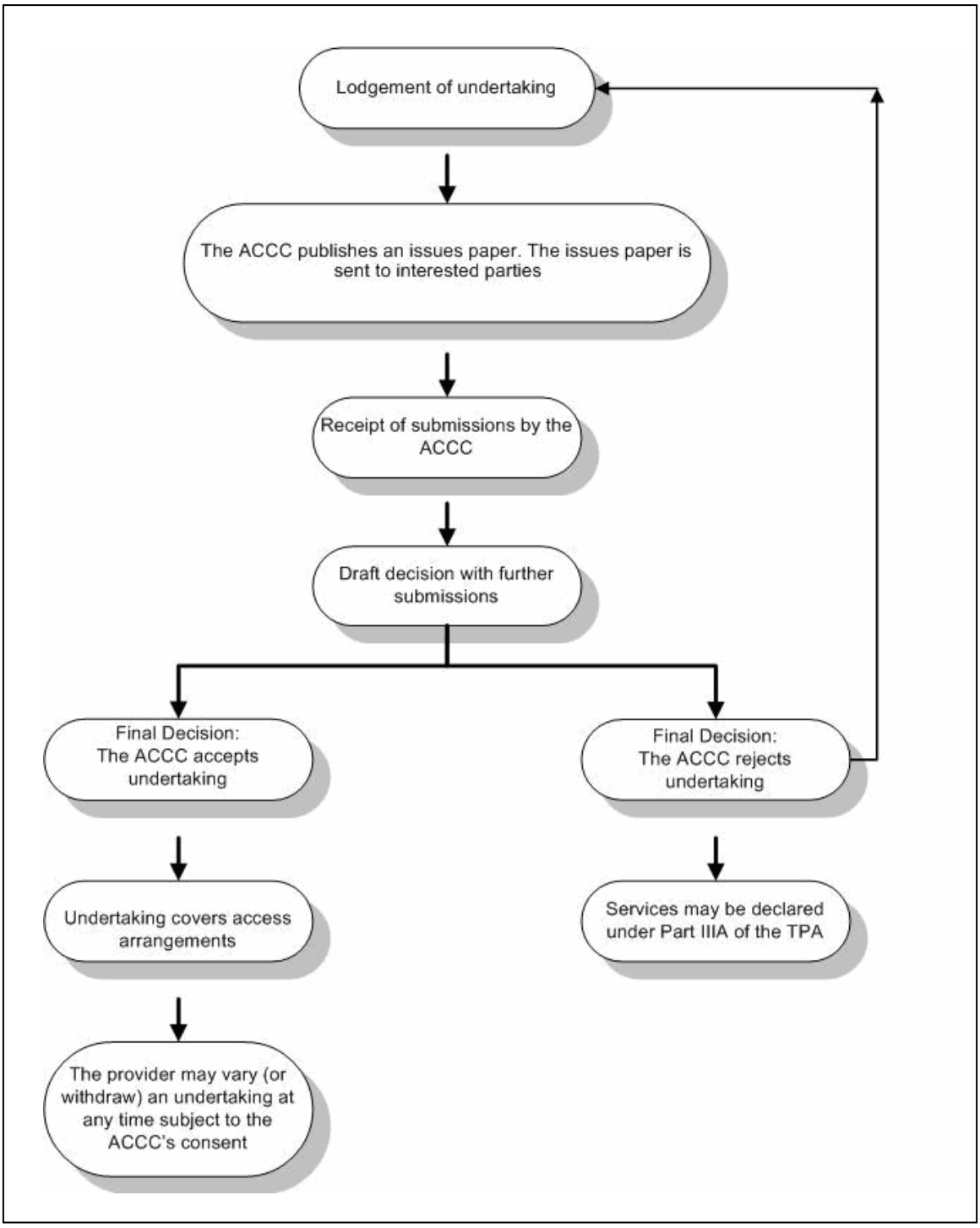
Assessment Process

In assessing the December Undertaking, the ACCC had regard to submissions made on the June and December Undertakings. Part C of this draft decision discusses in detail the provisions relevant to the ACCC's assessment of ARTC's Undertaking and the framework the ACCC applied in making that assessment.

Under s.44ZZBC of the Act, the ACCC is required to use its best endeavours to make a decision on an access undertaking application within six months of receiving the access undertaking application, that is, by 20 June 2008. The ACCC is releasing this draft decision for comment before it issues a final decision.

The following figure (Figure 1) summarises the procedures for the ACCC's assessment of ARTC's Access Undertaking application.

Figure 1: Access Undertaking Assessment Process



Post Draft Decision Process

If ARTC takes the view that it wishes to address the issues raised in the ACCC draft decision and wishes to take the December Undertaking toward a final decision, ARTC must:

- withdraw the December Undertaking from the consideration of the ACCC;
- amend the December Undertaking to address the issues raised in the recommendations of this draft decision; and
- resubmit the amended Undertaking incorporating the changes to the ACCC for final decision.

Indicative Timetable

Process	Date - 2008
Publication of Draft Decision	29 April
Submissions on Draft Decision	Approx 4 weeks
Receipt of Submissions	26 May
ACCC Final Decision	mid July

Submissions

Stakeholders are invited to make a submission on the ACCC's draft decision. These submissions will be taken into account in forming the ACCC's final decision.

Unless a submission is marked confidential, it will be made available to any person or organisation on request. The sections of submissions that are confidential should be clearly identified.

Details of the ACCC's mailing and electronic mail addresses for lodging submissions are detailed below. Submissions should be forwarded by 5:00pm (AEST) 26 May 2008 to:

Mailing Address

Submissions should be addressed to:

General Manager – Transport and Prices Oversight (TPO)
Regulatory Affairs Division
ACCC
GPO Box 520
MELBOURNE VIC 3001
(03) 9290 1862

Electronic Mail:

Electronic versions of submissions should be emailed to: **transport.prices-oversight@accc.gov.au** and **dominic.l'huillier@accc.gov.au**

Further Inquiries:

Mr Dominic L'Huillier — Director of Transport Regulatory, the ACCC.
Telephone: (03) 9290 1807

Part A Industry Background

Summary

The Australian Rail Track Corporation Ltd was created after the Commonwealth and State Governments agreed in 1997 to the formation of a 'one stop' shop for all operators seeking access to the national interstate rail network.

ARTC is responsible for the access management of over 10,000 kilometres of standard gauge track in South Australia, Victoria, New South Wales and Western Australia. Access management incorporates the planning, scheduling and transit of trains through the network and associated commercial arrangements with train operators.

ARTC owns tracks in the interstate network in South Australia and leases tracks in Victoria. In September 2004, ARTC also entered a 60-year lease over the interstate NSW rail tracks and the NSW Hunter Valley coal network. This Undertaking covers terms and conditions of access to standard gauge tracks along the interstate network, including the track leased in NSW. However, the Undertaking does not cover access to tracks in the Hunter Valley coal network. ARTC is expected to lodge a separate access undertaking for the Hunter Valley coal network with the ACCC some time in 2008.

Eight major operators currently use the ARTC owned or leased network namely—Asicano;[3] *Australian Southern Railroad; CityRail; CountryLink; Freight Link; Great Southern Railway; Queensland Rail; and Specialised Container Transport.*

Introduction

In 1991, the Australian Government owned the Australian National Railways Commission, trading as Australian National. Australian National, owned and maintained track in NSW, Western Australia, South Australia, Tasmania and the Northern Territory. It also provided intrastate rail freight services in South Australia and Tasmania, and interstate rail freight services in the Northern Territory, South Australia, Western Australia and NSW, and passenger services on the Indian Pacific, Ghan and Overland trains.

The Australian Government split up Australian National and horizontally separated and privatised Australian National's intrastate freight operations in Tasmania and South Australia. A number of private operators commenced interstate rail freight operations in competition with National Rail.[4] To improve, among other things, the efficiency and

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[3] Asciano was listed on the ASX in 2007. The company combines Pacific National rail operations with the Patrick's ports and stevedoring businesses.

[4] National Rail was established in 1991 as a result of an agreement between the Commonwealth and the States of NSW, Victoria, Queensland and Western Australia. National Rail was established 'for the purpose of conducting, among other things, rail freight operations in Australia on a commercial basis in accordance with principles compatible with those set out in the Heads of Government Agreement on the National Rail Freight Corporation dated 31 October 1990' (National Rail

competitiveness of the rail industry, Commonwealth and State Transport Ministers agreed to establish a national rail track access company that would provide access to the interstate rail network. Following the Rail Summit in September 1997, an Inter-Governmental Agreement was signed to this effect on 14 November 1997.

A.1. Australian Rail Track Corporation

ARTC was created in 1997 through the Inter-Governmental Agreement between the Commonwealth, Victoria, South Australia, NSW, Western Australia and Queensland. ARTC was established as a consolidated interstate rail track owner to create a single process for access, consistent with the Competition Principles Agreement and the National Rail Summit Heads of Agreement.

The objectives of ARTC under the Inter-Governmental Agreement are to provide efficient and seamless access to the interstate rail network by:

- operating the business on commercially sound principles;
- pursuing a growth strategy for interstate rail;
- improving interstate rail infrastructure through better asset management and a program of commercial and grant funded investment; and
- promoting operational efficiency and uniformity on the interstate network.

The Inter-Governmental Agreement provided for ARTC to have commercial performance incentives and the capacity to price, market and manage supply of its services flexibly in the context of a competitive transport market.

A.1.1. Functions of ARTC

The Inter-Governmental Agreement provides that ARTC will:

- own and manage the Commonwealth owned interstate track and related assets;
- manage, through lease contract, Victoria's interstate track and related assets;
- manage, through a lease contract, any other interstate track and related assets agreed between the parties;
- provide access to the track it manages;
- provide access for interstate operations by accredited rail operators to other track, through agreements with track owners;
- manage track maintenance and construction, train pathing, scheduling, timetabling, and train control on its network;

Corporation Agreement Act [1992], p. 10). In 2001, National Rail's freight operations were sold to Pacific National.

- develop arrangements for the efficient interaction of interstate and intrastate track and traffic on track it controls;

- develop and monitor uniform safe working, technical and operating requirements and work with other track owners to achieve this; and

- manage an interstate track investment program with commercial funding and grants from the parties in consultation with rail operators and track owners, with priority given to capital investment requested by rail operators.

A.1.2. ARTC Network

ARTC is responsible for the management and network access to approximately 10,000 kilometres of standard gauge track in South Australia, Victoria, NSW and Western Australia. Management incorporates the planning, scheduling and administering the transit of trains through the network and associated commercial arrangements with train operators.

ARTC owns tracks in the interstate network in South Australia and leases tracks in Victoria. In September 2004, ARTC entered a 60-year lease over the interstate NSW rail tracks and the NSW Hunter Valley coal network. ARTC's 60-year lease essentially includes the interstate rail network outside of the Sydney metropolitan commuter network from Macarthur to Newcastle, the Hunter Valley coal network and some parts of the regional rail network that may form part of a future Melbourne-Brisbane inland route.

The Undertaking covers terms and conditions of access to standard gauge tracks along the interstate network, including the track leased in NSW. However, the Undertaking does not cover access to tracks in the Hunter Valley coal network.[5] ARTC is expected to lodge a separate access undertaking for the Hunter Valley coal network with the ACCC some time in 2008.

The rail corridors that are covered by the Undertaking and that ARTC owns/leases are summarised below:

South Australia

ARTC owns the following rail corridors:

- Adelaide-Wolseley;

- Adelaide-Pt Augusta-Kalgoorlie;

- Pt Augusta-Whyalla;

- Broken Hill-Crystal Brook;

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[5] The Hunter Valley coal network includes the following parts of ARTC's leased network: Islington – Maitland; Maitland – Dartbrook mine; Muswellbrook – Ulan mine; Maitland – Craven mine.

- Tarcoola-Alice Springs (ARTC has leased this corridor to Asia Pacific Transport, operators of the Alice Springs-Darwin Railway); and

- Parts of the Adelaide metropolitan track between Dry Creek and Outer Harbour.

Victoria

ARTC leases the two mainline interstate standard gauge corridors from the Victorian Government:

- Melbourne-Wolseley; and

- Melbourne-Albury.

New South Wales

The NSW rail system consists of three networks:

- Sydney metropolitan network — owned and managed by Rail Corporation (RailCorp) NSW;

- Leased Network (Hunter Valley and Interstate) — owned by Rail Infrastructure Corporation (RIC), but leased and managed by ARTC; and

- Country Regional Network owned by RIC and managed by ARTC.

The Undertaking covers the following rail corridors:

- Albury-Macarthur;

- Woodville Junction (Newcastle)-Queensland Border;

- Cootamundra-Broken Hill; and

- Parkes (Goobang Junction)-Werris Creek/Ulan.

Under the terms of ARTC's NSW lease, the provisions of the NSW Rail Access Undertaking apply to the NSW leased network operated by ARTC until an undertaking for these parts of the network is submitted to and approved by the ACCC.[6]

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[6] In September 2004, ARTC commenced a 60 year lease of certain parts of the New South Wales rail network, including the interstate rail network and the Hunter Valley coal network. Under the terms of ARTC's NSW lease, ARTC is required to submit an access undertaking or undertakings to the ACCC for approval in relation to the NSW leased network. ARTC has chosen to submit one undertaking for the Interstate network (incorporating the NSW interstate network) and a separate access undertaking covering the ARTC leased Hunter valley network. The Hunter V Undertaking is expected to be submitted to the ACCC sometime in 2008. Until then, the Hunter Valley coal network is subject to the 2004 NSW Rail Access Undertaking which is administered by the NSW economic regulator, IPART.

Western Australia and Queensland

The remainder of the interstate network is still controlled by various State government agencies or private entities as follows:

- Brisbane-Queensland border (Queensland Rail);
- Kalgoorlie (WA) - Perth (West Net Rail, partly owned by Babcock and Brown Infrastructure);[7] and
- Parts of the interstate network within the Sydney metropolitan commuter network (Macarthur-Chullora-Woodville Junction (Newcastle) (Rail Corp)).

A.1.3. Major Operators on the ARTC Network

The following above rail operators are the largest users of tracks in the ARTC network:

- Asciano (the consolidated holding company of Pacific National (PN)) – the dominant operator on most segments of the ARTC network, providing general and bulk freight services;
- Specialised Container Transport (SCT) – mainly services the general non-container freight market along the East-West route, although it recently commenced services from Melbourne to Sydney;
- Queensland Rail (QR) – the dominant vertically integrated operator in Queensland. Also operates along the eastern seaboard with general freight services on the Brisbane-Sydney and Sydney-Melbourne corridors, and provides coal freight services in the Hunter Valley;
- FreightLink – provides above rail services on the Tarcoola-Darwin line;
- CityRail and CountryLink – mainly provides passenger services in NSW; and
- Great Southern Railway (GSR) – provides long distance passenger services between Sydney and Perth (The Indian Pacific), Melbourne and Adelaide (The Overland), and Adelaide and Darwin (The Ghan).

A.1.4. Regulatory History

The Inter-Governmental Agreement provided that ARTC would lodge an access undertaking application with the ACCC after consulting with track owners.

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[7] WestNet Rail is a rail infrastructure owner and rail access provider operating in Western Australia with a long term lease for track from the Western Australian Government. It operates and maintains approximately 5,100 kilometres of rail infrastructure *within* the southern half of Western Australia. Babcock and Brown Infrastructure owns a 51 per cent of WestNet Rail, with a call option over the remaining 49 per cent. The below-rail business revenue is derived from access charges. ARTC has negotiated an agreement with the Western Australian Government that gives ARTC rights to sell access for *interstate* operations under new agreements. WestNet controls maintenance, investment and operations between Kalgoorlie and Perth.

In May 2002, the ACCC accepted an Access Undertaking (2002 Undertaking) from ARTC for open access to tracks on the interstate network managed by ARTC in Victoria and South Australia, extending to Broken Hill in NSW and to Kalgoorlie in Western Australia. The 2002 Undertaking expired on 1 June 2007.

On 8 June 2007, ARTC lodged an access undertaking application with the ACCC for tracks covered by the 2002 Undertaking and also for tracks in NSW (June Undertaking). The June Undertaking set out the terms and conditions upon which ARTC would negotiate access to interstate rail tracks in South Australia, Victoria, NSW and Western Australia. However, on 15 October 2007, ARTC withdrew its June Undertaking application from the ACCC's consideration.

On 20 December 2007, ARTC lodged a revised interstate access undertaking application (December Undertaking) with the ACCC for assessment under Part IIIA.

A.2. The Rail Market

Under the undertaking provisions in Part IIIA of the Act, the ACCC is not required to specifically address market power. That said, the ACCC notes that the Australian rail industry faces some competition from road freight, especially in the shorter non-bulk movements. However, rail continues to dominate the task of moving bulk goods. The principal intrastate haulage task for the railways is to move bulk goods such as coal, ores and grain. These bulk markets usually face low competition with road (especially as the distance of conveyance increases).

The structure of rail markets can affect the environment in which ARTC sells access and rail operators negotiate to buy those services. It is useful background, therefore, to look at the key characteristics of these markets prior to looking at ARTC's proposed Access Undertaking in detail.

First, below rail, ARTC is clearly a monopoly supplier of rail access services. No one else provides a rail network that can service the same regions, and it is highly unlikely that anyone would build a competing rail network. ARTC argues, however, that its prices are constrained by road transport and, therefore, the scope to increase its commercial viability depends on growing rail volume by investing to improve rail's competitiveness.

Second, above rail, there is considerable diversity in the type of services provided. Broadly, these services can include:

- Intermodal freight — general non-bulk freight (for example, manufactured goods) that is transported from its origin to destination using two or more modes, such as road and rail. Even within this freight category there is some diversity. Some products are carried in containers. Others are loaded onto palettes and transported in wagons. Intermodal freight is the largest category of traffic on ARTC's interstate network;

- Bulk products — the transport of mining products, such as coal, ores and minerals, agricultural products, such as grain, and bulky manufactured products, for example steel; and

- Passenger services — long distance and regional passenger services.

ARTC's interstate network also covers services with a range of origins and destinations. The network can broadly be split into North-South services (Melbourne to the Queensland border) and East-West services (the Eastern states to Western Australia), but it also supports a number of intrastate and regional services.

All above rail operators that provide inter-modal, bulk and passenger services rely on ARTC to supply an important business input and ARTC may have an impact on the price and quality of above rail transport services. The customers of above rail operators may therefore be sensitive to different aspects of the price service package. Some are looking for the cheapest price. Others are seeking different mixes of speed, reliability, service flexibility and/or the management of safety issues (for example those carrying dangerous or volatile products). Thus, the Undertaking needs to accommodate a range of services needs.

Competition in the above rail market is growing. While there are still some barriers to entry, changes in government regulation and privatisations over the last ten years have increased the scope for private sector competition.[8] In addition, as a result of undertakings made by Toll Holdings as a condition of the ACCC not opposing its acquisition of Patrick Corporation, PN (now Asciano) provided a package of initiatives, including making train paths, wagons and locomotives and terminal space available to another operator, which is anticipated to improve competition on the East-West segment of ARTC's network.[9]

Third, broader freight services, such as road and sea, affect the rail industry in a number of ways, including potentially providing competitive pressure that affects the service standards and prices rail needs to offer its customers. The extent of this competition is likely, however, to differ considerably among traffics.

Some traffics, because of their size, weight, location or the distance for transportation are more suited to rail. For example, it is generally recognised that rail is most suited to bulk traffic that is transported long distances with origins or destinations that are not convenient for shipping. In such cases, the capacity to switch freight from rail to other modes can be limited. For other freights there is more scope to transfer freight between modes, with some rail freights highly sensitive to the price or service offered by road or sea based alternatives. Previous analysis by the ACCC, however, has recognised that there are limits to such competition. In its consideration of Toll Holdings proposed acquisition of Patrick Corporation the ACCC noted that:

> Market inquiries indicated that rail line-haul services formed a separate market to other modes of transport on the east-west corridor. In particular, it was found that while some non-bulk freight is transported via truck, air, and sea, these modes of transport did not provide a significant competitive constraint on rail.[10]

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8 ACCC, *Public Competition Assessment: Toll Holdings Limited's Proposed Acquisition of Patrick Corporation Limited*, 5 May 2006, pp. 8-9.

9 ibid., pp. 12-13.

10 ibid., p. 8.

In addition, if rail improves its attractiveness and increases its volumes, then the average cost of rail transport is likely to fall and the range of freight for which road or sea are not viable alternatives could increase. In its explanatory guide to the June Undertaking, ARTC states that:

> ARTC's financial success and sustainability relies heavily on the recovery of long term acceptable returns from investment. ARTC is constrained from simply increasing access pricing in order to recover its investment. ARTC's strategy for long term asset sustainability in its current competitive environment is, through strategic investment in, and management of, its assets to grow rail volumes, and asset utilisation, on the network through contributing to improving rail competitiveness in the longer term.[11]

Because it cannot raise prices and must rely on volume growth, ARTC argues that it bears considerable commercial risk from the investment it undertakes.

While ARTC may not be able to exercise market power over prices, justifying an absence of market power solely based on levels of cost recovery is problematic, particularly where past investment was not undertaken on a commercial basis. The combination of sunk non-commercial investments and ongoing government grants make it virtually impossible to draw meaningful conclusions about market power from cost recovery data.

The ACCC further observes that, as noted above, the rail market is segmented and certain types of freight could not be competitively transported by either road or sea, even though the choice of mode for other freight is more marginal. In addition, the types of freight for which road and sea are viable alternatives could change during this Undertaking, particularly given that it is proposed that it would apply for ten years.

In assessing the December Undertaking the ACCC has considered how the structure of the rail market and the commercial incentives facing ARTC are likely to affect the capacity of this Undertaking to deliver outcomes that are consistent with the criteria in s.44ZZA of the Act.

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[11] ARTC, *Explanatory Guide to the 2007 Interstate Access Undertaking*, June 2007, p. 4.

Part B Access Undertaking Proposed by ARTC

Summary

This chapter summarises ARTC's proposed Access Undertaking application. ARTC's Undertaking has nine parts: a Preamble (Part 1), which introduces and sets out the objectives of the Undertaking; a Scope and Administration section, which includes the proposed regulatory term and the network covered by the Undertaking (Part 2); a framework for negotiating access to the network and resolving disputes (Part 3); the pricing principles to be used by ARTC to derive access charges (Part 4); ARTC's processes for managing network capacity and connections and additions to the network (Parts 5 and 6); train control and management on the network (Part 7); ARTC's proposed service quality key performance indicators (Part 8); definitions (Part 9) and the Schedules to the Undertaking (schedules A to I), which provide further information relevant to access seekers applying for and negotiating access to the network.

B.1. Part 1 'Preamble'

The Preamble contains background information on ARTC and its views on its competitive environment. It outlines why ARTC has submitted an undertaking to the ACCC under Part IIIA of the Act and the objectives of the December Undertaking.

The Preamble states that ARTC was established to manage the granting of access to the interstate rail network. The Undertaking covers terms and conditions of access to that part of the interstate rail network owned or leased by ARTC and sets out the terms and conditions for providing access to the interstate mainline standard gauge track across that network.

ARTC intends to price network access services in an equitable, transparent and non-discriminatory manner to encourage growth of the rail market. The Preamble notes that, while ARTC is unlikely to be able to price access services to fully recover economic costs, the Undertaking seeks to ensure that ARTC's cost structure is efficient and that an appropriate balance is struck among the legitimate business interests of ARTC, potential access seekers and the public interest.

The preamble also notes that the Undertaking will be applied consistently to access applications that fall within its scope.

B.2. Part 2 'Scope and Administration of Undertaking'

The Undertaking provides for the negotiation of access to operate train services on the network. Access includes use of the track network and associated facilities, but does not extend to extensions of the network or tracks and infrastructure that other track owners may connect to the network. Sidings and yards are not included within the scope of the December Undertaking.

The December Undertaking will extend to include the Southern Sydney Freight Line (SSFL) when it is completed and commissioned for rail operations and the applicable indicative access charge has been accepted by the ACCC in accordance with the terms of the Undertaking. The December Undertaking does not affect existing access agreements.

The term of the December Undertaking is ten years from one month after it is approved by the ACCC. There is provision to vary the Undertaking, at ARTC's discretion, subject to consent from the ACCC.

The December Undertaking also provides for ARTC to take out and maintain a minimum $250 million liability insurance policy to protect against damage, injury or ARTC's liability to train operators.

B.3. Part 3 'Negotiating for Access'

The framework by which ARTC intends to deal with operators seeking access to services provided by its network is outlined in Part 3 of the Undertaking. Part 3 includes initial negotiation procedures, treatment of confidential information, information contained in the Indicative Access Proposal, the negotiation process once an access application has been lodged, the finalisation of an access agreement, and dispute resolution.

The following issues are outlined in this part of the Undertaking:

1. Framework. ARTC commits to negotiating in good faith and the broad procedures for negotiating access to the network are outlined.

2. Provision of Information. ARTC outlines the information it will provide to operators to assist with negotiations. This part of the Undertaking indicates when an operator is required to pay ARTC's costs for providing additional information outside certain standard information, if that information is not readily available to ARTC.

3. Parties to Negotiation. The Undertaking stipulates that ARTC will only deal with accredited operators or applicants who acquire the services of an accredited operator to provide the services. An applicant must meet certain prudential criteria prior to commencing negotiations, including that it has an ownership structure with a sufficient capital base and assets of value to meet actual or potential liabilities under an access agreement. ARTC may refuse to negotiate with an applicant if it considers that the applicant fails to meet these criteria. The matter may be referred to arbitration if the applicant considers that ARTC has unreasonably refused to negotiate or if ARTC considers the applicant's request for access to be frivolous.

4. Confidentiality. For the purpose of negotiating network access the Undertaking considers confidential information to be information that relates directly to an applicant's future markets or business strategy and ARTC's or the applicant's customers. The Undertaking binds the recipient of confidential information to treat that information as secret and confidential and to not use that confidential information for purposes not allowed by the Undertaking.

5. Access Application and Acknowledgement. Requests for access must comply with the format prescribed in the Undertaking. ARTC must acknowledge receipt of an access application and may seek additional information or clarification of the information in the application where necessary.

6. Indicative Access Proposal. ARTC undertakes to provide an Indicative Access Proposal within 30 days of acknowledging an applicant's request for access. The Indicative Access Proposal will set out, among other things:

- the extent of available capacity;
- details of the nature and cost of additional capacity that may be required to meet the demands of the applicant in the case of insufficient existing capacity;
- whether access applications exist from other operators that may reduce available capacity for the applicant;
- reference to the Indicative Access Agreement (IAA) and a reference to ARTC's current market terms and conditions as published on ARTC's website;
- an estimate of initial access charges; and
- indicative train path availability.

6. Negotiation. The Indicative Access Proposal forms the basis for negotiating price and non-price conditions of access to the network. An applicant may either progress an access application under the negotiation process on the basis of the arrangements outlined in the Indicative Access Proposal or indicate that the Indicative Access Proposal has not been prepared in accordance with the Undertaking and would not be an appropriate basis for continuing the negotiation process. ARTC may revise the Indicative Access Proposal and the applicant may refer the matter to arbitration if the revised Indicative Access Proposal is not satisfactory.

Where two or more applicants are seeking mutually exclusive access rights, ARTC intends to grant access to the applicant which, in ARTC's view, provides the highest present value of future returns to ARTC after considering the risks associated with the access agreement.

7. Access Agreement. An access agreement may be the IAA (if the service sought is an indicative service), ARTC's current market terms and conditions, or a negotiated access agreement reflecting agreed amendments. An access agreement must address the essential elements set out in Schedule C, unless otherwise agreed between ARTC and the applicant.

8. Dispute Resolution. The Undertaking stipulates that parties must use reasonable endeavours acting in good faith to resolve a dispute as soon as practicable. There is provision for a three-step approach to dispute resolution:

- **Negotiation** between senior representatives of the parties;

- **Mediation** subject to agreement between the parties. The mediator is appointed by agreement of the parties or, if the parties are unable to agree on a mediator, by the President of the Law Society of South Australia; and

- **Arbitration by the ACCC.** The arbitrator must take into account the Undertaking provisions, the objectives and principles of Part IIIA of the Act, and the Competition Principles Agreement and the legitimate business interests of ARTC along with a number of other considerations and the matters referred to in s.44X of the Act. In making a determination the arbitrator may deal with the matters in s.44V of the Act but must not make a determination that would have any of the effects described in s.44W.

Disputes in relation to an executed access agreement are dealt with in accordance with the provisions of that access agreement.

B.4. Part 4 'Pricing Principles'

The Undertaking sets out the pricing principles used by ARTC to derive access charges.

Access charges for indicative services are to be based on the Indicative Access Charge published by ARTC. Indicative services are services pertaining to specific geographical segments which have the following characteristics:

- maximum axle load of 21 tonnes;

- maximum speed of 110 km/h; and

- length not exceeding 1,800 metres west of Adelaide and Parkes, 1,500 metres east of Adelaide and Parkes, and 1,800 metres on the Melbourne-Macarthur segment and Melbourne-Parkes-Cootamundra segment.

Access charges for non-indicative services are negotiated with access seekers.

In devising access charges ARTC has regard to the characteristics of the relevant service, the indicative access charge, logistical impacts of the service, and the commercial impact on ARTC, including the opportunity costs to ARTC, market value of the train path and the credit risk of the business seeking access. Access charges cannot be differentiated based on the identity of the applicant or if the characteristics of the service sought by two applicants are alike and they operate in the same end market.

Access charges are structured as a multi-part tariff comprising two fixed components and a variable component. The first fixed component is levied on a dollar per kilometre ($/km) basis and is specific to each train service type and segment. The second fixed component, the excess network occupancy charge (ENOC), is a dollar charge per hour ($/hr) levied when an operator requests a train path that would exceed the reasonable allowance for segment run times determined by ARTC. An allowance is also made by ARTC for the reasonable requirements for operational activities of trains while they occupy the network. Both fixed components are levied irrespective of usage.

The variable component is related to distance and mass and is levied as dollars per gross tonne kilometres travelled ($/gtkm).

The Undertaking provides for the Indicative Access Charges to be adjusted at the discretion of ARTC provided that, in total, the adjustments do not exceed the accumulated value of the consumer price index (CPI) over the first five years of the Undertaking and again over the second five years of the Undertaking. The cumulative price variations actually applied by ARTC will be published on its website.

Access charges are forward-looking and subject to floor-ceiling revenue limits on each track segment. The Undertaking restricts revenue earned on each segment to fall within this floor-ceiling band. The floor is given by avoidable cost, that is the costs that would be avoided if the segment was removed from the network. The ceiling is defined by full economic cost, including segment specific costs, a return on and a return of segment specific assets and a return on and a return of a share of non-segment specific assets. Non-segment specific costs and depreciation of, and return on, non-segment specific assets are directly attributed to each segment where possible, or to a corridor(s) or identified as system-wide.

The returns on assets are calculated by applying ARTC's weighted average cost of capital (WACC) to the value of assets employed (the asset value is based on depreciated optimised replacement cost (DORC)). The regulatory asset base (RAB) will be rolled forward annually and ARTC has included in the December Undertaking a traditional 'building blocks' approach with the RAB rolled forward taking into account annual inflation, net capital expenditure and depreciation.

B.5. Part 5 'Management of Capacity'

On receiving and access application, ARTC undertakes a network capacity analysis to determine whether an applicant's requirements can be met within existing capacity constraints. The capacity analysis enables capacity entitlements, train paths, and access charges to be finalised in an access agreement.

Where an applicant seeks to contract network capacity that will not be used for more than six months, ARTC levies a capacity reservation charge. The capacity reservation charge is determined based on the fixed and variable charge that would arise if the access rights were 50 per cent utilised. If ARTC can secure utilisation of the capacity during the reservation period, the reservation charge is reduced accordingly.

If two or more applicants seek access to mutually exclusive access rights, ARTC undertakes to grant access to the operator who offers, in ARTC's view, the most favourable terms and conditions, that is the agreement which would generate the highest present value of future returns for ARTC, having regard to the relevant costs and risks.

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

B.6. Part 6 'Network Connections and Additions to Capacity'

ARTC would consider building extra network capacity to meet access seeker demand, provided that such capacity is in ARTC's commercial interests, bearing in mind its overall business activity and the economic and technical feasibility of the extra capacity created. Any additional capacity, once constituted, would be owned and managed by ARTC.

ARTC can also build extra network capacity at its own initiative for the benefit of the rail industry. In such cases, ARTC may apply to the ACCC to have the additional capacity included in the Undertaking, including varying the indicative access charges to reflect the cost of such capacity. The ACCC may approve ARTC's application for additional capacity if it believes that the addition is worthwhile or beneficial to the industry.

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

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

B.7. Part 7 'Network Transit Management'

ARTC's objective in train management is to exit trains according to their contracted exit time. The Network management principles, set out in Schedule F, apply where there is a conflict between trains in transit.

B.8. Part 8 'Performance Indicators'

ARTC must maintain the network in a fit for use condition and publish, on its webpage, the network performance indicators set out in Schedule G. ARTC will also incorporate into its annual internal audit process a review of its performance indicator reporting.

B.9. Schedules

There are a number of schedules which form part of the Undertaking and provide further information relevant to applying for and negotiating access to the network. These are:

Schedule A – Access application

Schedule B – Information to accompany access application

Schedule C – Essential elements of access agreement

Schedule D – Indicative access agreement as at commencement date

Schedule E – ARTC owned network

Schedule F – Network management principles

Schedule G – Performance indicators

Schedule H – Capital expenditure

Schedule I – Segments

Part C Legislative Framework and Principles

Summary

This chapter provides an overview of the legislative provisions relevant to the ACCC's assessment of ARTC's Undertaking and the framework the ACCC intends to apply in making that assessment. The chapter also outlines the access framework in Part IIIA of the Act, as background to the context in which the ARTC Undertaking was developed and is being assessed.

Part IIIA of the Act establishes a legal regime to help parties to access services provided by facilities with natural monopoly characteristics to promote competition in upstream or downstream markets. Undertakings are one of the mechanisms that can be used to achieve access.

An Undertaking is developed by an access provider to establish the terms and conditions that would form the basis for access negotiations covering the infrastructure owned or operated by that provider. If the Undertaking is accepted by the ACCC it is a legally binding document.

In accessing an Undertaking the ACCC must have regard to the criteria in s.44ZZA of the Act. In applying the principles embodied in these criteria to ARTC's Undertaking, the ACCC has formulated a framework covering four broad categories of issues: access pricing; capacity, interface and connectivity; negotiation and arbitration; and enforcement. These categories reflect the main groups of issues that have arisen in the ACCC's consideration of the Undertaking and the elements of the framework reflect the application of the relevant criteria to each of these categories.

C.1. Access Undertakings and Part IIIA of the Act

Part IIIA of the Act establishes a legal regime to help parties to access services provided by facilities with natural monopoly characteristics to promote competition in upstream or downstream markets. It provides three alternative mechanisms for achieving access:

- undertakings;
- declaration; and
- effective regimes.

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

Once accepted, the services covered by the undertaking cannot be declared, removing this right, or potential right, from third parties. The third party rights that would arise if a service was declared are substantial. Accordingly, when considering an undertaking

the ACCC is likely to be concerned to ensure that the proposed Undertaking provides a clearly enforceable basis by which third parties can negotiate access to such services on terms and conditions (whether set out in the undertaking or agreed by negotiation) that satisfy the legislative criteria in Part IIIA.

If the ACCC does not accept the Undertaking, anyone (including rail operators and other interested parties) may seek declaration of infrastructure services. Declaration gives current and potential users the right to negotiate terms of access with ARTC in the first instance and, if negotiations prove unsuccessful, it provides for the ACCC, upon notification of an access dispute, to arbitrate that dispute.

The third mechanism for achieving access, the establishment of an effective regime, requires an application by a state or territory government to the National Competition Council. The ARTC leased rail network assets in NSW are currently subject to the 2004 NSW Rail Access Undertaking, though that regime has not been certified as effective.

By lodging an access undertaking, ARTC has opted to pursue the first mechanism for establishing access terms and conditions. The advantage of an undertaking is that it '...provides a means by which the owner or operator of a facility can obtain certainty about access arrangements, before a third party seeks access.'[12] It can also avoid the possibility of time consuming and expensive disputes about whether a service should be declared.

The ACCC's role in assessing undertakings is prescribed by s.44ZZA of the Act. Once an undertaking has been submitted, the ACCC must decide whether or not to accept the undertaking, usually after conducting a public consultation process. In making its decision the ACCC is required to have regard to the following criteria:

1. the objects of Part IIIA, which are to:

    - promote the economically efficient operation of, use of, and investment in the infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets (s.44AA(a)); and

    - provide a framework and guiding principles to encourage a consistent approach to access regulation in each industry (s.44AA(b)); and

2. the pricing principles specified in s.44ZZCA:

    - that regulated access prices should:

        — be set so as to generate expected revenue for a regulated service or services that is least sufficient to meet the efficient costs of providing access to the regulated service or services (s.44ZZCA(a)(i)); and

        — include a return on investment commensurate with the regulatory and commercial risks involved (s.44ZZCA(a)(ii)); and

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[12] Second Reading Speech, *Competition Policy Reform Bill 1995*, p. 7.

- that the access price structures should:
  - — allow multi-part pricing and price discrimination when it aids efficiency (s.44ZZCA(b)(i)); and
  - — not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its own downstream operations, except to the extent that the cost of providing access to other operators is higher (s.44ZZCA(b)(ii)); and
- that access pricing regimes should provide incentives to reduce costs or otherwise improve productivity (s.44ZZCA(c));

3. the legitimate business interests of the provider (s.44ZZA(3)(a));
4. the public interest, including the public interest in having competition in markets (whether or not in Australia) (s.44ZZA(3)(b));
5. the interests of persons who might want access to the service (s.44ZZA(3)(c));
6. whether the undertaking is in accordance with an access code that applies to the service (s.44ZZA(3)(da)); and
7. any other matters that the ACCC thinks are relevant (s.44ZZA(3)(e)).

The above criteria include amendments made by Parliament in 2006, adding to Part IIIA of the Act the objects clauses (s.44AA(a) and (b)) and a set of 'generic' access pricing principles (s.44ZZCA), and requiring the ACCC to have regard to these matters in its consideration of an undertaking against the criteria in s.44ZZA(3).[13]

C.1.1. Elements of an Access Undertaking

Overall, the ACCC considers that an Undertaking will be ineffective unless it is sufficiently detailed to be court enforceable. Thus, the boundaries to negotiations specified in an undertaking must be clearly defined. As a starting point for negotiations undertakings should:

- clearly specify what services are subject to the undertaking;
- specify what terms and conditions are open to negotiation;
- provide a framework for negotiations including clearly defined boundaries for the negotiations;
- provide relevant information necessary for meaningful negotiations;

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[13] Details of the 2006 amendments to the Act are in the *Revised Explanatory Memorandum of the Trade Practices Amendment (National Access Regime) Bill 2006* and Miller, R. (2007) *Miller's Annotated Trade Practices Act*, 28th edition, Australian Competition and Consumer Law, NSW: Thomson.

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

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

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

C.2. Legislative Considerations Under Part IIIA

This section considers the legislative criteria the ACCC is required to have regard to in its assessment of the Undertaking.

C.2.1. Objects Clauses

Section 44AA of the Act provides that the objects of Part IIIA of the Act are to:

> (a) promote the economically efficient operation of, use of and investment in the infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets; and
>
> (b) provide a framework and guiding principles to encourage a consistent approach to access regulation in each industry.

Object (a)

When assessing an undertaking the ACCC should take into account the object of promoting economic efficiency in the operation of, use of and investment in the infrastructure by which services are provided. In the ACCC's view, this requires the consideration of the different types of economic efficiency:

- Technical or productive efficiency, which is achieved where individual firms produce the goods and services that they offer to consumers at *least* cost;
- Allocative efficiency, which is achieved if the resources used to produce a set of goods or services are allocated to their highest valued uses (i.e. those that provide the greatest benefit relative to costs); and

- Dynamic efficiency, which reflects the need for industries to make timely changes to technology and products in response to changes in consumer tastes and in productive opportunities.

These three types of economic efficiency are, in general, complementary, and are all promoted by effective competition. Determination of terms and conditions for access to the services provided by the infrastructure can, however, sometimes involve balancing the consideration of the different benefits of the three types of economic efficiency. How this balancing is achieved will typically depend on the physical and cost characteristics of the infrastructure and the demand for the services, such as whether capacity is scarce.

The ACCC's understanding of Object (a) of Part IIIA of the Act is that, in terms of promoting the efficient operation of, use of and investment in access infrastructure, and hence promoting effective competition in upstream and downstream markets, any pricing framework should generally satisfy two high-level criteria. First, it should encourage the efficient use of the existing access infrastructure by access users. For example, by appropriately reflecting the costs associated with providing the declared service. Second, the pricing framework should reveal and signal opportunities for investment or other improvements to access provision.

Object (b)

Object (b) of Part IIIA of the Act encourages consistency in the approach to access regulation, while also recognising that the most efficient access pricing framework for a particular access service should be determined on the basis of relevant characteristics of the industry in which that service is provided.

The ACCC's understanding of Object (b) is consistent with that adopted in the *Revised Explanatory Memorandum to the Trade Practices Amendment (National Access Regime) Bill 2006*. As stated in the explanatory memorandum, while this objective seeks to promote a consistent approach to access regulation in each industry, it is also important to recognise that industry-specific access regimes accepted under Part IIIA may be divergent due to different market characteristics. In particular, it is the ACCC's view that the intention of Object (b) is to provide a consistent 'overarching framework' for access regimes and not to place binding restrictions on how access pricing frameworks are applied – for example, by state and territory regimes – which should properly be determined on the basis of the characteristics of the access facility in that jurisdiction.

C.2.2. The Pricing Principles Specified in s.44ZZCA of the Act

Section 44ZZCA of the Act provides that the pricing principles for Part IIIA of the Act are:

> (a) that regulated access prices should:
>
> > (i) be set so as to generate expected revenue for a regulated service or services that is at least sufficient to meet the efficient costs of providing access to the regulated service or services; and
> >
> > (ii) include a return on investment commensurate with the regulatory and commercial risks involved; and

(b) that the access price structures should:

(i) allow multi-part pricing and price discrimination when it aids efficiency; and

(ii) not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operators is higher; and

(c) that access pricing regimes should provide incentives to reduce costs or otherwise improve productivity.

Pricing Principle (a)

(i) Expected revenue at least sufficient to meet efficient costs of providing access

The ACCC's understanding of pricing principle (a) is that it is intended to set a 'revenue floor' for the revenue raised by the provider from access charges, being the 'efficient costs of providing access to the regulated service.'

Section 44ZZCA does not prescribe a particular methodology (such as long-run marginal cost or incremental cost) for determining the efficient costs. The appropriate methodology will depend on the circumstances of each case.

(ii) Regulatory risk

The revised *Explanatory Memorandum to the Trade Practices Amendment (National Access Regime) Bill 2006* notes that the reference to regulatory risk 'is intended to refer to the perception that the exercise of regulatory discretion will be undertaken in a heavy-handed, arbitrary or uneven fashion.' The memorandum goes on to state:

> While such perceptions may deter investment in any dysfunctional market subject to regulation, regulatory risk takes on greater importance for infrastructure investors, due to the length of time and expense required for service providers to respond to changes in a market, perceptions that regulatory decisions tend to be biased in favour of service users rather than service providers/investors, the scale of investment in infrastructure and the sunk nature of assets. Pricing Principle (a)(ii) requires regulators specifically to factor in regulatory and commercial risks in setting access prices. This may assist to address perceptions that regulatory bias favours service users.

In the past, the ACCC has taken a cautious approach to setting regulatory parameters and continues to develop transparent and predictable processes, which help to deal with many of the perceived problems commonly associated with regulatory risk. The ACCC considers, however, that, in general, dealing with any actual or perceived regulatory risk simply by systematically increasing the allowed rate of return on investment is not an appropriate methodology. To systematically increase the allowed rate of return on investment would result in the redistribution of the proceeds of investment from consumers to shareholders, thereby obviating one of the purposes of regulation in the first place. It might also distort investment if the risk mark-up was greater than the actual risk for the project.

(iii) Commercial risk

When assessing an undertaking it is generally necessary to consider the appropriate rate of return on capital. The rate of return on capital is a market-determined rate required

by investors to provide capital to the company. The appropriate rate of return on capital may depend on the level of commercial risk of the project.

One method of determining the appropriate rate of return on capital is to estimate the WACC. In determining the WACC, cost of debt financing is separated from the cost of equity financing, as the two options carry different levels of commercial risk. The WACC is then calculated by taking the average of these two weighted by the proportion of each type of financing used in the project.

The cost of debt financing is often derived by directly measuring the current effective interest rate on the various debts held by the firm. Alternatively, it can be derived by a benchmark return on bonds with similar credit rating to the firm. Cost of equity financing is derived by starting with the risk-free rate of investment, and adding a premium based on the commercial risk of the investment, determined on a case-by-case basis.

While there are a number of methods for determining the appropriate return on equity, a common method is the use of the capital asset pricing model. Under such a model, a premium reflecting the riskiness of a project is added to the risk-free rate. The premium is calculated using the market-determined risk premium coupled with the riskiness of the project relative to the riskiness of the market as a whole.

Pricing Principle (b)

(i) Multi-part pricing and price discrimination

Section 44ZZCA(b)(i) states that access price structures should allow multi-part pricing when it aids efficiency. Access pricing arrangements that incorporate multi-part prices can, in principle, allow for many of the efficiency advantages associated with setting marginal or per-unit prices equal to short-run marginal cost, while at the same time promote efficient investment by allowing an access provider to recover a relevant share of fixed costs through fixed charges or higher infra-marginal pricing. The simplest multi-part pricing arrangement is a two-part tariff that involves an up-front charge which contributes to the recovery of fixed costs, as well as a per unit, or usage charge, which reflects the short-run marginal cost of providing the service.

(ii) Vertical integration

Section 44ZZCA(b)(ii) states that access price structures should not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its own downstream operations, except to the extent that the costs of providing access to other operators is higher. This section aims to ensure that access pricing allows suppliers of goods and services that are dependent upon access to the declared service to be able to compete on their relative merits.

Pricing Principle (c)

Section 44ZZCA(c) states that access pricing regimes should provide incentives to reduce costs or otherwise improve productivity.

In principle, there are numerous ways in which an access pricing regime for a specific service may be designed. In practice, however, pricing regimes are often variants of either cost-of-service/rate-of-return regulation or price-cap regulation. Depending on

how they are implemented, both of these forms of regulation, and variations based on them, have the potential to provide incentives to reduce costs and improve performance. The general point is that the incentives to reduce costs and improve performance under any access pricing regime depends on how closely linked an access provider's general level of prices are to the access provider's actual costs associated with providing those services.

The appropriateness of a particular pricing regime will depend on the characteristics of the facility under examination and how it is implemented in practice. Generally, this will involve considering the different types of potential efficiency gains, as well as facility-specific factors such as the importance of service quality, the potential for efficiency gains and the relative risk allocation between access providers and access users.

C.2.3. Legitimate Business Interests of the Provider

When having regard to the legitimate business interests of the access provider, the ACCC considers whether particular terms and conditions in the proposed undertaking are sufficient and necessary to maintain those interests.

The following issues may be relevant to identifying the legitimate business interests of the service provider:

- ongoing viability of services covered by the undertaking;
- the costs of extensions to the facility incurred by the service provider — such extensions may be required to facilitate access where capacity constraints exist;
- protection of plant and equipment — in some circumstances it may be appropriate for the service provider to specify the terms and conditions of use of infrastructure facilities to limit damage or for safety reasons; and
- ability of the service provider to meet obligations imposed by government.

C.2.4. Public Interest, Including the Public Interest in Having Competition in Markets (whether or not in Australia)

In having regard to the public interest, the ACCC explores the extent to which the Undertaking improves the welfare of other parties and the broader community. It considers a broad range of public interest issues, but has particular regard for economic efficiency considerations, reflected in the specific references to the public interest of having competition in markets, which is a clear reference to the Act's objective of promoting competitive markets.

While no list of public interest considerations can be exhaustive, clause 1(3) of the Competition Principles Agreement (11 April 1995) provides an example of such considerations:

- government legislation and policies relating to ecologically sustainable development;
- social welfare and equity considerations, including community service

obligations;

- government legislation and policies relating to matters such as occupational health and safety, industrial relations and access and equity;
- economic and regional development, including employment and investment growth;
- the interests of consumers generally or as a class of consumers;
- the competitiveness of Australian businesses; and
- the efficient allocation of resources.

Interests of Consumers

The way the undertaking impacts on end-users, not just the users of the infrastructure service, can be an important public interest consideration. This can include the interests of end-users in obtaining:

- lower prices than would otherwise be the case;
- increased quality of service; and
- increased diversity and scope in product offerings including access to innovations in a quicker timeframe than would otherwise be the case.

The Australian Competition Tribunal noted that, over the long-term, the apparent tension between the interests of the service provider and end-users may be resolved. For example, very low prices may be in the short-term interests of end-users. However, over the long-term, sustainably low prices are more likely to enhance their interests. Similarly, in *Re Michael; Ex parte Epic Energy (WA) Nominees Pty Ltd (2002)* ATPR 41-886 (*Michael*), Parker J discussed the public interest in the maintenance and encouragement of future investment in significant infrastructure, by protecting past investment decisions.

C.2.5. Interests of Persons Who Might Want Access to the Service

Persons who might want access to the service will, in general, use that service as an input to supply services to end-users. That is, they are likely to be upstream producers (such as electricity generators) or downstream service providers (such as electricity and gas retailers and rail freight operators). The interests of final consumers (end-users) will, in general, be considered in the context of the public interest.

In *Michael* Parker J noted (at [135]) that this criterion is counterpoised to the 'legitimate business interests' criterion of the service provider although there is scope for the 'respective interests to find mutual accommodation.'[14] As discussed above in

[14] In the context of s.2.24(f) of the *National Third Party Access Code for Natural Gas Pipeline Systems*.

relation to the interests of consumers, assessed over the long-term, there is likely to be less conflict between the interests of the access provider and access seeker, particularly where the access provider is not integrated into the downstream market. For example, it is in access seeker's long-term interest that prices and returns are sufficient to provide the incentives needed to induce the access provider to invest in and adequately maintain services.

In assessing terms and conditions included in an undertaking against the interests of access seekers, a range of issues may arise including:

- Does the undertaking appropriately provide for the services which access seekers are likely to require?

- Are access terms and conditions reasonable? In general, it will be in the interests of access seekers that prices reflect the efficient provision of the service (subject to commercial viability) and do not incorporate pricing designed to generate significant monopoly profits.

- Does the undertaking incorporate non-price barriers to access?

- Does the undertaking include incentives for the access provider to improve efficiency over time?

- To the extent that pricing is based on asset valuation, how appropriate is the approach to valuing assets given the circumstances of the undertaking?

- Does the pricing provide incentives for efficient investment by the access provider? In general, it will be in the interests of access seekers that pricing reflects efficient investment choices, and not reflect the choice of inappropriate technology, construction of facilities much larger than could be justified by existing or prospective usage or earlier than necessary replacement of plant and equipment.

- Are the processes for negotiating and setting prices clear and transparent?

- Is sufficient information available to access seekers to engage in meaningful negotiation with the prospect of outcomes reflecting the objects of Part IIIA?

- Are the ongoing operational arrangements such that access seekers are reasonably informed about the service?

- Does the undertaking need to include service standards? Will the service standards meet reasonable user needs? Has the access provider demonstrated a commitment to ongoing maintenance of the service? Is there transparency in service quality (for example availability of measures of service reliability to interested parties on request and/or processes for regular independent service audits)?

Access seekers may also want to ensure that their use of the infrastructure service is not unnecessarily limited by restrictive standards.

C.3. Existence of Another Effective Access Regime and Other Relevant Considerations

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

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

The ACCC is required to reject an undertaking lodged by an infrastructure provider if the Commonwealth Minister has already ruled that the infrastructure is subject to an effective state or territory access regime under s.44N (s.44ZZA(3AA)).

In this instance, the ARTC leased rail network assets in NSW are subject to the 2004 NSW Rail Access Undertaking, but this regime has not been certified as effective by the Commonwealth Minister. There is also no rail industry access code that applies to the ARTC rail network so that s.44ZZA(3)(da) is not relevant to the assessment of this Undertaking.

Finally, as noted above, the ACCC must also have regard to any other matters it thinks are relevant to its assessment of the Undertaking (s.44ZZA(3)(e)). This gives the ACCC the flexibility to consider circumstances specific to a particular service. This could include, for example, the capacity to enforce the undertaking (as discussed above), or other maters such as the extent to which the undertaking is consistent with other regulation, or the extent to which the undertaking protects existing contracts. Any such considerations must not be irrelevant to the ACCC's consideration of the Undertaking.

C.4. Framework for Assessing ARTC's Undertaking

In applying the principles outlined in section C.2 to the ARTC Undertaking the ACCC has formulated the framework in Box C.1. The framework addresses four broad categories of issues: access pricing; capacity, interface and connectivity; negotiation and arbitration; and enforcement.

These categories reflect the main groups of issues that have arisen in the ACCC's consideration of the Undertaking. The elements within each category reflect an application of the criteria (discussed in C.2) to the specific circumstances of the ARTC Undertaking covering the interstate rail network.

First, the price for access to ARTC's track should reflect the 'generic' access pricing principles in s.44ZZCA. The principles are concerned with whether prices are efficient and encourage the efficient use of rail track infrastructure, reflect ARTC's costs of operating the track efficiently, and generate incentives for ARTC to continue to reduce its costs, improve its quality and undertake efficient investment.

These principles also encapsulate other aspects of the s.44ZZA criteria that relate to pricing, as the pricing principles are designed to deliver prices that account for the legitimate interests of the service provider, the interests of potential third party users and the public interests, and also to promoting economically efficient operation of the network, which is reflected in the objects clause.

Box C.1: Framework for assessing the Undertaking

The ACCC considers that, as far as possible, the Undertaking should reflect the following framework:

A. Access Pricing

A.1. Access prices should generate no more than sufficient revenue to recover the efficient costs of providing access to the infrastructure as well as earn a return that is commensurate with regulatory and commercial risk;

A.2 Access prices should provide incentives to reduce costs and otherwise improve productivity;

A.3 Access prices should provide incentives for ARTC to provide services at efficient levels of cost and quality; and

A.4 Access prices should promote efficient use of, operation of and investment in the network, including using multi-part prices and price discrimination where appropriate.

B. Capacity, Interface and Connectivity

B.1 Capacity management and network transit management provisions should be clearly specified so as to inform all parties of their respective rights and obligations;

B.2 Capacity enhancement, capacity management and network transit management provisions should promote effective and efficient use of the network covered by this undertaking; and

B.3 Capacity management and network transit management provisions should promote effective and seamless connectivity between the ARTC interstate and connecting tracks, in particular other parts of the NSW rail network, including the Hunter Valley coal network.

C. Negotiation and arbitration

C.1 Access processes should promote commercially negotiated outcomes in a timely manner; and

C.2 Access processes should provide timely and effective dispute resolution processes.

D. Enforcement

D.1 The provisions in the Undertaking should be sufficiently clear to allow enforcement.

Second, non-price terms and conditions often have as large an impact on the efficiency and effectiveness of the use of infrastructure as prices. The main issues are likely to arise in the enhancement and management of capacity, and interface and connectivity between parts of the regulated network and other networks. Overall, the enhancement

and use of capacity should promote efficient long-term use of the network. The interface and connectivity across ARTC's interstate network and other rail networks, including other rail lines in NSW, should also promote efficient and seamless capacity and network transit management processes for all rail traffics.

The components of the framework that relate to capacity, interface and connectivity reflect an application of the objects clause, to promote economic efficiency and encourage a consistent approach to access regulation, and balance the legitimate interests of service providers with the interests of potential third party users and the public interest.

Third, Part IIIA of the Act establishes an access regime which encourages negotiation of terms and conditions of access in the first instance with recourse to arbitration if negotiation fails.

The negotiation and arbitration part of the framework recognises that it is in the legitimate business interests of the access provider, in this instance ARTC, in the interests of potential access seekers, and in the public interest that negotiation and arbitration processes are effective. There are several elements to effectiveness. The standards for negotiation should be clear, ensuring that the parties are certain about the process and their obligations. Timeframes should be reasonable as unnecessary delays can frustrate access. The quantity and quality of information provided by both parties should be sufficient to promote effective negotiations. In addition, dispute resolution processes should be independent and impartial, and the dispute resolution body should have appropriate skills.

Finally, s.44ZZJ of the Act sets out the mechanism for enforcing access undertakings. It provides for the ACCC to apply to the Federal Court for an order if it considers that the service provider has breached any terms of an undertaking.

For the Federal Court to enforce an undertaking it needs to be able to clearly identify the terms and conditions set out in that undertaking. This necessitates that the provisions in the undertaking should be sufficiently clear to allow enforcement. This is an 'other matter' which is relevant to the ACCC's consideration of an undertaking and therefore, draws on s.44ZZA(3)(e).

The rest of this report uses this framework as a basis for assessing ARTC's Undertaking.

Part D - Assessment of ARTC's Undertaking

The assessment follows the structure below:

- D.1. Preamble;
- D.2. Scope and Administration of the Undertaking;
- D.3. Negotiating for Access and Dispute Resolution;
- D.4. Pricing Principles;
- D.5. Financial Model;
- D.6. Capacity Management;
- D.7. Investment, Network Connections, Additions to Capacity and Network Transit Management;
- D.8. Performance Indicators;
- D.9. Schedules; and
- E. Draft Decision.

D.1. Preamble

Summary

Part 1 of ARTC's Undertaking (the Preamble) is an introductory statement, which outlines the context and the objectives of the Undertaking. The Preamble states that the Undertaking is a voluntary undertaking with the intent of establishing a workable, open, non-discriminatory, efficient and inclusive process for lodging and processing access applications. A key intent of the Undertaking is to ensure a balance between the legitimate business interests of ARTC, the interests of the public and the interests of applicants wanting access to the network.

The ACCC's draft assessment concludes that clause 1.2 should contain explicit recognition that one of the objectives of the Undertaking is to provide access to the network. One way of achieving this would be to change Part 1 of the Preamble so that that part of clause 1.1(f), which states that the purpose of the Undertaking is to provide a framework for access negotiations, is moved to the 'objectives' section (clause 1.2) of the Undertaking.

ARTC's Proposal

The Preamble in the December Undertaking is divided into two main sections — an Introduction (clause 1.1) and Objectives (clause 1.2).

Introduction

The Preamble's Introduction sets out the history of ARTC, such as when it was established and why (clause 1.1(a)) and ARTC's role in granting access (clause 1.1(b)). It also notes that ARTC is a vertically separated provider of access operating in an environment in which it faces competitive pressures from other modes of transport (clause 1.1(c)).

ARTC states that, as the manager of a significant part of the interstate rail network, it will not discriminate price on the basis of the identity of the customer. ARTC argues that it seeks to stimulate customer confidence, competition and market growth in the rail industry (clause 1.1(d)).

The Introduction also states that maintenance of the network and associated facilities is outsourced or managed under competitively tendered contracts, with a view to ensuring that ARTC's cost structure reflects 'efficient infrastructure practice' (clause 1.1(e)).

Clause 1.1(f) of the Introduction states that ARTC prepared the Undertaking pursuant to its charter objectives and to provide a framework to manage negotiations for access to the network. ARTC further states that the Undertaking would be applied consistently to access applications that are within the scope of the Undertaking (1.1(f)).

Objectives

The Preamble states that the Undertaking is voluntary, with the intent of establishing a workable, open, non-discriminatory, efficient and inclusive process for lodging and processing access applications (clause 1.2(a)). The Preamble also notes that ARTC will: use transparent and detailed methodologies for determining access terms and conditions (clause 1.2(b)); provide binding dispute resolutions process (clause 1.2(d)); and operate consistent with the objectives of Part IIIA of the Act and the Competition Principles Agreement (clause 1.2(e)).

Clause 1.2(c) states that the Undertaking attempts to:

> reach an appropriate balance between:
>
> (i) the legitimate business interest of ARTC:
>
> (A) the recovery of all reasonable costs associated with the granting of Access to the Network;
>
> (B) a fair and reasonable return on ARTC's investment in the Network and Associated Facilities (including maintenance costs) commensurate with its commercial risk; and
>
> (C) stimulate customer confidence and market growth in the rail industry;
>
> (ii) the interest of the public:
>
> (A) increase competition ensuring efficient use of resources;
>
> (B) reducing the potential for abuse of market power by operators or major users of single purpose infrastructure facilities; and
>
> (C) promoting other relevant social objectives, such as an increase of freight traffic from road to rail;
>
> (iii) the interests of Applicant's wanting Access to the Network:
>
> (A) providing Access to the Network on fair and reasonable terms; and
>
> (B) providing Access in an open, efficient and non-discriminatory manner.

Views of Interested Parties

Interested parties raised a number of issues with the Preamble. They stressed the tension between ARTC's roles as a commercial entity with an objective to provide sustainable returns on investment and as a public entity and manager of a network that cannot, and in their view should not, be operated to earn a full commercial rate of return. These issues raised concerns about the Undertaking's capacity to balance appropriately the interests of ARTC and access seekers.

ARTC as a Commercial Entity

PN submitted that one of the difficulties with the Undertaking is that while ARTC is 'operating as an arm of government policy,' it is also required to adopt commercial principles and objectives in an industry with low returns that cannot be operated in strictly commercial terms.[15] It viewed these objectives as incompatible[16] and, as such, the Undertaking will not produce outcomes that are consistent with both the aims of government policy and 'the long term interests of the rail freight industry.'[17]

Similarly, SCT submitted that ARTC is integral to, and an arm of, the Australian Government.[18] SCT believed that an analysis of the business activities of ARTC is, in effect, an assessment of the Australian Government's investment in and operation of national rail infrastructure.[19] Moreover, SCT submitted that there is no commercial risk in ARTC's activities due to its connections with the Australian Government and, as such, returns on investment should have the same criteria as road infrastructure.[20]

FROG submitted that ARTC is not a 'traditional' commercial entity but acts as a public entity provider of rail infrastructure that is a key 'economic enabler.'[21] Whereas RailCorp took the view that the Undertaking had been formulated for 'a vertically separated network provider with a strictly commercial agenda.'[22]

FROG also submitted that the Preamble to the December Undertaking should recognise that ARTC is not a 'traditional' commercial entity but a public entity provider of rail infrastructure.[23]

Interests of Access Seekers

PN submitted that the interests of access seekers and the public interest are not appropriately balanced and that clause 1.2 does not actually list as an objective the provision of access to the network. PN also stated that the June Undertaking was silent

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15 Pacific National, *Pacific National Submission to ACCC Re: Approval of ARTC Interstate Access Undertaking*, July 2007 (Pacific National *July Submission*), p. 2.

16 ibid.

17 ibid.

18 SCT Logistics, *Re: Australian Rail Track Corporation (ARTC) Rail Access Undertaking – Interstate Network*, February 2008 (SCT *February Submission*), p. 1.

19 ibid.

20 ibid.

21 Freight Rail Operators' Group (FROG), *ARTC Interstate Access Undertaking 2007 – Freight Rail Operators' Group Submission to the ACCC*, July 2007 (FROG *July Submission*), p. 17.

22 RailCorp, *Australian Rail Track Corporation (ARTC) 2007 Access Undertaking – RailCorp Comments*, 7 August 2007 (RailCorp *August Submission*), p. 5.

23 Freight Rail Operators' Group (FROG), *ARTC Interstate Access Undertaking 2007 – Freight Rail Operators' Group Submission to the ACCC*, February 2008 (FROG *February Submission*), p. 10.

on ARTC's purpose in providing the network.[24] In its view, ARTC was incorporated to provide the rail network for the benefit of access seekers.[25]

Both FROG and QR submitted that they support a transparent regulatory framework and that the Undertaking should be flexible to accommodate practical commercial outcomes.[26] However, QR also submitted that, while ARTC may not possess market power in the sense that it can extract monopoly rents, it is still a monopolist in its bargaining position during commercial negotiations with access seekers and, as a result, QR believes that the Undertaking does not appropriately balance the interests of ARTC and access seekers.[27]

The New South Wales Minerals Council (NSWMC) proposed that the Preamble should acknowledge that there should be price and non-price discrimination.[28] FROG believed that the concept of pricing on the basis of efficient costs should also be included in the Preamble.[29]

Assessment of Issues

A Preamble contains preliminary statements that explain the purpose of the Undertaking and assist in its interpretation. However, a Preamble does not contain individual legal obligations *per se*.

That said, the ACCC considers that the Preamble should be consistent with the legislative criteria and has, therefore, considered areas where this may be of material concern.

ARTC as a Commercial Entity

ARTC submitted the Undertaking as a commercial entity with a stated aim of providing its shareholder, the Australian Government, a sustainable return on its investment. That said, clause 1.1(d) of the Undertaking says that ARTC is unlikely to earn sufficient revenues on any segment to cover the economic cost of providing infrastructure services.

ARTC contends that it is constrained in the short term from earning higher revenues by intermodal competition and that higher prices would adversely affect network utilisation.[30] Given this constraint, ARTC explains that its 'strategy for long term asset

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24 Pacific National *July Submission*, p. 51.

25 ibid.

26 Queensland Rail, *Queensland Rail Submission to ACCC on ARTC Interstate Access Undertaking 2007*, July 2007 (QR *July Submission*), p. 5; FROG *July Submission*, p. 1.

27 QR *July Submission*, p. 5.

28 New South Wales Minerals Council (NSWMC), *NSW Minerals Council Hunter Rail Access Task Force Response to Australian Competition and Consumer Commission Issues Paper regarding Australian Rail Track Corporation 2007 Access Undertaking For Its Interstate Rail Network*, August 2007 (NSWMC *August Submission*), p. 14.

29 FROG *February Submission*, p. 10.

30 ARTC, *2007 ARTC Interstate Access Undertaking, Explanatory Guide*, June 2007, p. 4.

sustainability in its current competitive environment is, through strategic investment in, and management of, its assets to grow rail volumes, and asset utilisation, on the network through contributing to improving rail competitiveness in the longer term.'[31]

The issue for the ACCC is whether it is possible for ARTC's commercial focus to be balanced with its low levels of cost recovery in a way that is consistent with the criteria in Part IIIA. The question of whether ARTC should or should not have a commercial focus is an issue for the Australian Government, not the ACCC. The Preamble recognises that ARTC must balance the needs of access seekers, the public interest and its legitimate business interests (clause 1.2(c)). The Undertaking also appears to address ARTC's dual focus in a range of ways. For example, ARTC is required to fulfil its obligations as appropriate under the *Corporations Act 2001* but it also receives periodic capital grants from Australian governments to construct or maintain rail infrastructure. Therefore, while ARTC's structure is that of a commercially focused body corporate, it is not seeking a return on capital for capital expenditure funded through government grants.[32]

Overall, the ACCC considers that ARTC's approach to outlining general principles in the Preamble on its commercial focus and its aim to maximise long term revenues, even if it is not currently achieving a full commercial rate of return, is not inconsistent with the Part IIIA criteria against which the ACCC is required to assess this application.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 1 setting out the commercial role of ARTC do not raise objections under Part IIIA of the Act.

Interests of Access Seekers

The ACCC notes submissions on ARTC's bargaining position during commercial negotiations. The ACCC recognises that bargaining power is an on-going concern when access is sought to infrastructure with monopoly characteristics. This issue is, however, recognised in the December Undertaking. The stated intent of the Undertaking is to 'use transparent and detailed methodologies, principles and processes for determining access revenue limits, terms and conditions' (clause 1.2(b)), while clause 1.2(c)(iii) states that the intent of the Undertaking is to reach an appropriate balance between the interests of Applicants wanting access to the network including:

- (A) providing Access to the Network on fair and reasonable terms; and
- (B) providing Access in a open, efficient and non-discriminatory manner.

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31 ibid., p. 4.

32 ARTC does seek to recover depreciation on the communications and signals component of grant funded capital expenditure (approximately $190 million).

That said, the ACCC believes that the second part of clause 1.1(f) that states that ARTC has prepared this Undertaking 'to provide a framework to manage negotiations with applicants for access to the network for the purposes of operating services' is better placed under clause 1.2 as an objective. The ACCC believes that clause 1.2 should explicitly recognise that one of the objectives of the Undertaking is to provide access to the network.

Draft Decision

Recommendation:

- The ACCC's preliminary view is that clause 1.1(f) of the Preamble should be moved to clause 1.2 to become an objective of the Undertaking.

D.2. Scope and Administration of the Undertaking

Summary

Part 2 of the Undertaking (Scope and Administration) sets out the network of railway lines to which the Undertaking's access provisions apply. The Undertaking covers ARTC's interstate rail network, namely, the East-West network (from Sydney and Melbourne to Kalgoorlie in Western Australia) and the North-South network (from Melbourne to Queensland).

Part 2 also specifies the grant, duration and term of the Undertaking, as well as the process for its review and that it only covers new or amended agreements and does not affect existing agreements. In particular, ARTC is proposing a ten-year term, with the Undertaking taking effect one month after it is accepted by the ACCC. ARTC proposes that the Undertaking will continue until it expires or is withdrawn by ARTC (subject to ACCC agreement). ARTC (but not operators) may also seek an amendment to the Undertaking if, in ARTC's opinion, circumstances have changed such that an amendment is warranted.

In conducting its draft assessment, the ACCC found that the Undertaking's scope is unclear and needs to be amended to provide greater certainty as to its coverage. In particular, the ACCC recommends that ARTC include in the Undertaking clear maps that delineate the network covered by the Undertaking. The ACCC also recommends that clause 2.2 be made consistent with the Act, which states that an undertaking takes effect 21 days after the ACCC publishes its decision (s.44ZZBA(1)(a)).

In addition, while the ACCC accepts ARTC's proposed ten-year regulatory term, it recommends that the Undertaking require ARTC to review, in consultation with operators, the Undertaking and its operability after five years.

Lastly, the ACCC considers that the Undertaking should specify that 3 months prior to its expiry, ARTC will submit to the ACCC a written statement outlining whether or not it intends to submit a new voluntary Undertaking to the ACCC for its consideration, and if ARTC intends to submit such an Undertaking it would also apply to the ACCC for an extension of the expiring Undertaking, pursuant to s.44ZZBB of the Act.

D.2.1. Scope of the Undertaking

ARTC's Proposal

Network Description and Coverage

Clause 2.1(a) indicates the coverage or scope of the Undertaking. It states that:

> The Undertaking provides for the negotiations of access required for the operations of train services by operators on the network, with the details of specified services and sections of the network defined during access negotiations…

To understand what the Undertaking covers, it is necessary to understand three terms used in clause 2.1(a) — access, service and network. The Undertaking (clause 9.1) defines each of these terms as follows:

- access — 'access to use of the network, or any part thereof, for the purposes of running a service';
- service — 'a train run by the operator using the network, which provides rail freight or passenger services including work trains'; and
- network — 'the network of railway lines delineated or defined in Schedule E of the Undertaking'.

Hence, the Undertaking's scope of coverage is defined in Schedule E, which divides the ARTC network into five sections:

- SA/WA/NSW— South Australia, part Western Australia (Kalgoorlie to WA/SA border) and part NSW (SA/NSW border to Broken Hill);
- mainline South Australia to Melbourne;
- mainline NSW to Melbourne;
- Melbourne boundaries; and
- NSW leased network.

These five text based descriptions each note whether mainlines, crossing loops, authority points, dual gauge lines or turnouts are included in the network description. For example, the SA/WA/NSW network description specifically includes all crossing loops in the corridors described in that division.[33]

The five sections also separately note that the track forming the network only extends as far as the track owned or leased by ARTC and identifies those sections of track which do not form a part of the network. For example, the NSW leased network section of Schedule E lists that the Hunter Valley Newcastle coal lines are not part of the Undertaking.[34]

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[33] The Schedule notes tracks between delineated points or landmarks as being included in the network and names them according to their geographic location. For example, The Crystal Brook to Dry Creek line is defined as the 'mainline from the southern end of Crystal Brook triangle to the southern apex of the Dry Creek triangle' (see Schedule E, p. 44).

[34] See Schedule E of the Undertaking, p. 44.

Clause 2.7(b) of the December Undertaking states the information ARTC will publish on its website, including a map of the network. While ARTC is required to publish maps of the network, it has not annexed any network maps to Schedule E.[35]

The Undertaking also states that access to the network will include the benefit of the 'associated facilities' required for access to the track (clause 2.1(a)). Clause 9.1 defines 'associated facilities' as:

> …all associated track structures, over and under track structures (including supports for equipment or items associated with the use of the Network), tunnels, bridges, train control systems, signalling systems, communication systems and associated plant machinery and equipment from time to time but only to the extent that such assets are related to or connected with the network but does not include any sidings or yards.

Extensions and the Southern Sydney Freight Line

The scope of the December Undertaking (clause 2.1(b)) states that:

> Except as provided for by cause 2.1(c) [i.e. the SSFL] this Undertaking does not extend to any extension to the network nor to the track and infrastructure not part of the Network that may connect to the Network.

In other words, ARTC proposes that the Undertaking will not automatically cover future extensions to the network. Nor does the Undertaking include track and infrastructure not part of the network that may connect to the network. An extension is a defined in the December Undertaking as 'the addition of infrastructure not forming part of the Network when the addition is proposed as part of an Access Application or during the negotiation process' (clause 9.1).

As noted in clause 2.1, one exception to this is the Southern Sydney Freight Line (SSFL) (clause 2.1(c)). The SSFL is rail infrastructure to be constructed by ARTC along the rail corridor adjacent to the existing rail track between Macarthur and Sefton in Sydney. The new line will connect the network at Macarthur with the metropolitan freight-only network at Sefton and provide direct independent access to Enfield, Chullora and Port Botany. The intention appears to be for the SSFL to increase freight movement and capacity in the outer-Sydney region. This is expected to benefit above rail operators using the Sydney-Melbourne corridor, and indirectly benefit all operators, as enhanced capacity around the Sydney bottleneck may have flow-on benefits across the network.

Although the SSFL is under construction, ARTC intends to include it in the scope of the December Undertaking once the line is complete and the ACCC has accepted the relevant indicative access charge (clause 2.1(c)). The Undertaking provides that at least six months prior to commissioning the SSFL for operation, ARTC will develop and submit to the ACCC the indicative access charge for the SSFL, to improve certainty in the operation of the SSFL when it is commissioned (clause 2.4(b)).

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[35] ARTC, *2007 ARTC Interstate Access Undertaking Additional Explanatory Guide*, December 2007, pp. 21-22.

Views of Interested Parties

Network Description and Coverage

FROG and PN raised concerns regarding the clarity of the network coverage outlined in the Undertaking. For example, FROG noted that Schedule 1 of the June IAA included the lines from Goobang Junction to The Gap and Merrygoen to Ulan but that these lines were not mentioned in the text or contained in the diagrams.[36] ARTC subsequently deleted the lines from Goobang Junction to The Gap and Merrygoen to Ulan in its December IAA.

While FROG submitted that the December Undertaking network line diagrams were clearer regarding what was included within the Undertaking, it believed that the diagrams remained at odds with what is in the text of the Undertaking. FROG stated in its submission on the December Undertaking that the textual description used to define the network was confusing and appeared to be inconsistent. FROG also noted that the maps and diagrams had been excluded from the December Undertaking.[37]

Stakeholders raised concerns regarding ARTC's clarification that sidings and yards are excluded from the December Undertaking.[38] Asciano, for example, argued that exclusion of sidings and yards would break up the network and that it would need to have three separate access agreements under three access undertakings with ARTC to access track in NSW.[39] SCT submitted that while it is reasonable in concept to exclude sidings and yards from the definition of associated facilities, there may be some sidings and yards that are essential to running train services and/or where it is impractical for an operator to construct alternative facilities. Thus, in SCT's view, ARTC is a monopoly supplier of these facilities and if certain yards and sidings are to be excluded from the Undertaking they should be identified and nominated separately.[40]

FROG echoed these concerns and also stated that the lack of status of the network diagrams in the December Undertaking added more uncertainty to the exclusion of sidings and yards, claiming that it is impossible to know which lines are covered at locations such as Dry Creek.[41]

Similarly, QR contended that the undertaking 'picks and chooses' the services and infrastructure covered and questioned whether this approach allowed for the smooth

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36 Freight Rail Operators' Group (FROG), *ARTC Interstate Access Undertaking 2007 – Freight Rail Operators' Group Submission to the ACCC*, July 2007 (FROG *July Submission*), p. 2.

37 ibid., p. 10.

38 ibid., p. 2.

39 Asciano, *Asciano Submission ACCC Issues Paper: ARTC Rail Access Undertaking*, February 2008 (Asciano *February Submission*), p. 5; see also Pacific National, *Pacific National Submission to ACCC Re: Approval of ARTC Interstate Access Undertaking*, July 2007 (Pacific National *July Submission*), p. 52.

40 SCT Logistics, *Re: Australian Rail Tack Corporation (ARTC) Rail Access Undertaking – Interstate Network*, February 2008 (SCT *February Submission*), p. 6.

41 Freight Rail Operators' Group (FROG), *ARTC Access Undertaking – Interstate Network Response to ACCC Issues Paper*, February 2008 (FROG *February Submission*), p. 10.

provision of access overall.[42] QR argued that the exclusion of 'sidings or yards' from the December Undertaking may leave access seekers in a position where it is necessary to seek declaration of services required for the operation of a train service, while the majority of the infrastructure is covered by a voluntary undertaking.[43]

Austrack, although not explicitly referring to the sidings and yards issue, emphasised the importance of open access to terminal infrastructure for effective rail competition going forward.[44]

Extensions and the Southern Sydney Freight Line

Stakeholders were concerned about the exclusion of extensions to the network from the Undertaking. FROG, PN and QR all submitted that the June Undertaking was not clear on how ARTC proposed to deal with extensions to the network if they occurred during the regulatory period.[45]

FROG and Asciano approved of the December Undertakings clauses that dealt with ARTC seeking ACCC approval of the indicative access charge for the SSFL. FROG noted, however, that the December Undertaking did not reference or discuss the possibility that ARTC might take up responsibility for other parts of the national rail network. Overall, FROG and Asciano were concerned that the SSFL was receiving 'special treatment' and suggested that future additions to the network be subject to the same conditions as the SSFL.[46]

Assessment of Issues

Network Description and Coverage

The ACCC is concerned to ensure that the December Undertaking is clear about its exact coverage. In its June Undertaking, ARTC submitted separate A3 maps, including line diagram maps, of the NSW network entitled 'North,' 'South' and 'West' and annexed them to Schedule E as a descriptive aide to the definition of the network. Line diagram maps of the network outside NSW were not included.

The line diagram maps were, however, removed as an annexure to Schedule E of the December Undertaking. Though the December Undertaking does provide for ARTC to publish a map of the network on its website (under clause 2.7(b)(i)). The ACCC notes that any maps published by ARTC pursuant to clause 2.7(b)(i) are for illustrative purposes only, as the network is wholly defined in Schedule E of the Undertaking.

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42 Queensland Rail, *QR Submissions ACCC Response to ACC Issues Paper on ARTC Access Undertaking – Interstate Network*, February 2008 (QR *February Submission*), p. 14.

43 SCT *February Submission*, p. 6.

44 Austrak Management and Consulting, *Submission to the ACCC Regarding the Draft ARTC Access Undertaking Submitted on 20 December 2007*, February 2008 (Austrack *February Submission*), pp. 3-5.

45 Pacific National *July Submission* p. 6; Queensland Rail, *QR Submission to ACCC on ARTC Interstate Access Undertaking 2007*, July 2007 (QR *July Submission*), p. 6; FROG *July Submission*, p. 3.

46 FROG *February Submission*, p. 2; Asciano *February Submission*, p. 4.

The complexity of the geographic coverage of the network is acknowledged by ARTC in its December Explanatory guide, which states:

> …to improve clarity for access seekers, ARTC has now clarified those parts of the interstate network that are covered by the Undertaking. Primarily, the amendments seek to clarify some uncertainty expressed by stakeholders with regard to the included and excluded parts in the Newcastle region. ARTC has included on the maps, the ARTC Sector Codes that reference the written description of the Network in NSW.[47]

However, ARTC also states that:

> …it should be noted that the maps provided with the Undertaking no longer are formally part of the Undertaking. Description of the network is included at Schedule 1 of the Indicative Access Agreement. The maps provided with the Undertaking are current as at December 2007 and are intended to provide some indication as to configuration of the Network to assist stakeholders in their review. ARTC intends to publish (and update from time to time as is necessary) maps of the Network in order to assist Access Seekers as required under clause 2.7(b) of the Undertaking...[48]

The ACCC considers that the geographic scope of the network covered by the Undertaking should be clearly definable. Stakeholders have evidently been concerned that this is not the case, and in the context of the June Undertaking the ACCC sought further information from ARTC on the coverage of the Undertaking regarding Goobang Junction to The Gap, Merrygoen to Ulan and Sector 915 Islington Junction to Scholey Street Junction. ARTC stated that these lines are not covered by the Undertaking, but accepted that the maps in the June Undertaking were not clear on these line segments.

In the December Undertaking, the ACCC notes that the description of the network in Schedule E essentially mirrors Schedule 1 of the Indicative Access Agreement, with one exception — the NSW network section in Schedule E contains the provision: 'Excludes Sandgate Flyover.' The relevant Newcastle coal lines are then listed. In contrast, the IAA contains a provision which states 'Excluding the following Newcastle Coal Lines' and as such does not mention the Sandgate Flyover in its description of the network.

The ACCC also notes that, in the absence of detailed maps of the metropolitan Adelaide, Sydney and Melbourne networks on ARTC's webpage, it is not possible to accurately check these rail paths on the information publicly available.

The ACCC's preliminary view is that there are two deficiencies in the definition of the scope of the December Undertaking. First, the NSW leased network sections outlined in the Undertaking do not contain detailed information on the precise extent of the network, which does appear for the South Australian to Melbourne, NSW to Melbourne and SA/WA/NSW sections. This creates potential areas of dispute.

Second, given the complexity of ARTC's network, a purely text based description of its geographic scope is potentially unclear and open to dispute. ARTC's commitment to

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47 ARTC, *2007 ARTC Interstate Access Undertaking Additional Explanatory Guide*, December 2007, p. 20.

48 ibid.

publishing maps is not enough because the maps that are available do not have sufficient detail to clearly illustrate the text based descriptions of the network coverage in the Undertaking. For example, clarity is also required on the interface between the Interstate network on the Sydney to Brisbane route and the Hunter Valley network. In addition, it is noted that the flexibility to change the maps highlighted by ARTC is not relevant, given that the maps should present an accurate picture of the scope of the December Undertaking and it is not possible for ARTC to change that scope without applying to the ACCC to approve an amendment to the Undertaking.

Overall, the ACCC considers that there are deficiencies in the transparency and clarity of the geographic scope of the Undertaking specified in Schedule E, and in Schedule 1 of the IAA. These limitations are compounded by the absence of clear maps that are incorporated in the Undertaking and delineate its geographic coverage. Such limitations affect the enforceability of the Undertaking under s.44ZZJ. Given these limitations, the ACCC's preliminary view is that these aspects of the Undertaking do not satisfy either the public interest or interests of access seeker criteria in s.44ZZA.

Draft Decision

The ACCC's preliminary view is that clause 2.1 and Schedule E, setting out the scope of the network covered by the Undertaking, are unacceptable in terms of the requirements in s.44ZZA(3) of the Act.

Recommendation:

- That the details provided on the geographic scope of the Undertaking for the NSW leased network be similar to that provided for the ARTC owned and Victorian leased parts of the network; and

- That ARTC include maps that delineate the network covered by the Undertaking.

Associated Facilities

The ACCC asked ARTC to clarify whether sidings and yards were included in the definition of 'associated facilities' in the June Undertaking. In the December Undertaking, ARTC changed the definition of 'associated facilities' to clarify that sidings and yards are excluded and indicated to the ACCC that this definitional change simply reflected ARTC's original intention.

The ACCC considers that a siding is a track section distinct from a mainline, crossing loop, authority point, turnout or associated facility and it is used for purposes auxiliary to the network provider providing a train path to an operator. Auxiliary purposes may include storing rolling stock and maintaining equipment, making up trains or loading and unloading goods. The ACCC considers a yard to be the land surrounding a siding, which is used for purposes associated with sidings.

In its January Issues Paper, the ACCC asked stakeholders to comment on the exclusion of sidings and yards from the definition of associated facilities. The ACCC also asked

stakeholders, in formulating their response, to take note of the fact that the December Undertaking is a voluntary undertaking and that ARTC is not obliged to include any particular facilities in the Undertaking unless it can be demonstrated that their exclusion would undermine the effectiveness of the regime such that it is no longer appropriate for the ACCC to accept the Undertaking, having regard to s.44ZZA of the Act.

As noted above, the ACCC received submissions from stakeholders on this issue including submissions that argued that the exclusion of sidings and yards from the definition of associated facilities may break the network into different jurisdictions which are subject to different access agreements.[49]

The ACCC notes, however, that while the submissions highlighted the potential inconvenience caused by not including sidings in the Undertaking, they did not provided concrete evidence to demonstrate that excluding sidings makes the Undertaking unworkable, or the extent to which it would go against the promotion of efficient use of the infrastructure. As a result, the ACCC believes that there is insufficient information at present to conclude that the exclusion of sidings and yards from the definition of associated facilities would make it inappropriate for the ACCC to accept the Undertaking, having regard to s.44ZZA of the Act.

Draft Decision

The ACCC's preliminary view is that, on the basis of the information currently before it, the exclusion of sidings and yards from the definition of 'Associated Facilities' in the December Undertaking does not raise objections under Part IIIA of the Act.

Extensions and the Southern Sydney Freight Line

The scope of the December Undertaking proposed by ARTC clearly identifies that the only extension to the network ARTC currently intends to include in the Undertaking is the SSFL. The ACCC recognises some interested parties' views that other extensions to the network should be treated the same as the SSFL, but notes that this is a voluntary Undertaking. As was discussed with sidings and yards, ARTC is not obliged to include any particular facilities in the Undertaking unless it can be demonstrated that their exclusion would undermine the effectiveness of the regime such that it is no longer appropriate for the ACCC to accept the Undertaking, having regard to s.44ZZA of the Act. The ACCC does not have sufficient evidence to conclude this is the case for all extensions to the network.

ARTC has chosen to include in the December Undertaking provisions that allow for coverage of the SSFL, once it is commissioned, and the ACCC has assessed the appropriateness of these provisions.

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[49] Pacific National *July Submission*, p. 52; Asciano *February Submission*, p. 5; FROG *February Submission*, p. 10; QR *February Submission*, p. 14.

The provisions covering the SSFL specify that ARTC will develop and submit for ACCC approval the indicative charge to apply to the SSFL (clause 2.4(b)). ARTC intends to submit the indicative access charge at least six months prior to the SSFL being commissioned for service. The December Undertaking would not cover the SSFL until the applicable indicative access charge has been accepted by the ACCC (clause 2.1(c)). The ACCC considers that the provisions relating to the SSFL in the December Undertaking are reasonable as they provide certainty for access seekers about the process for covering the line, and do not protect the SSFL against declaration unless the ACCC is satisfied that the charges proposed for the line are appropriate.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 2.4 setting out ARTC's approach to the SSFL do not raise objections under Part IIIA of the Act.

D.2.2. Grant and Duration of the Undertaking

ARTC's Proposal

ARTC undertakes that it will comply with the terms and conditions specified in the December Undertaking in granting of access to its Network and proposes that the Undertaking take effect one month (30 days) after it is accepted by the ACCC and continue until the earlier of:

- the expiry of the term; or
- withdrawal of the Undertaking in accordance with the undertakings terms of the Act.

Views of Interested Parties

Parties did not specifically raise concerns with the triggers for commencing and ceasing the Undertaking. However, interested parties were concerned at there are no statutory protections available to access seekers between the expiry of one undertaking and the execution of a new undertaking, apart from the ability to apply for a service to be declared. PN noted that this 'gap' period was:

> …disruptive to the industry and raises considerable uncertainty. It is therefore suggested that the Undertaking should address this issue through the insertion of an obligation on ARTC to seek approval for an extension of the undertaking from the ACCC in circumstances where a replacement will not be approved prior to its expiry. Clearly this would not be appropriate in the circumstance where there is an intention not to have an undertaking at all, however, where the intention is that a new undertaking will replace an existing one then it is reasonable to extend the existing provisions, provided that this is not seen as giving an incentive to delay the introduction of a new undertaking. As the extension would be subject to the approval of the

> ACCC, this should not be an issue as the ACCC will have the opportunity to assess the benefits of extension against any negatives that might result.[50]

QR also submitted that it would be advisable to have certainty beyond the proposed regulatory period.[51] QR believed that from the expiry of the 2002 Undertaking to the expected approval of the current Undertaking, access seekers are required to negotiate with ARTC in an environment without access to formal dispute resolution procedures and it believed that this was commercially unacceptable.[52]

SCT shared similar concerns and submitted that the sudden end of the June Undertaking is problematic as freight contracts run for several years.[53]

Assessment of Issues

Commencement of Undertaking

ARTC proposes that the Undertaking take effect 30 days after it is approved by the ACCC. The ACCC considers that 30 days would allow ARTC and operators to achieve a smooth transition to negotiating access pursuant to the provisions of the Undertaking. However, it is inconsistent with the Act. Paragraph 44ZZBA(1)(a) states that an undertaking takes effect 21 days after the ACCC publishes its decision. The ACCC also considers that a period of 21 days is also sufficient time for ARTC and operators to achieve a smooth transition.

Consequently clause 2.2 of the December Undertaking should be redrafted so that it is consistent with s.44ZZBA and 44ZZBF of the Act.

Draft Decision

Recommendation:

The ACCC's preliminary view is that the ARTC Undertaking should be amended to replace clause 2.2 with:

ARTC undertakes to the ACCC that it will comply with the terms and conditions specified in this Undertaking in relation to the grant of Access to Operators to the Network for Services. This Undertaking takes effect twenty-one (21) days after it is accepted by the ACCC, subject to section 44ZZBF *of the Act and will continue until the earlier to occur of:*

(a) the expiry of the Term; or

(b) withdrawal of this Undertaking in accordance with its terms and the Act.

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50 Pacific National *July Submission*, p. 5.

51 QR *February Submission*, p. 14.

52 ibid.

53 SCT Logistics, *Submission on the ARTC Undertaking*, July 2007 (SCT *July Submission*), p. 9.

Gap Period

The ACCC also notes that when an undertaking expires there are no statutory protections available to access seekers between the expiry of one undertaking and the execution of a new undertaking, unless an access seeker applied for, and obtained, declaration of the service provided by ARTC's network.

The resulting 'gap' between undertakings can be considerable and can contribute to uncertainty in the industry. Access seekers may also be uncertain over the status of access negotiations that crossover into periods of time that are not subject to an undertaking. In addition, it is not possible to ensure that access arrangements concluded during the gap period are consistent with either the old or the new Undertaking, which could undermine an important ongoing principle in ARTC's access regime, such as not discriminating between access seekers in like circumstances.

The ACCC considers that the uncertainty during 'gap' periods is an important issue, especially considering that these gaps are often lengthy. As it is undesirable to have a prolonged gap, the ACCC considers that in the future ARTC should seek an extension of the operation of the Undertaking to 'fill the gap' until a new Undertaking is executed.

In this context, the ACCC believes that, having regard to the objects of s.44ZZA(3) of the Act, access seekers should benefit from a regulatory regime that reduces uncertainty during 'gap' periods. It proposes that clause 2.2 of the December Undertaking be amended to provide a process for anticipating future Undertakings and extending the operation of any expiring undertaking to fill any potential gap.

Draft Decision

Recommendation:

The ACCC's preliminary view is that Clause 2.2 of the December Undertaking should be amended to address the following:

- Three months prior to the expiry of the term of the Undertaking ARTC will submit to the ACCC a written statement outlining whether or not it intends submit a new voluntary Undertaking to the ACCC for its consideration.
- If ARTC intends to submit a new voluntary Undertaking to the ACCC for its consideration; ARTC would also apply to the ACCC for an extension of the expiring Undertaking, pursuant to Part IIIA s.44ZZBB of the TPA.
- The extension application would include a proposed extension period which, in ARTC's view, reasonably estimates the time it would take for ARTC to formulate a new Undertaking and have that Undertaking take effect following approval by the ACCC.
- If ARTC does not propose to submit to the ACCC a new voluntary Undertaking the recommendations above would not be applicable. Nothing in the clause would

prevent ARTC from submitting a voluntary Undertaking to the ACCC at any time in the future.

D.2.3. Term of the Undertaking

ARTC's Proposal

ARTC originally proposed a five-year regulatory term in its June Undertaking. In the December Undertaking it extended the proposed regulatory term to ten years.

ARTC believes that this longer term would increase certainty in the industry and promote greater commitment and investment by network users. ARTC also believes that a ten-year term would assist in achieving the modal shift from road to rail that underpins its investment in the North-South corridor, as this shift depends on complementary investment in above rail assets.

ARTC proposes that the risk associated with a longer regulatory period lies with ARTC, as it would be making a commitment in an industry environment that is yet to stabilise. However, ARTC believes that the benefits for industry investment, growth and sustainability outweigh the risks.[54] ARTC also noted that it can mitigate these risks by seeking to amend the Undertaking, if warranted.

ARTC notes that increasing the term of the Undertaking will increase its administrative costs, due to its need to extend its financial modelling and projected increases in capital expenditure. It has proposed to mitigate these extra costs by:

- not furnishing the ACCC with detailed revenue and expenditure forecasts for the whole Undertaking, but, rather, project ceiling limits, floor limits and revenue out for the second years; and

- providing the ACCC with a new set of five-year capital expenditure estimates during the fifth year of the Undertaking, rather than providing them now.

Views of Interested Parties

The parties' views about the possible benefits and detriments of an Undertaking with a ten-year term were varied. A number of stakeholders gave the concept of a ten-year term qualified support, in principle, but raised questions about its suitability in the specific instance of the December Undertaking.

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[54] ARTC, *2007 ARTC Interstate Access Undertaking Additional Explanatory Guide*, December 2007, pp. 5-6.

El Zorro supported a ten-year term but had concerns as to whether it would really 'increase certainty' and 'promote greater commitment and investment by users of the network.'[55]

SCT and PN suggested, in the context of the June Undertaking, that a five-year term was too short as the investment timeframe for a rail operator is between ten and twenty years.[56] However, while they supported the concept of longer term undertakings in principle, both argued that December Undertaking should be shorter in duration because of other concerns they had about the suitability of the Undertaking.[57]

All other submissions raised some concerns about the ten-year term proposed by ARTC:

- Asciano submitted that the benefit of a ten-year term may be significantly reduced if the December Undertaking needs to be revised to allow for changes to the network's definition or parameters;[58]

- FROG submitted that increasing the term to ten years increases the risk that the network would change substantially before the expiry of the term;[59]

- GSR argued that more certainty is needed in the pricing of non-indicative services and, in its absence, a five-year term is preferred. GSR also submitted that a ten-year undertaking would prevent it from seeking declaration of the network in the event that it was dissatisfied with the access prices set by ARTC.[60] In its view, this situation would be contrary to the interests of access seekers and the criteria in s.44ZZA(3) of the Act;[61]

- Austrack submitted that the interaction between ARTC's operations and intermodal terminals should be taken into account more fully if the term of the December Undertaking is extended to ten years;[62]

- QR supported retention of a five-year undertaking term, given the relative immaturity of Australia's rail industry.[63] In particular, QR cited that the implementation plan for the Competition and Infrastructure Reform Agreement includes a commitment to developing a National Rail Access Code. QR argued

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55 El Zorro, *Re: ARTC Issues Paper 2008*, January 2008, p. 1.

56 Pacific National *July Submission*, p. 5.

57 SCT *February Submission*, p. 2.

58 Asciano *February Submission*, p. 4.

59 FROG *February Submission*, p. 2.

60 Great Southern Rail, *ARTC – Access Undertaking December 2007*, February 2008 (GSR *February Submission*), p. 2.

61 ibid.

62 Austrack Management and Consulting, *Submission to the ACCC Regarding the Draft ARTC Access Undertaking submitted on 20 December 2007*, p. 5.

63 QR *July Submission*, p. 7.

that a ten-year undertaking might undermine national consistency in rail access if a national code is adopted before the ARTC December Undertaking expires; and

- QR acknowledged that the greater risk inherent in providing long term certainty in access terms and conditions lies with ARTC,[64] but questioned whether operators would be exposed to the risk that long term certainty would be priced at a premium into access agreements, reflecting the value of the ARTC's risk.[65]

Assessment of Issues

The Act does not specifically indicate what regulatory term should be adopted for an undertaking accepted by the ACCC. The ACCC must, however, assess the proposed term against the criteria in s.44ZZA(3).

In its decision on the 2002 Undertaking, the ACCC considered that a five-year period, then proposed by ARTC, was reasonable given that the rail industry was undergoing substantial change. The ACCC considered that a five-year period provided an opportunity to reassess the Undertaking in light of developments in the industry and did not preclude ARTC and operators from entering longer term access arrangements.

The issues for assessing the term of this Undertaking are:

1. Would a ten-year Undertaking undermine national processes?

2. Do the concerns raised by stakeholders about issues such as pricing for non-indicative services warrant a shorter period?

3. Is ten years too long given the current state of the rail industry?

In considering whether a ten-year term for the Undertaking is reasonable, the ACCC notes that a longer term provides scope for ARTC to maximise cost recovery (by providing an environment for more above rail investment and growth in the use of rail services). The ACCC also agrees that a ten-year term for the Undertaking may help promote efficient investment in above rail services, as the investment time for an above rail operator investing in terminals, locomotives and rolling stock is typically ten to twenty years. The ACCC considers that, to the extent that a longer Undertaking facilitates investment, it is also likely to contribute to promoting competition in the rail industry.

One of the assessment criteria the ACCC must be mindful of is whether the Undertaking is in accordance with an access code that applies to the service (s.44ZZA (3)(da)). The ACCC notes that no access code applies at this time and, therefore, the Undertaking is not inconsistent with s.44ZZA(3)(da). It has, however, been nationally agreed that a National Rail Access Code would be developed.

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64 ibid., p. 5.

65 ibid.

The ACCC notes that the provisions of the Competition and Infrastructure Reform Agreement provide that any National Rail Access Code would be developed 'through an agreed approach to the application of the Australian Rail Track Corporation access undertaking model including pricing and access mechanisms that will be appropriate if vertically integrated operators retain control of relevant sections of track' (clause 3.2 of the Competition and Infrastructure Reform Agreement). As such, the ACCC considers that the national process explicitly recognises that there will be an ARTC Undertaking in place that provides a backdrop to the negotiation of a national approach to rail access. The ACCC does not consider that accepting a ten-year undertaking would undermine the ability of industry participants to jointly develop a National Rail Access Code. In fact, given that such national processes are often lengthy, having longer term certainty about the ARTC Undertaking could be of benefit, as it would reduce the likelihood that the ARTC Undertaking could expire while the national process is being finalised. Thus certainty about ARTC's Undertaking potentially furthers, rather than hinders, the national process.

Considering the other issues raised by interested parties, the ACCC notes that most submissions gave qualified support for a longer regulatory term and that their concerns about the term in this Undertaking were linked to broader concerns about the Undertaking's scope and provisions. The ACCC has taken these broader concerns into account in assessing the Undertaking and either assessed that the other provisions are appropriate or identified the need for some change to the Undertaking. The ACCC, therefore, does not consider that the broader issues raised by parties warrant a shorter term for the Undertaking.

Finally, rail access regimes have now been operating in Australia for some years and are well understood by industry and rail infrastructure owners and there have been few formal disputes about access to the ARTC network. While the rail industry is growing and developing, the ACCC does not consider that the industry is so unstable that a fresh assessment of access terms and conditions would be needed after five years. In addition, the five-year review of the Undertaking proposed in the following section would help identify if there was a need for ARTC to seek an amendment to the Undertaking. The ACCC has also looked at the financial position of ARTC and concluded that its level of cost recovery will not reach the regulatory ceiling over the proposed ten-year term, so again ARTC's circumstances are unlikely to change to the point that reconsidering the access regime is warranted. The ACCC has therefore concluded that ARTC's proposed regulatory term is reasonable.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 2.3 setting out ARTC's Undertaking term do not raise objections under Part IIIA of the Act.

D.2.4. Review of the Undertaking

ARTC's Proposal

Clause 2.4 of the Undertaking states that ARTC will review the Undertaking in the following circumstances:

- if, during the term, ARTC is of the opinion that circumstances have changed such that the Undertaking is no longer commercially viable for ARTC or becomes inconsistent with the Undertaking's objectives (clause 2.4(a));

- at least six months prior to the commissioning for operations of the SSFL, ARTC intends to develop and submit to the ACCC, the indicative access charge that will apply to the SSFL (clause 2.4(b)); and

- by 31 December 2011, ARTC will develop and submit to the ACCC, capital expenditure in the form of an extended Schedule H, applicable to the period 1 July 2012 to 30 June 2017 (clause 2.4(c)).

The Undertaking (clause 2.4(d)) also states that ARTC will consult with operators regarding a variation to the Undertaking and it may only vary the Undertaking with the consent of the ACCC.

Views of Interested Parties

Parties did not raise concerns about the review of the Undertaking, except in regard to capital expenditure.[66] The issue of capital expenditure and associated review provisions are discussed in chapter D.7 of this draft decision.

Assessment of Issues

The issues surrounding the provision by ARTC of an indicative access charge prior to the commissioning of the SSFL (clause 2.4(b)) were addressed earlier in this chapter.

The ACCC notes that once accepted by the ACCC the December Undertaking is legally binding on ARTC. Whilst an operator cannot initiate a review, the interests of operators are protected by the fact that any review is subject to approval by the ACCC and will be conducted under the provisions of Part IIIA of the Act. Further, any amendments proposed by ARTC during the term of the Undertaking would also be subject to the provisions of the Act and ARTC proposes to consult operators prior to seeking a review (clause 2.4(d)).

However, the ACCC is mindful that, over the next ten years, there could be changes, such as government policy reforms (for example environmental policy changes), which may directly affect the rail industry and whether the Undertaking continues to meet the needs of operators. In this sense, the ACCC is concerned that the December Undertaking should be flexible enough to adapt to any such changes.

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[66] Pacific National *July Submission*, p. 22; FROG *February Submission*, p. 2.

To ensure that ARTC formally considers the ongoing effectiveness of the Undertaking, the ACCC recommends that the December Undertaking include a clause requiring ARTC to review the Undertaking after five years, in consultation with stakeholders, to ascertain whether it continues to meet the needs of access seekers. This review would not require any assessment process by the ACCC.

Draft Decision

Recommendation:

- That the Undertaking include a provision requiring ARTC to undertake a review, in consultation with stakeholders, of the Undertaking after five years.

D.2.5. Existing Contractual Agreements

ARTC's Proposal

The December Undertaking applies only to the negotiations of new access agreements or the negotiation of access rights in addition to those already the subject of an access agreement. A party to an existing access agreement is not required to vary a term or provision of that agreement (clause 2.5).

However, the IAA attached to the December Undertaking proposes that an operator may give ARTC notice in writing, not less than 120 days prior to expiry of an access agreement, that it wishes to renew the agreement in relation to its scheduled train paths. ARTC may consent to this renewal of scheduled train paths and enter into a new agreement with the operator on terms and conditions in accordance with the access undertaking in force at the time.[67]

This is in contrast to the previous 2002 Indicative Access Agreement which required operators to provide only 60 days to give notice regarding the renewal of an agreement and gave operators an automatic right of renewal.

ARTC submits that the 2002 IAA enabled an operator to 'lock in' paths indefinitely (known colloquially as 'grandfathering rights'). Whereas the December Undertaking now provides that guaranteed path entitlements will not exceed the term of the access agreement.[68] Under clause 2.9 of the IAA, the operator does not have any automatic or enforceable rights of renewal or extension of any scheduled train path under the access agreement.

Views of Interested Parties

Given that the Undertaking does not affect existing contractual rights, FROG noted its concern about how ARTC intends to deal with 'differential pricing' that may arise if

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67 ARTC, *Explanatory Guide to the 2007 Interstate Access Undertaking*, June 2007, p. 30.

68 ibid.

there is a conflict between a contract previously entered into and the December Undertaking.[69]

QR noted that an incumbent must notify ARTC that it wishes to renew its agreement not less than 120 days before its existing contract expires. If another party lodges an access application with ARTC around that time, the Undertaking provides a process for notifying both parties and ultimately granting access in accordance with clause 5.3 of the Undertaking. QR submitted that it is unclear how ARTC will manage the receipt of access applications received prior the expiry of an existing agreement.[70]

Assessment of Issues

The ACCC considers that an undertaking provides a mechanism to facilitate the negotiation of terms and conditions of access, including more advantageous terms and conditions than may be provided for in the Undertaking itself. However, it is not the purpose of an Undertaking to act as an instrument for improving terms and conditions in existing access arrangements. That is, the ACCC notes that the December 2007 Undertaking does not diminish existing contractual rights and agreements negotiated under the 2002 Undertaking. That said, ARTC is obliged not to differentiate between access seekers in like circumstances, so that in negotiating new contracts under the December Undertaking ARTC would need to take account of the provisions in existing contracts for like services.

In assessing the December Undertaking the ACCC considered whether the rights to renegotiate agreements provided for in the Undertaking and the IAA are appropriate and whether the rights of all access seekers are sufficiently clear.

The renewal notice period for operators has been extended in the December Undertaking from 60 to 120 days and the terminology of the clause has changed from 'long term contracted train paths' to 'scheduled train paths.'[71] Also, the provisions in clause 2.9 of the IAA no longer compel ARTC to renegotiate a new agreement, as an operator no longer has any automatic or enforceable rights of renewal.

The ACCC considers that the 120 days provided for in the December Undertaking allows sufficient time for renegotiation of existing contracts. It also considers that providing 120 days to renegotiate contracts, while precluding operators from 'locking in' existing train paths in perpetuity, is an appropriate balance as it allows some level of contestability in the market, as it allows ARTC to take into account network capacity constraints and demand, while operators have sufficient scope to renegotiate train paths before the expiry of an existing agreement.

In addition, the ACCC considers that the clarity and certainty in the rules for renegotiating contracts have been improved as ARTC has inserted into Schedule C of the December Undertaking (Essential Elements of an Access Agreement) a clause stating that the renegotiation of scheduled train paths is to be consistent with clause 2.9

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69 FROG *February Submission*, p. 11.

70 QR *July Submission*, p. 13.

71 ARTC, *Explanatory Guide to the 2007 Interstate Access Undertaking*, June 2007, p. 30.

of the IAA. An access agreement negotiated under this Undertaking must address the essential elements set out in Schedule C, unless otherwise agreed by the parties. By including this reference in Schedule C, the ACCC believes that there are now well defined rules in the Undertaking that would assist operator in understanding ARTC's approach to renegotiating all contracts, not just those for indicative services.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 2.5 setting out ARTC's approach to existing contractual agreements under the Undertaking do not raise objections under Part IIIA of the Act.

D.2.6. ARTC's Insurance

ARTC's Proposal

ARTC proposes that it will take out and maintain liability insurance with a limit of not less than $250 million. This is an increase on the 2002 Undertaking, in which ARTC was required to take out an insurance policy with a limit of not less than $200 million.

ARTC submits that it is seeking consistent insurance arrangements for itself and access seekers over the whole network, citing that $250 million is the minimum cover required by the NSW Government under ARTC's lease of the NSW assets.[72]

Views of Interested Parties

FROG and PN submitted that while $250 million insurance coverage may be appropriate for access seekers operating in NSW, there is little reason to require that amount for operators elsewhere.[73] FROG also argued that while it supports 'consistent arrangements over the whole of the network,' insurance was not an area in which consistency was necessary.[74] FROG questioned whether ARTC is obliged to provide coverage with a limit of not less than $250 million, it considered that the NSW safety legislation requires parties to have an appropriate level of coverage, but does not specify any particular amount.[75] FROG noted, by way of example, that RailCorp requires a minimum of $250 million for insurance, but noted that it was not aware that the same obligation necessarily applied to operations outside of Sydney.[76]

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[72] ibid., p. 25.

[73] Pacific National *July Submission*, p. 49; FROG *July Submission*, p. 14.

[74] FROG *July Submission*, p. 14.

[75] ibid.

[76] ibid.

FROG and PN argued that the quantum of insurance should be determined by the risk of a particular operation, and submitted that it is appropriate to allow some variation to avoid placing unnecessary burdens on less risky parties.[77]

Assessment of Issues

The ACCC considers that while insurance premiums add to an operator's costs, it is in the public interest that comprehensive insurance cover is held by ARTC and by operators, to ensure that losses caused in connection with the network can be compensated for and damage to infrastructure repaired.

The ACCC notes the submissions by parties that requiring $250 million insurance across the network on the basis of the NSW government requirements may raise costs for operators who do not use the NSW network. The ACCC considers, however, that given the use of $250 million by the NSW government and that inflation is likely to have increased the cost of incidents since the 2002 Undertaking, $250 million in insurance coverage does not seem unreasonable. There may also be some added advantages of adopting a consistent insurance policy across the ARTC network, as network traffic is interconnected and accidents associated with the NSW network may affect operators on other parts of the network.

The ACCC also notes parties' submissions that insurance costs should reflect the risks incurred by individual operators. While there is an intuitive logic to setting variable insurance costs according to the risks incurred by, or associated with, individual operators, the ACCC considers that ARTC's administrative costs in determining operator risks are substantial and would provide an avenue for costly and inefficient disputes. These factors would undermine the intent of an undertaking to provide certainty and would also be contrary to the Council of Australian Governments' intention to promote harmonised national rail access arrangements.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 2.6 setting out ARTC's insurance commitments do not raise objections under Part IIIA of the Act.

[77] ibid., pp. 14-15; Pacific National *July Submission*, p. 49.

D.3. Negotiating for Access and Dispute Resolution

Summary

One role of an undertaking is to clarify for access seekers and the access provider the terms and conditions of access and the access negotiation process. Part 3 of ARTC's Undertaking outlines the negotiation and dispute resolution processes ARTC will follow when negotiating access with an access seeker.

Key elements of ARTC's negotiation framework include: preliminary meetings and exchange of information between access seekers and ARTC; submission of an access application by the access seeker; preparation of a response (known as an Indicative Access Proposal) by ARTC; negotiations to develop an access agreement; and dispute resolution procedures including negotiation, meditation and arbitration. The Undertaking provides that either party may give a dispute notice if any dispute arises under the Undertaking or in relation to the negotiation of access between ARTC and an access seeker. If a dispute is referred to arbitration, the arbitrator would be the ACCC.

The ACCC's draft assessment recommends two changes to Part 3 of ARTC's negotiation process. First, that ARTC provide written reasons to an access seeker if it ends access negotiations because it has evidence the applicant no longer meets the prudential requirements. Second, that the Undertaking be amended to make it clear that ARTC is obliged to offer the Indicative Access Agreement to an operator seeking to run indicative services.

D.3.1. Objective, Framework and Provision of Information

ARTC's Proposal

ARTC's broad objective is to encourage use of its network by negotiating with an access seeker in good faith (clause 3.1). ARTC submits that any access negotiation process should be flexible to suit the specific circumstances of the applicant seeking access and provide certainty to industry as to how access applications would be handled. To achieve this, ARTC's proposed negotiation framework (clause 3.2) provides for:

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

- both ARTC and the applicant are to negotiate in good faith.

To assist applicants to negotiate for access, ARTC proposes to provide applicants with the following information (clause 3.3):

- path length availability;
- available capacity;
- axle load limitations;
- maximum allowable speeds;
- infrastructure characteristics;
- applicable safe working requirements;
- segment run times;
- DORC values in relation to the segment to which access is being sought; and
- the incremental costs and economic cost for the segment to which access is being sought.

ARTC also proposes that outside of certain standard information, that is, information that is not ordinarily and freely available to ARTC, it will provide additional information subject to having the opportunity to estimate the reasonable cost of preparing such information and the applicant agreeing to pay such costs (clause 3.3(a)(x)).

ARTC's rationale for clause 3.3(a)(x) is that preparing additional information, not normally held, can be complex and costly and it is reasonable to recover the cost of providing such information. Moreover, ARTC submits that such a clause would discourage applicants from seeking substantial information in excess of normal requirements, without considering the cost involved.[78]

Views of Interested Parties

There were only limited comments from interested parties on the framework for negotiation and the provision of information. PN noted that:

> Generally speaking, the information nominated by ARTC to be provided to an access seeker is helpful.[79]

However, PN also observed that the information to be provided by ARTC to access seekers is less comprehensive than that required under the NSW Rail Access

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[78] ARTC, *2007 Interstate Access Undertaking Explanatory Guide*, June 2007 p. 25.

[79] Pacific National, *Submission to ACCC RE: Approval of ARTC Interstate Access Undertaking*, July 2007 (Pacific National *July Submission*), p. 8.

Undertaking. NSWMC suggested, with some qualifications, that the minimum information required should be that outlined in Schedule 5 of the NSW Access Undertaking.[80]

Assessment of Issues

An effective negotiation framework is important to facilitating third party access, including the provision of sufficient information to enable access seekers to engage in meaningful negotiations with ARTC. For interstate rail services, the ACCC notes that there have not been any problems identified with the level of information ARTC has provided in the past.

The ACCC also recognises that, due to the individual circumstances of the access seeker, access applications are unlikely to be identical and negotiations may vary substantially from application to application. Therefore, the ACCC does not consider that it is practical or effective to prescribe all the information that should be initially provided to a potential access seeker and, as result, considers that the information provisions in the Undertaking meet access seekers' initial needs.

In terms of clause 3.3(a)(x), where the applicant is required to pay the costs of providing 'other information,' the ACCC believes that such a clause is reasonable as it encourages access seekers to ensure they request relevant information and do not make frivolous information requests.

However, the ACCC also believes that an applicant should only be required to pay the costs of providing 'other information' if that information is not ordinarily and freely available, as is provided for in clause 3.3(a)(x) and 3.3(b)(ii) of the Undertaking.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 3.1, 3.2 and 3.3 setting out ARTC's provisions of information do not raise objections under Part IIIA of the Act.

D.3.2. Parties to Negotiation

Clause 3.4 of the Undertaking sets out the conditions under which ARTC would commence and cease negotiations and outlines the prudential and accreditation requirements an access seeker must meet before ARTC would commence access negotiations. Where an access seeker fails to meet these requirements, ARTC may cease or refuse to negotiate.

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[80] New South Wales Minerals Council (NSWMC), *Response to Australian Competition and Consumer Commission Issues Paper regarding Australian Rail Track Corporation 2007 Access Undertaking for its Interstate Rail Network*, August 2007 (NSWMC *August Submission*), p. 14.

ARTC's Proposal

ARTC proposes to only negotiate with access seekers that:

- comply with the requirements and processes set out in the Undertaking (clause 3.4(a));
- are an accredited operator or, where the access seeker is not an accredited operator, it will procure the services of an accredited operator and either the access seeker or the accredited operator meets all the terms and conditions of the access agreement (clause 3.4(b)); and
- can meet the following prudential requirements (clause 3.4(d)):
  - be solvent (3.4 (d)(i));
  - not be currently in material default or have not been in material default, in the previous two years, of any agreement with ARTC or any agreement in accordance with which access to rail infrastructure has been provided to the access seeker or a related party of the access seeker (3.4(d)(ii)); and
  - demonstrate financial adequacy — that is, have a legal ownership structure with a capital base and asset value to meet the actual or potential liabilities under an access agreement, including timely payment of access charges and insurance premiums (3.4(d)(iii)).[81]

In relation to financial adequacy, ARTC stated that:

> In order to mitigate credit risk associated with the difficulty associated with seeking recourse against a customer or operator, that forms part of more complex legal and financial entity structure, ARTC is seeking to extend its prudential test to include demonstration that an access seeker has sufficient resources to meet actual or potential liabilities that might meet under an access agreement.[82]

The Undertaking provides for ARTC to refuse to negotiate with an applicant if any of the above conditions are not met. If ARTC refuses to negotiate for reasons as described in clause 3.4(a) and 3.4(c), ARTC will provide a written explanation to the access seeker within ten business days (clause 3.4(e)). If an access seeker considers ARTC has unreasonably refused to commence or subsequently unreasonably ceased negotiations, the access seeker may refer the matter to arbitration in accordance with the Undertaking (clause 3.4(f) and (g)). Lastly, it is worth noting that in the December Undertaking, ARTC has amended clause 3.4(d)(iii) to remove the requirement to demonstrate to 'the reasonable satisfaction of ARTC' that an access seeker has sufficient financial resources to meet its obligations.

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[81] See clauses 3.4(a) to (d) of the Undertaking.

[82] ARTC, *2007 ARTC Interstate Access Undertaking, Explanatory Guide*, June 2007, p. 25.

Views of Interested Parties

Prudential Requirements

Several submissions raised issues about clause 3.4(d)(ii) and ARTC's right to refuse to negotiate if an applicant or a related party to that applicant is (or has been in the previous two years) in material default of any access contract. For example, the NSWMC argued the material default provisions of the Undertaking are too restrictive and act as an inappropriate barrier to negotiation.[83] PN also argued that:

> ARTC should be able to avoid negotiation with a party that has materially defaulted with ARTC within the previous two years period, but the extension to other parties is inappropriate.[84]

PN submitted that a material default, under another contract, may arise for a number of reasons and could certainly include matters other than those of a prudential nature (for example, defaults on operational matters).[85]

Similarly, GSR argued that:

> ….the requirement that neither the applicant nor any related party be in material default of any agreement in accordance with which access to rail infrastructure not managed by ARTC has been provided to the applicant or a related party of the applicant is not commercially reasonable or appropriate. It exceeds what is required to satisfy ARTC's legitimate business interests and is overly onerous for access seekers.[86]

Finally, SCT suggested that the Undertaking is unreasonably loose in allowing ARTC full discretion in applying the prudential criteria. SCT submitted:

> We would suggest that as a minimum, whenever the ARTC exercises discretion, it be required to inform the other party in writing of its decision and the reasons for that decision giving the other party in turn the right to challenge this in a court or arbitration forum.[87]

Financial Adequacy

When the June Undertaking was submitted, PN and FROG raised concerns about clause 3.4(d)(iii), which requires an applicant to demonstrate its financial adequacy to meet its actual or potential liabilities under an access agreement. PN noted that this clause was a new requirement, compared with ARTC's 2002 Undertaking, and PN and FROG submitted that it is unclear why such an obligation should be placed on an access seeker over and above the protections available to ARTC through the solvency requirements of the Undertaking.[88] PN stated that:

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83 NSWMC *August Submission*, p. 15.

84 Pacific National *July Submission*, p. 9.

85 ibid., p. 8.

86 Great Southern Railway Limited, *Submission RE: Australian Rail Track Corporation Access Undertaking*, August 2007 (GSR *August Submission*), p. 31.

87 SCT Logistics, *Submission on the ARTC Undertaking*, July 2007 (SCT *July Submission*), p. 10.

88 Freight Rail Operators Group (FROG), *ARTC Interstate Access Undertaking Submission to ACCC*, July 2007 (FROG *July Submission*), p. 18; Pacific National *July Submission*, p. 9.

> If what is meant is some form of current financial adequacy test…then (the) undertaking ought to specify the test which ARTC will apply to determine whether the criteria have been met.[89]

NSWMC submitted that clause 3.4(d)(iii) would become a time consuming cost imposition on applicants and an unnecessary barrier to negotiation, arguing:

> It is a requirement that can, is, and would normally be, addressed in the Access Agreement. The subclause should be removed from the Undertaking.[90]

The release of the December Undertaking and the revised wording of clause 3(d)(iii) has not allayed stakeholder concerns. FROG remarked that the changes 'do little to clarify the issue, nor to give any confidence that the matter will be appropriately dealt with.'[91] QR went further and argued that the test for financial adequacy is more onerous than in the June Undertaking:

> 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 (to) both 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.[92]

SCT expressed a similar sentiment to QR and FROG stating that it believed the financial adequacy criteria were unreasonable and noted that state rail access regimes in Victoria, Queensland and NSW do not have 'extreme' financial adequacy requirements such as clause 3.4 d(iii).[93]

SCT also commented that the use of deposits, bonds and guarantees is standard commercial practice if one party to a transaction is concerned about the creditworthiness of the counter party, but the December Undertaking does not employ such standard commercial mechanisms.[94]

Assessment of Issues

The ACCC considers that ARTC should not be obliged to negotiate with an access seeker that is not genuine about gaining access to its network nor has the capacity to meet the obligations of an access agreement. It is appropriate for ARTC to be able to 'screen' applicants to ensure unsuitable operators are identified and excluded from the negotiation process.

Part of this 'screening' process includes ensuring applicants are of good financial standing. In this regard, the solvency requirements and the 'financial adequacy' aspects of the Undertaking appear reasonable in that they give ARTC comfort that a potential

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89 Pacific National *July Submission*, p. 9.

90 NSWMC *August Submission*, p. 15.

91 Freight Rail Operators' Group (FROG), *ARTC Access Undertaking – Interstate Network Response to ACCC Issues Paper*, February 2008 (FROG *February Submission*), p. 3.

92 Queensland Rail, *Response to ACCC Issues Paper on ARTC Access Undertaking – Interstate Network*, February 2008 (QR *February Submission*), p. 6.

93 SCT Logistics, *Submission on the ARTC Undertaking*, February 2008 (SCT *February Submission*), p. 3.

94 ibid.

access seeker can fulfil its financial obligations under an access agreement and protect the legitimate business interests of ARTC.

Provisions such as clause 3.4(a), which reserves ARTC's right to negotiate only with applicants who comply with the relevant obligations and processes set out in the Undertaking, also protect ARTC's legitimate business interests from frivolous or vexatious applications. The ACCC is of the view that these provisions are balanced by the requirement for ARTC to provide to access seekers written reasons if it refuses to negotiate. Moreover, access seekers interests are further protected by the availability of a dispute resolution process.

Many of the prudential requirements of ARTC's access undertaking (i.e. clauses 3.4(d)(i) and 3.4(d)(ii)) are generally consistent with other rail access regimes in Australia, which also require access seekers to demonstrate that they have the necessary financial resources to carry on the proposed rail operations.[95] The Victorian State Rail Regime allows for the access provider to refuse to negotiate with the access seeker if they are in, or have been in, material default in a similar manner to clause 3.4(d)(ii).[96]

The ACCC considers that an access seeker's performance in other rail access agreements is relevant to assessing the risk to ARTC of an access seeker breaching its access agreement, and that further protection is warranted to ensure that access seekers cannot avoid the consequences of such a default by simply establishing a new company. As a result, the ACCC believes that clause 3.4(d)(ii) is reasonable in minimising default risk and providing ARTC with the ability to provide lower access prices to genuine access seekers.

The ACCC notes, however, that the third prudential requirement – clause 3.4(d)(iii) – imposes financial adequacy conditions that are over and above what is found in most other Australian rail regimes. This clause imposes a requirement to demonstrate a legal ownership structure with a sufficient capital base to meet the actual or potential liabilities under an access agreement. Standard practice in existing rail regimes does not seek to assess the capital base and legal ownership structure of an access seeker.

Given that clause 3.4(d)(iii) is new and takes a different approach to what is standard practice in other Australian rail regimes, the ACCC is mindful to ensure that prudential provisions operate appropriately in practice and do not discourage entry or act as a barrier to entry. ARTC submits that the way the clause is currently presented provides a set of criteria which applicants need to meet in order to satisfy the prudential requirements. These criteria go to whether the applicant has a legal structure and asset

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95 See for example, Access Undertaking, 3rd May 2006, Pacific National in favour of the Essential Services Commission Victoria, and Appendix 2, section 6.5.2 of the (Approved) *Queensland Rail Draft Access Undertaking June 2006* and section 14 of the *Western Australian Railways (access) Code 2000*.

96 Pacific National in favour of the Essential Services Commission Victoria, Appendix 2, section 6.5.2.

base sufficient to meet its obligations, such as the timely payment of access charges, and payment of insurance premiums and deductibles.[97]

The ACCC is of the view that, if ARTC applies clause 3.4(d)(iii) in the manner indicated and uses a criteria based assessment, this clause is unlikely to discourage entry by access seekers. Furthermore, the objectives ARTC is seeking to achieve in applying the assessment of clause 3.4(d)(iii), that is, the payment of access charges and insurance premiums, are already a feature of existing Australian rail regimes.[98] Therefore, the ACCC considers that while the financial adequacy criteria may be more comprehensive than in other regimes, they are not inconsistent with striking an appropriate balance between the parties' interests, as required under the Part IIIA criteria.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 3.4 do not raise objections under Part IIIA of the Act.

D.3.3. Confidentiality

ARTC's Proposal

The Undertaking (clause 3.5(a)) requires each party to acknowledge that the following information is secret and confidential:

- all information relating directly to the applicant's future markets;
- the applicant's future market and business strategies; and
- the strategies of ARTC's or the Applicants customers.

The Undertaking requires that the receiver of confidential information must not use that information for purposes other than those allowed in the Undertaking. The Undertaking (clause 3.5(b)) proposes, however, that confidential information does not include information that is:

- in the public domain at the time of disclosure;
- obtained lawfully from third party without restriction on use or disclosure;
- required to be made public by operation of the law; or

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97 ARTC, *2007 ARTC Interstate Access Undertaking Additional Explanatory Guide*, December 2007, p. 6.

98 For example, see Access Undertaking, 3rd May 2006, Pacific National in favour of the Essential Services Commission Victoria, Appendix 2.

- necessary for the provision of advice to the receiver.

ARTC submitted that it proposed confidentiality provisions in the December Undertaking that are more relaxed than what was included in the 2002 Undertaking because it:

> …is seeking to relax the confidentiality arrangements associated with an access application or negotiation to only include certain information that is commercially sensitive, as opposed to an all inclusive arrangement with limited exceptions as currently applies. ARTC submit that its intention is to remove what might be an unnecessary constraint to a timely and open negotiation process. [99]

Views of Interested Parties

There were no submissions from parties on this matter.

Assessment of Issues

The appropriate handling of confidential information is important to protect the legitimate business interests of access providers and access seekers. The ACCC has reviewed the Undertaking's confidentiality requirements and is satisfied that the provisions are sufficient to protect the confidentiality of information exchanged between access seekers and ARTC, and that the confidentiality provisions are acceptable, having regard to the legislative criteria in s.44ZZA(3) of the Act.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 3.5 setting out ARTC's approach to confidential information do not raise objections under Part IIIA of the Act.

D.3.4. Access Application and Acknowledgment

ARTC's Proposal

The Undertaking provides that access requests are to be submitted in a form consistent with Schedule A of the Undertaking and must contain the information set out in Schedule B of the Undertaking. Prior to submitting an access application, the applicant may seek initial meetings with ARTC (clauses 3.6(a), (b) and (c)).

On receiving an access application, clause 3.7 provides that ARTC must, within five business days, either acknowledge the application or request additional information if such information is necessary to process the application. If additional information has been requested, ARTC must acknowledge the application within five business days of receiving the additional information.

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[99] ARTC, *2007 ARTC Interstate Access Undertakin*g, *Explanatory Guide*, June 2007, p. 25.

Views of Interested Parties

No submissions were received from stakeholders on this matter.

Assessment of Issues

The ACCC considers clauses 3.6 and 3.7 and Schedules A and B of the Undertaking provide an appropriate process for submitting and acknowledging access applications and these clauses satisfy the legislative criteria of s.44ZZA(3) of the Act.

Draft Decision

The ACCC's preliminary view is that the provisions in clauses 3.6 and 3.7 and Schedules A and B of the Undertaking setting out ARTC's approach access applications and acknowledgement of those applications do not raise objections under Part IIIA of the Act.

D.3.5. Indicative Access Proposal and Negotiation

An Indicative Access Proposal (IAP) sets out the access provider's response to an access seeker's application. In particular, an IAP outlines the proposed terms and conditions against which ARTC is willing to negotiate access.

Clause 3.8 of the Undertaking sets out what information ARTC's IAP will contain and the processes for its submission to an applicant. Clause 3.9 of the Undertaking sets out the process for applicants to follow should they wish to progress their application on the basis of ARTC's IAP.

ARTC's Proposal

ARTC proposes to provide an IAP to the applicant within thirty business days of acknowledging an access application. The Undertaking requires ARTC to use reasonable efforts to provide an IAP within this timeframe (clause 3.8(a)). Should ARTC consider it is not reasonable to respond within 30 business days, due to the complexity of the access application, it would notify the applicant of the extra time required to deliver the IAP (clause 3.8(b)). The access seeker can refer the matter to arbitration if it considers the estimate of extra time is excessive (clause 3.8(b)).

The December Undertaking provides for the IAP to include the following information (clause 3.8(c)):

- the results of a capacity analysis and whether there is sufficient available capacity to accommodate the access request;
- if additional capacity is required, an estimate of the costs of the works to provide additional capacity;
- whether or not there is a conflicting access application;

- a reference to the IAA and a reference to the current available market terms and conditions as published on ARTC's website;
- an estimate of the likely charges for the access rights requested;
- details of additional information required for ARTC to progress the access application; and
- indicative train path availability.

ARTC proposes that its IAP be non-binding, that is, it contains indicative arrangements only and does not oblige ARTC to provide access in accordance with the specific terms, conditions and charges contained within it (clause 3.8(d)).

Where an access seeker believes that ARTC is not making reasonable progress in preparing the IAP, then the applicant may refer the matter to the arbitrator for determination in accordance with the dispute resolution procedures of the Undertaking (clause 3.9(d)).

ARTC also proposes that where it is unable to provide an IAP based on the access seeker's access application, it would, if possible, submit to the applicant an IAP offering alternative access, which it believes may meet the applicant's access requirements (clause 3.8(f)).

Views of Interested Parties

Timeframes

PN submitted that the Undertaking provides for the IAP to contain an appropriate level of information. PN and FROG were concerned, however, that the 30 days provided for ARTC to respond with an IAP is too long, and should be reduced to 20 business days while still recognising that preparation of the IAP may take longer in exceptional circumstances.[100] In addition, NSWMC argued that clauses 3.8 (a) and (b) provide no course of action if ARTC does not provide the information within thirty days.

NSWMC and PN also raised issues with the approach to arbitration if ARTC failed to provide an IAP within an appropriate timeframe. NSWMC submitted that:

> Clause 3.8 (e), provides that 'if [after the time periods in Clause 3.8(a) or Clause 3.8(b)], the Applicant believes that ARTC is not making reasonable progress in the preparation of the proposal, then the Applicant may refer the matter to the arbitrator for a determination *in relation to the progress of the Indicative Access Proposal* (NSWMC emphasis) in accordance with clause 3.12.4' NSWMC suggests that Clause 3.8 (e) be amended by deleting the words in italics and, for clarity, substituting the words 'of access terms and conditions.'[101]

PN argued that provision for an access seeker to seek arbitration if ARTC is not progressing an application fast enough is effectively redundant. PN states that:

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[100] Pacific National *July Submission*, p. 11; FROG *July Submission*, p. 10.

[101] NSWMC *August Submission*, p. 16.

> It is difficult to imagine how the applicant would know whether ARTC is not making reasonable progress in the preparation of the proposal, particularly a new entrant that was not *au fait* with rail access arrangements. If the applicant formed the view anyway that progress was not being made (recalling that 30 business days have already elapsed, and probably substantially more than this is clause 3.8 (b) has been invoked), it is absurd to imagine that arbitration would provide a useful remedy.[102]

Further, PN argued that the timeframe in clause 3.4(e) of the Undertaking, requiring ARTC to advise within ten business days if it decides to refuse to negotiate, is too long and should be reduced to five business days.[103]

Market Terms and Conditions

Interested parties expressed three concerns about to the role of the current available market terms and conditions (clause 3.8(c)(vi)). Firstly, PN argued that the flexibility afforded by available terms and conditions that are outside the December Undertaking potentially allows 'ARTC, at its discretion, to undermine significant parts of the approved IAA thereby undermining the undertaking process itself.'[104]

Secondly, PN also noted that, notwithstanding its reservations about clause 3.8(c)(iv), clause 2.7(b)(vii) already requires ARTC to publish the standard terms and conditions on its website. This effectively makes clause 3.8(c)(iv) redundant.[105]

Finally, QR commented that the requirement to publish current available market terms and conditions does not provide any certainty that ARTC will offer access on the terms and conditions listed on its website.[106]

Assessment of Issues

An IAP is an important part in the negotiation process as it provides access seekers with key information to begin meaningful negotiations and ascertain the feasibility of entering into an access agreement. Stakeholder comments on the IAP process revolved around two main issues — timeframes and ARTC's ability to vary its standard terms and conditions.

Timeframes

Timeframes are necessary to ensure that the negotiation process is timely and orderly. In the absence of any timeframes, the negotiation process could become protracted and act as a barrier to entry. To reduce the risk of delay, the Undertaking requires ARTC to 'use reasonable efforts' to provide an IAP to an access seeker within 30 days.

The ACCC notes PN's concern that it may be difficult to assess the amount of effort ARTC is applying in preparing an IAP. However, the ACCC believes the nominated timeframes may be considered an upper limit (except in exceptional circumstances) and

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102 Pacific National *July Submission*, p. 11.

103 ibid., p. 10.

104 ibid., p. 11.

105 ibid.

106 QR *February Submission*, pp. 6-7.

the requirement for ARTC to 'act in good faith' should ensure it seeks to meet its obligations expeditiously. While the ACCC acknowledges stakeholder arguments that the proposed timeframes should be shortened, it accepts that ARTC's proposed timeframes are largely consistent with those in similar regimes.

The ACCC also notes NSWMC's concerns that there is no course of action specified by the Undertaking if ARTC does not provide an IAP to an access seeker within thirty days.[107] However, this issue should not be of undue concern to access seekers as the Undertaking requires ARTC to 'act in good faith and there is recourse to dispute resolution of the Undertaking if ARTC does not provide an access seeker with the IAP within the specified 30 day timeframe.

The ACCC concludes that the timeframes and procedures of clause 3.8 for access application submissions and acknowledgement are reasonable and acceptable having regard to the criteria of s.44ZZA(3) of the Act.

Current Available Market Terms and Conditions

The December Undertaking provides for ARTC to publish two types of information, the IAA and current available market terms and conditions, to inform negotiation around the IAP and to reach an access agreement. The IAP must clearly inform access seekers about where they can obtain copies of the IAA and the current available market terms and conditions.

The IAP is ARTC's response to an access seeker's application for access (clause 3.8). That is, it sets out the *proposed* terms and conditions under which ARTC is willing to provide access to an access seeker. The IAP is not legally binding and, as such, is a starting point for access negotiations whether those negotiations relate to the indicative service or otherwise.

In contrast the IAA is a pro-forma agreement that sets out the terms and conditions on which ARTC is willing to provide access to *indicative services*. In other words, the IAA provides a level of assurance to access seekers, over and above the Undertaking, about the terms and conditions of gaining access to the network for indicative services. Under the conditions of the Undertaking, ARTC cannot change the IAA without ACCC approval.

The current available market terms and conditions reflect current industry standard terms and conditions on which ARTC is willing to grant access to run indicative and non-indicative services. ARTC may negotiate terms and conditions with access seekers different to those in the IAA from time to time and these terms and conditions are viewed by ARTC as 'market' terms and conditions. 'Market' terms and conditions are published and made available to access seekers wishing to operate on the network on a like for like basis. This is in contrast to an access agreement (clause 3.11(a)), which, once signed, is legally binding and contains the actual terms and conditions upon which access would be granted.

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[107] NSWMC *August Submission*, p. 16.

In the December Undertaking, ARTC clarified its intention to inform access seekers about both the market terms and conditions and the IAA published on its website. The terms and conditions of the IAA would still be as an alternative available to access seekers at any time. ARTC took the view that this approach was more flexible and equitable for access seekers.

Given the capacity to negotiate terms and conditions different to those in the IAA, the ACCC considers that ARTC's proposal to publish current available market terms and conditions on its website creates a more transparent approach to access. While the provisions in the June Undertaking were potentially unclear about the difference between the standard or market terms and conditions and the IAA, the December Undertaking makes it clear that they are separate documents. More broadly, the Undertaking allows ARTC to change the current market terms and conditions but such changes do not affect the provisions in the IAA, or ARTC's obligation to seek ACCC approval if it wishes to change the IAA.

Draft Decision

The ACCC's preliminary view is that the provisions in clauses 3.8 and 3.9 setting out ARTC's approach to the indicative access proposal and negotiation do not raise objections under Part IIIA of the Act.

D.3.6. Negotiation Process

Clause 3.10 of the Undertaking establishes the conditions under which access negotiations would commence and cease if an applicant indicates a willingness to progress negotiations on the basis of ARTC's IAP. This part of the Undertaking also sets out the process ARTC would follow if it received two or more applications for mutually exclusive access rights.

D.3.6.1. Commencement and Cessation of Negotiation Period

ARTC's Proposal

After an applicant has indicated a willingness to negotiate, the December Undertaking provides that negotiation of an access agreement would commence as soon as reasonably possible to progress towards an access agreement (clause 3.10(a)), and that negotiations would cease upon any of the following events:

- execution of an access agreement (clause 3.10(b)(i));
- written notification by the access seeker that it wishes to withdraw its access application (clause 3.10(b)(ii));
- expiration of three months from the commencement of the negotiation period or such a period as agreed by ARTC and the applicant (clause 3.10(b)(iii));

- ARTC believing that the negotiations are not progressing in good faith toward the development of an access agreement (clause 3.10(b)(iv));

- a determination under the dispute resolution process that negotiations are not proceeding in good faith (clause 3.10(b)(v)); or

- ARTC receiving evidence that the applicant no longer satisfies the prudential requirements (clause 3.10(b)(vi)).

Views of Interested Parties

PN and the GSR submitted that the Undertaking, in particular clause 3.10(b)(iii), provides ARTC with the ability to frustrate the negotiation process. Clause 3.10(b)(iii) provides for the negotiation period for an access agreement to cease three months after the commencement of negotiation, unless both parties agree to an extension. GSR argued:

> This would enable ARTC to frustrate the negotiation and provision of third party access, as there is no provision for 'stopping the clock' for ARTC's internal processes and ARTC is able to refuse to extend the negotiation period following the expiration of 3 months.[108]

GSR further submitted that ARTC's rights under clause 3.10(b)(iv), which allows ARTC to end the negotiation if it believes they are not progressing in good faith, are asymmetric and do not require ARTC's conclusion to be reasonable.[109]

Similarly, NSWMC submitted that clause 3.10(b)(iv) gives excessive and unfair discretion to ARTC to cease negotiations and disadvantage the applicant. Further, NSWMC argued that clause 3.10(b)(v) generates unequal negotiating power between the two parties. NSWMC states:

> …if the Applicant is of the view that the negotiations are not progressing in good faith, there is no reciprocal right for the Applicant to refer the matter to the arbitrator….NSWMC suggest that sub-clauses (iv) and (v) be recombined and made reciprocal. Alternatively, the Sub-clauses could be deleted altogether and each party allowed recourse to dispute settlement, including arbitration under Clause 3.12.1 (a).[110]

PN argued that the Undertaking appears incomplete, as ARTC can notify the applicant of its intention to cease negotiations due to evidence that the applicant does meet the prudential requirements, but the applicant does not have an opportunity to provide ARTC with reasonable evidence to the contrary. PN stated:

> There is no standard provided by which ARTC will form its judgment and the level of evidence might be very slight, even unsubstantiated rumour. It is inappropriate to leave this to ARTC's discretion without having given the applicant the opportunity to respond.[111]

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[108] GSR *August Submission*, p. 31.

[109] ibid., p. 32.

[110] NSWMC *August Submission*, p. 18.

[111] Pacific National *July Submission*, p. 13.

RailCorp considered that the negotiate/arbitrate model adopted within the Undertaking places it at a significant disadvantage in its negotiations with ARTC and suggested that the model adopted should be backed up by obligations on ARTC for dealing with customers at risk of disadvantage under ARTC's monopoly position.[112]

Assessment of Issues

The ACCC notes stakeholder concerns about the length of time involved in executing an access agreement. While specifying the detail of the stages in the negotiation process, including timeframes, can seem overly prescriptive, it provides access seekers and the access provider with greater certainty about their rights and obligations in the negotiating process. The ACCC considers that it is difficult to specify a more 'streamlined' negotiation process without detracting from the certainty and protections a detailed process provides all parties.

The ACCC considers that ARTC's negotiation framework aims to facilitate the flow of information so that all parties can make informed decisions, while protecting their legitimate business interests. The Undertaking also specifies the conditions under which negotiations may cease, protecting the legitimate interests of the access provider (for example, ensuring that negotiations are only required to take place where an access seeker is both genuine about access and has the ability to undertake its commitments) and provides certainty for the access seekers (for example, by clearly setting out the reasons under which negotiations can cease and where access seekers feel aggrieved, providing an option for dispute resolution).

The ACCC acknowledges stakeholder views that clause 3.10(b)(iv), which provides for ARTC to end negotiations where it considers that the access seeker is not negotiating in good faith does not include an equivalent right for access seekers. However, clause 3.1 of the Undertaking provides an equivalent protection for access seekers by imposing a general obligation on ARTC to negotiate in good faith. Where an access seeker believes ARTC was not negotiating in good faith, they could refer the matter for arbitration. On this basis, the ACCC considers clause 3.10(b)(iv) is reasonable.

In relation to clause 3.10(b)(vi), while evidence of a failure to comply with prudential requirements could be expected to be a relatively straightforward matter, the ACCC nonetheless considers that there is the potential for any dispute resolution to become protracted. This may eventuate because of the uncertainty of ARTC's specific concerns in relation to the prudential criteria, amongst other reasons. The ACCC therefore considers that it is likely any disputes that relate to the prudential criteria would be expedited by ARTC providing written reasons as to why an access seeker does not meet those criteria. ARTC made several points in relation to concerns about the provision of written reasons, including that it has no commercial motivation to terminate a negotiation unnecessarily, nor to negotiate in bad faith. ARTC also noted that it has never terminated a negotiation using the equivalent to clause 3.10 in the 2002 Undertaking. Further, neither the ACCC nor stakeholders raised concerns about that clause during the 2002 Undertaking assessment.

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[112] RailCorp, *Australian Rail Track Corporation (ARTC) 2007 Access Undertaking – RailCorp Comments*, 7 August 2007 (RailCorp *August Submission*), p. 3.

The ACCC notes, however, that consideration of this Undertaking is a new and separate process from the 2002 assessment, the provisions relating to the prudential criteria have been strengthened considerably in this Undertaking and the application of those criteria has been raised by a number of participants. Therefore, given the strengthening of the prudential criteria, the ACCC considers that there needs to be considerable transparency in their application, to inform negotiation processes and prevent lengthy avoidable disputes

ARTC would achieve this transparency by amending clause 3.10(b)(vi) to require it to provide, in writing, its reasons for ceasing negotiations based on evidence relating to prudential matters. The provision of written reasons would help access seeker's meet ARTC's concerns and simplify dispute resolution processes relating to these issues.

Draft Decision

Recommendation:

Clause 3.10(b)(vi) of the December Undertaking be amended to require ARTC to provide written reasons to an applicant where it decides to issue a notice of intent to end negotiations.

D.3.6.2. Requests for Mutually Exclusive Capacity

Clause 3.10(d) of the Undertaking sets out the process by which ARTC handles requests for mutually exclusive capacity. That is, where two or more access seekers want access to the same capacity.

ARTC's Proposal

ARTC proposes that if two or more applicants seek mutually exclusive capacity, it would seek, but not undertake, to satisfy all access seekers' requirements.[113] ARTC submitted that, when it did not accommodate requests for mutually exclusive capacity, access would be given to the applicant agreeing to terms and conditions most favourable to ARTC (clause 3.10(d)(ii)). ARTC further proposes to make this decision based on the access agreement that represents the highest present value of future returns to ARTC, after considering all risks associated with that access agreement.

ARTC notes that it has accommodated all requests for capacity on its interstate network to date and has not had to invoke clause 3.10(d)(ii) as yet. ARTC also commented that an access seeker always has access to dispute resolution under the Undertaking if it is dissatisfied with ARTC's decision on allocating capacity.

[113] ARTC, *Explanatory Guide to the 2007 Interstate Access Undertaking*, June 2007, p. 16.

Views of Interested Parties

PN argued that the proposed process for choosing among competing access applications is opaque and suggested alternative criteria for allocating train paths and resolving incompatible access applications.[114] PN submitted that:

> the process contemplates two (or more) access seekers negotiating in a blind race with each other to offer ARTC the most valuable proposition, presumably without any understanding of the other party's position.[115]

Similarly, FROG stated that:

> Given the importance of premium paths to the ability of a rail operator to successfully compete in the interstate freight transport market, FROG considers it critical that ARTC allocates train paths through a coherent and transparent process…FROG considers that limiting capacity allocation to 'the highest net present value of future returns after considering all risks concerned with the access agreement' may not represent the terms and conditions most commercially favourable to ARTC.[116]

Whereas, GSR submitted that:

> …where two or more applicants are seeking mutually exclusive access rights, in these circumstances, an appropriate approach having regard to the Appropriateness Criteria would be: to require ARTC to finalise the access agreement that strikes an appropriate balance between the criteria in appropriateness criteria; to qualify the provisions by reference to grandfathering of an existing user's existing access rights; or deletion of these provisions.[117]

The NSWMC argued that two or more applicants concurrently negotiating for access in such circumstances is akin to an auction and the applicants should have the protections bidders would have in an auction. In particular, NSWMC submitted that:

> ARTC should adequately inform applicants in negotiations and should make known to each applicant involved the following: any criteria (in addition to the highest net present value to ARTC) against which ARTC will determine the most favourable Access Agreement for the Available Capacity; costs of providing Additional Capacity for the unsuccessful applicants as per clause 6.2 of the undertaking; the access charges for each applicant that are equivalent to the other applicant(s) offer(s) the process and schedule for initial, further and final offers by applicants.[118]

QR submitted that it is 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. QR argued 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

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114 Pacific National *July Submission*, p. 12.

115 ibid.

116 FROG *July Submission*, p. 4.

117 GSR *August Submission*, p. 32.

118 NSWMC *August Submission*, p. 18.

favourable to ARTC. QR also noted that the QR Access Undertaking includes a queuing mechanism to make the capacity allocation process more transparent.[119]

Assessment of Issues

The ACCC notes that ARTC's use of a net present value test to assign mutually exclusive access rights is consistent with other rail access regimes. ARTC's test is that it will accept an access agreement with that access seeker that provides it with the most favourable terms and conditions (clause 3.10(d)(ii)). Other rail access regimes have similar provisions, for example QR's Access Undertaking states that if two or more access seekers are seeking access to the same capacity, QR would finalise an access agreement with the railway operator with whom QR can agree to terms and conditions, 'which are most favourable in terms of the commercial performance of Queensland Rail's below rail services.'[120] The ACCC is of the view that, given both ARTC and QR have included similar provisions in their respective undertakings, such a principle appears reflective of the standard regulatory outcome in Australia's rail industry.

The ACCC is of the view that assessing applications using the net present value principle is an adequate basis for granting access to competing applicants.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 3.10 setting out ARTC's approach to mutually exclusive access do not raise objections under Part IIIA of the Act.

D.3.7. Access Agreements

The Undertaking sets out the principles and processes for negotiating access. However, as part of these negotiations, an access agreement must be developed and finalised.

An access agreement provides clarity and certainty about the obligations of access providers and access seekers and sets out the price and non-price terms on which access to the relevant service will be provided to an individual access seeker. Clause 3.11 of the Undertaking sets out the provisions for finalising an access agreement.

ARTC's Proposal

The Undertaking provides that the granting of access will be finalised by the execution of an access agreement and specifies that the parties to an access agreement will be ARTC and:

- if the applicant is an accredited operator, that applicant (clauses 3.11(a)(i)); or
- if the applicant is not an accredited operator, that applicant, or the accredited operator or both (as the case may be) (clauses 3.11(a)(ii))

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[119] QR *July Submission*, pp 10-11.

[120] QR Access Undertaking (2005) endorsed June 2006, revised June 29, 2007, pp. 31 and 64.

It should be noted that clause 3.4(b) of the Undertaking provides for ARTC to negotiate with an applicant who is not an accredited operator, but who acquires the services of an accredited operator to operate the proposed services, provided either the applicant or the accredited operator meets all the terms and conditions of the access agreement.

ARTC proposes that an access agreement would be:

- the IAA — subject to the applicant satisfying the prudential requirements; or
- the current available market terms and conditions as published on ARTC's website; or
- a negotiated access agreement to reflect agreed amendments to the access agreement. A negotiated access agreement must, unless otherwise agreed, address at least the essential elements set out in Schedule C (clause 3.11(c)).

Views of Interested Parties

PN raised concerns about clarity in who could negotiate an access agreement. It noted that the Undertaking specifically provides for negotiation with a party that is not an accredited operator but it does not explicitly provide that ARTC will negotiate with an accredited party:

> It is assumed that ARTC believes that it is unnecessary to state the latter, but to a lay reader, it could be interpreted that while there is no prohibition to negotiate with an Accredited Operator, there is no obligation to do so either. It would be helpful for the Undertaking to make the obligation explicit for the benefit of clarity.[121]

PN also suggested that it is unnecessary for the undertaking (clause 3.11(a)(ii)) to contemplate tripartite arrangements. As the name suggests, a tripartite agreement is an agreement between three parties. PN took the view that a tripartite access agreement would blur accountabilities and be counterproductive. It stated that:

> …all that is necessary is that a party to the agreement agrees as a condition that the train services will be operated by an accredited operator. How that is achieved is a matter for the applicant and all that ARTC ought to be concerned with is that the contracting party fulfils its obligations that the operator is accredited.[122]

FROG was concerned about the role of the IAA in the Undertaking and suggested that the practical scope of the IAA is reduced because it only applies to indicative services and, therefore, 'unnecessarily restricts the utility of the standard agreement to only 60% of ARTC's business at most.' [123] Several other stakeholders were also critical that the IAA applies only to indicative services.

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[121] Pacific National *July Submission*, p. 10.

[122] ibid, p. 12.

[123] FROG *February Submission*, p. 4.

QR argued that the Undertaking needs to specify the terms and conditions ARTC will contract for non-indicative services; 'the issue for operators is that what ARTC already does in respect of non-indicative train services is inadequate.'[124]

Assessment of Issues

Negotiation of Access Agreements

The ACCC believes that the option of providing unbundled access arrangements (that is, separating out access rights from haulage rights) provides flexibility for end users and operators to collaborate on an access application without being constrained by an overly prescriptive approach. The ACCC considers that clause 3.4(b), which allows accredited operators and non-accredited operators to enter into access agreements, provides an appropriate balance in that it facilitates the parties seeking access to negotiate the type of access arrangement that best suits their needs. Allowing end users to negotiate access directly with ARTC may also increase above rail competition by giving large end users greater control over their access arrangements and more flexibility in who they subcontract to provide haulage services.

In relation to tripartite agreements (clause 3.11(a)(ii)), the ACCC's view is that there are no legal issues associated with tripartite arrangements providing that the relevant instruments are appropriately drafted. The important aspect from an access provider's perspective is that the terms and conditions of the access agreement are observed. It is less important whether the end user or the operator discharges the obligations under the access agreement, as long as the legitimate business interests of the access provider are protected. As a result, the ACCC considers that clause 3.11(a)(ii) is appropriate.

Principles of the Access Agreement

The purpose of access negotiations is to conclude a set of agreed terms and conditions of access set out in an access agreement. The ACCC notes that an IAA is included as a schedule to the Undertaking.

The IAA sets out in detail, the terms and conditions on which access to indicative services might be offered. However, access seekers and ARTC are free to develop an access agreement which differs from the IAA. That is, the IAA does not seek to displace the primary role of negotiation or to otherwise abrogate the rights of an access seeker to negotiate a different access agreement (see section D.9.2).

ARTC informed the ACCC that it intends to offer the IAA to an access seeker where:

- the access seeker is seeking access to indicative services;
- the access seeker meets the prudential requirements in clause 3.4(d); and
- either:
  - the network has sufficient capacity to meet the access seekers needs; or

[124] QR *February Submission*, p. 7.

– ARTC has agreed to provide additional capacity.

The Undertaking, however, is not clear on this issue. It does not explicitly oblige ARTC to offer the terms of the IAA as an access agreement in the circumstances mentioned above.

There is an argument that ARTC is obliged to offer the terms of the IAA to access seekers through the definition of the term 'Access Agreement' in clause 9.1. An 'Access Agreement' is defined in the Undertaking as an agreement in which 'the current indicative terms and conditions of which are set out in Schedule D'.

Arguably, this definition covers the standard terms and conditions of the IAA and should, therefore, oblige ARTC to offer the terms of the IAA for an Access Agreement if desired by an access seeker. However, that argument is insufficiently strong and the drafting is insufficiently clear for the ACCC to rely on the Undertaking's existing drafting.

Rather, an amendment to clause 3.11 is necessary to provide certainty on this issue.

Draft Decision

Recommendation:

The ACCC's preliminary view is that the provisions in clause 3.11 should be amended to read as follows:

(a) The granting of Access will be finalised by the execution of an Access Agreement. The parties to the Access Agreement will be ARTC and:

(i) If the Applicant is an Accredited Operator, that Applicant; or

(ii) If the Applicant is not an Accredited Operator, that Applicant or the Accredited Operator or both (as the case may be).

(b) Subject to clause 3.11(c) ARTC may offer any of the following as an Access Agreement:

(i) the Indicative Access Agreement subject to the Applicant satisfying the prudential requirements in clause 3.4(d); or

(ii) the current available market terms and conditions as published on ARTC's website; or

(iii) an updated Access Agreement to reflect agreed amendments to the Access Agreement. A negotiated Access Agreement will, unless otherwise agreed between ARTC and the Applicant at least address the essential elements set out in Schedule C. The details of Schedule C do not provide an exhaustive list of the issues that may be included in an Access Agreement.

(c) ARTC must offer the Indicative Access Agreement to an Applicant if the Applicant:

(i) seeks access to Indicative Services; and

(ii) meets the prudential requirements in clause 3.4(d); and

(iii) either:

(A) the Network has sufficient Available Capacity to meet the Applicant's needs; or

(B) ARTC consents to provide Additional Capacity to meet the Applicant's needs in accordance with clause 6.2.

(d) Once the Applicant has notified ARTC that it is satisfied with the terms and conditions of the Access Agreement as drafted, ARTC will, as soon as reasonably practicable, provide a final Access Agreement (or, if applicable, an amendment to an existing Access Agreement) to the Applicant for execution.

(e) Where the ARTC offers an Access Agreement and the Applicant accepts the terms and conditions offered in that Access Agreement, both ARTC and the Applicant will execute the Access Agreement. The parties will use reasonable endeavours to comply with this clause as soon as practicable.

D.3.8. Dispute Resolution

Access to services under Part IIIA of the Act is based on a negotiate-arbitrate model. That is, the access provider and access seeker negotiate on price and non-price terms, having recourse to a binding dispute resolution process.

While ARTC's access undertaking establishes a basis to manage negotiations for access to the interstate rail infrastructure, disputes may still arise. Hence, an effective dispute resolution process is an important part of any access undertaking.

ARTC's Proposal

Clause 3.12 of ARTC's Undertaking sets out the proposed process for resolving disputes arising from access negotiations. The Undertaking provides that either party may give a dispute notice if *any* dispute arises under the Undertaking or in relation to the negotiation of access between an access seeker and ARTC (clause 3.12.1(a)).

Disputes arising under a *signed access agreement*, however, are dealt with in accordance with the dispute resolution procedures in that access agreement.

Dispute Resolution Stages

The Undertaking provides for a three staged dispute resolution process:

- negotiation — initially disputes are referred to senior representatives of the respective parties to resolve (clause 3.12.2);

- mediation — if the dispute is not resolved through negotiation by senior representatives within ten business days, then, if the parties agree, the dispute may be referred to the chief executive officers (CEOs) of both parties for mediation (clauses 3.12.3(a)(i) and 3.12.3(b));

    - formal mediation — failing resolution of the dispute by CEOs within ten business days, the dispute will be referred to formal mediation to be mediated by a single mediator appointed by agreement of the parties or a mediator appointed by the President of the Law Society of South Australia (clauses 3.12.3(c) and (d)); Otherwise, if the parties do not wish to solve the dispute by mediation, either party may refer the dispute by written notice to an arbitrator for determination (clause 3.12.3(a)(ii)).

- arbitration and determination by the arbitrator — either party may terminate the meditation proceedings and notify the ACCC of a dispute. The ACCC will arbitrate the dispute under s.44ZZA(6) of the Act. The determination by the arbitrator shall be final subject to any rights of review by a court of law (clause 3.12.4(b)(xiii)).

Procedures of the Arbitration

The Undertaking (clause 3.12.4(b)(iii)) proposes that, the procedures for the arbitration will be those that would apply if the ACCC was arbitrating a dispute in relation to a declared service (Division 3 Subdivision D of Part IIIA of the Act) and also:

- the arbitrator will observe the rules of natural justice but is not required to observe the rules of evidence;

- a party may appoint a person, including a legally qualified person, to represent them or assist it in the arbitration; and

- the arbitrator will include in its determination its findings on questions of fact and law and including references to the evidence on which the findings of fact were based.

Conducting an Arbitration

In conducting arbitration, the Undertaking (clause 3.12.4(b)(iv)) provides that the arbitrator will:

- proceed as quickly as is possible and consistent with a fair and proper assessment of the matter;

- while having the right to decide on the form of presentations, encourage a written presentation by each party with exchange and with rebuttal opportunities and questioning by the arbitrator;

- call on any party the arbitrator believes necessary to give evidence;

- decide how to receive evidence and consider the need to keep evidence confidential and the need to protect the confidentiality of the arbitration process;

- present their determination in a draft form to the parties and hear argument from the parties before making a final determination; and

- hand down a final determination in writing which includes all their reasons for making the determination.

Deciding a Dispute

In deciding a dispute, the Undertaking (clause 3.12.4(b)(vi)) requires the arbitrator to take into account: the principles and methodologies set out in the Undertaking, the objects of Part IIIA of the Act and of the Competition Principles Agreement; ARTC's legitimate business interests and investment in the network; the costs of providing access, the interests of parties with rights to use the Network, and the economically efficient operation of the network; the public interest; operational and technical requirements and any other matters the ACCC deems appropriate (clause 3.12.4(vi)).

The Undertaking also provides for the joint conduct of related arbitrations and the joining of additional parties to arbitration. The parties must comply with the determinations or directions of the arbitrator unless they have appealed the decision (clauses 3.12.4 (ix)(x) and (xi)).

Unlike the 2002 Access Undertaking, ARTC has proposed not to include a Conflict Manager in the dispute resolution process in the December Undertaking. ARTC submits that it sees little value in the additional and somewhat contemporary option incorporated in the 2002 Undertaking to the standard negotiate-mediate-arbitrate provisions already provided in the Undertaking.[125]

The Charging of Costs for an Arbitration

In the event that a dispute is arbitrated, the access seeker must agree to accept the costs charged by the ACCC (clause 3.12.4(b)(ii). The ACCC has the option, but not the obligation, to charge for its costs when conducting an arbitration. These costs (if charged) would be calculated at the rates specified in the Act or the amounts mentioned in regulation 6F of the Act (clause 3.12.4 (b) (xiii)). Regulation 6F of the Act enables the ACCC to charge a pre-hearing fee (usually paid by the person notifying the dispute) and a hearing fee (per day or part day) for its costs in conducting an arbitration. (The hearing fee is usually apportioned between the parties to the dispute, at the ACCC's discretion.)

Views of Interested Parties

Dispute Resolution Provisions

A key concern expressed in submissions was that the dispute resolution procedures outlined in the Undertaking are not an effective mechanism to resolve disputes about the terms and conditions for non-indicative services. RailCorp noted that:

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[125] ARTC, *2007 Interstate Access Undertaking Explanatory Guide*, June 2007, p. 25.

> once outside the indicative service category, dispute resolution follows a potentially expensive and time-consuming process ending in formal arbitration.[126]

In particular, dispute resolution by arbitration was viewed as a lengthy and expensive. For example, FROG noted that:

> Arbitration is a lengthy and expensive process and likely to significantly deter a party from pursuing access to the rail network if it is not already a participant in the rail business. This also must be seen as a potential barrier to entry.[127]

There was a general view expressed by access seekers that it was not economic to seek arbitration for many matters, including for existing disputes. RailCorp further suggested that one reason why no disputes were lodged under ARTC's 2002 Undertaking was that the dispute resolution provisions were a deterrent to access seekers with legitimate issues.[128]

PN commented that access seekers were reluctant to seek arbitration because of a view that the large difference between current access prices and the regulatory ceiling meant that any price below the ceiling would probably conform to the requirements of the Undertaking and therefore any arbitration decision would fall ARTC's way. Therefore, arbitration, even if not too expensive or time-consuming, was ineffective. There was also concern that the arbitration provisions of the Undertaking, in particular clause 3.12.4(b)(vi)(l), limit the public benefits which the arbitrator is required to take into account in deciding a dispute. GSR stated that:

> The public interest referred to in clause 3.12.4(b)(vi)(l) should not be limited by reference to the public interest in having competitive markets.[129]

Many submissions stressed that an effective and efficient dispute resolution mechanism is a prerequisite to the efficient provision of access and that arbitration was unsatisfactory except in cases of large financial importance.

Interested parties also commented on the ACCC's powers when conducting an arbitration. PN submitted that the ACCC's arbitration powers conferred by the incorporation of Division 3 Subdivision D of Part IIIA of the Act appear to be heavy handed, wide reaching and inappropriate for a voluntary access undertaking. For example, the arbitration provisions under Subdivision D allow the ACCC to compel the provision of certain evidence under oath and give a wide range of directions. PN submitted that failure to comply with the ACCC's directions or determinations may attract a penalty of imprisonment.

A number of issues were also raised about the clarity of the dispute resolution provisions in the Undertaking. The NSWMC questioned whether the dispute resolution model in clause 3.12.1(a) is an inclusive model. That is, any dispute arising under the Undertaking is to be resolved in accordance with the dispute resolution process of the

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126 RailCorp *August Submission*, p. 4.

127 FROG *February Submission*, p.3.

128 RailCorp *August Submission*, p. 4.

129 GSR *August Submission*, p. 32.

Undertaking unless the parties otherwise agree. This was the NSWMC's understanding of the December Undertaking, but it wished the ACCC to formally confirm this view because it felt that the provisions in the Undertaking were unclear.[130]

PN remarked that clauses 3.4(f), 3.8(b), 3.8(e) and 3.9(d)), which provide for a party to avail itself of the dispute resolution process, are redundant since any dispute can be resolved using the process under clause 3.12.1(a). PN commented that removing additional references to the dispute resolution process would significantly reduce the Undertaking's complexity and that the only reference to the dispute resolution process, outside of those in clause 3.12, should be if the right to access the general process is removed.[131]

Interested parties commented on the drafting of the dispute resolution provisions. PN suggested that the carve out from the arbitration procedures in Division 3 Subdivision D of Part IIIA of the Act is confusing and that there is a doubling-up of matters already covered by the Subdivision D. FROG had a similar view, commenting that:

> There is a significant overlap between the provisions of Subdivision D and the December Undertaking (for example those clauses around joint arbitrations). It is very unclear what will happen if there is a conflict in the provisions.[132]

Finally, on the removal of a conflict manager from the arrangements that apply to dispute resolution, PN argued that while the availability of this mechanism appeared to offer some benefits to dispute resolution its removal does not prohibit parties from agreeing to use a conflict manager if this would assist in resolving he dispute.[133]

The Charging of Costs for an Arbitration

GSR stated that the December Undertaking is ambiguous as to whether, when an access seeker notifies a dispute for arbitration, the access seeker will be required to pay the full costs of the arbitrator or whether the costs will be split between the parties. GSR stated that even if the costs are to be split between parties,

> … an access seeker might be wary to bear the costs of arbitration, and thus reluctant to seek arbitration where the extent of those costs is not wholly within its control. GSR observes that the extent of the arbitrator's costs in an arbitration will depend on the conduct of both parties during the arbitration process.[134]

GSR went on to make the point that charging the costs for arbitration could increase the access seekers' reluctance to avail themselves of this option, particularly if the amount of costs is uncertain. GSR noted that its concerns about the uncertainty of costs are heightened by the possibility that under clauses 3.12.4(b)(ix) and 3.12.4(x), the arbitrator has the ability to join arbitrations and to join additional persons to an

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130 NSWMC *August Submission*, p. 18.

131 Pacific National *July Submission*, p. 16.

132 FROG *February Submission*, p. 4.

133 Pacific National *July Submission*, p. 15.

134 Great Southern Railway, *ARTC – Access Undertaking December 2007*, February 2008 (GSR *February Submission*), p. 3.

arbitration. Joining arbitrations, or persons to an arbitration, is likely to increase the arbitrator's costs, and GSR noted that the December Undertaking does not provide a mechanism for these costs to be shared. The joining of arbitrations is, therefore, likely to increase uncertainty about the costs charged for an arbitration.

Assessment of Issues

A key objective of an access undertaking is to facilitate access negotiations by providing access seekers and the access provider greater certainty about the terms and conditions of access. An undertaking also seeks to reduce uncertainty in resolving possible disputes by clarifying how disputes would be addressed if they arose.

It is possible to categorise access disputes into three broad categories:

- disputes where an access seeker and access provider are unable to agree on the terms and conditions of access (whether it be price or non-price issues);
- disputes where an access seeker alleges that an access provider is hindering access; and
- disputes about the access provider's compliance with its obligations in an access undertaking.

Even within the above categories, many access disputes will be different. For example, some disputes may be relatively minor and time sensitive, making them more suited to mediation than full regulatory arbitration. Other disputes may be so irreconcilable that a formal arbitration process is necessary.

In this context, the ACCC considers that the dispute resolution stages proposed by ARTC are reasonable in that they provide several stages of dispute resolution — negotiation, mediation, formal mediation and binding arbitration — which are flexible enough to accommodate various types of disputes. The ACCC also believes that the dispute resolution model adopted by ARTC seeks to have as broad a coverage, reducing the chances that a dispute ends in litigation. The dispute resolution provisions of the access undertaking are also broadly similar to those in other rail access regimes.[135]

Stakeholders have suggested that it is unnecessary to have specific clauses throughout the undertaking, which provide for dispute resolution or arbitration given that clause 3.12.1(a) covers *any* dispute in relation to the Undertaking.

The ACCC considers that the presence of clause 3.12.1(a) appears to make more specific dispute resolution clauses unnecessary. However, such clauses do not appear to cause any detriment to the operation of the Undertaking and some, such as ss.3.4(f), 3.8(b) and 3.8(e), appear to clarify how the Undertaking's dispute resolution procedures would operate in certain circumstances.

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[135] For example, the Queensland Rail Undertaking and Western Australian Railways (access) Code 2000.

Arbitration Provisions

Arbitration is a process whereby the parties submit their dispute to an arbitrator who then makes a determination that is binding upon the parties. The Undertaking provides for either party to notify the ACCC of a dispute to be determined by arbitration with the ACCC to perform the role of arbitrator.

The Undertaking also provides for the procedures of the arbitration to be equivalent to those applying in relation to Division 3 Subdivision D of Part IIIA of the Act (clause 3.12.4(b)(iii)). Stakeholders have suggested, however, that there are a number of areas in the Undertaking where the arbitration provisions could be clarified. For example, as noted above, PN submitted there is a doubling up of matters in the provisions that are already covered by the Act and the carve out to the Act Part IIIA Division 3, Subdivision D, is confusing.

The ACCC considers that, while it may be possible to simplify the arbitration provisions in the Undertaking, they are currently sufficiently clear to allow for effective arbitration processes and, therefore, do not raise objections under Part IIIA of the Act. In addition, the ACCC believes that the arbitration provisions of Part IIIA, adopted by ARTC in the December Undertaking, are appropriate as they are generic enough to cater for the specific issues and circumstances that are likely to surround the variety of possible disputes.

Arbitration Powers — Non-Indicative Services

Clause 4.2 of the Undertaking provides for ARTC to set charges having regard to a range of factors. Clause 3.12.4(vii)(a) also provides that the ACCC's arbitration determination may deal with any of the matters referred to in s.44V of the Act. In particular, s.44V(2)(c) of the Act provides that a determination may deal with any matter relating to access including specifying the terms and conditions of an access seeker's access.

Based on these provisions and on those of the Undertaking, it is the ACCC's view that it can arbitrate on the substance of any dispute arising under the undertaking – this includes both indicative and non-indicative price and non-price terms and conditions of access.

Section 44ZZA(6) of the Act requires the ACCC to resolve disputes in accordance with the Undertaking. However, the ACCC believes compliance with s.44ZZA(6) of the Act involves more than simply examining ARTC's compliance with its obligations in its Undertaking. Rather, the Undertaking provides for the ACCC to consider a range of factors in deciding a dispute. These include, among other matters, the objects of Part IIIA and the economically efficient operation of the network. Therefore, in arbitrating a dispute, the ACCC is not obliged to conclude that a disputed price is acceptable just because it complies with the Undertaking and is below the ceiling.

Conflict Manager

The ACCC notes that some rail access regimes provide that matters may be sent for expert determination before they are brought to the regulator for arbitration. For example, the QR Access Undertaking provides that where a dispute cannot be resolved

in the first instance by the parties' respective CEOs, parties may agree to refer the dispute to an expert for resolution. The experts include:

- the President of CPA Australia (for financial matters);
- the President of the Institution of Engineers (for non-financial matters); and
- the President of the Law Society (where appropriate).

The ACCC acknowledges the merit of involving an arbitrator with significant experience and/or knowledge of particular matters. However, it does not believe that ARTC's Access Undertaking needs to prescribe a role for experts. Parties to a dispute are free to agree to appoint an expert arbitrator to mediate a dispute, if they believe this is appropriate. The ACCC as arbitrator can also seek the assistance of individuals with expert skills if necessary. The ACCC, therefore, does not object to the exclusion of a conflict manager from ARTC's Access Undertaking

The Charging of Costs for an Arbitration

Arbitrating disputes under a voluntary access undertaking is not an ACCC function mandated by legislation. Therefore, it is not unreasonable for the ACCC to be given the option to recover its costs for conducting such arbitrations.

Furthermore, the ACCC has discretion on when it charges costs and how those costs are apportioned, and can take into account the incentives and impact on access seekers and the access provider in making such decisions. For example, if the actions of one party lead to unreasonable delay or a party asks for the consideration of matters that are outside the scope of what could normally be expected in an arbitration, then the costs for this additional period of arbitration could be apportioned to that party by the arbitrator. The ACCC considers that its discretion to charge and apportion costs should overcome the concerns expressed by interested parties, that they may be arbitrarily required to fund an inappropriate share of arbitration costs.

In addition, when an arbitrator joins additional parties to an arbitration, the normal reason would be that the issues under dispute for each party are sufficiently similar that it is expected that the overall costs to each party would be reduced through a joint hearing. Therefore, the ACCC believes the concern that access seekers may be exposed to increased costs if matters are joined is unfounded. Furthermore, the arbitrator's discretion to allocate costs should mitigate this risk as it can also ensure parties are not charged more than a fair share of costs of any arbitration.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 3.12 setting out ARTC's approach to dispute resolution under the Undertaking do not raise objections under Part IIIA of the Act.

D.4. Pricing Principles

Summary

The Undertaking sets out ARTC's framework for all price negotiations. For 'indicative' services, ARTC commits to offering these services at the indicative access charges in the Undertaking.[136] *The Undertaking does not prescribe prices for other services, but commits ARTC to negotiate access prices for 'non-indicative' services having regard to factors that include the charges for indicative services. ARTC commits to not differentiate charges on the basis of the applicants' identity, or among users who are requesting the same service and who operate in the same end market.*

Access charges are generally multi-part tariffs with a variable component levied when the path is used and two fixed components, a flagfall charge and an excess network occupancy charge (ENOC). Increases in indicative access charges are constrained by a cumulative CPI-based formula, whereby increases in CPI not applied in one year can be accumulated over five years.

The ACCC identified two issues in relation to the pricing principles proposed by ARTC. First, ARTC's proposal to be free to increase prices as often as it considers appropriate could create uncertainty and affects rail operators' contractual agreements. Therefore, the ACCC's preliminary view is that the escalation formula should be modified so that prices can only increase once a year.

Second, the ACCC also has a preliminary view that ARTC's commitments to not to apply the ENOC when a better path is not available, or if ARTC is unable to provide the contracted path or an agreed substitute path, should be included in the Undertaking.

D.4.1. Introduction

Part 4 of the Undertaking sets out the charges ARTC intends to apply for gaining access to its network and the principles on which access charges are developed. In chapter C.2, the principles used by the ACCC to assess ARTC's prices were set out as follows:

A.1 Access prices should generate no more than sufficient revenue to recover the efficient costs of providing access to the infrastructure as well as earn a return that is commensurate with regulatory and commercial risk;

A.2 Access prices should provide incentives to reduce costs and otherwise improve productivity;

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[136] The indicative service broadly equates to intermodal freight (i.e. general non-bulk freight (for example manufactured goods) that is transported from its origin to destination using two or more modes, such as road and rail) and accounts for about 60 per cent of ARTC's revenue. Non-indicative services cover all other freight including steel, minerals, passenger services and grain.

A.3 Access prices should provide incentives for ARTC to provide services at efficient levels of cost and quality; and

A.4 Access prices should promote efficient use of, operation of and efficient investment in the network, including by use of multi-part prices and price discrimination where appropriate.

These principles need to be applied to all aspects of ARTC's pricing, including price transparency, level, structure, escalation, differentiation and the introduction of new charges.

D.4.2. Indicative and Non-Indicative Access Charges

D.4.2.1. Access Charges for Indicative Services

ARTC's Proposal

Clause 4.6 of the Undertaking sets out the Indicative Access Charge for train services in specific segments that have the following characteristics:

- axle load of 21 tonnes;
- maximum speed of 110 km/hr; and
- length not exceeding:
  - 1800 metres west of Adelaide and Parkes;[137]
  - 1500 metres east of Adelaide and Parkes (until Capital Expenditure is commissioned on the segments Melbourne – Macarthur and Parkes – Cootamundra);
  - 1800 metres on the segments Melbourne – Macarthur and Parkes – Cootamundra (following commissioning of Capital Expenditure on these segments).

Access charges for indicative services are a multi-part tariff comprising (table D.4.1):

- a variable charge, based on use, and levied as dollars per gross tonne kilometres;
- a fixed (flagfall) component levied on the basis of dollars per kilometre; and
- an excess network occupancy component based on dollars per hour.

[137] That is, the train, including the locomotive, must not be longer than 1800 metres if it is travelling west of Adelaide or Parkes.

Table D.4.1: Access Charges for Indicative Services (at 1 February 2008)[138]

Segment	Variable Access Charge $/kgtkm	Flagfall Access Charge $/km	Excess network occupancy charge $/hr or part thereof	Allowance for reasonable requirements for operational activities hr
Adelaide – Parkeston	2.531	3.263	261	1.2
Adelaide – Melbourne	2.831	1.756	124	0.7
Melbourne – Macarthur	2.320	0.923	69	0.2
Newcastle – Queensland Border	2.950	0.855	55	0.2
Crystal Brook – Parkes	3.300	0.911	80	0.6
Cootamundra – Parkes	3.248	0.880	54	0.1
Adelaide – Pelican Point	3.727	2.343	n.a.	n.a.
Tarcoola – Asia Pacific Interface	4.741	3.954	150	0.1
Port Augusta – Whyalla	4.269	2.202	n.a.	n.a.
Moss Vale – Unanderra	3.730	0.949	n.a.	n.a.

Source: ARTC, December Undertaking, Clause 4.6.

Views of Interested Parties

Issues participants raised about the scope and transparency of access charges were primarily about whether the approach used for indicative services should be broadened to other services (see the section below on non-indicative services). No specific issues were raised about the transparency of indicative charges, nor did submissions suggest that any of the current indicative services should not be covered by the indicative tariff.

Assessment of Issues

An important consideration for the ACCC in assessing whether the Undertaking balances the interests of the access provider, access seekers and the wider public interest, is whether the indicative charges and ARTC's commitments in respect of those charges are set out clearly.

The Undertaking specifies the variable and flagfall components of access charges for indicative services in each segment. Access seekers, therefore, have certainty about the access price that they will be charged if they seek access to the network to operate an indicative service. While access seekers can negotiate a different price with ARTC, they do so in the knowledge that ARTC has committed to accommodating an indicative service at the indicative charge.

[138] All charges are exclusive of GST.

The reference service's usefulness for setting indicative prices depends on the choice of service. Ideally, the reference service should be clearly defined and represent a reasonable proportion of the services operated on ARTC's network. Clause 4.6 of the Undertaking describes the characteristics of ARTC's indicative services. In practice, indicative services are primarily intermodal freight services. That is, freight carried in containers or vans that use more than one mode of transport in its journey from pick up to delivery. The ACCC considers that the Undertaking's definition of indicative service is sufficiently clear to provide users with certainty about the type of service to which the indicative charges apply.

Further, the types of trains that operate the indicative service account for about 60 per cent of ARTC's revenue, and indicative services are, by far, the largest service category on ARTC's network.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 4.6 setting out ARTC's access charges for indicative services do not raise objections under Part IIIA of the Act.

D.4.2.2. Access Charges for Non-indicative Services

ARTC's Proposal

The Undertaking does not specify prices for non-indicative services. Rather, clause 4.2 provides for ARTC to negotiate access charges for non-indicative services having regard to:

- the characteristics of the relevant services;
- access charges for indicative services;
- the commercial impact on ARTC (including the term of the access agreement, the potential for business growth, the opportunity cost to ARTC, the use of capacity, the business's credit risk, the market value of the train path sought, the segments of the network to which access is sought and any relevant charges previously agreed under the Undertaking);
- the logistical impact on ARTC (including the impact on other services and the risk of the operator failing to perform, and reduced capacity and system flexibility);
- the applicants capital or other contributions to ARTC's costs; and
- the cost of any additional capacity.

In order of their contribution to ARTC's revenue (highest to lowest), non-indicative services include steel, minerals, passenger services, general freight and grain.

ARTC publishes on its website access charges for non-indicative services and a general description of the services to which those charges relate. Charges for non-indicative

services include fixed and variable components. The variable part of the charge is the same across all services, indicative and non-indicative, except for heavy freight. The fixed, or flagfall, component varies between indicative and non-indicative services and among non-indicative services (Table D.4.2).

Table D.4.2: ARTC's Access Charges (as at 1 February 2008)

ARTC PRICING	North – South				Hunter Valley and Inland			
Track Access Prices	BORDER LOOP ISLINGTON	TOTTENHAM MACARTHUR	COOTAMUNDRA PARKES	MOSS VALE UNANDERRA	MAITLAND - MUSWELLBROOK	MUSWELLBROOK MERRYGOEN	MUSWELLBROOK - WERRIS CREEK	PARKES - WERRIS CREEK
VARIABLE PRICE per '000 GTK								
All Traffic [excludes Heavy Freight]	$2.950	$2.320	$3.248	$3.730	$3.143	$2.773	$3.143	$2.065
Heavy Freight		$4.500		$6.000				
FLAGFALL PRICE per TRAIN KM								
Express Passenger	$1.762	$1.882		$1.698	$1.663		$1.678	$1.681
Passenger								
Express Freight		$0.978	$0.978					
Regular Freight / Heavy Freight	$1.606	$1.557	$1.286	$0.949	$4.399	$4.500	$3.833	$0.500
Super Freight*	$0.855	$0.923	$0.880		$0.400	$0.433	$0.400	$0.090
Standard Freight	$0.756	$0.571	$0.389	$0.478	$0.400	$0.390	$0.400	$0.077

ARTC Pricing Schedule	East – West						
Track Access Prices	PARKES - CRYSTAL BROOK	ADELAIDE - PARKESTON	TARCOOLA - ALICE SPRINGS #	PT AUGUSTA - WHYALLA	ADELAIDE - PELICAN PT	ADELAIDE - MELBOURNE	APPLETON DOCK JUNCTION - FOOTSCRAY RD
VARIABLE PRICE per '000 GTK							
All Traffic [excludes Heavy Freight]	$3.300	$2.531	$4.741	$4.269	$3.727	$2.831	
Heavy Freight							
FLAGFALL PRICE per TRAIN KM							
Express Passenger	$1.668						
Passenger	$1.417	$3.470	$4.259			$2.136	
Express Freight	$0.927	$3.284				$1.717	
Regular Freight / Heavy Freight	$0.986	$3.273		$2.202		$1.993	$40.110
Super Freight*	$0.911	$3.263	$3.954	$2.202	$2.343	$1.756	$40.1
Standard Freight	$0.465	$2.327		$1.590	$1.950	$1.670	$40.110

Flagfall	**Train Type and Description**	**Trains**
Express Passenger	Max train speed above 115kph / Max Axle Loading up to 19T	XPT, Intra Urban Passenger, Intra State passenger
Passenger	Max train speed 115kph / Max Axle Loading up to 19T	Long Distance Passenger
Express Freight	Max train speed 115kph / Max Axle Loading up to 20T	Bi-modal
Regular Freight	Max train speed 80kph / Max Axle Loading up to 25T / Length to corridor standard max	Scheduled Services including Steel, Ore, Cement, Concentrates
Heavy Freight	Max train speed 80kph / Max Axle Loading up to 23T / Length to corridor standard max	Limestone
Super Freight*	Max train speed 110kph / Max Axle Loading up to 21T / Length up to corridor standard max	Intermodal, Land Bridging
Standard Freight	Max train speed 80kph / Max Axle Loading up to 23T / Length to corridor standard max	Non Scheduled Services including Grain, Minerals

Source: ARTC Website

*** Is the Indicative Service. Note: Rates apply to ARTC business customers. GST will be added to the total invoice charge based on above charges. Some rounding may occur on the final invoice**

ARTC also provides access to the network on an *ad hoc* basis, as opposed to long-term arrangements with fixed, scheduled train-paths. The majority of services provided under *ad hoc* arrangements are non-indicative services, mainly the transport of grain.

ARTC considers that its core business is to provide access to indicative services. The Undertaking states that the predominant use of the network is for indicative services and that 'investment in the development of the network is primarily to improve utilisation and performance of Indicative Services' (clause 4.2). ARTC further submitted that when formulating prices for non-indicative services, it is relevant to take into account the extent to which the network's capacity to provide indicative services is affected by the supply of non-indicative services.[139]

Views of Interested Parties

Operators generally believed that the Undertaking contains insufficient information about the terms and conditions of access for non-indicative services. They argued that the guidance in the December Undertaking on the prices for indicative services is not a reasonable guide for negotiating prices of non-indicative services and, therefore, there is considerable uncertainty about non-indicative prices.

RailCorp, for example, stated that the Undertaking fails to acknowledge non-indicative services and does not give effective guidance to how non-indicative services will be treated compared with indicative services.[140] Similar views that the Undertaking fails to provide sufficient certainty about the prices for non-indicative services and gives ARTC too much discretion in relation to such services were also expressed by NSWMC, GSR, SCT, QR, FROG and Asciano (PN).[141]

Stakeholders argued that this lack of certainty and ARTC's current approach to pricing for non-indicative services has resulted in inefficient utilisation of the network, and extreme impacts on access rates for certain traffics, which affect the viability of rail and modal choice.[142]

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139 ARTC *2007 Interstate Access Undertaking Explanatory Guide*, June 2007, p. 26.

140 RailCorp, *Submission to ACCC: ARTC Undertaking 2007*, August 2007 (RailCorp *August Submission*), p. 2.

141 New South Wales Minerals Council (NSWMC), *Response to Australian Competition and Consumer Commission Issues Paper Regarding Australian Rail Track Corporation 2007 Access Undertaking for its Interstate Rail Network*, August 2007 (NSWMC *August Submission*), p. 24; Great Southern Railway Limited, *Submission RE: Australian Rail Track Corporation Access Undertaking*, August 2007 (GSR *August Submission*), pp. 1 and 8-13; SCT Logistics, *Submission on the ARTC Undertaking*, July 2007 (SCT *July Submission*), pp. 4 and 11-12; Queensland Rail, *Queensland Rail Submission to ACCC on ARTC Interstate Access Undertaking 2007*, July 2007 (QR *July Submission*), p. 6; Freight Rail Operators' Group (FROG), *ARTC Access Undertaking – Interstate Network Response to ACCC Issues Paper*, February 2008 (FROG *February Submission*), p. 1; Asciano, *ACCC Issues Paper – ARTC Rail Access Undertaking*, February 2008 (Asciano *February Submission*), p. 2; Pacific National, *Submission to ACCC RE: Approval of ARTC Interstate Access Undertaking*, July 2007 (Pacific National *July Submission*), p. 23.

142 Great Southern Railway Limited, *Submission RE: Australian Rail Track Corporation Access Undertaking*, August 2007 (GSR *August Submission*), p. 10; Asciano *February Submission*, p. 2.

The December Undertaking makes it clear that ARTC is committed to publishing the prices for non-indicative services on its website. In response to this change to the Undertaking, interested parties argued that transparent non-indicative prices are not, on thier own, sufficient to allay concerns.[143] They argued that non-indicative prices need to be fully scrutinised through assessment of the Undertaking and that transparency does not guarantee that non-indicative prices will not increase once the Undertaking is approved. In addition, FROG and Asciano argued that many non-indicative services are long standing services and, therefore, it is possible and appropriate for ARTC to specify their price in the Undertaking.[144]

A number of submissions suggested that prices for at least some non-indicative services should be prescribed in the December Undertaking, and those prices should be subject to scrutiny under Part IIIA (for example, FROG, SCT Logistics, Asciano (PN)).[145]

In addition, RailCorp argued that the exclusion of non-indicative services 'fails to acknowledge that some smaller operators on the ARTC network are at a competitive disadvantage in dealing with ARTC under the negotiate and arbitrate model.'[146] GSR contended that the prices ARTC charges different users of the network do not distinguish appropriately between the costs of accommodating each of those services. Specifically, GSR stated that the access charges for passenger services were too high relative to freight, particularly given that passenger services are shorter, lighter and faster than freight services and can move through the network more efficiently.

Assessment of Issues

Combined, non-indicative services are an important part of ARTC's business, though there is considerable diversity among the types of traffic, the trains used to carry that traffic and the markets supplied by non-indicative services.

In considering whether ARTC's approach to non-indicative services is appropriate two key issues emerge:

- Does the December Undertaking strike the appropriate balance between certainty for access seekers and flexibility for ARTC to negotiate prices?
- If it is appropriate to constrain ARTC's flexibility are the constraints in the December Undertaking appropriate?

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143 See, for example, FROG *February Submission*, p. 6; Great Southern Railway, *ARTC – Access Undertaking December 2007*, February 2008 (GSR *February Submission*), p. 9; Queensland Rail, *QR Submission ACCC: Response to ACCC Issues Paper on ARTC Access Undertaking – Interstate Network*, February 2008 (QR *February Submission*, p. 7; SCT Logistics, *Re: Australian Rail Track Corporation (ARTC) Rail Access Undertaking – Interstate Network*, February 2008 (SCT *February Submission*), pp. 4-5.

144 FROG *February Submission*, p. 6; Asciano *February Submission*, p. 2.

145 Freight Rail Operators Group (FROG), *ARTC Interstate Access Undertaking Submission to ACCC*, July 2007 (FROG *July Submission*), p. 9; SCT *February Submission*, p. 4; Asciano *February Submission*, p. 3; Pacific National *July Submission*, pp. 23-24 and 33.

146 RailCorp *August Submission*, p. 2.

Flexibility v Certainty

Predetermining all access prices is not a requirement of Part IIIA. An undertaking could describe access prices in a number of ways. For example, it could list prices for different services, set a range within which prices are negotiated, provide a suite of possible charge and service combinations, specify indicative charges or reference tariffs, or specify factors that would be taken into account when negotiating prices.

Under Part IIIA, the issues of flexibility and uncertainty can be viewed as a trade-off between the advantages to ARTC of pricing discretion (including the flexibility to match prices more closely to the service being provided) and the disadvantages to access seekers of being denied the protection of greater certainty in access charges.

As noted in submissions, there are benefits to access seekers from having certainty in prices, including non-indicative prices. These benefits include:

- giving above rail operators the certainty needed to invest in above rail capital equipment and knowing that they will be able to realise a return on that investment because it is not possible for ARTC to appropriate that return in the future by raising prices once the investment is made. A lack of certainty could deter investment in above rail assets. In a recent submission to the Productivity Commission, Charles River and Associates argued:

  > The major concern with deregulating access prices for intermodal rail freight is that the infrastructure owner may take the opportunity to increase access prices to levels that would capture some or all of the above-rail operators' return on and of capital (and other fixed costs). More specifically, the infrastructure owner would seek to shift to itself some of the quasi-rents associated with above-rail operators' sunk investments. These include not only investments in physical assets, but also and very importantly, investments in expanding the use of the rail network, for example, by the development and marketing of innovative service options.[147]

- allowing operators to assess more easily the viability of new services, reducing the costs of planning future business growth and investment in above rail assets;

- compounding uncertainty from the risk that factors outside the rail industry could increase ARTC's market power during the term of the Undertaking, and increase its capacity to raise prices. While such factors are by nature difficult to anticipate, ARTC's market power could change with changes in the regulation, such as pricing carbon emissions or taxing road freight; and

- the above factors not only affect existing operators, but can raise entry barriers for prospective operators and can discourage the use of rail transport relative to other modes.

There are also benefits from ARTC having flexibility to negotiate prices:

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[147] Charles River and Associates, *Note on Deregulation of Rail Infrastructure*, 10 October 2006, p. 3.

- it recognises the diversity in non-indicative services and the benefits from having flexibility to vary prices to reflect the characteristics of the services provided. ARTC can negotiate a price level and structure that maximises cost recovery while taking account of market conditions;

- it gives ARTC the capacity to take into account all the impacts each service has on the costs of managing and maintaining the network, including interaction between services. This is recognised in the Undertaking which provides that, when setting prices for non-indicative services, ARTC can take into account a service's consumption of network capacity that would otherwise be available to indicative services; and

- ARTC also has the flexibility to charge prices that reflect demand conditions in the market where the service operates. Where revenues do not fully recover fixed and common costs, prices differentiated on the basis of ability to pay and the market value of a train path could generate more revenue without unduly distorting decisions about consumption of network capacity. The pricing principles in Part IIIA, against which the ACCC assesses applications, note that price discrimination should be allowed when it aids efficiency.

In practice, however, a number of factors limit the efficiency benefits of giving ARTC full discretion to negotiate non-indicative prices. First, the impact on access seekers noted above needs to be recognised.

Second, there can be practical difficulties that limit ARTC's ability to achieve the theoretical benefits from unconstrained flexibility to negotiate prices. Efficient price discrimination is difficult to implement in practice. To set prices that improve cost recovery without distorting the demand for rail access it is necessary to understand precisely how operators' demand for rail services would respond to higher prices (that is, the elasticity of their demand). Without such understanding, prices may be pushed too high, resulting in a fall in the use of the rail network and a loss in efficiency and community welfare.

Because of the benefits of certainty to access seekers and the practical difficulties obtaining all the theoretical benefits from full price flexibility, the ACCC considers that there should be constraints on ARTC's capacity to set prices. The next issue is whether the current limits in the Undertaking on ARTC's discretion are sufficient.

Limits on ARTC's Discretion

In practice, ARTC's discretion in setting charges for non-indicative services is not unrestrained. Several aspects of the Undertaking mitigate the potentially negative effects of price discretion:

- the Undertaking commits ARTC to setting access prices for non-indicative services having regard to indicative prices charged for indicative services. This commitment establishes the prices of indicative services as a fundamental factor to be taken into account by ARTC when negotiating prices for non-indicative services and by the ACCC when arbitrating disputes. The commitment by ARTC to 'have regard' to access charges of indicative services means that prices of indicative and non-indicative services are not disconnected. By

committing to 'have regard,' ARTC should be able to explain the relationship between the two sets of prices. At the very least, this commitment provides access seekers with a benchmark against which they can compare non-indicative prices when negotiating access;

- the 'like for like' pricing provisions in the Undertaking also limit ARTC's discretion to apply unrestrained price differentiation. Clause 4.3 of the Undertaking obliges ARTC not to discriminate on the basis of the identity of access seekers, and where the characteristics of the services are alike and access seekers are operating in the same end market. This provision prohibits price differentiation among similar services, helping to protect small operators who are competing against large operators in the same market, and constrains price discrimination to, for example, differentiating between broad product categories such as intermodal freight, bulk freight (grain steel and minerals) and passenger services;

- operators are protected by the dispute resolution provisions in the Undertaking, which allow disputes about charges for non-indicative services to be referred to arbitration. The ACCC notes that it could arbitrate on prices of non-indicative services, even where revenues in the relevant segment are below the regulatory ceiling. The scope of dispute resolution is discussed in more detail in section D.3.8; and

- previously, ARTC voluntarily published on its web site access charges for the main non-indicative services. The December Undertaking requires ARTC to continue this practice. Guaranteed transparency in prices makes it easier for operators to determine whether ARTC has breached the 'like with like' provisions in the Undertaking, or whether they have a legitimate dispute over the prices they have been offered.

It is not essential for the ACCC to assess the prices of all services provided by ARTC for the Undertaking to be acceptable under Part IIIA. Arguably, since the access provisions in Part IIIA are intended to promote negotiated outcomes, the main purpose of access undertakings is to provide a framework for negotiation that produces outcomes that meet the Part IIIA criteria. In some cases, guidance on access prices is needed to facilitate negotiation, but it is unlikely to be necessary for the regulator to vet, *ex-ante*, the individual prices for each service. Even if it is possible for ARTC to include more prices in its Undertaking, the ACCC is constrained to assessing whether the current provisions in the Undertaking are sufficient.

The ACCC considers that, given the impact of uncertainty on above rail operators and the practical limitations on achieving all the theoretical benefits of price discrimination, ARTC's pricing of non-indicative services should be constrained. It also considers that the constraints in the December Undertaking are sufficient to link the negotiation and arbitration of non-indicative services to indicative prices and to provide sufficient transparency for operators to judge whether ARTC has breached its obligations in the Undertaking.

The other concern of operators, whether there are likely to be inappropriate increases in non-indicative prices over time, is addressed in chapter D.4.5 on price escalation.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 4.2 of the Undertaking dealing with access charges for non-indicative services do not raise objections under Part IIIA of the Act.

D.4.3. Price Level

ARTC Proposal

Revenue from ARTC's services does not cover the economic costs of providing those services. In its Explanatory Guide ARTC argued that because of strong intermodal competition, access charges are constrained to levels below economic cost. ARTC claimed that 'pricing at above these levels in order to reach greater recovery of full economic cost is likely to adversely effect network utilisation.'[148]

It has, however, increased prices. On the east-west route, the variable and flagfall access charges that ARTC proposes to charge for indicative services are higher than the charges applicable under the 2002 Undertaking. ARTC argued in the Explanatory Guide that the increase was necessary to reverse the previous trend of falling real access revenue yields on the east-west corridor.[149] ARTC further argued that because rail was considerably cheaper than road on the medium and long-haul routes, and because access costs represent a small proportion of total user costs, the increase in charges is unlikely to affect rail's relative competitiveness.[150]

Views of Interested Parties

Participants recognised that ARTC does not recover the full cost of providing rail services. They submitted, however, that increasing charges on the east-west route would damage rail's competitive position. PN argued that while ARTC's revenue yields have decreased, most operators have also experienced falls in real rail freight prices on the east-west corridor.[151] For example, PN claimed its real freight rates have fallen 34 per cent since 1998-99.[152]

Rail operators also argued that they could not absorb the price increases as it is not possible for them to pass the increase in charges on to end users without losing market share.[153] QR's views were typical of these concerns:

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148 ARTC *2007 Interstate Access Undertaking Explanatory Guide*, June 2007, p. 4.

149 ibid., p. 58.

150 ibid.

151 Pacific National *July Submission*, p. 25.

152 ibid.

153 See, for example: Pacific National *July Submission*, p. 25; SCT *July Submission*, p. 5.

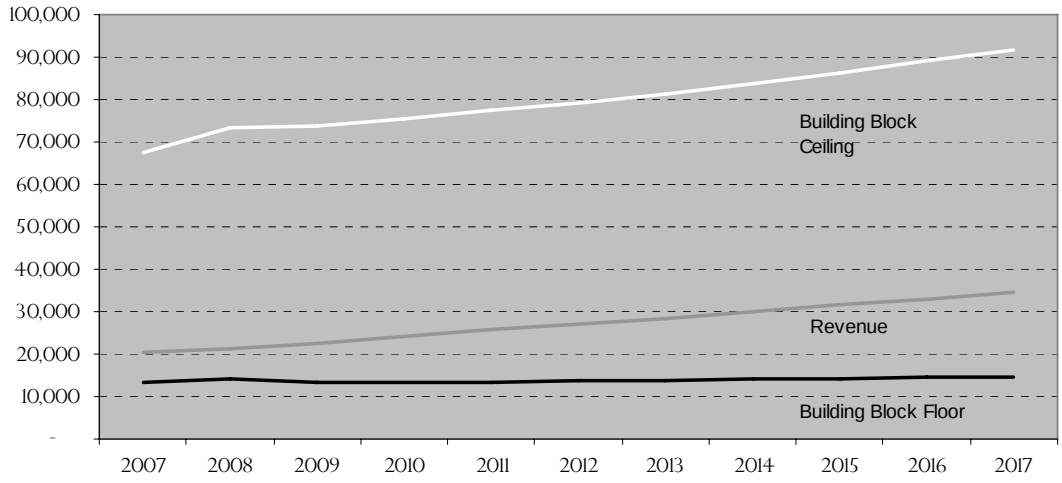
> QR disputes ARTC's apparent assumption that access charges for the East-West corridor can be substantially increased without adversely impacting upon the ability of rail operators to compete in this transport market. QR considers that both road and shipping present viable competitors to rail for this market, and ARTC has failed to take adequate account of this fact in proposing a significant increase in East-West prices.[154]

Assessment of Issues

An important issue for the ACCC's assessment is whether ARTC's prices are likely to breach the regulatory ceiling during the term of the December Undertaking. The ceiling proposed in the December Undertaking allows ARTC to earn revenues that cover the efficient cost of operating and maintaining the infrastructure, holding assets (return on capital) and replacing assets (return of capital).[155]

Even with recent price increases, ARTC is not expected to recover the full economic cost on any segment of the network during the term of the Undertaking. Figures D.4.1 to D.4.6 illustrate that revenue on each major segment in ARTC's network is forecast to lie between the regulatory revenue floor and ceiling derived under the building block model.

Figure D.4.1: Crystal Brook (SA) – Parkes (NSW) (Forecast Revenue and Building Block Bands)



[154] QR *July Submission*, p. 14.

[155] The proposed revenue ceiling is discussed in full in section D.5.1.

Figure D.4.2: Newcastle (Islington Junction via mains) – Queensland Border (Border Tunnel) (Forecast Revenue and Building Block Bands)

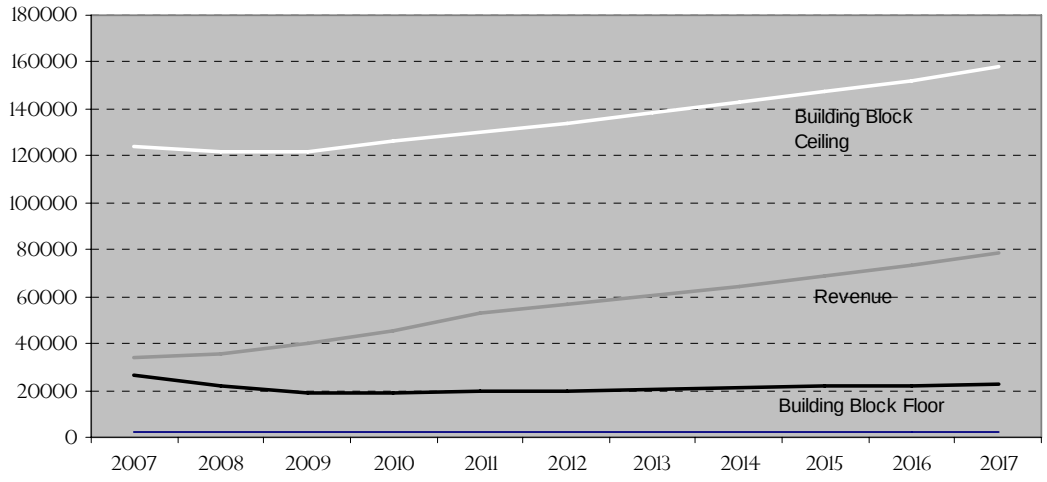


Figure D.4.3: Melbourne (Tottenham) – Macarthur (NSW) (Forecast Revenue and Building Block Bands)

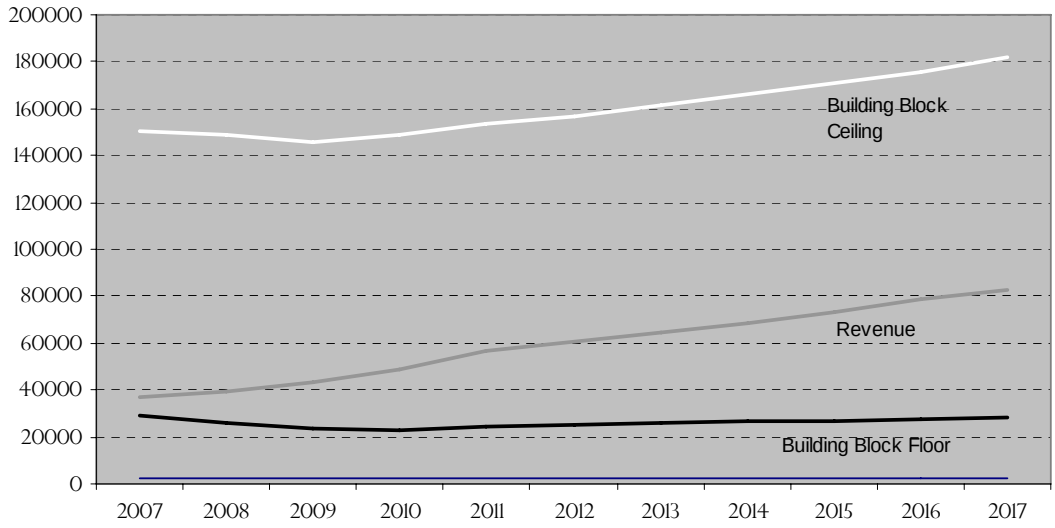


Figure D.4.4: Cootamundra (NSW) – Parkes (NSW) (Forecast Revenue and Building Block Bands)

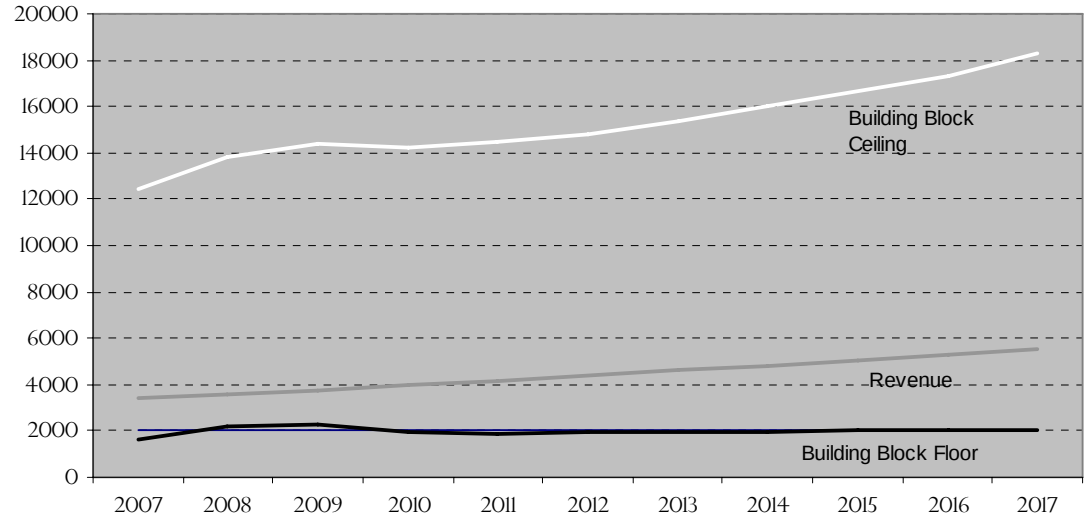


Figure D.4.5: Adelaide (Dry Creek) – Parkeston (WA) (Forecast Revenue and Building Block Bands)

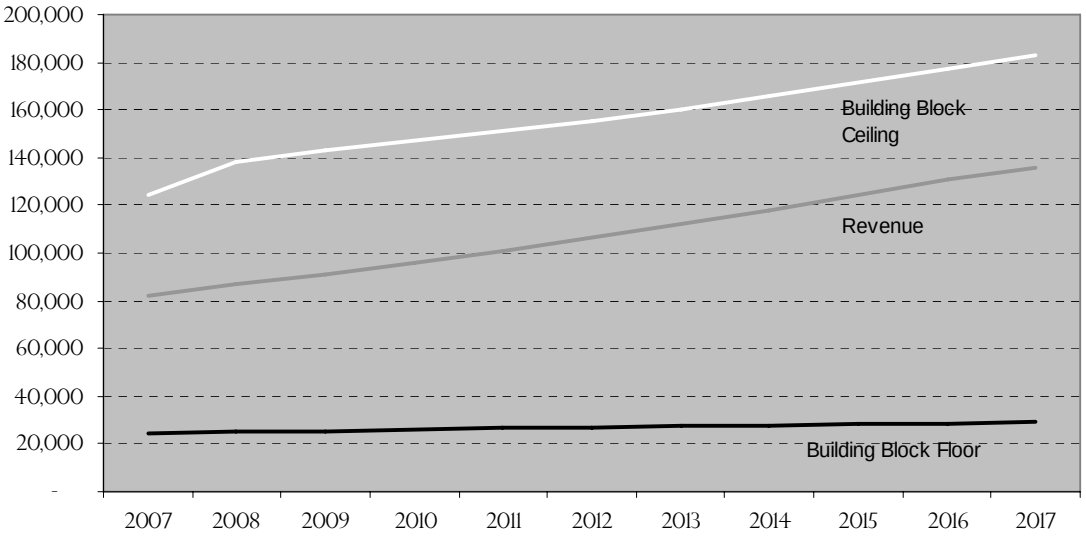
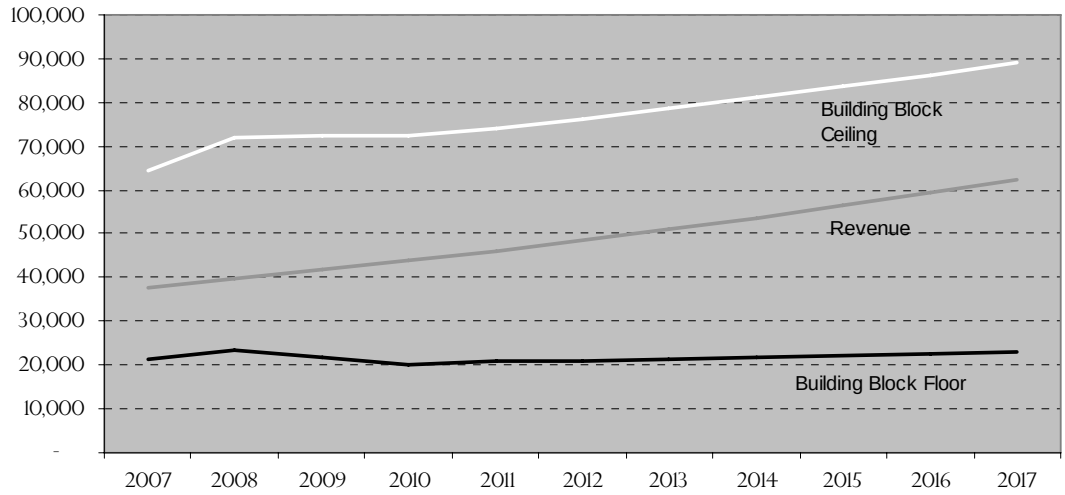


Table D.4.6: Adelaide (Dry Creek) – Melbourne (Spencer Street) (Forecast Revenue and Building Block Bands)



Source: ACCC from data provided by ARTC.

Figures D.4.1 to D.4.6 show that over the term of the Undertaking, the proposed charges, combined with increased traffic volumes, will allow ARTC to improve cost recovery. However, while revenues by the final year of the Undertaking are estimated to more than cover operating and maintenance costs and to contribute to (a partial) return on capital, they are not expected to reach the economic cost of providing services on any of the major segments.

The ACCC reviewed the assumptions ARTC used to predict the revenue growth presented in these charts. It notes that, while there appears to be scope to improve the efficiency of the rail network (particularly in NSW) and that the new ENOC in the December Undertaking could increase ARTC's revenues, overall, it is unlikely that any errors in the estimates would be large enough to change the conclusion that the regulatory ceiling would not be breached on any segment during the term of the December Undertaking (the floor and ceiling tests are discussed in more detail in chapter D.5).

The ACCC notes concerns from operators about price levels even if prices are below the regulated revenue ceiling. In assessing prices going into an Undertaking the ACCC needs to balance access seekers' need for certainty with the pricing principles in Part IIIA, which recognise that it is legitimate for ARTC to seek to recover revenue that is at lease sufficient to meet the efficient costs of providing access to the regulated service, including a return on investment commensurate with the regulatory and commercial risk involved. Recent changes to the price of indicative services on the east-west corridor have maintained the real value of those prices over time, and while significant price increases implemented between Undertakings are of concern as they may undermine the objective of an Undertaking to provide a stable and predictable environment for above rail investment, the ACCC does not consider that overall the growth in access prices has been inappropriate.

This assessment is based on a global evaluation of revenues and the regulatory framework in the December Undertaking. The ACCC has not assessed prices for individual non-indicative services and this conclusion does not necessarily mean that in an arbitration the ACCC would conclude that any individual price is necessarily appropriate simply because it falls below the revenue ceiling.

Draft Decision

The ACCC preliminary view is that the provisions in clause 4 setting out ARTC's level of access prices do not raise objections under Part IIIA of the Act.

D.4.4. Price Structure

ARTC's Proposal

Clause 4.6 of the Undertaking sets out the variable and fixed components of the access charges that apply to indicative services. Currently the variable charge is the same for indicative and non-indicative services, except heavy freight on two NSW segments. The fixed charge varies among types of traffic, depending on the characteristics of the train used to transport that freight.

The variable component of the access charge for indicative services generates the majority of access revenue from those services. Variable costs, however, account for only a small share of total economic costs. Table D.4.3 provides data on the proportion of access revenue that is expected from variable charges in the major segments of the network and the share of variable costs in total economic costs.

Table D.4.3: Comparison of Variable Costs and Revenue and Total Costs and Revenue, Major Network Segments (selected years).

	Variable access charge as a proportion of total revenue for indicative services (%)			Variable costs as proportion of total economic costs (%)[156]		
	2008	**2012**	**2017**	**2008**	**2012**	**2017**
Adelaide – Kalgoorlie	72	72	72	14	9	9
Adelaide – Melbourne	77	79	79	17	15	17
Melbourne - Sydney	76	74	76	9	6	7
Newcastle – QLD Border	77	77	80	10	7	7
Adelaide - Parkes	85	90	90	6	5	4
Parkes - Cootamundra	95	89	89	6	7	6
Moss Vale - Unanderra	99	97	97	0.3	0.3	0.4

Source: ARTC.

[156] Economic costs are defined as operating and maintenance expenditures directly attributable to each segment, combined with allocated indirect and fixed costs, depreciation and a return on assets.

On average, the proportion of access revenue derived from the variable access charge is expected to range from around 72 per cent (Adelaide-Kalgoorlie) to over 90 per cent in some other segments. While the average share of variable costs in total costs ranges from less than one per cent (Moss Vale-Unanderra) to just under 20 per cent (Adelaide-Melbourne).

Views of Interested Parties

Two operators questioned the incentive effects of the access fee structure used by ARTC. GSR submitted that the current structure favours slower freight traffic over faster passenger traffic.[157] QR was concerned that the pricing structure encourages longer trains over shorter trains and questioned whether access charges for indicative services are consistent with the characteristics of the network.[158] According to QR, ARTC's network is essentially designed for shorter trains but its prices (and path management policies) encourage the use of longer trains.

> QR's analysis … 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.
>
> 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.
>
> 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 length trains, 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.[159]

In essence, QR considered that ARTC's proposed access pricing structure raises the unit cost of access for indicative services that are not configured to the maximum limitations of the indicative service. This, combined with the fact that most of the premium train paths are held by longer trains notwithstanding the network being designed primarily for shorter trains, means that it is difficult for new operators to establish a viable presence through small scale entry.

In addition, GSR argued that, to promote efficient use of the network, variable charges should reflect the variable costs imposed by individual traffics. GSR submitted that the weight of a train and its axle loads are key drivers of cost in rail and this is reflected in

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157 GSR *August Submission*, p. 22.

158 QR *July Submission*, pp. 15-16.

159 ibid.

the way that ARTC levies the variable access charge, that is, as a rate per gross tonne kilometre (gtkm). However, GSR claimed that the Undertaking does not provide guidance on how mass and distance are taken into account when formulating charges. GSR noted that the variable charge is applied to passenger and freight trains at the same rate per gtkm but argued that passenger services impose lower variable costs on the network. According to GSR, passenger trains have less impact on the tracks and impose smaller maintenance costs because they '… are much lighter … have smaller axle loads … and … are more efficient than freight trains.'[160] This, according to GSR, means that passenger services should be charged a lower variable charge than freight services.[161]

Assessment of Issues

Efficient Pricing in Rail Access

Part IIIA of the Act notes that it is appropriate to charge for access using a multi-part pricing and price discrimination when it aids efficiency. Theoretically, the variable charge in a multi-part price will aid efficiency if it reflects, as closely as possible, the additional cost (marginal cost) of providing access to an individual operator. Such pricing (which in its most pure form is known as marginal cost pricing) encourages efficient use of the network by making it financially viable for operators to use the network if they value that use more than the cost of running their train. Such price structures are common in a competitive market.

The main role of a fixed (or flagfall) charge in a multi-part price is to recover costs that are not recovered through the variable component of the access fee in a way that minimises the impact on the incentives for operators to enter the market or run additional services. Ideally, a fixed charge should be levied as a lump sum for access to the infrastructure and should aim to cover costs that are incurred whether the train actually runs or not, that is, the fixed costs of operating the network. Examples of such costs include head office expenses, train planning/scheduling and weed control.

Access charges set by ARTC are, however, not cost-based. The variable and flagfall charges are not set to cover the variable and fixed costs of the network. Instead, ARTC claims that the flagfall and variable charges are set with reference to demand considerations and represent the highest charge that ARTC considers it can apply without substantially affecting the volume of network traffic. This approach reflects ARTC's strategy to encourage demand for access, and a belief that setting fixed charges at full cost-recovery levels would dampen traffic growth and compromise the network's long-term viability.

There are two broad issues that emerge from the submissions and the ACCC's analysis. First, looking forward for indicative services overall, is there a risk that ARTC's approach to pricing will diverge so far from costs that there could be a significant reduction in efficiency, particularly as the levels of cost recovery on the network increase?

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[160] GSR *August Submission*, pp. 22-23. Great Southern Railway's claim that passenger trains are more efficient than freight trains rests on the argument that they '… are faster, more reliable and more flexible than freight trains.'

[161] ibid.

Second, whether the approach of using a single price for all indicative services is appropriate, or whether the prices for indicative services should be diversified.

This analysis does not cover the prices of non-indicative services as these are not prescribed in the Undertaking. This does not mean that the ACCC has concluded that the prices for non-indicative services are appropriate, simply that it is not its role to analyse these prices as part of its assessment of the Undertaking.

The Relationship Between Indicative Charges and Cost

The analysis below looks at the variable and fixed components of access price for indicative services. It is illustrative only. The ACCC recognises that market constraints are a legitimate consideration in setting prices and there can be practical difficulties in setting efficient cost based prices. Also, efficient prices need to be based on efficient costs to deliver efficient outcomes. Costs are discussed elsewhere in this report. This section focuses on prices. The analysis below considers the broad relationship between prices and costs to identify issues that may warrant further investigation.

To undertake this analysis the ACCC needs to estimate the costs relevant to the variable component of the indicative charge (marginal cost) and the fixed component of the charge (fixed costs). Obtaining an appropriate proxy for marginal costs is difficult. These difficulties are well recognised in the regulatory literature, which has identified alternative methods for approximating the marginal cost of infrastructure services. Box D.4.1 notes various approaches.

Box D.4.1 – Pricing Methodologies

Marginal Cost

Marginal cost typically measures the change in cost as a result of adding one gross tonne kilometre of freight to the rail network. The econometric approach to estimating marginal cost defines a total cost function and then takes the first derivative of the cost function with respect to gross tonne kilometres. This approach uses engineering data to identify key relationships between different activities and costs, such as the specific costs imposed on the infrastructure by individual services.

Marginal cost is complex and difficult to measure and estimates vary widely — 'despite a great deal of research work, there is currently no general agreement on how actually to measure and calculate rail infrastructure marginal costs ...'[162] European Union Task Force estimates of rail's marginal cost, derived from econometric modelling, ranged from €0.13/gtkm to €1.23/gtkm.[163]

Incremental Costs

Incremental cost typically measures the cost per gross tonne kilometre of accommodating an increase of one increment in output. Incremental cost is often advocated as an alternative to marginal cost because it is simpler to measure, and is consistent with the way operators and infrastructure owners typically make decisions about service provision.

One major difference between marginal and incremental costs is the extent of non-variable costs captured by each measure. Marginal costs only measures changes in variable on-going maintenance costs. Incremental costs may include some fixed operating costs or common costs, depending on how broadly the concept is defined.

Average Variable Costs

Average variable cost is generally accepted as a reasonable proxy for marginal cost or avoidable cost. This measure sets prices based on the train characteristics that drive the network's variable costs. Access prices are then set per gtkm, to refect important drivers of track maintenance and renewal costs, such as weight, distance, speed and axle load.

In the following analysis the ACCC uses a calculation of average variable cost as a proxy for marginal costs and compares these costs against the variable component of the indicative access charge. The fixed component of the access charge is compared to a calculation of ARTC's fixed operating costs.

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[162] Thomas, J., *EU Task Force on Rail Infrastructure Charging: Summary of Findings on Best Practice in Marginal Cost Pricing*, accessed on 20 March 2008, at: http://www.imprint-eu.org/public/Papers/IMPRINT3_Thomas.pdf

[163] ibid.

The variable cost in the analysis below is calculated as the costs incurred by ARTC on a segment in a financial year that would be avoided if no rail traffic ran across this line. The fixed cost in the analysis below is the costs incurred by ARTC on a segment in a financial year to maintain the track in a serviceable condition, plus executive and finance and procurement costs allocated to that segment. The calculation of these costs excludes capital costs to construct the rail line and to extend capacity and so, therefore, should be considered to be short-run cost concepts.

Figures D.4.7 to D.4.10 illustrate the projected relationship between indicative charges and variable and fixed costs for each line segment over the term of the December Undertaking.

Figure D.4.7. North-South Rail Lines: Percentage Difference Between Unit Variable Revenues and Unit Variable Costs for Indicative Services.

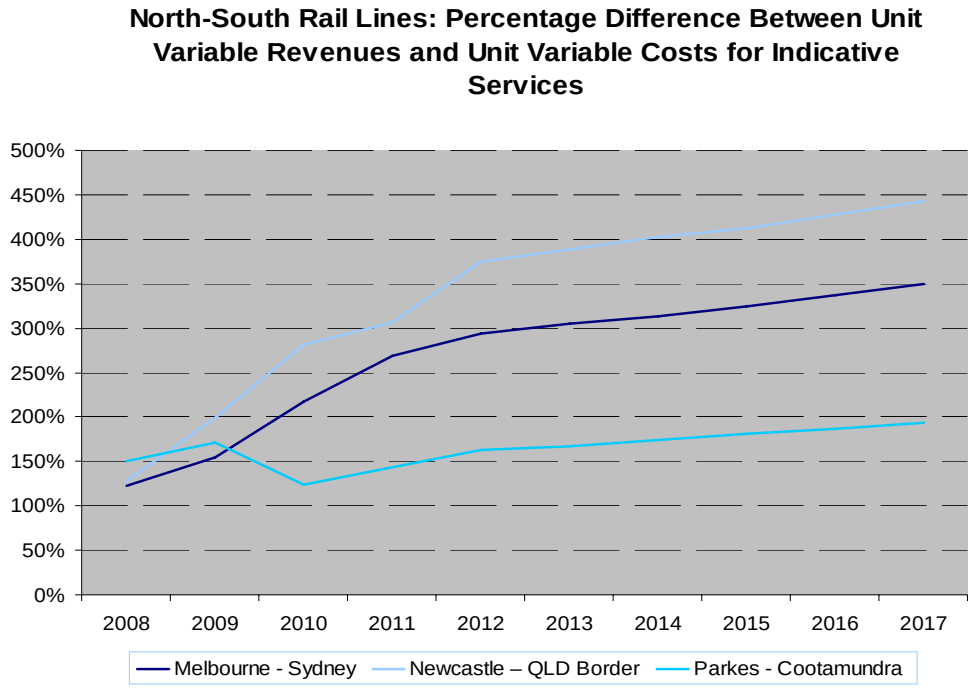


Figure D.4.8. North-South Rail Lines: Percentage Difference Between Unit Fixed Revenues and Unit Fixed Costs for Indicative Services

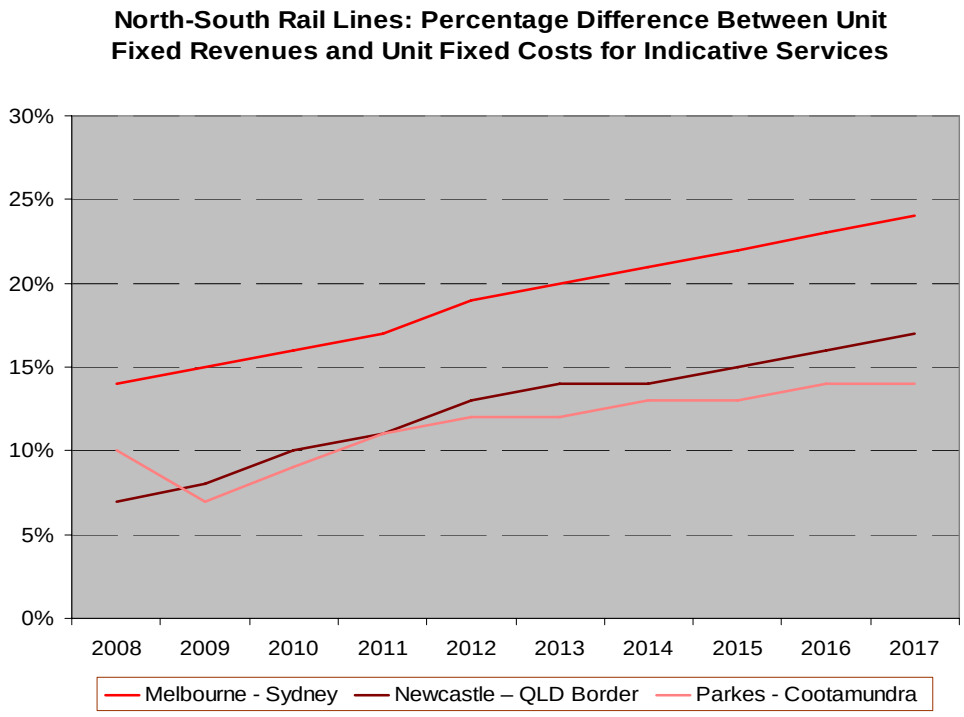


Figure D4.9. East – West Lines: The Percentage Difference Between Unit Variable Revenues and Unit Variable Costs for Indicative Services

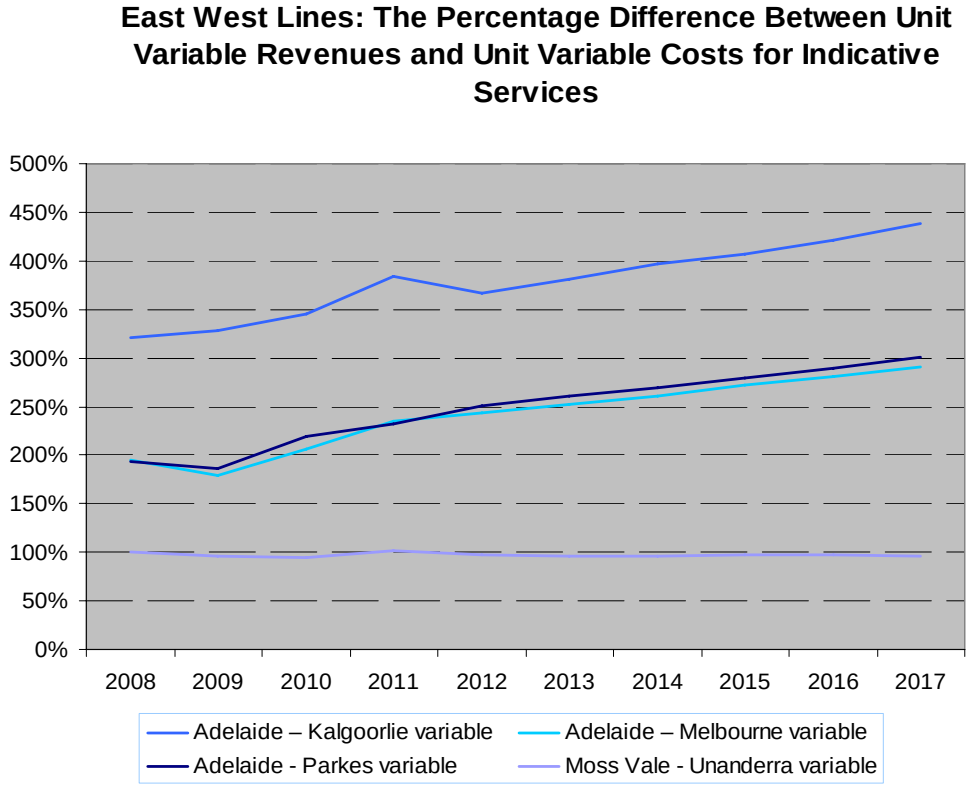
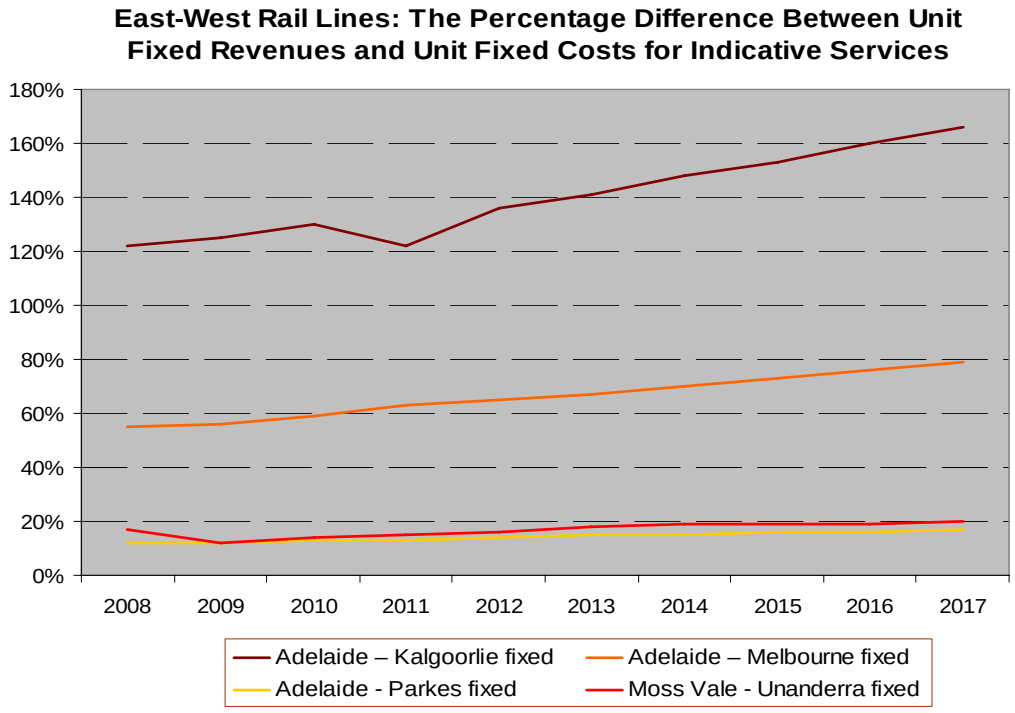


Figure D4.10. East-West Rail Lines: The Percentage Difference Between Unit Fixed Revenues and Unit Fixed Costs for Indicative Services



Key observations from the figures above are:

- for most key segments revenue from variable charges is higher than variable costs. With the exception of Adelaide to Kalgoorlie, revenue from the flagfall is less than fixed costs (excluding a return on capital);

- in the initial year of the Undertaking, the largest gap between variable access charges and average variable costs is in the Adelaide-Kalgoorlie segment. By the final year of the Undertaking, the gap between variable access charges and average variable costs in the Melbourne-Sydney and Newcastle-Queensland Border segments widens, because access charges increase subject to the CPI cap while unit costs decline as traffic volumes grow and new investments improve the quality of the infrastructure, reducing on-going maintenance expenditure; and

- in the initial year of the Undertaking, the Adelaide-Kalgoorlie segment is the only major segment in ARTC's network where average revenue from the flagfall charge covers average fixed costs (excluding a return on capital). In the Adelaide-Melbourne segment, revenue from the flagfall covers about 55 per cent of fixed costs, while in the other segments coverage is at most 18 per cent. By the final year of the Undertaking, the proportion of unit fixed costs covered by revenue from the flagfall charge improves in all segments.

The data indicate that ARTC's access charges may not be structured to match cost drivers and revenue sources closely. In essence, the evidence suggests that ARTC relies

heavily on the variable charge as the major source of revenue and this is unlikely to change over the term of the Undertaking.

The gap between variable charges and average variable costs suggests that the variable component of the indicative access charge is higher than the cost to ARTC of providing access to additional traffic in the short run. It is unclear from this analysis whether ARTC's variable charges reflect the cost of making provision for additional traffic on its rail lines or whether it is relying on variable charges to recover its capital costs.

In addition, the analysis shows a trend for variable changes to continue to increase relative to variable cost, such that ARTC's reliance on revenue from the variable charges appears to be increasing. As traffic on the network grows, and unit costs fall, reliance on the variable charge would be expected to fall, not increase, for a regulated business operating at its revenue ceiling. If ARTC continued to rely heavily on the use of variable charges when it is operating at the revenue ceiling, there is a risk that such prices could discourage efficient use of the network as price sensitive traffic, which would be prepared to pay prices close to the cost it imposes on the network, may be priced off the network by higher variable charges.

Secondly, large fixed charges may risk distorting competition between operators of different sizes and inhibiting entry into the freight services market if not set appropriately. If a large fixed access fee restricts demand for access, it can defeat the objective of improving cost recovery and affect the long-term financial viability of the infrastructure. Also, if infrastructure utilisation is growing strongly and network capacity constraints are becoming evident, access charges with a small variable and large fixed component, can encourage use of the network[164] and exacerbate capacity problems.

A third issue is that the cost concepts in the above analysis relate to short-run costs only and therefore abstract from ARTC's cost recovery of the Interstate Network's capital cost and the cost of servicing additional capacity. This makes the ACCC concerns noted above indicative only. Additionally, evidence on the costs associated with use of the network and the nature of the relationship between many cost drivers and costs is scant. The drivers of cost are complex and this affects decisions on how variable charges should relate to variable cost and whether the variable charge should be different for different traffics. Furthermore, interaction between traffics, such as managing passenger priority or allocating train paths among trains that travel at different speeds can also impose costs on the rail network.

The ACCC, therefore, considers that the structure of ARTC's prices warrants further consideration, over time, particularly as cost recovery on the network increases. Increasing cost recovery will potentially reduce the incentives for ARTC to encourage the use of the network and, therefore, increase the risks that inappropriate pricing structures could develop or be maintained. The ACCC suggests that when ARTC

[164] A large fixed charge encourages use of train paths because most of the cost of a path must be paid regardless of whether it is used. A low variable charge may inappropriately encourage use of the network if it does not reflect growing congestion costs or the value of limited network capacity.

considers future changes to indicative prices that it should also look at whether it is appropriate to re-balance the price structure.

Charges for Individual Services

Some stakeholders raised concerns about the structure of ARTC's access charges and the approach used to set the variable and/or the fixed components of those charges. The case for greater variation within indicative charges is discussed in this section. As noted above, this analysis does not cover the prices of non-indicative services, as these prices are not prescribed by the Undertaking. ARTC's current approach to non-indicative charges, that is charging all operators the same variable price on each line segment and varying the fixed component of the charge, reflects past practice, but it is not required by the Undertaking.

In its submission, QR raised concerns that the flagfall charged by ARTC for indicative services unfairly benefits longer trains because the network is not designed for long trains, not all operators can access the train paths that allow for longer trains and this discourages competition by raising the cost of entry for operators wishing to commence services at a smaller scale. The concerns raise by QR could eventuate if the flagfall is too high relative to the variable charge or shorter trains should be charged a lower flagfall than longer trains.

The analysis above indicates that on north-south segments, where QR has the greatest concerns about the impact of the flagfall on competition, the flagfall is well below fixed costs and there is, if anything, excessive reliance on the variable component of the charge.

It may, however, be legitimate to charge shorter trains a lower flagfall if they account for fewer capital costs or have more elastic demand and therefore cannot bear as high a flagfall as longer trains. Whether shorter trains have different demand elasticity when compared to longer trains is difficult to determine because it would depend on factors such as the freight being carried by each type of train.

The ACCC considers that charges that adjust the fixed component of the access charge to reflect length of train may, in effect, remove the operation of the like with like clause. There is a risk that such a change would narrow the interpretation of 'the characteristics of the service are alike' (clause 4.3(b)) so much that only identical services would be classified as like services.

Given broad industry support for retaining the obligation in the December Undertaking not to discriminate between like services, and the complexity of disaggregating indicative services and increasing the number of indicative charges, the ACCC considers that administration costs and other considerations would outweigh the benefits of changing the approach to pricing indicative services.

Draft Decision

The ACCC preliminary view is that the provisions in clause 4.6 setting out ARTC's structure of indicative access prices do not raise objections under Part IIIA of the Act.

D.4.5. Price Escalation

ARTC's Proposal

ARTC proposes to change the approach for setting the maximum annual variation for Indicative Access Charges from the 'greater of CPI – 2 per cent or 2/3rds of CPI' used in the 2002 Undertaking to a 'cumulative' CPI-based approach. The new approach is given by the following formula:

$AC_t = AC_{t-1} * (1 + TV_i)$

Where:

AC_t is the Indicative Access Charges for Indicative Services following the relevant Review Date;

AC_{t-1} is the Indicative Access Charges for Indicative Services immediately preceding the relevant Review Date;

TV_i is the greater of:

(A) $(((\text{CPI Index}_i / \text{CPI Index}_0) / CV_{i-1}) – 1) * 100$, and

(B) Zero

Where:

TV_i is the maximum variation (%) to Indicative Access Charges that may be applied from 1 July 2008 and thereafter from each 1 July until expiry of the Term ('Determination Date');

CPI Index_i is the All groups Consumer Price Index, Weighted Average of Eight Capital Cities, Index Number for the March quarter of the year preceding the relevant Determination Date;

CPI Index_0 is the All groups Consumer Price Index, Weighted Average of Eight Capital Cities, Index Number for the March quarter of the year 2007, being 155.6;

CV_{i-1} is the cumulative impact of the application of variations actually applied by ARTC to the Indicative Access Charges for Indicative Services between the first Determination Date (1 July 2008) and the relevant Determination Date. The cumulative impact would be determined in accordance with the following formula:

$CV_{i-1} = (1 + V_1) * (1 + V_2) * \ldots * (1 + V_{i-1})$

Where

V_1, V_2, V_{i-1} are the actual variations which have been applied from the first Determination Date (1 July 2008) to the relevant Determination Date.

The above formula does not include a discount factor and allows 'accumulation' of rises that are not applied in any one year. ARTC would have the flexibility to increase

prices more than once a year, or not at all, with the guarantee that price increases would not exceed changes in the CPI.

ARTC proposed a ten-year regulatory term in its December Undertaking. To ameliorate concerns with the cumulation of price increases over ten-years, ARTC proposed to accumulate price increases in five-year blocks, such that price increases in the first five years of the Undertaking are capped by the cumulative increase in CPI over that time. Price increases not affected in the first five years of the Undertaking cannot be carried over into the second five years.

To enhance certainty about likely price movements, ARTC also commits in the December Undertaking to regularly publish a 'state of play' with information on the extent of price increases that it is able to implement within the cap; that is, total cumulative CPI increases less actual price rises applied to date. ARTC explained that through the proposed escalation formula it is:

> … seeking to increase flexibility in indicative access price variability to better reflect market conditions. The existing mechanism means that any opportunity to increase pricing that is forgone (for any reason) cannot be recovered, impacting longer term sustainability.[165]

The price cap mechanism in the Undertaking does not apply to non-indicative services. ARTC is not legally obliged to limit increases in non-indicative access prices in any one year or over the term of the Undertaking. Access seekers are, however, still free to negotiate contractual arrangements that include limits on price increases.

Views of Interested Parties

In the context of the price escalation formula interested parties were concerned about the cumulation of price increases over five years, ARTC's ability to increase prices more than once a year, lack of a discount factor in the formula and the formula not covering prices for non-indicative services.

Interested parties argued consistently that the cumulative of price increases creates uncertainty and fails to recognise the impact on above rail operators of unpredictable price shocks. There was also scepticism about ARTC's ability to exercise discretion and apply price increases without adversely affecting above rail operators and the demand for rail services.[166] SCT's comments were typical of these views:

> If an increase were warehoused by ARTC and several CPI increases applied all at once, there would be little or no opportunity in the short term for an operator to recover part or all of that increased cost.[167]

PN, FROG and QR also argued that the reset at year six included in the December Undertaking does little to improve certainty. PN and FROG asserted further that the reset may actually encourage ARTC to increase prices at the end of five years.[168]

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165 ARTC, *Explanatory Guide to the 2007 Interstate Access Undertaking*, June 2007, p. 61.

166 See for example: FROG *July Submission*, pp. 6 and 13; QR *July Submission*, p. 19; QR *February Submission*, p. 9; Pacific National *July Submission*, pp. 33-34.

167 SCT Logistics, *Submission on the ARTC Undertaking*, July 2007, p. 12.

Interested parties also argued that ARTC's commitment to publish a state of play on price increases may benefit new entrants, but not existing operators who can track price increases and have access to data on inflation. QR argued that publishing a state of pay may benefit operators more if it include escalation forecasts and the basis for those projections, and was developed in conjunction with operators.[169]

FROG and Asciano argued strongly that allowing ARTC to increase prices more than once a year is also a problem for operators.

> Currently industry, both the rail operators and its customers, are geared to a single annual access price change. In this way rail operators can manage their customer contracts appropriately and customers are able to make modal decisions for the year based on known costs. The additional uncertainty of a prices rise at any time will create unnecessary additional contractual complexity and uncertainty making rail a less attractive modal option.[170]

There was strong criticism of ARTC's proposal not to include a discount factor in its CPI escalation formula. Interested parties argued that the approach in the December Undertaking fails to recognise the need for continual pressure on ARTC to improve its efficiency. Operators also noted that real freight rates are falling and, therefore, they cannot pass on full CPI price increases.

QR argued that ARTC is entitled to a share, but not all, of the benefits from increased traffic volumes, but full CPI increases mean that ARTC captures benefits that should accrue to above rail operators.[171] NSWMC argued that by using an inflation adjustment without a discount factor ARTC's approach is inconsistent with that in other rail access regimes. NSWMC recognised that some flexibility in price increases may be needed but suggested that if ARTC wanted to exercise such flexibility it should be required to justify its approach to either the ACCC or end users.[172]

Finally, interested parties also argued strongly that the price escalation formula should apply to non-indicative prices.[173] Operators argued that recent price increases for non-indicative services have been above the price escalation formula in the 2002 Undertaking and, therefore, they are not confident that ARTC would moderate price increases for non-indicative services without strong controls in the December Undertaking.[174]

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168 FROG *February Submission*, p. 7; Asciano *February Submission*, p. 5; QR *February Submission*, p. 8.

169 QR *February Submission*, p. 10.

170 FROG *February Submission*, p. 7; see also Asciano *February Submission*, p. 7.

171 QR *February Submission*, p. 9.

172 NSWMC *August Submission*, p. 24.

173 Pacific National *July Submission*, p. 33; Asciano *February Submission*, pp. 2-3; FROG *February Submission*, p. 1.

174 See for example: FROG *July Submission*, p. 9; Pacific National *July Submission*, p. 23; SCT *February Submission*, p. 2.

Assessment of Issues

There are three key issues that arise from the price escalation formula proposed by ARTC. One, the methodology used for price increases, including the ability to bank or accumulate price increases and to increase prices more than once a year. Two, the absence of a discount factor. Three, the exclusion of prices for non-indicative services from the control on price rises.

Cumulative Price Increases

A key issue is whether the potential benefits to operators of having certainty about the future path of access prices outweighs the benefits of the flexibility to delay price rises. The operators' concerns arises from two sources:

- if prices have not been increased by the full value of CPI in early years, the maximum possible increase in later years is higher than what would be allowed under an annual CPI increase; and

- unlike the 2002 Undertaking, in which prices could only be increased once a year, the December Undertaking allows for multiple changes each year.

Uncertainty about the cost of access can complicate bidding for new freight business and planning future investment. A particular concern is whether the risk of large price increases in the later part of the escalation period increases uncertainty for above rail operators and discourages investment in above rail assets. Such uncertainty may also complicate contractual processes between above rail operators and their customers, as contracts would need to be amended, moving away from the current practice of annual price variations, to accommodate the potential for access prices to change more frequently.

From ARTC's perspective, the ability to accumulate price increases allows it to align price movements with industry conditions overall, minimising price impacts on operators when conditions are not favourable and maximising cost recovery because, if market conditions improve, price increases are only delayed and not forgone. While this policy may mean that over the life of the Undertaking price increases are higher, operators are still assured that prices will not rise by more than CPI over the relevant five-year block.

On balance, the ACCC considers that the cumulative price increase component of the price escalation formula is not inconsistent with Part IIIA of the Act. It provides ARTC scope to benefit from price increases forgone in previous years while operators are protected by the overall CPI cap and the five-year time constraint. It may mean that higher prices are more likely, but the maximum possible increase over the five years is as easy to estimate as annual CPI increases. The greatest uncertainty is in the later years of the cumulation period for above rail operators considering new investment, if ARTC has chosen not to increase prices in early years. While such costs are not trivial, the ACCC considers that, given the accumulation period is restricted to five years and the period of greatest uncertainty would be limited to the later part of this five year period, these costs are not sufficiently large for ARTC to reject the Undertaking based on ARTC's inclusion of the cumulative price escalation formula.

The ACCC does consider, however, that ARTC's ability to increase prices more than once a year will affect above rail operators contractual arrangements with their customers. While it is theoretically possible to manage multiple price increases through changes to access contracts and freight contracts, there are limitations to the flexibility of these changes:

- the Undertaking locks in the price escalation provisions, limiting the scope for arbitration to resolve disputes if the above rail operator felt that there were important reasons why their contract should manage price increases differently, and ARTC did not agree with this view; and

- changing the approach in freight contracts away from the accepted industry norm may raise concerns among the customers of above rail operators and deter them from using rail services.

Given the risk of costs to above rail operators and limited evidence that the freedom to increase prices more than once a year has significant benefits for ARTC, the ACCC has concluded that this aspect of the price escalation formula does not balance the interests of access seekers and the access provider, and that the escalation formula should be modified so that prices can only be increased once a year.

Discount Factor

There was considerable criticism among interested parties about ARTC's failure to include a discount factor in its price escalation formula. Many argued that, as a result, the Undertaking fails to provide sufficient assurance to operators that ARTC is committed to lowering costs and improving service levels.

The provisions in Part IIIA require the ACCC to assess access arrangements taking into consideration the efficiency of costs and incentives to pursue efficiency gains. This is evident in the pricing principles, with s.44ZZCA providing that revenues should at least cover efficient costs and that access pricing regimes should provide incentives to reduce costs or improve productivity. The objects clause, 44AA(a), also provides that regimes should promote economically efficient operation of, and investment in, infrastructure.

In general, unregulated monopolist infrastructure owners have weak incentives to improve efficiency, share the benefits of efficiency improvements with customers and improve service quality. The challenge for regulators is to ensure that, in the absence of competition, regulated infrastructure owners face adequate incentives for efficiency. There are several accepted regulatory approaches for achieving this.

The discount factor in a price escalation formula can serve a variety of roles. First, it may be used in cost based undertakings, in which prices are near the ceiling, to smooth a price path so that revenues will approximate costs at the end of the regulatory period and large price adjustments are not needed to rebalance costs and revenues. Second, it can be used to ensure the benefits of efficiency improvements are shared between the regulated firms and its customers. Third, it is also arguable that if the discount factor is set so that the regulated business needs to improve its efficiency to maintain its profitability, then it could act as a driver for efficiency gains.

Overall, it is common regulatory practice to constrain a regulated firm's prices and to consider whether that constraint should allow price changes to be more than, less than or equal to CPI. The ACCC, therefore, considers that the analysis of ARTC's Undertaking should include consideration of an X factor and whether that X factor should be positive, negative or zero.

ARTC's additional explanatory guide lists reasons why it believes it is unnecessary to include a discount factor in its price escalation formula.[175] These reasons focus on whether a discount factor is needed to drive efficiency. The ACCC has reviewed and analysed these reasons and reached the following views. First, there is some evidence that ARTC has improved its efficiency. While ARTC's obligation under the Undertaking is to report performance against KPIs, not meet performance benchmarks, ARTC indicates that it is committed to improving service standards. That said, there are potential concerns about ARTC's costs going forward. Evidence suggests that unit operating expenditures in the December Undertaking are higher than in the 2002 Undertaking. The cost difference appears to originate in NSW, where unit operating expenditure is higher than for the rest of the network. The ACCC received expert advice from PWC that some of ARTC's NSW costs may be above efficiency benchmarks.[176] Evidence of technical inefficiency in NSW makes it even more important to guarantee that ARTC faces strong incentives to improve efficiency.

Second, the ACCC considers that, while the general provision in clauses 1.1(e) and 1.2 (the preamble and objectives of the December Undertaking), refer to ARTC's desire to operate the network efficiently, none of the other provisions in the Undertaking contain enforceable commitments on ARTC to pursue efficiency improvements or to base charges on efficient costs. The ACCC has assessed ARTC's costs as part of its assessment of this Undertaking, but there is no explicit ongoing requirement in the Undertaking to continue efficiency improvements.

The ACCC, therefore, considers that incentives are needed for ARTC to continue to reduce its costs. However, there are incentives for ARTC to improve efficiency even without including efficiency drivers in the Undertaking. Because ARTC is recovering less than economic costs on all segments and the network is below full utilisation, it has an incentive and a capacity to reduce costs and encourage growth in the use of its services. Allowing ARTC to keep any cost reductions it achieves means it would retain the full financial benefit of efficiency improvements and the incentives to pursue such improvements would be strong. Since it is most likely that ARTC's revenues would remain below full cost recovery for the next ten years, these incentives are expected to continue for the term of this Undertaking.

Overall, in assessing ARTC's proposed escalation formula the ACCC considers that it is important to analyse whether that formula should include a discount factor and what the appropriate size of such a discount factor would be. By limiting price adjustments to CPI, ARTC has implicitly set its discount factor at zero.

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175 ARTC, *Additional Explanatory Guide*, December 2007, pp. 15-19.

176 PricewaterhouseCoopers (2008) *Australian Competition and Consumer Commission Review of ARTC Operations and Maintenance Cost and Cost Allocation Method*, March, p. 27.

In assessing whether a discount factor of zero is appropriate in the context of the December Undertaking the ACCC notes that:

1. while a smooth price path over the term of the Undertaking is important to generate certainty for access seekers, because ARTC is below the ceiling, it is not necessary to use the discount factor to match revenue and cost changes over the term of the Undertaking;

2. similarly, given that the rail network is operating so far below cost recovery there is justification for ARTC to retain a greater proportion of its cost reductions to improve the financial viability of the network, rather than automatically sharing a proportion of those gains across all customers; and

3. there is no need to design a discount factor as an incentive to improve efficiency because, as noted above, such incentives already exist.

The ACCC, therefore, concludes that, in this case, an X of zero within a CPI-X price cap would be appropriate given the circumstances of the December Undertaking. The ACCC stresses, however, that this conclusion is based on the circumstances of the December Undertaking and would not necessarily apply to other rail networks nor would it necessarily hold for the interstate network in the future.

Price Increases for Non-Indicative Services

The issues relevant to whether ARTC should be required to apply the price escalation formula in the December Undertaking to non-indicative services are similar to those discussed in D.4.2.2 about whether the Undertaking should prescribe non-indicative prices. Consistent with that chapter, the ACCC considers that the impact on access seekers of ARTC's capacity to vary prices needs to be weighed against the benefits of price flexibility.

From ARTC's perspective, flexibility in how and when it increases prices can improve its ability to maximise cost recovery, rebalance and adjust prices as appropriate and respond to the demands of different traffics and different services.

However, the impact on access seekers of unrestrained increases in non-indicative prices is potentially significant. Non-indicative services include products such as bulk minerals and steel. These are the traffics where the practical alternatives to transport by rail are most limited, and ARTC is likely to have the greatest market power. Given the potential cost to access seekers, the ACCC considers it inappropriate for ARTC's capacity to raise non-indicative prices to be completely unrestrained.

In practice, even though non-indicative prices are not covered by the price escalation formula, the ACCC considers there are still constraints on ARTC's capacity to increase such prices. The commitment in the Undertaking to set non-indicative prices having regard to the prices charged for indicative services includes having regard to how prices increase over time. Again this commitment creates a connection between the indicative and non-indicative prices, so that indicative service prices are a fundamental factor to be taken into account by ARTC when negotiating access for non-indicative services and by the ACCC in arbitrating any relevant disputes. Access seekers' ability to

compare increases in the price of indicative and non-indicative services is further strengthened by the requirement for ARTC to publish non-indicative prices.

While recognising that the outcome of any dispute resolution process depends on the circumstances of the dispute, the ACCC notes that the escalation formula in the December Undertaking already allows for price increases for indicative services that fully reflect increases in CPI. The ACCC considers that there would need to be strong justification for increases in the price of non-indicative services that are greater than that provided for indicative services. It also notes that by excluding non-indicative services from the escalation formula, ARTC has left open the potential for an arbitration on the price of non-indicative services to conclude that price rises less than CPI are appropriate, depending on all the circumstances of the dispute.

Finally, it is open to access seekers to negotiate price escalation clauses in their agreements with ARTC. Such negotiations could agree to similar constraints on price increases to those in the Undertaking for indicative services, or agree on other constraints. As with all services covered by the December Undertaking, such negotiations are backed by a right to seek arbitration if a dispute arises.

In conclusion, while the ACCC considers that the December Undertaking would be improved if non-indicative services were covered by the escalation clause in the Undertaking, it does not consider that this is essential for the Undertaking to meet the criteria in Part IIIA.

Draft Decision

Recommendation:

- The ACCC's preliminary view is that the ARTC Undertaking should be amended so that price increases for indicative services can only be implemented once a year.

D.4.6. Excess Network Occupancy Charge

ARTC's Proposal

Clause 4.5(a)(iii) of the Undertaking provides for an excess network occupancy charge (ENOC) as follows:

a) Access charges will comprise:

- an excess network occupancy component, which is a function of time ($/hr or part thereof) sought by an Applicant for a Train Path on the Network, which is in excess of:

(A) a reasonable allowance for Section run times for the applicable Train service type as determined by ARTC;

(B) dwells for crossing and passing other Trains as determined and made available by ARTC for the Train Path; and

(C) an allowance for the reasonable requirements for operational activities whilst the Train occupies the Network as specified at 4.6(c).

b) Subject to clause 4.5(c), the application of the excess network occupancy component relates only to the contracted Train path, and not the utilisation of the Train Path.

c) In determining the excess network occupancy component, ARTC will pro-rata the flagfall component back to an amount per hour by reference to the total of Section run times applicable to the relevant Segment to which the flagfall component applies.

The ENOC is a function of time in excess of reasonable allowances for section run times and for other network utilisation needs (dwells for crossings and other operational activities) for the applicable train service type. It is levied irrespective of whether the contracted path is used. Though, clause 4.3(b) of the IAA provides that the ENOC will not be applied if it is ARTC's fault that the contracted train path is not available. This provision has not been included in the December Undertaking.

In the Explanatory Guide to the December Undertaking, ARTC clarifies that 'the ENOC only applies to the excess time in the contracted Train Path requested by access seekers and not the excess time that might arise in actual running.'[177] That is, it is not a charge for late trains. In addition, ARTC does not intend to apply the ENOC if the contract must include excessive transit times because a better path it not available, though this is not an explicit commitment in the December Undertaking.

ARTC argued in the Explanatory Guide to the June Undertaking that through the ENOC it is,

> seeking to identify relative consumption of capacity by usage outside of standard path prescription. ARTC's objective is to encourage efficient utilisation and rationing of Network capacity, so as to provide better signals for future investment in Network capacity.[178]

ARTC further noted that the ENOC is not intended to reflect the opportunity cost of increased network occupancy, but to 'encourage efficient utilisation and rationalisation of capacity…'

ARTC describes the methodology for calculating the charge as follows:[179]

> The excess occupancy charge will be charged on the basis of any hour (or part thereof) of time allowed in the schedule for the Train Path in excess of:
>
> section run times for the applicable flagfall category,
>
> dwells for crossing and passing other Trains, and,
>
> a specified allowance for reasonable above rail operating requirements.
>
> Effectively:

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177 ARTC, *Explanatory Guide to the 2007 Interstate Access Undertaking*, December 2007, p. 15.

178 ibid., p. 54.

179 ibid., pp. 54-5.

the 'base transit time' (to which the flagfall charge applies		=
	section run times for the applicable flagfall category	plus
	dwells for crossing/passing other trains	plus
	a specified corridor allowance for above reasonable above-rail activities.	

ARTC determined the 'corridor allowances for reasonable above-rail activities' after reviewing allowances for activities such as crew changing and locomotive fuelling.[180] The allowances 'are based on existing observed practices on the network and dwell times normally sought by operators when seeking paths.'[181] The charge is an hourly pro-rata of the flagfall component of the access charge, applied to the additional time associated with a requested train path above the standard allowances determined by ARTC. The following example was provided by ARTC to show how the charge would be calculated for the Adelaide – Parkeston segment, using running times for December 2006 (Table D.4.4).[182]

[180] ibid., p. 55.

[181] ARTC, *Additional Explanatory Guide*, December 2007, p. 14.

[182] ARTC, *Additional Explanatory Guide*, December 2007, pp. 32-4.

Table D.4.4: Section Run Times*

Section Run Times	*Indicative Services*	
	Down	***Up***
KALGOORLIE	15	0
PARKESTON (1850)	17	6
GOLDEN RIDGE	25	17
CURTIN	24	24
BLAMEY	17	24
KARONIE	22	16
CHIFLEY	23	18
COONANA	29	23
ZANTHUS	49	25
KITCHENER	18	40
BOONDEROO	24	19
NARETHA	31	23
RAWLINNA	23	31
WILBAN	24	22
HAIG	29	24
NURINA	31	28
LOONGANA	29	31
MUNDRABILLA	33	31
FORREST	20	32
REID	33	21
DEAKIN	30	31
HUGHES	29	30
DENMAN	28	27
COOK	36	30
FISHER	15	36
OMALLEY	18	15
WATSON	21	19
OOLDEA	47	20
BATES	28	48
BARTON	26	28
MUNGALA	25	26
MT CHRISTIE	28	27
WYNBRING	32	26
LYONS	212	31
MALBOOMA	28	20
TARCOOLA	32	29
FERGUSON	33	30
KINGOONYA	24	32
KULTANABY	40	27
WIRRAMINNA	23	39
BURANDO	33	23
PIMBA	30	35
WIRRAPPA	27	24
MCLEAY	24	27
HESSO	17	24
TENT HILL	26	16
SPENCER JCT	9	25
PT AUGUSTA	16	8
STIRLING NORTH	12	13
WINNINOWIE	19	14
MAMBRAY CREEK	14	20
PORT GERMEIN	15	13
PT PIRIE	6	12

COONAMIA	19	10
CRYSTAL BROOK	5	25
ROCKY RIVER	15	5
REDHILL	20	16
SNOWTOWN	18	19
NANTAWARRA	15	16
BOWMANS	15	14
LONG PLAINS	12	16
MALLALA	11	13
TWO WELLS	11	10
BOLIVAR	14	10
DRY CREEK YARD		12
TOTAL SECTION RUN TIME	**21509**	**1481**

*Determination of the ENOC:

Segment Run Time (ave. Down/Up)	1495
Indicative Flagfall Component ($/km)	3.263
Segment Length (km)	1992.5
Indicative Segment Flagfall ($)	6501.53
Flagfall per Minute Offered	4.349
Flagfall per Hour Offered	260.9
ENOC for Each Additional Hour Sought by Access Seeker	261

Views of Interested Parties

The common theme in operators' submissions to the June Undertaking was that the Undertaking provided little guidance on how the ENOC would be calculated and when it would be applied.[183] While operators recognise that the changes ARTC made to the December Undertaking provide substantially more information on the charge, they have ongoing concerns about the clarity of the charge, its complexity, the charge adding cost without accompanying benefits, and not mandating in the Undertaking ARTC's intention to not impose the charge if a shorter path is not available.

Despite the improved clarity in the December Undertaking, operators argued that there is still uncertainty about how the ENOC would impact on access costs and whether it could be changed during the term of the Undertaking by ARTC adjusting the parameters for calculating the charge, such as indicative section run times.[184]

Operators also argued that concepts in the ENOC, such as capacity and incremental capacity consumption, are extremely complex and not amenable to simple measures. PN, for example, argued that the total capacity of a rail network and the capacity consumed by a particular operator is difficult to measure. PN also argued that simple measures of network occupancy do not reflect the full extent of capacity consumed by some services, such as priority services (particularly passenger services), which take up more capacity than suggested by their running time, because of the 'shadow' priority

[183] See, for example: QR *July Submission*, pp. 22-23; Pacific National *July Submission*, pp. 21-22; GSR *August Submission*, p. 14.

[184] FROG *February Submission*, p. 6; Asciano *February Submission*, p. 5.

trains create when other trains must stand aside to give precedence to such services.[185] Similarly, QR argued that the ENOC would be difficult to apply.[186]

Some operators felt that an ENOC could be theoretically justified. SCT argued that the charge may be justified if it does not result in an overall increase in charges, so that revenue from the ENOC is offset by a reduction in other access charges. SCT also suggested that any benefits from more efficient utilisation of the network should be shared between operators and ARTC.[187] QR also argued that:

> 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 capacity.[188]

Other operators, such as FROG and Asciano saw little justification and few benefits from the charge and were concerned that it would increase the charging regime's complexity with no apparent benefit.[189]

Finally, operators welcomed ARTC's stated intention not to apply the charge when paths with 'normal' transit times are not available, but noted that this commitment is only in ARTC's explanatory guide and argued that it should be included in the December Undertaking.[190]

Assessment of Issues

ARTC's primary rationale for the ENOC is to 'encourage efficient utilisation and rationing of Network capacity, so as to provide better signals for future investment in network capacity.'[191] It is not ARTC's intention for the charge to operate as a congestion charge or to reflect the opportunity cost of reduced network capacity. The ENOC recognises that there are costs associated with slower services, which can delay faster trains and reduce the capacity available for services whose presence on the network is within the 'reasonable allowance.' As such, the ENOC recognises these additional costs and provides an incentive for rail operators to consume capacity in a way that promotes efficient operation and management of the network. The ACCC, therefore, considers that there may be a justification for ARTC to seek to levy a charge like the ENOC.

The ACCC also needs to consider whether ARTC's application of the ENOC is consistent with Part IIIA criteria. Two key questions have arisen in the application of this charge:

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185 Pacific National *July Submission*, p. 21.

186 QR *July Submission*, p. 22.

187 SCT *July Submission*, p. 10-11.

188 QR *July Submission*, p. 22.

189 FROG *February Submission*, p. 6; Asciano *February Submission*, p. 5.

190 Pacific National *July Submission*, pp. 21-22.

191 ARTC, *Explanatory Guide to the 2007 Interstate Access Undertaking*, June 2007, p. 54.

- Is the specification of the charge in the December Undertaking sufficiently clear, so it is not overly complex or uncertain?

- Are all the important commitments made by ARTC in relation to the ENOC enforceable?

The changes introduced in the December Undertaking have addressed many potential concerns about lack of clarity. The quantum of the charge and the basis on which it is calculated are now defined in the Undertaking. While concepts around capacity management are still complex, the ACCC considers that the scope of the ENOC is now clear.

Interested parties still have concerns about the potential for the charge to change during the term of the Undertaking. In particular, as the values of some of the parameters used to calculate the ENOC are not specified in the Undertaking, there is a risk that ARTC could change these parameter values in a way that changes the scope and application of the ENOC to the detriment of access seekers. The ACCC notes, however, that while the Undertaking does not include the values of all the parameters used to calculate the ENOC it does specify some of the key variables, such as the allowance for reasonable requirements for operational activities and the ENOC per hour.

The ACCC has considered whether parameters, like section run times, should be included in the Undertaking but notes that this could be unduly prescriptive. Over the term of the Undertaking new investment planned by ARTC is likely to reduce the run times on some segments. Therefore, locking such parameters into the Undertaking would be unduly prescriptive.

In addition, as long as the key parameters not specified in the Undertaking are well understood by the rail industry, failure to specify them in relation to the ENOC is unlikely to increase uncertainty significantly. If ARTC manipulated these parameters to change the application of the ENOC to cover classes of services not currently covered this would be relatively easy for access seekers to identify and prove.

Finally, there is additional protection for access seekers because the ENOC is subject to the price escalation formula in the Undertaking and, therefore, the indicative access charge, including the ENOC cannot increase by more than CPI.

There are, however, residual concerns with the nature of ARTC's commitments on the ENOC. ARTC stated in its explanatory guide to the December Undertaking that it does not intend to apply the ENOC when a contract with a better path cannot be offered because such a path is not available. Also, ARTC included in the IAA a provision committing not to apply the ENOC if ARTC is unable to provide the contracted path or an agreed substitute path. However, neither intention is included in the Undertaking.

The ACCC considers that both intentions should be set out in the Undertaking. This would protect users by formalising ARTC's pledge in legally enforceable commitments and avoid possible confusion about ARTC's intentions in the event of a dispute.

Draft Decision

Recommendation:

The ACCC's preliminary view is that the ARTC Undertaking should be amended to include provisions to the following effect:

- A new provision committing ARTC not to apply the ENOC in cases where a new contract must include a schedule with excessive transit times because a better path is not available.

and;

- A new provision committing ARTC not to charge the ENOC when the reason why the contracted train path is not available is ARTC's fault.

D.4.7. Price Differentiation

ARTC's Proposal

Clause 4.3 of the Undertaking limits the extent to which ARTC can differentiate access prices. ARTC commits that its access charges will not differ on account of the identity of access seekers and that it will not price differentiate where the characteristics of the services are alike and the access seekers are operating in the same end market. In ascertaining whether two services are alike, ARTC would have regard to, among other things:

- location, duration and quality of train path;
- nature of train consist;
- characteristics of the service;
- longevity of access; and
- arrival and departure times.

ARTC considers that the limits on price discrimination ensure greater equity and transparency in prices and 'stimulate market confidence and growth in the rail industry.'[192]

Views of Interested Parties

Submissions from operators generally favoured ARTC's policy on price discrimination.

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[192] ibid., p. 14.

Assessment of Issues

ARTC's December Undertaking limits but does not prohibit price discrimination. Discrimination is still possible when the characteristics of the service differ or the applicants operate in different markets.

The ACCC recognises that there can be benefits from price discrimination. It observed in its assessment of the 2002 Undertaking that ARTC's commitment to provide above-rail operators in the same end market 'like service at like prices,' restrains its ability to implement efficient price discrimination. The ACCC noted in its 2002 decision that a degree of price discrimination may be desirable, provided it does not distort above-rail competition. For infrastructure such as ARTC's rail network, which fails to recover its economic cost, prices that discriminate on the strength of users' demand for rail services may maximise revenue with minimum disruption to consumption decisions.[193] The criteria against which the ACCC assesses access undertakings also recognise these benefits. The pricing principles in section 44ZZCA(b)(i) of the Act allow, but does not require, 'price discrimination when it aids efficiency.'

However, as noted previously in this chapter, efficient price discrimination can be difficult to apply in practice, as it requires the infrastructure owner to have a detailed understanding of how operators' demand for rail services would respond to changes in price. The December Undertaking prohibits price discrimination between like services, for which it is most difficult to judge differences in operators' responsiveness to price changes, and the risk of distorting competition if price discrimination is applied inappropriately is greatest. It allows price discrimination among different services, such as intermodal freight, bulk freight and passenger services, where the differences in demand for rail services tend to be larger and easier to judge. This is where the benefits from price discrimination are largest and the risks and consequences of misjudging demand are less.

The ACCC also notes that restrictions on price discrimination are seen by all interested parties as important to promote confidence among operators and encourage use of the rail network.

Overall, the ACCC considers that the approach to price discrimination in the December Undertaking does not raise objections under the Part IIIA criteria.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 4.3 setting out ARTC's limits on charge differentiations do not raise objections under Part IIIA of the Act.

[193] ACCC, *Final Decision, ARTC Access Undertaking*, May 2002; p. 100. See also pp. 94, 95 and 99. The Final Decision is available on the ACCC web site at: http://www.accc.gov.au/content/index.phtml/itemId/757019/fromItemId/757001.

D.5. Financial Model

ARTC's proposed regulatory framework for the interstate rail network sets a floor and ceiling band for each line segment and restricts the revenue earned on each segment to fall within that band. The revenue floor is set at the costs that would be avoided if that segment was removed from the network. The ceiling is set at full economic cost, which includes segment specific costs, a return on and a return of segment specific assets and a return on and a return of a share of non-segment specific assets.

The ACCC analysed the financial model provided by ARTC in support of its proposed regulatory approach and concluded that ARTC's model, the growth assumptions and the floor and ceiling tests are reasonable.

ARTC's proposed methodology for calculating its weighted average cost of capital (WACC) (the return on assets) was also reviewed. ARTC's proposes a vanilla WACC and using ARTC's methodology the ACCC estimated the WACC would equal approximately 11.60 per cent, based on estimates of the risk free rate and cost of debt that reflect closing prices on 18 March 2008.

The ACCC accepts ARTC's proposed methodology for all of the WACC and revenue setting input parameters, except its gamma. The ACCC does not accept the proposed gamma of 0.30 because it would result in segment revenue ceilings that are above what is reasonable, given current studies on the value of imputation credits, and would overcompensate ARTC for the present value of the tax it would incur, if it was operating at its revenue ceiling..

The ACCC also concluded that ARTC's allocation of operating and maintenance costs among line segments is reasonable and that while there is potential for ARTC to reduce costs, particularly operating costs in NSW, these costs are still below industry benchmarks and ARTC is restricted in its ability to achieve these reductions immediately.

Introduction

ARTC's access undertaking application is underpinned by a financial model that it developed and provided to the ACCC. The ACCC has reviewed that financial model and the financial data ARTC used to support its Undertaking.

ARTC's financial model is based on a discounted cash flow (DCF) methodology and includes forecasts for capital expenditure, depreciation, revenues and costs (including tax). In general, the forecasts in regulatory financial models usually extend until (at least) the end of the regulatory period and demonstrate that the expected revenue in each future year is not above the regulated revenue ceiling or below the regulated revenue floor. The revenue ceiling normally constitutes the full economic recovery of operating the infrastructure, including a depreciation allowance, expected operating and maintenance costs and a fair return on invested capital. The revenue floor is often

defined as the costs that would be avoided if the service or group of services were not provided.

It should be noted that ARTC's June Undertaking application originally proposed a capitalisation loss model. In response to that Undertaking, access seekers raised a significant number of concerns with the proposed capitalisation loss model. Subsequently, ARTC withdrew the June Undertaking and in the December Undertaking it has reverted back to a traditional building block regulatory model.[194]

D.5.1. Framework

ARTC's Proposal

ARTC has proposed a post tax revenue model similar to the Post Tax Revenue Model (PTRM) used in many areas by the ACCC and the Australian Energy Regulator (AER).[195]

ARTC has modelled its network on a segment by segment basis each with its own revenue ceiling and revenue floor, for each calendar year of the Undertaking. ARTC proposes not to generate revenue on a segment or group of segments that is lower than its revenue floor (unless otherwise agreed by ARTC) or higher than its revenue ceiling. ARTC's financial model contains 9 major segments which are distinguished for the purposes of applying charges.[196] These are:

1. Adelaide (Dry Creek) — Parkeston (WA)
2. Adelaide (Dry Creek) — Melbourne (Spencer Street)
3. Melbourne (Tottenham) — Macarthur (NSW)
4. Newcastle (Islington Junction via mains) — Queensland Border (Border Tunnel)
5. Crystal Brook (SA)— Parkes (NSW)
6. Cootamundra (NSW) — Parkes (NSW)
7. Adelaide (Dry Creek) — Pelican Point (SA)
8. Port Augusta (SA) — Whyalla (SA)
9. Moss Vale (NSW) — Unanderra (NSW)

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194 The building block approach to economic regulation is widely used by regulators to establish a price control or revenue cap that provides for prices to recover the efficient costs of service provision. The key components of the building block model include: a return on capital (i.e. RAB x WACC); a return of capital (i.e. depreciation); and an allowance for operating and maintenance expenditure and tax.

195 This is different to the pre-tax revenue model adopted by ARTC in its 2002 Access Undertaking.

196 A segment is a component of the network of the Undertaking and is the smallest component for which the ceiling and floor limits apply.

ARTC's Revenue Ceiling

ARTC calculates a revenue Ceiling Limit for each segment (clause 4.4(f)) to include:

- segment specific costs (operating costs that ARTC can directly identify with a segment, for example segment major periodic maintenance);
- depreciation of segment specific assets (for example, depreciation on segment specific communications equipment);[197]
- a return on segment specific assets (for example, a real return on the depreciated value of the track on a segment);
- an allocation of non-segment specific costs (operating costs that ARTC cannot directly identify with a Segment, for example central administration);
- an allocation of return on non-segment specific assets (for example, central train control equipment);[198]
- an allocation of depreciation of non-segment specific assets (for example, depreciation on train maintenance machinery used across segments); and
- costs of supplying additional capacity if this is required.

ARTC does not propose to seek a return *on* capital for approximately $920 million of investments which were made or are to be made with 'gifted' funds from the Government. ARTC is only seeking a return *of* capital (i.e. depreciation) on those government grants invested in signalling and communications to enable it to maintain these investments in the long run. As discussed in section 5.3.10 ARTC does not depreciate any of its infrastructure assets as these assets are maintained at a steady state standard through ongoing major periodic maintenance.

ARTC's Revenue Floors

ARTC calculates the revenue floor limit for each segment to cover the incremental costs of that segment (clause 4.4(b)). Incremental costs, for the purpose of the floor limit, are defined by ARTC as the costs that could be avoided if the segment was removed from the network including segment specific and non-segment specific costs relating to the following activities:

- track, signalling and communications maintenance;
- maintenance contract support, administration and management, and project management;
- train control and communication;

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197 Segment specific *assets* are assets that ARTC can directly identify with a segment.

198 Non-segment specific *assets* are assets that ARTC cannot directly identify with a segment.

- train planning and operations administration; and
- system management and administration.

The floor limit excludes depreciation and return on segment specific assets (clause 4.4(b)).

ARTC's Financial Model

The revenue model ARTC provided to the ACCC forecasts annual revenue ceilings and floors and expected revenues and costs for each segment for each year of the Undertaking. ARTC forecasted volumes on each segment by estimating likely growth given likely customer demand. ARTC has indicated that customer demand and segment volume over the first five years of the Undertaking was estimated from: looking at past volume growth; speaking to customers; considering the dynamics in the whole transport industry; and considering ARTC's forecast investment and how this was expected to affect volumes. Cost estimates were based on forecast segment volumes, past costs and an allowance for expected inflation. Due to the difficulty with forecasting segment volumes a long way into the future, ARTC has extrapolated growth and volume figures for the second half of the Undertaking based on estimated volume and growth for the first five years of the Undertaking.

Once the post-tax return revenue ceiling is calculated, ARTC's financial model calculates a tax allowance to add to this amount.[199] This allowance reflects the company tax ARTC expects to pay, less the value of the imputation credits to its shareholders. This calculation is an iterative process and sets an overall pre-tax revenue ceiling that can then be used to evaluate ARTC's proposed prices and forecast revenue over the course of the Undertaking.

The initial regulated asset base (RAB) value of segment and non-segment specific assets has been estimated by ARTC using a Depreciated Optimal Replacement Cost (DORC) asset valuation methodology. The return on segment and non-segment specific assets is calculated based on these RAB values. The RAB values are then rolled forward annually according to the following formula:

$$RAB_{t\,start} = RAB_{t-1\,end} = (1 + CPI_{t-1}) * RAB_{t-1\,start} + Net\,Capex_{t-1} - Depreciation_{t-1}$$

Where:

$RAB_{t\,start}$ is the RAB at the start of the relevant year (t) (which for the first year following the Commencement Date would be the initial RAB);

$RAB_{t-1\,end}$ is the RAB at the end of the preceding year (t-1 as applicable);

$RAB_{t-1\,start}$ is the RAB as the start of the preceding year (t-1) as applicable;

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[199] Tax is a component of the building block method and may be calculated either directly if using an after tax approach (as in the case of the December Undertaking) or indirectly if using a pre-tax approach.

CPI_{t-1} is the inflation rate for the preceding year(t-1), determined by reference to the All Groups Consumer Price Index Statistics published for the March quarter of that year;

Net_Capex_{t-1} is the net addition to the RAB in year t-1 (that is the out-turn capital expenditure by ARTC less any disposals during period t-1) on a prudent basis; and

$Depreciaiton_{t-1}$ is the deprecation applicable to the RAB in year t-1

The return on capital is based on ARTC's Interstate Rail Network nominal vanilla WACC, less expected asset inflation, plus the tax allowance discussed above. Expected asset inflation is deducted from the revenue ceiling on each segment because the RAB values are adjusted annually for actual inflation as measured by the All Groups CPI.

Views of Interested Parties

Submissions on the general framework in the financial model discussed two broad issues:

- the floor and ceiling tests; and
- the move to a standard building block model;

FROG and SCT argued that gifted assets should be excluded from the RAB,[200] with SCT suggesting that the allowed return on assets should reflect the 'past (free) funding of these assets by the government.' SCT went on to submit that, as Government investment in infrastructure is not generally made with the expectation receiving of a normal capital market return, ARTC should not be allowed this rate of return when setting revenue ceilings.[201]

In addition, FROG and SCT argued that the revenue floor on segments should be based on the marginal costs caused by operators, as opposed to the avoidable costs of the segment[202] and FROG argued that non-segment specific costs should not be included in segment floors, because these are costs that cannot be avoided.[203] The NSWMC similarly submitted that only genuine incremental costs should be included in the

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200 SCT Logistics, *Re: Australian Rail Track Corporation (ARTC) Rail Access Undertaking – Interstate Network*, February 2008 (SCT *February Submission*), pp. 1-2.

201 Freight Rail Operators' Group (FROG), *ARTC Interstate Access Undertaking 2007 – Freight Rail Operators' Group Submission to the ACCC*, July 2007 (FROG *July Submission*), p. 6; SCT Logistics, *Submission on the ARTC Undertaking*, July 2007 (SCT *July Submission*), p. 18.

202 Freight Rail Operators' Group (FROG), *ARTC Interstate Access Undertaking 2007 – Freight Rail Operators' Group Submission to the ACCC*, February 2008 (FROG *February Submission*), p. 12; SCT *July Submission*, p. 18.

203 FROG *July Submission*, p. 5.

revenue floor and not avoidable costs.[204] It went on to define incremental costs as 'effectively a cash cost and excludes fixed costs, depreciation and return on capital.'[205]

NSWMC, in relation to concerns about cross subsidisation, argued that the stand alone principle must apply for all Hunter Valley coal traffic using the network. They define the stand alone principle to be that 'rail users must be required without exception to pay at least the incremental costs they impose on the infrastructure owner, on a service-by-service basis. Therefore, no rail users must be required to pay more than the services they require for their own operations than they would cost on a standalone basis.' They go on to argue that 'ARTC should not have the discretion to waive the obligation of any user or group of users to pay at least incremental costs.'[206]

Finally, several submissions were supportive of the change from the capitalisation loss model to a standard building block model.[207] QR, although not objecting to the building block methodology, considered that the capitalisation loss methodology proposed in the June Undertaking might be appropriate in certain circumstances.[208]

Assessment of Issues

ARTC's Financial Model

The PTRM proposed by ARTC for its December Undertaking uses a standard building block methodology to calculate revenue ceilings for each segment. This model is consistent with standard regulatory modelling.

The revenue model shows that ARTC does not expect to recover full economic cost on any network segment in any year of the Undertaking. But, ARTC does expect to recover above its avoidable cost on each segment. Given these results, the principle area that might be of concern with ARTC's modelling of its revenue ceilings and floors are the inputs used to derive the model's results, and the definitions of the floors and ceilings limits.

The ACCC considers that the main areas of potential concern in relation to the inputs to the model are: the DORC valuations; the capital expenditure forecasts; the cost allocation across segments; and the cost and volume growth rate assumptions on segments. The ACCC engaged independent consultants to review ARTC's DORC inputs and assumptions (discussed in D.5.2) as well as operating and maintenance costs and their allocation methodology (discussed in D.5.5 of this chapter).

This section considers:

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204 NSW Minerals Council Hunter Valley Rail Access Task Force, *Response to Australian Competition and Consumer Commission Issues Paper Regarding Australian Rail Track Corporation,* August 2007 (NSWMC *August Submission*), p. 5.

205 ibid., p. 22.

206 ibid.

207 See, for example: FROG *February Submission*, p. 5; SCT *February Submission*, p. 4.

208 Queensland Rail, *QR Submission ACCC: Response to ACCC Issues Paper on ARTC Access Undertaking – Interstate Network*, February 2008 (QR *February Submission*), p. 3.

- the floor and ceiling definitions;
- whether the model should give ARTC the opportunity to earn an appropriate return on investment in the network and therefore encourage efficient investment; and
- whether cross subsidisation between different rail users is likely to be an issue under the proposed Undertaking.

ARTC's Revenue Ceiling definition

In relation to the revenue ceiling, the arguments that gifted assets should be excluded from the RAB, or that the overall return should be set below a fair market return, are both questionable. When government funds are invested in a project they have a cost to society. Arguably, the true cost is the opportunity cost of the funds, or the value of the next best investment of equivalent risk in the capital market. This implies treating government investments similar to commercial investments, unless the government has explicitly identified that the funds have been invested to achieve broader community benefits and, therefore, should be treated differently (for example not being required to generate a rate of return).

In the case of this Undertaking, ARTC is only requesting a return *of* capital (that is, a depreciation allowance) on gifted funds. The ACCC considers this is reasonable if ARTC is required to maintain these assets in the long run without ongoing gifts from the government. ARTC is not requesting a return *on* capital for investments made with gifted funds.

Overall, the ACCC considers ARTC's revenue ceiling definition to be appropriate. It should only allow ARTC to earn a fair return on invested non gifted capital given expected operating costs and depreciation. This level of revenue should support future efficient investment in the network. The inclusion of a return *of* capital on both non gifted and gifted assets is considered appropriate as this would allow ARTC to maintain these assets.

ARTC's Revenue Floor definition

In relation to the revenue floor, the argument it should include only the marginal costs caused by a rail access seeker, as opposed to the avoidable costs of the segment, is questionable. While the actual marginal cost of an *extra* train on each segment may be very low, the marginal cost of the very first train run over a segment can be much higher, due to the common costs of running the segment. Therefore, a floor based on the current marginal cost for a further train would omit these common costs and result in a floor that is below the avoidable costs of the segment. Importantly, where revenue on a segment is below avoidable cost in anything other than the short run, it is likely to be profit maximising for ARTC to close the segment as the segment would not be sustainable in the long run. For these reasons, the ACCC does not consider that marginal cost is the appropriate measure of the revenue floor.

While ARTC included some non-segment specific costs in the calculation of segment specific avoidable costs, these costs were estimated on the basis of costs that would actually be avoided if the segment was closed. For example, one less segment would

require less central management which would result in some non-segment specific costs being avoided. As a result, it would appear that to argue that the non-segment specific costs included in the segment floors are not avoidable is incorrect. The ACCC had PriceWaterhouseCoopers (PWC) review the avoidability factors ARTC used to calculate the floor levels for each segment in its financial model. PWC concluded that ARTC's approach to considering the avoidability of individual segments of the network is not unreasonable.

In addition, ARTC adopted a straight line depreciation methodology matching asset cost to the life of the asset. The ACCC considers that ARTC's proposal to exclude depreciation on signals and communications from the floor is reasonable, because these costs are arguably sunk and could not be avoided if a segment was closed. In contrast, major periodic maintenance is an ongoing cost of maintaining and operating a segment which could be avoided in the event that the segment was closed and, therefore, should be in the floor definition.

Finally, in relation to concerns that ARTC can recover below the floor by agreement with access seekers, there are economic reasons to allow recovery down to at least as low as short run marginal cost for individual access seekers, even if this is below that user's share of the avoidable costs of the segment. This is because operating at marginal cost is viable in the short run (i.e. ARTC would not lose money) and increased use of the network where spare capacity exists is economically efficient. Therefore, the ACCC considers that allowing this discretion in ARTC's charging may increase the profitability and viability of its network and may also increase economic efficiency.

Overall, the ACCC considers ARTC's proposed floor definition to be appropriate because a floor based on the avoidable cost of a segment means it should be viable for ARTC to continue operating the segment at this level of revenue and should not give the incorrect incentive to close a viable segment.

ARTC's Investment incentives

In response to the concern that the capitalisation loss model may have provided better incentives for investments that cannot fully recover their costs in the short run, the ACCC considers that the December Undertaking should still allow ARTC to recover fully the cost of new investment. Firstly, due to the low level of recovery on all network segments, the building block ceiling is unlikely to significantly truncate ARTC's returns on any segment in the foreseeable future. Secondly, if extra capacity is needed ARTC can charge access seekers for this extra capacity (either through direct negotiation with access seekers or by seeking an amendment to the Undertaking) and, therefore, fully recover its costs with respect to this investment. In addition, the fact the RAB on existing assets is locked in going forward should not significantly change the incentives to invest efficiently as ARTC's processes for generating investments will be assessed by the regulator and rolled into the RAB at actual cost.

Cross Subsidisation

The generally accepted economic view is that for there to be cross subsidisation at least one service must be paying above stand alone costs and one service paying below incremental cost.[209] Importantly, having either condition alone is not sufficient for cross subsidisation to be proved. For this reason, the provision that allows ARTC to recover below the revenue floor by agreement is not an issue from a cross subsidisation perspective unless at least one access seeker or group of access seekers pays above their stand alone costs. In the context of a rail segment, the stand alone cost of using the segment would be close to the revenue ceiling of the segment, which ARTC cannot exceed under clause 4 of the Undertaking. That is, most of the costs of each segment are common fixed costs. For this reason, the ACCC considers that cross subsidisation is unlikely to be a significant issue over the course of the Undertaking, particularly as forecast revenue on all segments out to the end of the Undertaking is well below their revenue ceilings.

Conclusion

Overall, the ACCC considers that ARTC's definitions for the revenue ceiling and the revenue floor and their calculations are appropriate and accord with common regulatory practice. The ACCC also considers that the revenue model provides ARTC the opportunity to earn a fair return on future invested capital and should support efficient investment.

Draft Decision

The ACCC's preliminary view is that ARTC's post tax revenue model does not raise objections under Part IIIA of the Act.

D.5.2. ARTC's Regulated Asset Base Valuations

ARTC's Proposal

ARTC's December Undertaking valued the interstate rail assets using a DORC asset valuation methodology. ARTC engaged Booz Allan Hamilton (BAH) to prepare asset valuations of the interstate rail network.

ARTC's proposed asset valuation (i.e. RAB) includes a valuation of the recently leased NSW assets and a revaluation of the South Australian and Victorian assets. The 2002 Undertaking (approved by the ACCC) provided for a revaluation of the South Australian and Victorian assets upon its expiry.[210] ARTC has committed to not revaluing existing assets in future regulatory periods.

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[209] Faulhaber, G.R. (1975) 'Cross-Subsidization: Pricing in Public Enterprises,' *The American Economic Review*, 65(5), pp. 966-977.

[210] ACCC, *Decision – ARTC Undertaking*, May 2002, clause 4.4 (d)(iii).

Views of Interested Parties

Criticisms about the asset valuation in the December Undertaking included concerns about the effect of locking in the valuation going forward, the inclusion of gifted assets and criticism of DORC as a valuation methodology. QR commented that while locking in DORC values, as ARTC proposed, should allow firms to earn a fair return on the locked in DORC values it might result in prices being set at uneconomic levels because optimisation risk is asymmetric.

A number of stakeholders, including PN, SCT and FROG, commented that the Undertaking was silent on the valuation of 'gifted' assets.[211] Stakeholders suggested that these assets (those constructed or bought with government grants) should either be excluded from the asset base or included at a value of zero, as it is inappropriate for ARTC to earn a return on gifted assets.

In line with their arguments on the RAB and allowed return, SCT commented that it was inappropriate to use DORC based values for ARTC's regulated asset base, because the assets are 'principally national infrastructure assets where the Government(s) have elected to corporatise the ownership of the assets. In such an instance, the value of the asset to be used in determining access charges should be based on historical, depreciated cost.'[212]

Consultant's Report

Given the specialised nature of railway assets, the ACCC engaged PWC and Hi-Mark rail engineering consultants to independently evaluate ARTC's asset valuation. The consultant's report is available on the ACCC's website.

PWC reviewed: the data sources used by BAH to estimate ARTC's DORC asset values; the optimisation process undertaken by BAH; the assumptions behind the choice of the modern equivalent assets; the of estimation replacement costs; and the amount of depreciation assumed for the condition of the assets in place.

PWC concluded that, overall, the BAH valuations appear reasonable. In particular, PWC concluded that:

- BAH appears to have optimised out most assets not required and those not optimised are likely to be required in the near future due to volume growth;
- BAH's choice of the modern equivalent assets appears reasonable and in line with standard industry practice;

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[211] Pacific National, *Submission to ACCC RE: Approval of ARTC Interstate Access Undertaking*, July 2007 (Pacific National *July Submission*), p. 27; FROG *February Submission*, p. 5; SCT *July Submission*, p. 13.

[212] SCT Logistics, submission to the ACCC on the ARTC Access Undertaking, July 2007, p. 19.

- BAH's replacement asset cost estimates for the modern equivalent asset appears reasonable, particularly give that there has been a significant increase in these costs, in excess of CPI, over the past five years;

- the level of depreciation allowed for, given the condition of the assets in place, was reasonable; and

- random sampling of the data used by BAH to reach these results indicated that BAH's data sources and its use of those data sources appears reasonable.

Assessment of Issues

The questions that arise for the PWC consultants report, submissions and the ACCC's analysis include:

- Is DORC the appropriate valuation methodology?

- Should assets be revalued for this Undertaking and, if so, should they then be locked in going forward?

- Are the asset valuations proposed for the NSW network reasonable and, if revaluation is allowed, is the revaluation for the non NSW network reasonable?

Each of these issues is discussed below.

The Use of DORC

A DORC valuation estimates the value of replacing the assets required to provide what is (at the time of the valuation) considered to be the optimal services and then depreciates that value for the current condition of the assets in use. DORC is consistent with common Australian regulatory practice in rail and other areas and is well understood.

The argument that historical depreciated values are the appropriate RAB values, as opposed to DORC values, is dubious. Historical values will rarely reflect current opportunity cost to provide the optimal service today.

For these reasons, the ACCC considers that DORC is an acceptable asset valuation method for ARTC's network assets.

Should ARTC's Assets be Revalued?

The second question is whether ARTC should be able to revalue its existing assets and whether asset values should be locked in going forward.

The ACCC strongly believes that revaluation should not normally be allowed under a DORC framework because periodic revaluation:

- may not be necessary for the regulated firm to be fairly compensated over the life of its assets;

- may create unnecessary uncertainty for regulated firms and the users of regulated services;
- may encourage gaming of the regulator on revaluation estimates; and
- increases ongoing regulatory costs.

The ACCC also notes that revaluation was explicitly anticipated in the 2002 Undertaking.

Interested parties also questioned whether locking in asset values going forward would reduce ARTC's incentives to invest efficiently in infrastructure. In response to this concern, the ACCC considers that locking in DORC values that are rolled forward at inflation in stable technological areas should normally result in prices that support efficient investment. In the context of this Undertaking, the ACCC considers that ARTC should generally have the incentive to make efficient investment for the reasons discussed in section D.5.1 above.

Overall, the ACCC considers that, in this case, given that the revaluation was anticipated in the 2002 Undertaking and ARTC has committed to locking in asset values going forward, the proposed revaluation should be allowed, even though it is not normal regulatory practice.

Are ARTC's Proposed DORC Based Asset Values Reasonable?

The third question is whether the asset values proposed by ARTC are appropriate. On asset valuations, PWC drew the following conclusions:

- BAH's estimates of the optimised DORC regulated asset base values appear approximately correct for mid 2006 prices;
- given high cost inflation in the construction industry over the past five years, the estimated DORC values are, if anything, conservative at 2008 construction costs; and
- there can be error associated with estimating DORC values and the BAH valuations appears reasonable given the level of uncertainty associated with these estimates.

Overall, taking into account the views of interested parties and the advice from PWC, the ACCC has concluded that ARTC asset valuations are reasonable.

Draft Decision

The ACCC's preliminary view is that ARTC's DORC valuations do not raise objections under Part IIIA.

D.5.3. Return on Capital

Introduction

A firm's WACC is the value weighted risk-adjusted rate of return required by the debt and equity capital providers to the firm. It reflects the return these investors could expect to earn by investing in the next best investment of equivalent risk; that is, it represents the opportunity cost of capital.

ARTC used Synergies Economic Consulting (Synergies) to develop a methodology and estimate the WACC for ARTC's interstate rail network. Synergies based the estimated WACC on the Capital Asset Pricing Model (CAPM).

The ACCC examined each of the input parameters in the WACC methodology ARTC used. The ACCC considers that ARTC's gamma of 0.30 is too low and will result in revenue ceilings that would overcompensate ARTC for its corporate tax costs. The ACCC considers that the rest of ARTC's method for calculating the WACC would be reasonable if used in conjunction with a gamma value of 0.50 to calculate the WACC and ARTC's revenue ceilings.[213] The ACCC recommends ARTC change its gamma to 0.50.

ARTC's Proposal

ARTC proposed a vanilla WACC methodology, which at the time of submitting the Undertaking, ARTC estimated would generate a WACC of 10.93 per cent. As it is standard regulatory practice to update the WACC before an Undertaking is put into effect, the ACCC recalculated the WACC using ARTC's methodology prior to finalising the draft report (and would again recalculate the WACC prior to finalising its decision). The ACCC's estimate of the WACC, based on ARTC's methodology, is approximately 11.60 per cent as at 18 March 2008 (Table D.5.1).[214] The increase is due to changes in the debt market since the WACC was originally calculated by ARTC.

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[213] The ACCC is currently conducting a review of WACC in conjunction with the AER due to be completed in 2009.

[214] 11.60 per cent was the calculated using the estimated risk free rate and estimated cost of debt at the close of trade on 18 March 2008. It should be noted that no averaging of the risk free and cost of debt was done although this will be done for the final decision as discussed below.

Table D.5.1: ARTC's Suggested WACC and Revenue Model Input Parameters[215]

Parameter	Value
Rf (nominal)	5.96%
Debt	50%
Equity	50%
D/E	1.00
BBB bond rate (nominal)	9.38%[216]
Debt margin (nominal)	3.44%
Debt raising costs	0.125%
Cost of debt (Nominal)	9.57%
MRP	0.06
Gamma	0.30
Inflation	2.50%
Tax rate	30%
Asset beta	0.65
Debt beta	0.00
Equity beta	1.29
ke	13.59%
kd	9.51%
Vanilla WACC	11.60%

This results in a calculation of ARTC's vanilla WACC of 11.60 per cent as follows:

$$WACC_{Vanilla} = \frac{Debt}{Debt + Equity} \times Kd + \frac{Equity}{Debt + Equity} \times Ke$$

$$= \frac{0.5}{0.5 + 0.5} \times 9.51\% + \frac{0.5}{0.5 + 0.5} \times 13.69\% = 11.60\%$$

Each of the inputs to the WACC is discussed in turn below.

Views of Interested Parties

Submissions were only received on a few of the individual WACC parameters, and some of the issues raised on the June Undertaking have been addressed in the changes ARTC made prior to the December Undertaking. The remaining issues raised by interested parties are highlighted, where relevant, in the following sections.

Assessment of Issues

This analysis of the methodology used to calculate the WACC has been conducted in the context of ARTC's Interstate Rail Network covered by the December Undertaking. Importantly, it should be noted that some of the issues raised and conclusions reached

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[215] The risk free rate and yield on debt were the yield to maturity on 18 March 2008 based on the prices at the close of the days trading (and not based on the figures submitted by ARTC which are now out of date). All parameters and/or calculation methods were provided to the ACCC by ARTC in support of its December undertaking in ARTC's December 'Undertaking additional explanatory guide.'

[216] Eight year BBB Australian corporate bond yield obtained from Bloomberg on 18 March 2008.

are based on the specific circumstances of this Undertaking, and would not necessarily apply to other regulated infrastructure or other rail networks, nor would they necessarily hold for the interstate network in the future.

D.5.3.1. Risk Free Rate

ARTC's Proposal

ARTC proposes that the appropriate nominal risk free proxy is the estimated yield to maturity on Australian Commonwealth Government bonds with a maturity of ten years to be obtained from the Bloomberg data service. ARTC considers that a ten year maturity bond is appropriate due to the long term nature of its investment and that it is normal commercial practice for companies to match their asset lives with their bond maturities.

ARTC proposes simple averaging of the risk free rate proxy over a 20 day period leading up to the final decision. It also requested to be informed, in advance, of the averaging period, so it can hedge its interest rate risk over this period if it decides to do so.

Assessment of Issues

Australian Commonwealth Government Bond yields are considered to be the best proxy for the risk free interest rate in Australia, as these bonds are arguably the closest thing to a risk free asset observable in the Australian economy. ARTC's use of these bonds to estimate the risk free interest rate is not contentious as it is consistent with ACCC practice and other Australian regulators. In addition, the use of the Bloomberg data service to obtain these rates is considered acceptable.

The ACCC's preferred position is that the maturity of bonds used as the risk free proxy should match the term of the regulatory period. The ACCC considers this is appropriate because a risk free proxy with a maturity equal to the regulatory period should appropriately compensate the regulated firm for the interest rate risk it bears over the regulatory period.[217] As ARTC requested a proxy bond maturity of ten years, which is directly in line with the ten year term of the December Undertaking, it should be correctly compensated for any interest rate risk it bears over the course of the Undertaking.

The ACCC generally supports the use of an averaging period to measure the risk free rate. Averaging smoothes short term variations in the risk free proxy yield and allows regulated firms to hedge their interest rate exposure over the averaging period, if they choose to. The ACCC considers that having an averaging period that runs up to approximately one week before the proposed date of the final decision is reasonable, although the date of the averaging period must be set before it commences to eliminate actual or perceived estimation period selection bias. The ACCC considers that the averaging period proposed by ARTC of twenty trading days (close as possible before the final decision) is appropriate and the ACCC will use best endeavours to inform ARTC of the final decision's averaging period prior to it commencing.

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[217] The ACCC's general position is that resetting the revenue stream at the end of the regulatory period (at the start of the next regulatory period) removes any interest rate risk beyond this point, as the risk free rate and the yield on debt are reset.

D.5.3.2. Inflation

ARTC's Proposal

Expected inflation affects ARTC's revenue ceiling in several ways. Firstly, the return on capital component of the revenue ceiling is defined as a real return (calculated as the nominal Vanilla WACC less expected asset inflation). Secondly, the RAB is updated with actual inflation at the end of each period. In addition, expected inflation feeds into ARTC's forecast revenue and cost figures in their revenue model.

ARTC have proposed an inflation estimate of 2.5 per cent per annum over the term of the December Undertaking. This is in line with the mid point of the Reserve Bank of Australia's target inflation range of 2 to 3 per cent per annum.

Assessment of Issues

Under the revenue model ARTC proposed, if revenue is close to the revenue ceiling, using an expected inflation figure to calculate the maximum allowed revenue that is below true expected inflation, may set the nominal return allowed by the regulator above that required by the infrastructure owner to invest in its business.[218] Likewise, if the expected inflation figure used is higher than true expected inflation, the firm's regulated return may be below the nominal return it requires.

Until recently, the ACCC commonly used the Fischer equation to estimate future inflation in revenue determinations for regulated firms. However, since a 2007 National Economic Research Associates (NERA) report, which argued that indexed Commonwealth Government Bonds are biased due to a lack of supply, the ACCC has been cautious of using this method to forecast inflation.[219] In its most recent decision, the SP AusNet Transmission Determination 2008, the AER used the Reserve Bank's estimate of inflation for the next two years of 3 per cent per annum and 2.88 per cent per anum, respectively, and the mid point of the Reserve Bank's target inflation range of 2.5 per cent per annum for subsequent years. The problems of estimating inflation in the revenue models used in regulation are the focus of ongoing work by the AER and ACCC.

In ARTC's case, forecast of inflation does not have the same significance as in other areas of regulation, because ARTC is not expected to recover close to the revenue ceiling on any network segment over the course of the Undertaking. Changing the expected inflation figure does not alter this conclusion. Therefore, while the expected inflation figure of 2.5 per cent per annum seems likely to be less than true expected

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[218] For example, assume the nominal required return is 10 per cent per annum and the expected inflation allowed for in the model is 2.5 per cent, the regulator would set a return of approximately 7.5 per cent the revenue allowance (i.e. the real return on capital allowed in the revenue cash flows), as there is an assumption that there would be a further expected return of 2.5 per cent from the indexation of the RAB for inflation. However, if the true expected inflation is 3 per cent, the firm would actually expect a 7.5 per cent return in the cash flows and a further 3 per cent from RAB indexation. This results in a total return of approximately 7.5 per cent + 3 per cent = 10.5 per cent, overcompensation of the firm by 0.5 per cent. The overcompensation comes from setting the allowed real return on capital in the model using an inflation forecast that is below true expected inflation.

[219] NERA Economic Consulting (2007) *Bias in Indexed CGS Yields as a Proxy for the CAPM Risk Free Rate: A Report for the ENA*, March.

inflation in the short run, and may be less than true expected inflation in the long run, it does not result in an expectation that ARTC will over-recover over the course of the Undertaking. For this reason, the ACCC does not consider that the inflation estimate proposed by ARTC raises any objections under Part IIIA of the Act, given the overall context of the undertaking.

D.5.3.3. Cost of debt

ARTC's Proposal

ARTC proposes a credit rating of BBB at a debt to equity ratio of 50 per cent debt to 50 per cent equity. The BBB rating is based on past Australian regulatory decisions, which have tended to assume a credit rating of between Standard and Poor's ratings BBB and A. ARTC argues that a BBB credit rating is conservative and will ensure ARTC recovers its hypothetical costs of raising debt capital. ARTC notes that a firm's credit rating is a function of its debt to equity ratio and argues that BBB is reasonable given its chosen debt to equity ratio of one.

In support of its argument ARTC provided data on overseas rail firms' credit ratings showing that, on average, these operators hold significantly less than 50 per cent debt in their capital structure and issue BBB or A rated debt.

ARTC proposes that the appropriate maturity for the debt proxy is ten years, in line with the maturity proposed for the risk free proxy. ARTC also propose averaging the cost of debt over a 20 day estimation period with data to be obtained from the Bloomberg data service.

Currently, Bloomberg does not provide quoted yields for ten-year BBB debt due to a recent lack of liquidity in the Australian market place for these bonds. In response to this, ARTC have indicated they intend to use the yield on eight-year maturity BBB debt from Bloomberg to proxy for the cost of ten-year BBB debt.

Assessment of Issues

Standard regulatory practice in determining a company's cost of debt capital is to nominate a debt risk margin over and above the risk free rate. The allowed debt margin is assumed to reflect the debt margin at which a firm of similar credit risk could issue debt. Normally, debt issuance costs are added to this amount.

To a large degree, the debt margin required by debt investors reflects the probability of default on the debt and the expected loss in the event of default. The probability of default is a function of the firm's capital structure and the volatility of its operating cash flows. The expected loss in the event of default is a function of the expected recoverable value of a firm's assets net of transaction costs. Therefore, as asset types and cash flow variability changes considerably across industries, it is reasonable for the efficient level of debt and its cost to also vary.

The ACCC and AER have typically given a credit rating of BBB+ or A for 'standard' regulated firms operating in electricity and gas transmission and distribution with an assumed debt equity ratio of 60 per cent debt to 40 per cent equity. However, standard regulated firms are likely to have operating cash flows with significantly lower volatility than ARTC has on the interstate rail network, because 'standard' regulated

firms have greater ability to raise prices in the event demand decreases. Given this, a lower debt to equity ratio than 60 per cent debt to 40 per cent equity may be appropriate for ARTC if it is to operate with BBB rated debt. The appropriate gearing level for ARTC is discussed later in this report.

Currently, overseas rail operators normally operate with less than 50 per cent debt at credit ratings of between BBB and A. The leverage of a number of overseas rail operators is shown in Table D.5.2.

Table D.5.2: Leverage of Overseas Rail Operators

Company	Debt to Value (%)	Credit Rating (S&P)
Burlington Northern Santa Fe Corporation	21.88	BBB
Canadian National Railway Company	31.03	A-
Canadian Pacific Railway Limited	21.00	BBB
CSX Corporation	28.57	BBB-
Genesee & Wyoming Inc	24.24	N/A
Kansas City Southern	39.76	B+
Rail America	N/A	N/A
Union Pacific Company Limited	18.70	BBB
Simple Averages	**26.31**	**BBB**

Source: Figures for debt to value obtained from Bloomberg as at 31/12/2007. Bond rating obtained ratings obtained from Bloomberg for quarter 3 2007 with the exception of Canadian Pacific's credit rating which was directly estimated from the credit rating of bonds on issue on 27 March 2008.

The operating leverage and credit ratings of overseas rail operators implies that ARTC would be unlikely to be able to issue debt at better than a BBB rating if it where operating at a capital structure of 50 per cent debt to 50 per cent equity.

In addition, while data from trucking and shipping companies might imply a higher credit rating at ARTC's requested gearing level, these are questionable proxies for a below rail business. Trucks and ships can be sold for alternate use in the event of loss of business, train tracks cannot. This implies that trucking and shipping companies might have: lower probabilities of default; higher expected recovery rates in the event of default; and higher credit ratings than a train track operator for a given debt to equity ratio.

The ACCC considers that ARTC's use of a 20 day averaging period for the risk free rate is reasonable for the reasons discussed above.

The ACCC also considers that using ten-year maturity fair yields from Bloomberg to estimate the cost of debt and the debt margin would have been appropriate, as it is consistent with the ACCC's view that the term of debt should equal the regulatory term. However, given the current lack of BBB bond price data from Bloomberg, and that it is expected that eight-year BBB bond yields are a reasonable proxy for ten-year BBB debt yields, the ACCC considers it reasonable for ARTC to use Bloomberg

estimates of the eight-year BBB bond yield to estimate their cost of debt and debt margin.[220]

Overall, the ACCC considers that the cost of debt ARTC proposed is reasonable because: a BBB credit rating appears reasonable at ARTC's requested D/E ratio of 1; the theoretical maturity of the yield on debt ARTC has requested matches the term of the regulation; averaging the estimate of the yield on debt over a number of days is reasonable; and the technique for estimating the yield to maturity on ten-year debt, by using the yield to maturity on eight-year debt also seems reasonable, given that eight-year debt appears to be a reasonable proxy given the lack of a directly observable ten-year proxy.

D.5.3.4. Debt Issuance Costs

ARTC's Proposal

ARTC proposes debt raising costs of 12.5 basis points per year, based on recent Australian regulatory decisions that have allowed this amount.

Assessment of Issues

The cost of debt does not compensate an efficient firm for transaction costs incurred in raising its debt capital. Debt issuance costs are, however, genuine and ongoing costs of having debt capital on issue, and should be compensated for either through a direct cash flow allowance or an adjustment to the WACC. The ACCC's current practice is to allow debt raising costs to be recovered in the WACC, through an addition to the annual cost of debt.

The ACCC's view on debt issuance costs, based on a 2004 report by The Allens Consulting Group (Allens), is that debt raising costs vary depending on the amount of debt on issue. The Allens report illustrated that debt issuance costs fall as the amount of debt on issue rises because of economies of scale from a firm only requiring credit rating once a year, at a fixed cost, irrespective of the amount of debt it issues. Estimated debt issuance costs based on the 2004 Allens Report and updated for current costs by the AER in 2007 are shown in Table D.5.3.

[220] As at 9 April 2008, the A rated bond yield to maturity (YTM) for eight-year maturity bonds was 9.124 per cent while the A rated bond YTM for ten-year maturity bonds was 9.154 per cent. This supports the position that the yield curve for corporate bonds is essentially flat and that the eight-year BBB bond YTM from Bloomberg should be a good proxy for the (non-observable) ten-year BBB bonds YTM.

Table D.5.3: Estimated Debt Issuance Costs from Allens Consulting Group Report.

Fee	Explanation/Sources	1 Issue	2 Issues	4 Issues	6 Issues
Amount raised	Multiples of median MTN issue size	$200 million	$400 million	$800 million	$1,200 million
1) Gross Underwriting Fees	Bloomberg for Aust. Intl. issues, maturity adjusted	6.0	6.0	6.0	6.0
2) Legal and road show	$75K-$100K: Industry sources	1.0	1.0	1.0	1.0
3) Company credit rating	$30K-$50K S&P Ratings	2.5	1.3	0.6	0.4
4) Issue credit rating	3.5 (2-5)bps up-front: S&P Ratings	0.7	0.7	0.7	0.7
5) Registry fees	3K per issue Osborne Assoc.	0.15	0.15	0.15	0.15
6) Paying fees	$1/$1m Osborne Assoc.	0.01	0.01	0.01	0.01
Totals	**Basis points* p.a.**	**10.4**	**9.1**	**8.5**	**8.3**

* based on a standard maturity of 5 years

Based on these estimates, the ACCC considers that a fair allowance for debt issuance costs on ARTC's interstate rail network would be around 8.3 basis points per year given that at a 50 per cent debt level they would be holding over $1.5 billion in debt based on their current DORC valuations. The 12.5 basis points per year proposed by ARTC is, therefore, excessive.

Although the ACCC considers debt issuance costs of 12.5 basis points per year are above that needed to adequately compensate ARTC, the ACCC is of the view that, alone, the impact on the WACC of the difference between 8.3 and 12.5 basis points per year is insufficient to reject the undertaking, particularly as ARTC's expected revenue is significantly below its revenue ceiling on all segments for the duration of the Undertaking. In addition, as ARTC's requested equity issuance costs are significantly below the ACCC's benchmark cost estimates, ARTC's overall capital raising costs are quite close to the benchmark costs the ACCC thinks is reasonable.

Finally, it should be noted that if ARTC was expected to be operating closer to its revenue ceilings over the course of the Undertaking, the ACCC would have been likely to have objected to an allowance for debt issuance costs of 12.5 basis points and would have suggested that ARTC move its debt and equity issuance costs into line with the ACCC's standard benchmarks for these costs.

D.5.3.5. Cost of Equity

When estimating a firm's cost of equity capital, or required return on equity, it is standard regulatory practice to apply a domestic CAPM. The CAPM stipulates that any firm's cost of equity, $E(R_e)$, is given by the following formula:

$$E(R_e) = Rf + \beta_e \times [E(R_M) - Rf]$$

Where:

Rf = *risk free rate of return*;

$[E(R_M) - Rf]$ = *Market risk premium*; *and*

β_e = *equity beta*

In calculating the required return on equity, the two contentious issues are the equity beta and the market risk premium. Each of these is discussed in turn below.

Equity Beta

ARTC's Proposal

ARTC proposed using comparable international transport companies to estimate its asset beta. As is standard practice, the chosen companies' equity betas have been de-levered and averaged to estimate of ARTC's asset beta. This asset beta has then been re-levered to estimate ARTC's equity beta.

ARTC calculated equity and asset betas for the chosen comparable companies using the following filters: a minimum threshold of 58 monthly observations on the basis that at least 5 years of monthly data is necessary for each firm; beta estimates with a T statistic less than 2 were excluded on the basis they were not significantly different from zero at a 5 per cent significance level; beta estimates with an R squared of less than 0.1 were excluded; firms that operated any unrelated activities were excluded on the basis that they tend to be more diversified; and highly geared firms in the marine industry were excluded on the basis that this could distort the beta estimates. Finally, a simple (non value weighted) average of the included firms' betas was estimated. ARTC argues that this analysis supports an asset beta of 0.65 and an equity beta of 1.28 under the assumption of a 50 per cent debt to 50 per cent equity ratio and a debt beta of zero. As is standard ACCC and common Australian financial market practice, ARTC used the Monkhouse formula to de-lever proxy companies and to re-lever its asset beta to obtain an equity beta.

ARTC also completed an overview of its operations, from first principles, to further support the argument that the asset and equity betas it has arrived at are consistent with the level of systematic risk that its business operations are expected to bear.

Views of Interested Parties

NSWMC raised issues in its submission that it felt the ACCC should consider in assessing ARTC's equity beta:

> It is unclear whether the reference to 'an appropriate adjustment (beta) factor to the equity risk margin appropriate for investment in railway infrastructure forming part of the Network' [in clause 4.4h of the access undertaking] is a reference to an appropriate beta, or an adjustment to the beta related to investment in railway infrastructure.
>
> In several recent submissions by NSWMC to the Productivity Commission, NSWMC has advocated that the WACC applied to regulated monopoly services include a separately identified 'investment encouragement' component to ensure the WACC really is high enough to encourage investment, provided that this is determined by the regulator and does not result in double counting of an investment risk premium incorporated into the beta as

well as a separate investment incentive component. NSWMC continues to hold that view.[221]

Assessment of Issues

Beta measures the sensitivity of the return on an investment to changes in returns for the market as a whole. Essentially, it is the non-diversifiable, or market risk, investors bear when they invest in an asset. This non-diversifiable risk is the only risk that is compensated with a risk premium under the assumptions of the CAPM and is commonly measured by regressing the entity's returns against the returns on the overall market.

The equity beta of a firm has a direct relationship to its asset beta, debt beta and the assumed gearing ratio. The relationship between equity, asset and debt betas most commonly used by the ACCC is the Monkhouse formula.[222]

There are a number of approaches to estimating the equity beta of a given firm. These include: direct estimation from a firm's traded share price and observed dividends, estimation of betas from comparable companies; and deriving an estimate from first principles.

As ARTC is not a listed firm, its equity beta cannot be estimated directly. Therefore, using comparable companies to estimate the asset beta, which can then be converted to an equity beta, and/or first principle analysis must be used. Common financial market practice is to use the past 5 years of monthly equity return data to estimate a firm's equity beta.

ARTC's choice of proxy companies does not include Australian based companies (although MainFreight is New Zealand based and operates in Australia) and does not include companies primarily exposed to the Australian market. Therefore, none of these companies are ideal beta proxies to use in an Australian domestic CAPM. However, as the domestic market risk of transport companies in different domestic economies might be expected to be similar, they arguably provide a reasonable starting point. However, given some of the filters ARTC applied are questionable and ARTC used those filters to excluded some company data from its asset beta analysis, the ACCC has done its own analysis on whether an asset beta of 0.65 appears reasonable.[223]

Firstly, the ACCC considers that the asset betas of Australian trucking, shipping and other non-rail service providers are not suitable proxies for ARTC's asset beta. Although these firms are observable and have the desirable quality that they are Australian based, the systematic risks of these types of transport investments is likely to differ markedly to that of a below rail service provider. For this reason the ACCC has focussed on non-regulated below rail operators operating overseas to determine whether ARTC's requested beta seems reasonable. The use of overseas firms was

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[221] NSWMC *August Submission*, pp. 23-24.

[222] $$\beta_e = \beta_a + (\beta_a - \beta_d) \times \{1 - [\frac{R_d}{1+R_d}] \times [T_e \times (1-\gamma)]\} \times \frac{D}{E}$$

[223] By filter, the ACCC means the rules by which ARTC justified including or excluding companies from its proxy beta estimation.

necessitated by the lack of non-regulated below rail operators in Australia to use as proxy companies. Despite the fact these firms operate overseas, the ACCC considers these are arguably the best proxy companies to use to estimate ARTC's exposure to systematic risk. The proxy companies chosen by the ACCC, principally operating in North America, typically have asset betas estimated at over 0.65 under the assumption of a zero debt beta as shown in Table D.5.4 below. However, it is acknowledged that these operators may operate under slightly different conditions to ARTC, which may slightly increase their systematic risk. In particular, North American railways may have higher market risk because they often compete with one another due to parallel infrastructure. Despite this, on balance the ACCC considers that North American and other overseas rail operators' asset betas generally support ARTC's argument for an asset beta of 0.65 for its Interstate Rail Network.

Table D.5.4: Comparison Firms' Equity and Asset Beta Estimates

	Equity Beta	D/E ratio %	Asset Beta
Burlington Northern Santa Fe Corporation	0.969	41	0.69
Canadian National Railway Company	0.62	46	0.43
Canadian Pacific Railway Limited	0.793	32	0.60
CSX Corporation	0.822	72	0.48
Genesee & Wyoming Inc	1.54	28	1.21
Kansas City Southern	1.241	72	0.73
RailAmerica	1.498	133	0.65
Union Pacific Company Limited	1.097	38	0.80
Simple Average	1.0725	57.75	0.70

Source: Equity betas were estimated using Bloomberg using 5 years of monthly data. The debt to equity ratio is the estimated average debt to equity ratio over the beta estimation period and was the debt to equity ratio used for delivering the equity betas. Equity betas were delivered using the Monkhouse formula.

On ARTC's assumption of a debt beta of zero, Davis (2005) estimated debt betas on traded bonds and found they tended to fall between 0.1 and 0.2.[224] As such, assuming a debt beta of 0 may be incorrect. Using the wrong debt beta may result in a small error in the estimates. Although the ACCC's analysis indicates that, even allowing for such an error, ARTC's estimate of an equity beta of 1.28 at a 50 per cent debt to 50 per cent equity ratio appears reasonable.

Finally, it should be noted that ARTC operates under some market demand and price constraints due to inter-modal competition. This is the principle reason it operates well below its revenue ceiling on major segments. As such, it bears some market risk and if the economy does badly (or well) ARTC will lose (or gain) business and profits. This is different to a typical regulated business, such as electricity distribution or transmission, that can simply raise prices if demand drops and, therefore, bears far lower market risk. While the ACCC considers that an asset beta of 0.65 per cent is broadly acceptable for

[224] Davis, K. (2005) 'The Systematic Risk of Debt: Australian Evidence,' *Australian Economic Papers*, 44 (1), pp. 30-46.

ARTC's interstate network, this conclusion would not necessarily apply to other train networks nor would it necessarily hold for a future regulatory review in the future.

D.5.3.6. Market Risk Premium

ARTC Proposal

ARTC's June Undertaking proposed a market risk premium (MRP) of 6.5 per cent per annum, based on historical studies. These studies estimated that long-term average historical arithmetic annual returns on equity have been 6.5 per cent per annum or more above long term government bond rates. ARTC argues that long term historical studies provide the best estimate of future expected returns unless a plausible explanation can be provided for why future returns are likely to differ from past returns.

ARTC's experts report on the WACC, prepared by Synergies Consulting, considered that the argument that historically observed MRP has fallen in recent years is incorrect on the basis of a lack of a statistical significance of the results of these studies. The Synergies report also argued that survey data that shows financial market investors require a MRP of 6 per cent per annum or lower is not reliable, as these results are: influenced by recent events; may be based on short term expectations; are largely based on opinion; and may be susceptible to bias. Although, Synergies did acknowledge that survey data is forward looking as opposed to historical data which is backward looking.

ARTC in its December Undertaking proposed an MRP of 6 per cent per annum.

Views of Interested Parties

QR considers that that there is no compelling evidence as to why the MRP should be set lower than the rate determined from long-term historical average excess returns on equity over the risk free rate.

Assessment of Issues

The CAPM is a forward looking equilibrium asset pricing model. It posits that when the market is in equilibrium all investments will be rewarded with an expected risk premium over the risk free rate equal to the required MRP multiplied by the investment's domestic market risk (domestic beta). The MRP is forward looking and should be just sufficient to induce future investment in the market over the period of the model. If a domestic CAPM is applied in Australia, the appropriate MRP is the Australian domestic MRP.

The ACCC has used an MRP of 6 per cent per annum in all its recent regulatory decisions. In addition, all Australian regulators appear to have used a MRP of 6 per cent or lower in recent decisions, with 6 per cent per annum the most common (Table D.5.5).

Table D.5.5: MRP Values Adopted in Recent Energy Distribution Business Regulatory Decisions

Decision	Regulator	MRP value %
ERA Western Power Electricity Transmission & Distribution (Mar 2007)	ERA	5 to 6
SA Gas Distribution (Jun 2006)	ESCOSA	6
Queensland Gas Distribution (May 2006)	QCA	6
Country Energy Gas Distribution (Nov 2005)	IPART	6
Victorian Electricity Distribution (Oct 2005)	ESC	6
AlintaGas Distribution (June 2005)	ERA	5 to 6
ETSA Utilities (June 2005)	ESCOSA	6
AGL Gas Networks (Apr 2005)	IPART	5.5 to 6.5
Queensland Electricity Distributor (Apr 2005)	QCA	6
NSW Electricity Distribution (Jun 2004)	IPART	5 to 6

Source: 2008 Gas Access Arrangement Review, Weighted Average Cost of Capital, KPMG, 2007.

Historical return studies do demonstrate observed historical arithmetic average exceeds returns on the equity market over long term government bonds of more than 6 per cent per cent per annum. The most recent Australian based study by Brailsford, Handley and Maheswaran (2008) showed an *ex-post* historical arithmetic excess annual return of 6.8 per cent from 1883 to 2005, if imputation credits are fully valued, and 6.2 per cent if they are valued at zero.[225] The authors noted that their results are significantly lower than previous studies of the *ex-post* Australian historical MRP. This lower result was argued to be because the data used in previous studies were biased upwards due to errors in the dividend data used.

However, historical data only reflects future expectations if investors expect to receive this return in the future and price assets accordingly. Dimson, Marsh and Staunton (2002) argued that high equity returns over the second half of the twentieth century were due to three major factors: unprecedented growth in productivity and efficiency; a fall in the required return because of decreases in business and investment risk; and a significant decrease in transaction and monitoring costs over time.[226] The authors suggested that to estimate the forward looking MRP, past MRP needs to be adjusted downwards for unanticipated cash flow growth and unanticipated declines in business and investment risk. The adjustment downwards could be expected to be substantial, potentially 1 to 2 per cent.

Finally, current studies of Australian financial market practitioners involved in capital budgeting show they most commonly use 6 per cent per annum as an MRP for asset/investment valuations, providing strong evidence that this is the best estimate of

[225] Brailsford, T., Handley, J.C. and Maheswaran, K. (2008) 'Re-Examination of the Historical Equity Risk Premium in Australia,' *Journal of Accounting and Finance*, 15, pp. 73-97.

[226] Dimson, E., Marsh P. and Staunton, M. (2003) 'Global Evidence on the Equity Risk Premium,' *Journal of Applied Corporate Finance*, pp. 27-38.

the MRP investors require to make risky investments. [227] In addition, current surveys of investment bank brokers tend to indicate a forward looking MRP of 6 per cent per annum or less (Table D.5.6).

Table D.5.6: Summary of Broker MRPs

Broker	Valuation	Date	MRP estimate (%)
ABN Amro	David Jones Ltd.	10/12/02	4.5
Goldman Sach JB Were	Computershare	24/1/06	5.6
	Iluka Resources	26/2/04	6.0
Merrill Lynch	Sky City Ent.	23/1/06	4.5
CitiGroup	Wattyl	24/1/06	5.0
	Mirvac	23/1/06	5.5
	Amcor	11/12/02	5.0
UBS	Funtastic	25/1/06	5.0
Macquarie Equities	Gt. Sth. Plantations	8/12/05	4.5
JP Morgan	HPA Ltd	25/1/06	5.4
BBY Ltd	Sirtex Medical	Oct 2001	5.0

Source: Telstra's WACCs for Network ULLS and the ULLS and SSS Businesses, 2006, Capital Research, Neville Hathaway.

The ACCC therefore considers that the MRP of 6 per cent per annum proposed in ARTC's December Undertaking is appropriate.

D.5.3.7. Gearing

ARTC's Proposal

ARTC proposes a capital structure consisting of 50 per cent debt to 50 per cent equity. It argues that assuming the same optimal capital structure across all industries is incorrect as firms' abilities to hold and service debt vary among industries. ARTC argues that using the common regulatory assumption of 60 per cent debt to 40 per cent equity for its capital structure would be incorrect given its industry and business operations.

In support of its proposed debt to equity ratio, ARTC surveyed different companies across the rail, trucking and shipping industries. ARTC found the average capital structure across all firms was 71 per cent debt, including shipping outliers, and 57 per cent debt, excluding shipping outliers. The outliers ARTC excluded were shipping companies with very high debt equity ratios that operate under tight regulation. The average capital structure of the 12 rail companies in the survey was 27 per cent debt, with the most levered firm holding only 47 per cent debt.

ARTC also mentions that the Queensland Competition Authority assumed a debt equity capital structure of 55 per cent debt to 45 per cent equity for QR's central coal network in its most recent decision.

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[227] Truong G., Partington, G. and Peat, M. (2006) *Cost of Capital Estimation and Capital Budgeting Practice in Australia*, available at SSRN: http://ssrn.com/abstract=1019962

Based on this data, ARTC argues that the efficient debt level for its network should be set at 50 per cent, given the average debt level across all surveyed industries and the low level of debt in the capital structures of the surveyed rail companies.

Views of Interested Parties

NSWMC suggested that ARTC's proposed debt equity ratio may be more conservative than the optimal ratio for its business. It argued that 'the debt to equity ratio should be one that is considered the optimum target level for companies seeking to retain an investment grade credit rating appropriate for ARTC's business… rather than prudent as decided by reputable lenders.'[228]

Assessment of Issues

Under the standard regulatory assumption of less than full utilisation of imputation credits, debt has a tax advantage over equity. This causes a lower debt to equity ratio to result in a higher tax allowance being awarded to a regulated firm.

The debt to equity ratio is normally determined by regulators based on the long term debt to equity ratio an efficient firm in the industry would target. The target ratio should be the ratio that, combined with other management objectives, aims to maximise overall firm value. Common regulatory practice is to use a benchmark industry average to estimate the optimal debt to equity ratio and credit rating that can be achieved at this ratio.

ARTC's argument that different industries will have different efficient capital structures is theoretically sound. Therefore, the imposition of a capital structure of 60 per cent debt to 40 per cent equity may be inappropriate to determine ARTC's WACC and revenue ceiling.

The optimal capital structure is heavily driven by the business risk inherent to firms in an industry and the expected loss if default occurs. In industries where firms have higher business risk (that is more volatile operating cash flows), firms would be expected to carry less debt. Likewise, firms that have a higher expected loss if default occurs would be expected to carry less debt.

ARTC could be expected to have significantly more volatile cash flows (on its Interstate Rail Network over the term of this Undertaking) than other typical regulated businesses that are awarded a 60 per cent debt to 40 per cent equity capital structure. On this basis alone, a 50 per cent debt to 50 per cent equity capital structure may be a reasonable assumption.

The ACCC considers that shipping and trucking companies are less than ideal proxies for the optimal capital structure of a below rail service provider. Trucks and ships can be sold relatively easily for alternative use to recover funds if business cash flows decrease, whereas train tracks have virtually no alternative use and may be worth

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[228] NSW Minerals Council Hunter Valley Rail Access Task Force, *Response to Australian Competition and Consumer Commission Issues Paper Regarding Australian Rail Track Corporation*, August 2007 (NSWMC *August Submission*), p. 25.

almost nothing in the event operating cash flows of the business decline substantially. In addition, in the event of default the transaction cost of realising any value from use specific assets, such as train lines, might be significantly higher than general use assets such as trucks and ships.

The Queensland Competition Authority's assumption of a debt equity capital structure of a 55 per cent debt to 45 per cent equity ratio for QR's central coal network also lends support to a 50 per cent debt to 50 per cent equity ratio for ARTC's Interstate Rail Network. This is because a coal network could be expected to have more stable cash flows than a rail network that carries general inter-modal freight and may face more competition from other forms of transport. However, limited weight should be placed on other regulators' decisions without replicating and carefully analysing their results.

The ACCC's analysis of overseas train operators, using data from the Bloomberg professional data service, indicates that, on average, commercial firms operating both below and above rail operations have significantly lower debt to equity ratios than 50 per cent debt to 50 per cent equity. This data is shown in table D.5.4. While the ACCC considers that the rail operators in table D5.4 are less than ideal proxies for ARTC, due to their above rail operations, they are arguably the best proxies available.

The ACCC considers that a debt equity ratio other than 60 per cent debt to 40 per cent equity is appropriate given ARTC's assets and operations. This conclusion is not automatically applicable to other areas of regulation. Firms in other common regulatory areas, such as gas and electricity transmission and distribution, should be able to operate efficiently at a debt to equity ratio of 60 per cent debt to 40 per cent equity, or higher, due to their high degree of market power and the low volatility of their operating cash flows.

D.5.3.8. Imputation Factor (Gamma)

ARTC's Proposal

ARTC, in its December Undertaking used a value for gamma of 0.3 to estimate it's allowed tax cash flows in the revenue model. ARTC argues that this value for gamma is within the range contemplated by historic regulatory precedent.[229]

ARTC believes that 0.3 is high, however, as franking credits have no value because the marginal investor sets security prices and that the marginal investor is foreign (as Australia has insufficient capital to fund total capital investment in Australia). Therefore, share prices are set by foreign investors who cannot use imputation credits. As such, ARTC considers that a fair return, sufficient to induce efficient investment, should be set using a gamma of zero.

ARTC also argues that the introduction of the 45 day rule in 1997, requiring investors to hold shares for 45 days over the ex-dividend date to claim the imputation credits, eliminated any imputation value if it existed prior to that date. In addition, ARTC suggests that empirical studies showing a positive value for franking credits are invalid

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[229] ARTC, *Explanatory Guide to the 2007 Interstate Access Undertaking*, February 2008, p. 14

because there is multi-colinearity between the two independent variables, the value of cash dividends and the value of franking credits, in these studies.

Views of Interested Parties

QR considers that there is sufficient evidence to justify a gamma value of less than 0.5. However, QR did not propose a specific value simply suggesting that the ACCC should conduct a full review of all the input parameters necessary to calculate the WACC.

Assessment of Issues

Gamma is the market value of each dollar of corporate tax paid by the company that could be distributed to the company's shareholders. A higher (lower) gamma will result in a lower (higher) tax allowance being included in ARTC's revenue ceiling.

Gamma can range from zero to one and is argued to be the product of two variables:

- the proportion of tax paid that has been distributed to shareholders as franking credits (the payout ratio); and
- the value the average/marginal investor places on $1 of franking credits (the utilisation rate).

The ACCC looks at the payout ratio and utilisation rate of imputation credits to estimate the market value of franking credits. The payout ratio can be directly observed from taxation statistics but the value of franking credits must be estimated empirically. Estimation of the payout ratio and the utilisation rate are discussed below.

The Payout Ratio

A 2004 study by Hathaway and Officer, based on Australian tax office data, estimated a payout ratio of around 0.7 for imputation credits in Australia for the period 1988 to 2002 (Table D.5.7).

Table D.5.7: Payout Ratio of Imputation Credits by all Australian Companies

	1988 – 1999	1988 – 2000	1988 – 2001	1988 - 2002
Accumulated net company tax since 1987-1988	180 914	210 074	237 074	264 591
Credits retained in FAB accounts	48 933	57 884	84 905	76 975
Net credits distributed	131 981	152 190	152 112	187 615
Proportion of net tax that has been distributed	73%	72%	64%	71%

Source: Hathaway, N. and Officer, R.R. (2004) 'The Value of Imputation Tax Credits,' Update 2004, Capital Research Pty Ltd .

In a report for the ACCC, Lally (2002) examines the payout ratio for the eight largest listed firms in Australia: Telstra; News Corporation; NAB; Westpac; Commonwealth Bank; ANZ; Rio Tinto; and, BHP Billiton.[230] Using their recent financial statements he found that the contemporary payout ratio was equal to one.

On the basis of these studies the ACCC is of the opinion that the expected imputation payout ratio falls between 0.7 and 1.[231]

D.5.3.9. The Utilisation Rate

ARTC's assumption that the marginal investor is foreign is not theoretically valid under the domestic CAPM used by the ACCC and other Australian regulators to set and evaluate regulated firms' returns on capital. Under an Australian domestic CAPM, the correct assumption is fully segregated world capital markets, with all Australian investors being Australian resident (domestic) investors. This implies that paid out imputation credits will be fully valued in the share price and therefore, the utilisation rate should be set at one and that a gamma either equal to the actual payout ratio or assumed to be one should be used. This would put the value of gamma in the range of 0.7 and 1 and implies that using a gamma value of 0.5 conservatively favours regulated firms and should ensure future investment is not inadequately compensated due to an insufficient tax allowance.

If regulated firms such as ARTC wish to argue for an international CAPM, where imputation credits may have no value, they are entitled to do so. However, ARTC has not chosen to do this.

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230 Lally, M. (2002) *The Cost of Capital Under Dividend Imputation*, A Report Prepared for the ACCC.

231 It should be noted that there is a theoretical argument that the payout ratio should be assumed to equal one as the choice between paying out dividends (along with attached imputation credits) or not paying them out is a dividend policy decision. Firms should only choose not to pay out dividends (along with attached imputation credits) if they get something of at least as high a value (of both the dividends and imputation credits) in the future.

There are a number of empirical studies on the value of franking credits to shareholders (Table D.5.8).

Table D.5.8: Studies on the Value of Franking Credits

Study	Methodology	Utilisation
Brown and Clarke (1993)	Dividend Drop-Off	72%
Bruckner, Dews and White (1994)	Dividend Drop-Off	33.5%-68.5%
Walker and Partington (1999)	Dividend Drop-Off	88-96%
Hathaway and Officer (1999)	Analysis of tax statistics Dividend Drop-Off	0% 49% (large co. all stocks) 44% (all companies, all stocks)
Chu and Partington (2001)	Rights issues	Close to 100%
Twite and Wood (2002)	Inference from analysis of trading in derivatives	45%
Cannavan, Finn and Gray (2004)	Inference from value of individual share futures and low exercise price options	0%
Hathaway and Officer (2004)	Analysis of Tax Statistics, Dividend Drop-Off	40% 50%
Beggs and Skeels (2006)	Dividend Drop-Off	57%

Source: KPMG p. 42, with additions.

The latest and most comprehensive Australian dividend-drop off study was by Beggs and Skeels (2006).[232] Beggs and Skeels derive empirical estimates of the utilisation rate under the current tax regime (post 2000) as it applies to franking credits. The authors found that the estimated franking credit drop-off ratio was 0.572 (γ_2) from 2001 to 2004, with a cash drop off ratio of 0.800 (γ_1) in the same period. This study implied a utilisation rate of at least 0.572, with a gamma of between 0.40 and 0.57, assuming that gamma is a function of the payout ratio multiplied by the utilisation rate.[233]

From a theoretical perspective, Australian companies' increasing use of off market share buybacks to stream franking credits to investors who value them most highly, implies franking credits have value that should be reflected in share prices. The ability to stream franking credits also means that these credits can be utilised irrespective of who the marginal investor is, as long as some investors are domestic residents.

Finally, the recent case of *Envestra Ltd v Essential Services Commission of South Australia (NO. 2) [2007] SADC 90* in the district Court of South Australia found that a reasonable range for gamma was 0.35 to 0.5 on current evidence.

Overall, the ACCC considers that the use of a gamma of 0.30 by ARTC is not reasonable and results in revenue ceilings that are too high, given current studies on the

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[232] Beggs, D. and Skeels, C. (2006) 'The Market Arbitrage of Cash Dividends and Franking Credits,' *The Economic Record* , 82(258), pp. 239-52.

[233] While this is the common assumption in regulatory settings, it is not a settled position and it might be argued the long-term payout ratio should be set at one.

value of imputation credits to shareholders. The ACCC also concludes, after considering the fair value of the corporate tax paid to investors (i.e. the fair imputation credit value to shareholders), that a gamma of 0.30 would result in ARTC's pre tax revenue ceilings overcompensating it and, its investors, for the present value of the tax ARTC would incur if it was operating at its revenue ceiling.

Therefore, the ACCC recommends that ARTC change its gamma value to 0.50.

Draft Decision

The ACCC has taken an overall view in assessing the reasonableness of ARTC's proposed return on capital (WACC). Taken as a whole, the ACCC considers the WACC and revenue ceilings proposed by ARTC are not reasonable due to the gamma parameter.

In addition, the ACCC would also have been very likely to have rejected the WACC on the basis of the proposed debt issuance costs if ARTC had been closer to its revenue ceilings and if it had not been claiming significantly lower equity issuance costs.

Table D.5.9: Summary of WACC Parameters

Parameter	ARTC proposal	ACCC draft decision
Rf (nominal)	5.96%	5.96%
Debt	50%	50%
Equity	50%	50%
Debt to equity	1.00	1.00
BBB bond rate (nominal)	9.38%	9.38%[234]
Debt margin (nominal)	3.42%	3.42%
Debt raising costs	0.125%	0.125%
Cost of debt (Nominal)	9.51%	9.51%
MRP	0.06	0.06
Gamma	0.30	0.50
Inflation	2.50%	2.50%
Tax rate	30%	30%
Asset beta	0.65	0.65
Debt beta	0.00	0.00
Equity beta	1.28	1.29
ke	13.69%	13.72%
kd	9.51%	9.51%
Vanilla WACC	11.60%	11.61%

The ACCC's preliminary view is that the WACC parameters that ARTC has proposed are broadly reasonable with the exception of gamma. The ACCC recommends that ARTC amend its gamma from 0.30 to 0.50.

[234] Eight-year BBB Australian corporate bond yield obtained from Bloomberg on 18 March 2008.

D.5.3.10. Return of Capital

ARTC's Proposal

ARTC is seeking a return of capital on signalling and communications assets but not on rail infrastructure assets.

ARTC argues that rail infrastructure assets have an infinite economic and physical life because:

- it is unlikely that these assets would become stranded due to a significant fall in traffic volumes;
- it is unlikely that these assets would become obsolete as a result of technological change; and
- rail infrastructure assets are maintained at a steady state standard through regular Major Periodic Maintenance (MPM).

Since rail infrastructure is not subject to economic decay and does not require replacing, ARTC does not propose to apply a depreciation charge to these assets and therefore has not included a component for a return of capital on these assets in the regulatory revenue ceilings.

Signalling and communications equipment are assumed by ARTC to have an economic life of 30 years due to the possibility of technological obsolescence. Depreciation charges are calculated by applying straight-line depreciation to the optimised replacement cost values of the assets and are allocated to individual segments on the same basis as operating expenditures. Because depreciation is only applied to signalling and communications equipment it is a relatively small component of costs equalling approximately $4.2 Million in 2007-08.

Views of Interested Parties

There were no specific comments by interested parties on ARTC's approach to depreciation. SCT Logistics did, however, note that 'there is some double counting [between depreciation and the return on assets] under the generally-accepted definition of 'return on assets' where 'return on assets' is the amount in cents that must be returned each year to the owner from owning a dollars worth of asset.'[235]

Consultant's Report

In relation to allowed depreciation, PWC reviewed ARTC's assumptions on the lives of signalling and communications assets as part of its review of ARTC's DORC valuations. PWC's report indicates that the assumption of a 30 year life appears reasonable. PWC also reviewed Booz Allans Hamilton's assumptions on the remaining lives of the assets in place and found that the remaining asset lives were not unreasonable.

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[235] SCT *July Submission*, p. 18.

In relation to the MPM allowance (if considered depreciation), PWC reviewed this as part of its report on operating and maintenance costs. PWC found the MPM was reasonable and within the costs ranges of other rail operators.

Assessment of Issues

The ACCC considers that the issues relevant to its assessment of depreciation are:

- whether using MPM rather than depreciation, to reflect the cost of refurbishing and replacing capital, is appropriate;
- is the forecast level of MPM reasonable;
- is the use of straight line depreciation for signalling and communications equipment reasonable; and
- are the assumed asset lives for communications and signalling reasonable.

Each of these issues are discussed below.

Is the use of MPM in the Revenue Ceiling Appropriate?

Because MPM, rather than depreciation, reflects the costs of maintaining rail infrastructure in a steady state in perpetuity, the level of MPM in the building block regulatory ceiling represents the funding for asset refurbishment, renovation and/or replacement. As ARTC has indicated that it intends to spend the forecast MPM to maintain infrastructure assets in perpetuity, it makes little economic difference whether this maintenance allowance is classified as MPM or as depreciation and capital investment. Under either approach economic depreciation should be reflected in the revenue ceiling and the perpetually maintained assets' values should be reflected in the indexed DORC values. As a result, SCT's argument that there is double counting in relation to the "return on assets" under ARTC's approach to depreciation seems dubious. The return on assets is separate to the return of assets and as MPM maintains assets in perpetuity and other depreciation is removed from the RAB values, there does not seem to be any double counting.

Given that the cost of MPM includes a charge for asset replacement, the ACCC considers that ARTC's approach to not charging depreciation on these assets is appropriate. To do otherwise would mean that users would be paying twice for the cost of replacing assets.

Is the forecast MPM Reasonable?

PWC examined the MPM values ARTC assigns to network assets as part of the consultancy on operating and maintenance costs. As mentioned above, PWC found the MPM estimates generally did not appear unreasonable.

Is the Use of Straight Line Depreciation on Signals and Communication Assets Appropriate?

The use of straight line depreciation is common regulatory practice. It simplifies regulatory modelling and should not overcompensate access service providers. However, straight line depreciation can result in RAB values deviating from true

economic values and create incorrect pricing for long lived assets. In addition, non-economically based depreciation might give asset owners incentives to destroy assets and replace them to increase their RABs once the assets are fully, or close to fully, depreciated from a regulatory accounting perspective. Despite these concerns, in the context of ARTC interstate rail network the ACCC does not consider the use of straight line depreciation to be an issue. ARTC currently recovers well below their revenue ceilings, their regulatory RAB values deviating from economic values should not change their pricing and ARTC should have the incentive to minimise costs as opposed to maximising its RAB values.

Are the Assumed Lives for Signals and Communications Assets Reasonable?

In evaluation ARTC's DORC values, PWC examined the reasonableness of the assumed lives for signals and communications. It found that 25 years was reasonable for valuation purposes. This implies that ARTC depreciating these assets over 30 years is not unreasonable. PWC also found that ARTC's assumed remaining asset lives for these assets also appears reasonable.

Draft Decision

The ACCC's preliminary view is that the depreciation charges for signalling and communications equipment and the return of capital component for rail infrastructure assets implied in the MPM charges do not raise any objections under Part IIIA of the Act.

D.5.5. Cost Allocation

ARTC's Proposal

ARTC provided the ACCC with a financial model for the period 2007-08 to 2017-18, which includes its operating and maintenance costs and a methodology to allocate those costs to ARTC's individual rail lines. ARTC's financial model separates its operating and maintenance expenditures into those attributable to individual rail segments (direct costs) and those attributable to the entire network (indirect costs).

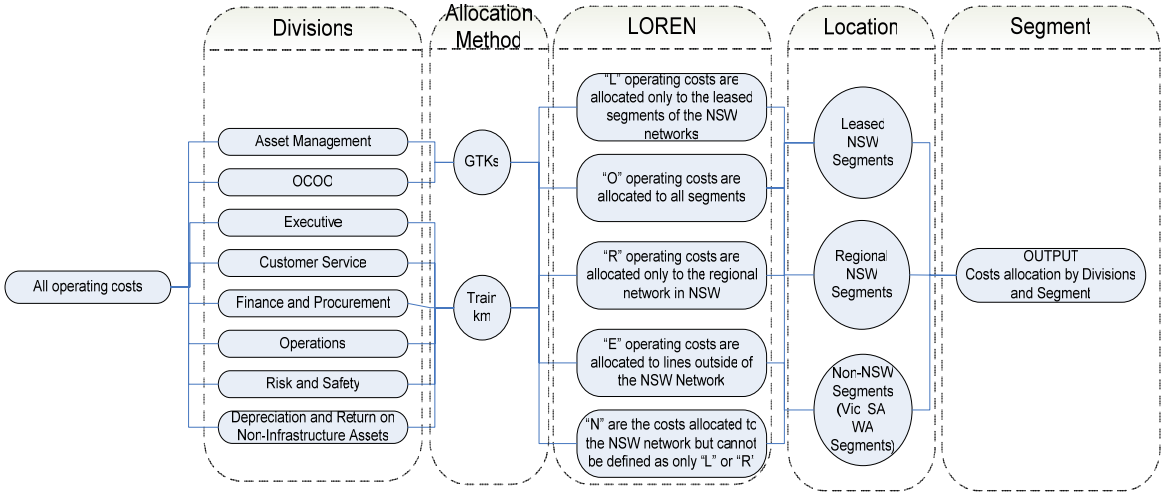
A significant proportion of ARTC's operating costs are incurred in the maintenance of its rail tracks. ARTC conducts two kinds of maintenance: routine maintenance (maintenance activities completed more than once a year); and MPM (the renovation of infrastructure facilities at intervals of more than a year). The financial model that supports the December Undertaking allocates routine and MPM expenditure directly to line segments. That is, ARTC's methodology of cost allocation deems all maintenance expenditures to be a direct cost of operating individual rail lines.

ARTC also incurs significant operating costs that can not be directly attributed to any one rail segment. These costs include the labour costs associated with path scheduling, train control and contract management; and the costs of ARTC's executive functions such as management, finance and procurement. In the 2002 Undertaking, ARTC

allocated these indirect costs to segments on the basis of train kilometres travelled in each segment relative to train kilometres travelled on the entire network.

To reflect the more complex operations of its expanded network, in particular as a result of the lease of the NSW network, ARTC has now chosen to allocate indirect costs via a three-step process. Firstly, costs are defined by their division, for example finance and procurement. Secondly, costs are tagged with either a gross tonne kilometre (GTK) or a train kilometre allocation method, depending on the division to which they are allocated. Lastly, costs are allocated by a process called LOREN to the leased NSW segments and the regional NSW segments or the non-NSW network. The LOREN cost allocation methodology is outlined in figure D.5.1 below.

Figure D.5.1: Operating Cost Allocation



Source: PwC, Review of ARTC Operations and Maintenance Costs and Cost Allocations Method, April 2008, p 17.

ARTC's proposed cost allocation approach in the December Undertaking is consistent with that currently used by ARTC in the Hunter Valley coal network under the NSW State rail access regime. The LOREN approach is also used by ARTC to allocate operating costs between the Hunter Valley coal network and parts of ARTC's Interstate Network.

In summary, ARTC's uses the LOREN methodology to allocate 38 per cent of the operating expenditure based on GTKs and 62 per cent based on the train kilometres.[236]

Views of Interested Parties

An issue that was raised by many interested parties was the potential for cross-subsidisation of Interstate rail lines covered in this Undertaking to rail lines outside the scope of the undertaking. Specifically, several stakeholders sought assurance that ARTC would not be allowed to allocate costs from the Interstate network to the Hunter Valley Coal Network. FROG expressed the view that, while it supported ARTC's current method of allocating common costs by corridors, it would like more detail on the costs that ARTC intends to allocate to each corridor. FROG was

[236] Figures calculated in PWC, Review of ARTC's Operations and Maintenance Costs and Cost Allocation Method, p. 13.

particularly concerned that the Hunter Valley network does not have costs allocated to it inappropriately.[237] PN shared FROG's views.[238]

The NSWMC made a more general point that whilst the undertaking was focused on interstate rail traffic, it must also be compatible with the operating and commercial characteristics of the Hunter Valley network, which would include the appropriate allocation of costs by ARTC.[239]

There were also more general submissions, which discussed the importance of only allowing ARTC to recover efficient costs. Whilst this is more an issue of the appropriate level of costs than the allocation methodology, cost allocation is important too. For example, FROG commented that ARTC has not committed to basing revenue limits on efficient costs.

Consultant's Report

PWC was engaged by the ACCC to independently assess the cost allocation methodology used by ARTC in the December Undertaking. Specifically, PWC was commissioned to review the reasonableness of ARTC's approach to cost allocation. A reasonable cost allocation methodology ensures that costs are allocated to the rail segments where they are incurred, preventing cross-subsidisation of one rail segment by another.

PWC found that ARTC has appropriately allocated operating and maintenance costs in accordance with the drivers of these costs. While PWC noted that there is no single 'correct method' for allocating costs to particular rail segments, it felt that any reasonable cost allocation approach would:

- directly attribute costs, rather than pooling costs and then allocating common costs;
- pool common costs, which cannot be directly allocated, into cost centres with common characteristics before allocating them to rail segments on the basis of an appropriate allocation driver that is consistent with end users' demand; and
- avoid over allocating costs across rail segments; that is, total allocated costs should equal the costs incurred by ARTC.

PWC found that ARTC has directly allocated many of its costs and did not find any circumstances where a direct cost of one rail segment was allocated as a common cost to the entire network. Further, PWC viewed the allocation of costs based on the LOREN approach as reasonable, since it first pools costs on the basis of common attributes before allocating these costs on the basis of costs drivers to various rail segments. PWC stated that:

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237 FROG *July Submission*, p. 5.

238 Pacific National *July Submission*, p. 26.

239 NSWMC *August Submission*, p. 3.

> We have confidence that the ARTC has developed a cost allocation process which is consistent with the characteristics of reasonable cost allocation methodologies…[240]

PWC also notes that ARTC's cost allocation methodology is more 'sophisticated' than that used for other rail networks in Australia.[241] PWC believes this reflects the increased complexity of ARTC's rail network compared with other networks and that such complexity is a consequence of the size of ARTC's operations and the leasing arrangements in NSW.

Finally, PWC found that 100 per cent of ARTC's costs were allocated across the various rail segments but that they were not over allocated.

PWC concluded that ARTC's cost allocation methodology is reasonable, as: it is consistent with the principles of good allocation processes; the sophistication of the cost allocation is appropriate for the complexity of ARTC's business; and the cost allocation process does not over allocate costs across the various rail segments.

Assessment of Issues

In the 2002 Undertaking, ARTC allocated maintenance costs based on a simple formula of 60 per cent GTKs and 40 per cent track kilometres. Operating costs were then allocated on the basis of train kilometres. This allocation was considered reasonable by the ACCC in 2002, given that ARTC's network was relatively homogenous at that time.

The 2004 lease agreement for ARTC to takeover much of the NSW rail network significantly changed ARTC's rail business. The ARTC rail network now includes the profitable Hunter Valley Coal Network and other lines close to metropolitan Sydney. The ACCC's consultant, PWC, considered that the change in the make-up of the network means that the 2002 cost allocation methods would be unsuitable for the December Undertaking.[242] PWC suggested:

> that the 2002 (cost allocation) methodology would result in the higher costs involved in running the NSW lease being spread across the entire ARTC network, leading to an over allocation of costs to WA, SA and Victoria and an under allocation to NSW segments.[243]

The ACCC concurs with PWC's view. The consequence of the cost allocation methodology employed in the December Undertaking is that ARTC now allocates 38 per cent of expenses by GTKs and 63 per cent by train km as well as employing the more sophisticated LOREN methodology to divide costs between areas of the network.[244] The ACCC also notes PWC's view that ARTC's cost allocation methodology:

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240 PriceWaterhouseCoopers (2007) *Review of ARTC Operations and Maintenance Costs and Cost Allocation Method*, March, p. 17.

241 ibid., p. 13.

242 ibid.

243 ibid.

244 ibid., p. 14.

- uses cost drivers commonly evident in rail networks, namely GTK and train km;
- uses location cost drivers, such the LOREN; and,
- separates rail segments and their costs on the basis of location.

In addition, in assessing ARTC's cost allocations, PWC looked specifically at the potential for costs to be inappropriately shifted between the interstate rail network and the Hunter Valley coal line. Therefore, its conclusions about the appropriateness of cost allocation across the network also apply to the allocation of costs between the interstate network and the Hunter Valley.

Overall, the ACCC notes that there is no single accepted methodology for cost allocation and alternative methodologies could be considered reasonable by a regulator. After considering the methodology proposed by ARTC and the findings of PWC, the ACCC concurs with PWC that ARTC's proposed allocation process is reasonable. The ACCC also notes that the cost allocators of GTKs and train kilometres used by ARTC are common to other state rail regimes.[245]

Draft Decision

The ACCC's preliminary view is that ARTC's approach to allocating operating and maintenance costs does not raise objections under Part IIIA of the Act.

D.5.6. Operating and Maintenance Costs

ARTC's Proposal

Over the proposed ten-year regulatory term of the Undertaking, ARTC proposes to spend approximately $987 million on maintenance and $1,075 million on operating expenditure for the Interstate Network.[246] Maintenance expenditure is works that preserve the condition of existing rail lines, for example re-sleepering or replacing signals and control infrastructure. Operating expenditure is work associated with the physical operation of the network and the fulfilment of contracts. Operating expenditure includes the scheduling of trains and train paths, negotiating contracts with access seekers and ARTC's executive functions.

Operating and maintenance expenditure differ considerably across the network with costs much higher in NSW.

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245 ibid.

246 ibid., p. 22.

Views of Interested Parties

There was little explicit comment from interested parties on ARTC's proposed operating and maintenance expenditures. PN noted that:

> ARTC's costs for the most part only come into play in determining the revenue floor and ceiling and are therefore are of academic interest only.[247]

Though several interested parties commented on the principles under which operating and maintenance costs should be assessed.

On clause 1.2(c)(i)(A) of the December Undertaking, which specifies that ARTC will seek to recover 'all reasonable costs,' PN noted that ARTC's 2002 Undertaking referred to the recovery of 'efficient costs' and, therefore, the new clause may allow ARTC to recover inefficient costs. PN suggested that the principle of efficiency should be retained in the Undertaking. FROG made a similar point, arguing that there is no unequivocal commitment by ARTC that the revenue limits will be based on efficient costs.

The NSWMC had different concerns because ARTC's Undertaking allows it to include forecast costs from periods far in the future when those costs are only forecasts and not ARTC's true costs. The NSWMC, therefore, submitted that ARTC should only be allowed to set access charges on the basis of actual costs.

Consultant's Report

Maintenance Costs

In their report for the ACCC, PWC assessed the reasonableness of ARTC's maintenance costs based on benchmarks of costs in other Australian below rail networks, observations about ARTC's actual costs and cost projections and the assessment of an efficient benchmark of maintenance costs provided by ARTC's consultant, WorleyParsons. PWC findings on the maintenance expenditure of other Australian Rail Networks is presented in Table D.5.10 below.

[247] Pacific National *July Submission*, p. 35.

Table D.5.10: Maintenance Expenditure Reference Points

		$ track kms
ARTC average over December Undertaking		12,981
Essential Services Commission (Vic), Pacific National Freight 2006		
Regional Fast Rail		22,162
Other passenger		28,849
Freight		15,081
Economic Regulation Authority (WA) 2007		
WestNet: Forrestfield – Kalgoorlie		18,784
Queensland Competition Authority		
QR Network[248]		8,920 — 12,870

Source: PWC (2008) Australian Competition and Consumer Commission Review of ARTC Operations and Maintenance Costs and Cost Allocations Method, March, pp. 20-21.

As illustrated above, ARTC's average maintenance expenditure over the regulatory period is $12,981 per track km, approximately in the middle of the benchmark range of $8,920 to $18,784 allowed by regulatory authorities for similar rail networks in Australia. PWC noted that the Queensland Competition Authority's reference points for QR's network are considerably lower than the average cost assumed by ARTC but crucially exclude the calculation of MPM. Once MPM is removed from ARTC's maintenance figures, its average maintenance costs are similar to the QR network, with maintenance costs falling in the middle of QR benchmark range.[249] PWC also commented that the cost of maintenance for QR's lines would be expected to be lower because its track is narrower gauge.[250]

In reviewing ARTC's actual and projected maintenance costs PWC compared the forecast level of costs for the December Undertaking with actual cost incurred during the 2002 Undertaking. ARTC's estimated that average maintenance costs per track kilometre over the December Undertaking is seven per cent less in real dollar terms than actual average costs for the 2002 Undertaking.

The final factor PWC considered in its assessment of ARTC's maintenance costs was the independent report by WorleyParsons appraising the efficient costs of ARTC's network. WorleyParsons was commissioned by ARTC to determine efficient industry benchmarks for maintaining ARTC's network. WorleyParsons separated these benchmarks for the east-west and north-south lines of ARTC's Interstate network because of a significant difference in their physical characteristics including: different terrain, climate, and the predominance of timber sleepers in the North-South corridor (Table D.5.11).

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248 Economic Regulation Authority, Final Determination on Westnet Rail's Proposed Floor and Ceiling Costs, 2007; based on average maintenance cost on 19/21tal lines where annual tonnages are in the range of 3 to 6mgt.

249 PwC (2008) *Australian Competition and Consumer Commission Review of ARTC Operations and Maintenance Costs and Cost Allocation Method,* March, p. 24.

250 ibid.

Table D.5.11: WorleyParsons Efficient Cost Benchmarks

	$GTK (000)	$ per track km
Maintenance Expenditure (excluding overheads)		
East-West ARTC Interstate Network	1.72	16,500
North-South ARTC Interstate Network	3.18	27,500
Total ARTC Interstate Network	2.17	20,200

Source: PWC (2008) Australian Competition and Consumer Commission Review of ARTC Operations and Maintenance Costs and Cost Allocations Method, March, p. 26.

The WorleyParsons report found that on the East-West network, ARTC's maintenance costs lie around 25 per cent below the efficient benchmark. On the North-South network ARTC's maintenance costs lie 20-25 percent below the WorleyParsons efficient benchmark, and these costs are expected to fall further with the replacement of timber sleepers on the north-south lines.[251]

PWC noted that, unlike WorleyParsons' assessment of efficient rail costs for the Essential Services Commission of Victoria, WorleyParsons' study for ARTC did not include an efficiency factor of 15 per cent. Worley-Parsons stated that it did not apply an efficiency factor for ARTC's maintenance costs as it had access to asset databases and cost data which were not available when estimating costs for the Essential Services Commission. PWC used the WorleyParsons' estimates as part of its assessment of the reasonableness of maintenance costs but did not rely on them to informing their analysis of the efficient maintenance costs benchmark.

PWC concluded that, although the reasonableness of ARTC maintenance costs is a subjective judgement, it has no reason to believe that ARTC's forecast maintenance costs are unreasonable. PWC cited a number of reasons for their view including that ARTC maintenance costs forecast for the December Undertaking are significantly less than the costs incurred over the 2002 Undertaking, and that ARTC's costs are expected to fall to approximately the middle of the benchmark range for similar Australian rail networks.

Operating Costs

PWC also assessed the reasonableness of ARTC's operating costs, comparing ARTC's proposed operating expenditures with the costs incurred in the previous regulatory period, assessing the level of costs in NSW, and benchmarking NSW and non-NSW costs against operating expenses in other rail systems.

Average operating costs have increased by more than 200 per cent across the network between the 2002 and December Undertakings, from $6,074 to $14,134 per track km. To some extent, this increase reflects higher operating costs across all segments of the network, but it is also driven by substantially higher operating costs in NSW. There is a

[251] ibid., p. 27.

substantial difference in operating expenditure between the two parts of ARTC's Interstate Network: $19,697 per track km in NSW and $7,773 outside NSW.[252]

To assess ARTC's operating costs on the NSW and non-NSW parts of the Interstate network, PWC used various reference points including ARTC's operating costs at the expiry of the 2002 Undertaking and the operating expenses of Westnet rail on its Forrestfield to Kalgoorlie rail line.

After assessing ARTC's operating costs against the above reference points, PWC noted that it is difficult to make meaningful comparisons across track-owners/managers, given the diversity in individual operations and the differing technologies employed by operators. However, PWC concluded that the Interstate Network and Forrestfield-Kalgoorlie line are essentially equivalent operations. Against this benchmark PWC notes that:

> The average operating expenditure for the non-NSW segments over the Undertaking is $7,773 per track km is approximately 44 per cent lower than the WestNet Rail reference point. Meanwhile, the operating expenditure on the NSW segments is $19,697 per track km over the ten year period of the Undertaking, which is approximately 41 per cent higher than the WestNet Rail reference point.[253]

PWC further concluded that there are likely to be considerable economies of scale in operating costs for large rail networks. This conclusion would tend to support the view that ARTC's NSW operational costs were relatively high since they are similar to the Forrestfield-Kalgoorlie line, a network with a much smaller scale.

In looking at the reasons for general cost increases between the two Undertakings and the higher costs in NSW, PWC suggested that one explanation for the increase in costs is that integrating the NSW rail lines into the network has led to considerable diseconomies of scale. PWC also noted that ARTC figures show that increases in employees account for a large proportion of the increase in operating costs.[254] PWC also recognised that the costs associated with the NSW lease are likely to affect operational costs in NSW and ARTC's ability to reduce those costs.

Overall, PWC concluded that, given ARTC's costs in NSW are driven by its lease arrangements, ARTC's overall operating costs are reasonable. Though higher than in the 2002 Undertaking, operating costs on the non-NSW segments are still well below the Forrestfield to Kalgoorlie benchmark. PWC also noted that real operating costs will decrease slightly by the conclusion of the December Undertaking, increasing the case that they are reasonable.

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252 This is a average annual figure for the course of the ten years in the December Undertaking. See PWC, p. 29.

253 PwC (2008) *Australian Competition and Consumer Commission Review of ARTC Operations and Maintenance Costs and Cost Allocation Method*, March, p. 32.

254 ibid., p. 30.

Assessment of Issues

Maintenance Costs

The ACCC considers ARTC's forecast maintenance costs to be reasonable, although the reasonableness of maintenance cost is a subjective judgement. Firstly, ARTC's forecast maintenance costs are projected to decline over the period of the December Undertaking against the maintenance costs incurred under the 2002 Undertaking by approximately 7 per cent, measured by maintenance cost per track km. Secondly, ARTC's maintenance costs are expected to fall to approximately the middle of the benchmark range for similar Australian rail networks. And lastly that ARTC's independent consultant, WorleyParsons, established a set of maintenance cost benchmarks against which ARTC's maintenance costs appear efficient.

However, the ACCC notes that maintenance costs are relatively high throughout the NSW section of the Interstate Network. It notes that ARTC argues that its maintenance costs have fallen and the East-West segment of the network, because its use of external contracts has driven cost savings by introducing competitive pressures, but the option of external contracts is not currently available to it in NSW, due to the terms in its lease contract for the NSW track. The ACCC's view is that ARTC should seek to reduce the maintenance costs in NSW and in future regulatory decisions, the ACCC will again assess the reasonableness of ARTC's costs based, taking into account ARTC's efforts to reduce the costs in NSW to an efficient benchmark.

Operating Costs

The ACCC views ARTC's current forecast operating costs as reasonable. In making this assessment, the ACCC notes that since ARTC earns less revenue than the regulated ceiling, it faces incentives to reduce costs as costs savings should result directly in increases in its profits which it will keep in the long run.

For the non-NSW part of the network, ARTC's costs are well below the costs of the Forrestfield-Kalgoorlie line and are therefore comparable with available external cost benchmarks, even though they have increased.[255]

For the NSW portion of the Interstate Network, costs are significantly higher than other parts of the regulated network. ARTC states that the higher costs in NSW are primarily due to the lease arrangements, which specify that ARTC must employ the existing staff associated with the NSW Interstate network, while, in contrast, it has been able to drive cost efficiencies in the non-NSW parts of the Interstate Network by contracting out much of its operation. ARTC also argued that the resources and corporate support needed to service its business have risen substantially with the organisations increased size and spread and this can, to some extent, explain the rise in operating costs.

The ACCC notes that much of the increased costs on the NSW network are a condition of ARTC's lease for that part of the network. Whilst the ACCC considers the costs of the NSW network may be above what is efficient, ARTC has limited capacity to address this immediately. Furthermore, ARTC has carefully allocated the costs associated with the NSW network only to users of those segments, meaning it is

[255] ibid., pp. 28-29.

unlikely that high costs are being transferred from NSW to other parts of the network. Therefore, the ACCC concludes that ARTC's costs are reasonable, but there should be a strong focus on decreasing those costs going forward, particularly in NSW.

Draft Decision

The ACCC's preliminary view is that the current levels of operating and maintenance costs do not raise objections under Part IIIA of the Act.

D.6. Capacity Management

Summary

Part 5 of ARTC's Undertaking sets out the capacity management provisions relating to the allocation, reservation, and transfer of train paths. The Undertaking's capacity management provisions are based on administrative mechanisms, that is, rules as opposed to market mechanisms such as auctions.

ARTC proposes to assign initial access rights (i.e. train paths) to the first customer with whom ARTC can negotiate and execute an agreement which in ARTC's opinion is most favourable to it. ARTC also proposes that operators may reserve network capacity more than six months prior to the commencement of the service subject to a reservation fee. The intentions of the reservation fee are to compensate ARTC for the opportunity cost of reserving capacity and to prevent capacity hoarding.

Capacity rights may be transferred between the holder of capacity rights and a third party provided that the assignment to the third party is approved by ARTC. ARTC also proposes that where a holder of capacity rights has under-utilised their capacity, the assigned capacity may be reduced or cancelled (the 'use it or lose it' rules).

The ACCC's preliminary view is that the capacity management provisions concerning capacity analysis, allocation and transfer do not raise objections under Part IIIA of the Act. However, the ACCC's preliminary view is that, while there is a theoretical justification for a capacity reservation fee in situations in which capacity is scarce, ARTC's proposed methodology is much broader and is likely to result in the fee being imposed where there is little or no opportunity cost of reserving capacity and the costs of capacity hoarding are minimal. Therefore, the ACCC considers that the fee, as currently proposed by ARTC, does not satisfy the statutory criteria and should be deleted from the Undertaking. The ACCC is also of the view that the 'use it or lose it' provisions in the Undertaking do not raise objections under Part IIIA.

D.6.1. Introduction

The capacity management provisions of the Undertaking relate to the reservation, allocation, and transfer of network capacity. Capacity management is an important component of network efficiency as the provisions affect the extent to which the network is used. The following discussion introduces some of the key concepts that are referred to in this chapter and are relevant to the ACCC's assessment.

Rail Capacity

Rail capacity is the volume of above-rail services that the below-rail network is capable of providing in a given time period. Capacity is neither infinite nor a linear function of the physical characteristics of the network. The extent of capacity in a rail network depends on below-rail factors and above-rail factors. For example, on the below-rail side, network capacity is a function of the physical characteristics of the network (such as the condition of tracks, the number of passing loops, the extent of curvature in the

rail lines, and the sophistication of signalling equipment), as well as the network management principles governing the operation of above-rail services. Whereas, on the above-rail side, network capacity is affected by the characteristics of the services utilising the network (such as the length of trains, grinding profile of car wheels, and haulage weight per car), as well as the speed of the services (which largely depends on the physical characteristics of the service and of the network) and the order in which services are run.

Network capacity is thus a function of inter-dependent factors that are not controlled entirely by either the above-rail operator or the network provider.

Train Paths

Assigning network capacity requires a basic 'unit' of capacity to be defined. The basic network capacity unit adopted by ARTC is the 'train path.' In general, a train path is a defined entry, exit and transit time for a train on a particular network segment or corridor.

Scheduled Versus Ad Hoc Train Paths

The December Undertaking classifies train paths as either scheduled or *ad hoc* (clause 9.1). Scheduled train paths are designed for regular services such as intermodal freight with a planned origin and destination. These train paths provide scheduled and planned services over a defined time period and thus certainty as to the extent of capacity utilisation.

Ad hoc train paths, on the other hand, are generally more itinerant and sporadic and are used mostly by bulk freight (such as grain). They do not require significant operational planning from ARTC and are placed within the timetable several months in advance and are planned around expected arrival times. Train operators have information about the expected times of the *ad hoc* train paths, but they are not guaranteed that the path will be available. The *ad hoc* train paths can be booked at short notice without detailed negotiation between operator and ARTC and, depending on the flexibility of the operator, ARTC states that it can usually find a suitable *ad hoc* train path.

Capacity Management – Administrative Versus Market Based

Management of capacity can occur through market or administrative based mechanisms. Market based mechanisms assign capacity by allocating train paths to the operators who value them most. In principle, market based mechanisms promote network efficiency. The problem, however, is that market based mechanisms have practical difficulties, including the complicated ways in which train paths can be put together to produce a variety of types of service and the fact that the value of a particular train path for a particular use depends on how other train paths are being used (such as the impact of complementary or competing trains).

Capacity management is, therefore, generally based on administrative mechanisms (or rules) that are set-out and implemented by the rail infrastructure provider. While administrative mechanisms address many of the transaction costs associated with market based mechanisms, they are usually discretionary and may not provide the correct pricing and valuation signals to promote efficient use of the network or further

network investment. It is thus of little surprise that the Bureau of Transport and Regional Economics found that:

> For most countries, generally, there is no clear model for capacity management, with little use being made of modulated prices. This is explained, in part, in that on-going capacity allocation is dominated by traditional public interests (notably, passenger trains) while for many other operations, paths allocation is based on grandfather rights to traditional freight users. Thus, new third-party entrants and new open access entrants are given access on residual capacity that exists after the incumbent has allotted its pathing needs. Some countries seek to manage capacity through blanket higher charges at times and routes where demand is high. Great Britain has experience with congestion charging though the passive (fixed) charge adopted there provided little in the way of incentives to either invest in additional capacity or reduce demand for congested capacity. These approaches adopted work against competition objectives.[256]

Network capacity management thereby raises a number of efficiency concerns that are difficult to balance against practical operational realities. In assessing the December Undertaking the ACCC has, therefore, recognised that the mechanisms and processes by which train paths are allocated, reserved, and transferred can have a substantial effect on network efficiency and the costs faced by above and below rail operators.

D.6.2. Capacity Analysis

ARTC's Proposal

As part of assessing an applicant's Indicative Access Proposal, ARTC undertakes a capacity analysis to ascertain whether there is sufficient available capacity on the network to meet the applicant's requirement (clause 5.1(a)). Available capacity in the Undertaking is defined as:

> …capacity that is not committed capacity (including committed capacity in instances where it will cease being committed capacity prior to the time in respect of which capacity is being assessed) (clause 9.1).

The intention of the capacity analysis is to determine whether sufficient capacity is available to meet the requirements of the operator or whether additional capacity needs to be provided. If ARTC believes complex capacity analysis is required, because there are major impediments to the provision of additional capacity to meet the applicant's requirements, the Undertaking allows for recovery of the reasonable costs of carrying out this analysis (clause 5.1(b)).

Views of Interested Parties

Interested parties raised concerns about the proposed capacity analysis charge in clause 5.1(b) and whether operators should be required to pay for more complex capacity analysis.[257] The NSWMC, for example, submitted that the scope of the capacity

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[256] Bureau of Transport and Regional Economics (2003) *Rail Infrastructure Pricing: Principles and Practice*, Report no. 109, Canberra: Bureau of Transport and Regional Economics, pp. 177-8.

[257] Great Southern Railway, *Submission Regarding the Australian Rail Track Corporation Access Undertaking – Submission to the ACCC by Great Southern Railway Limited*, August 2007 (GSR *August Submission*), p. 33; New South Wales Mineral Council, *NSW Minerals Council Hunter Rail Access Task Force – Response to Australian Competition and Consumer Commission Issues Paper*

analysis and the associated charge need to be agreed between the parties beforehand and that the access seeker should have full access to the capacity analysis report.[258]

By contrast, GSR submitted that the proposed introduction of a capacity analysis fee is inappropriate, given that it is a function that ARTC would normally carry out and that it is reasonable to expect that the costs of capacity analysis would already be recovered by the indicative access charges.[259]

Assessment of Issues

The key issue arising from the ACCC's analysis of the capacity allocation process is whether ARTC should be able to charge individual access seekers a capacity analysis charge when they require more complex capacity analysis to progress their access application.

The ACCC considers that ARTC has commercial incentives to increase utilisation of the network. These incentives mean that ARTC is likely to undertake periodic and extended analysis of network capacity. Therefore, as recognised in the Undertaking, there is a level of capacity assessment that should be readily available to ARTC and made available to access seekers free of charge. The question for the ACCC is, therefore, whether the inclusion of the provision to charge for more complex assessments is:

- irrelevant — are more complex and costly assessments really needed;
- open to abuse — is the use of the charge sufficiently well defined to prevent ARTC inappropriately charging for more routine capacity analysis; or
- inefficient — if a more complex and costly analysis is needed should the cost of that assessment be paid by the applicant requiring the analysis.

It appears clear that there are circumstances in which an applicant's requirements are complex and ARTC may incur additional costs over and above that normally incurred in determining capacity requirements for a standard access application. Therefore, it is not appropriate to dismiss the charge as irrelevant. It is then necessary to look at ARTC's application of the charge.

The provision in the December Undertaking that allows ARTC to seek agreement to levy a capacity analysis charge is quite specific. It states that the charge can be agreed:

> Where ARTC believes that there are major impediments to the provision of Additional Capacity to meet the requirements of the Applicant, and that the Capacity enhancement that might be necessary would have a significant bearing on the economics of the proposed operation, the Capacity Analysis may be done in more detail which may require more time for the preparation of the Indicative Access Proposal (see clause 3.8(b)).

Regarding Australian Rail Track Corporation 2007 Access Undertaking For Its Interstate Rail Network, August 2007 (NSWMC *August Submission*), p. 25.

258 ibid.

259 GSR *August Submission*, p. 33.

The application of the charge is, therefore, restricted to situations where there are major impediments to the provision of additional capacity and it is unlikely that ARTC would be able to use this provision to inappropriately extend the application of the charge.

Finally, should the cost of more complex analysis be borne by those access seekers requiring such analysis or by all above rail operators through general access charges? The ACCC's preliminary view is that for unusually complex or costly requests there are potentially efficiency benefits in requiring additional costs to be paid directly by the applicant requiring that analysis. This ensures that those with relatively simple access requests are not cross-subsidising more complicated applications. The ACCC also notes that the applicant will be fully aware of this charge as it is agreed up front and subject to the Undertaking's negotiation provisions. Therefore, the applicant can choose whether to proceed with the application and incur the charge. This would also potentially discourage applicants with very costly and complex access requests from making frivolous applications.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 5.1 setting out ARTC's capacity analysis do not raise objections under Part IIIA of the Act.

D.6.3. Capacity Reservation Fee

ARTC's Proposal

Operators who are negotiating freight contracts will often need to reserve capacity on the rail network in advance, so they have the certainty needed to enter into those contracts and to make any necessary above rail investments. The December Undertaking proposes that ARTC can levy a capacity reservation fee on access seekers wanting to execute an access agreement more than six months prior to commencing the service (clause 5.2(a)). ARTC argues that the capacity reservation fee allows it to recover the opportunity cost of setting aside network capacity and prevents capacity hoarding by operators. ARTC states that:

> … making capacity available with long lead time reduces ARTC's ability to maximise utilisation of that capacity in the ensuing period. Almost all capacity utilisation on the network is under a longer term contract. Short to medium term access rights have a significantly reduced chance of attracting utilisation. ARTC seeks to be compensated for this opportunity cost. ARTC will have regard for the extent of this opportunity cost in determining the reservation fee. ARTC also recognises that a reservation fee may, in itself, act as a barrier to a new entrant. In this regard, ARTC has a commercial incentive to accommodate the needs an access seeker and increase network utilisation. Where ARTC can secure utilisation of the capacity during the period of reservation, the reservation fee will be reduced accordingly.[260]

[260] ARTC, *Explanatory Guide to the 2007 Interstate Access Undertaking*, June 2007, p. 28.

ARTC proposes to determine the capacity reservation fee based on the foregone opportunity cost, the reservation period and other demand for the capacity rights. That is, the capacity reservation fee would be no greater than the flagfall component of the charge for the reserved access rights, plus the variable component that would arise if the access rights were 50 per cent utilised. Full utilisation is determined by applying the average train length and average axle load for an indicative service. ARTC also proposes that the capacity reservation fee would be reduced if the reserved capacity is used by another operator (clause 5.2(b)).

ARTC argues that the main reason for introducing the fee is to address a balance between the needs of the access seeker to lock into future capacity and the interests of ARTC in not wanting to set aside capacity for a period in which its ability to sell that capacity for anything other than short-term use is limited.

Views of Interested Parties

The majority of stakeholders had concerns regarding the appropriateness and methodology of the capacity reservation fee.[261] NSWMC was of view that the capacity reservation fee does not reflect opportunity cost when the network is not constrained, and that the fee may be inflated above the actual opportunity cost foregone.[262]

Operators argued that while it is normal and prudent commercial behaviour to secure access rights well ahead of commencement of train operations, this does not imply that there is logic in charging a reservation fee. Furthermore, operators believe that ARTC should manage its business to have capacity available when it is required rather than quarantining capacity from the point of contracting.[263]

In addition, GSR submitted that ARTC applying a fee for reserving capacity more than six months in advance is inconsistent with the much longer notification periods (one or two years) for an access holder to inform ARTC that it intents to cancel a long term scheduled train path (IAA clauses 9.9(c) and (d)).

In contrast, one operator, QR, supported, in theory, ARTC's inclusion of the capacity reservation fee. QR submitted that the capacity reservation fee represents an opportunity cost when capacity is constrained and acts as a deterrent to capacity hoarding by train operators. However, QR did not support ARTC's specific proposal, because it believed that there was little detail surrounding how the charge would be set.[264]

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261 SCT Logistics, *Submission on the ARTC Undertaking*, July 2007 (SCT *July Submission*, pp. 12-13; Freight Rail Operators' Group (FROG), *ARTC Interstate Access Undertaking 2007 – Freight Rail Operators' Group Submission to the ACCC*, July (FROG *July Submission*), p. 9; Pacific National, *Pacific National Submission to ACCC Re: Approval of ARTC Interstate Access Undertaking*, July 2007 (Pacific National *July Submission*), pp. 38-39.

262 NSWMC *August Submission*, pp. 25-26.

263 Pacific National *July Submission*, p. 38.

264 Queensland Rail, *Queensland Rail Submission to ACCC on ARTC Interstate Access Undertaking 2007*, July 2007 (QR *July Submission*), pp. 28-30.

While the December Undertaking provided further detail (clause 5.2(b)) as to how ARTC proposes to set the reservation fee, operators submitted that the valuation and calculation of the reservation fee is still problematic. They believed the capacity reservation fee's ceiling is too high and ARTC has too much discretion in determining the fee.[265] In any event, operators argued there were sufficient anti-hoarding provisions in the access agreement already via the 'use it or lose it' provisions.[266]

Operators were also concerned that the capacity reservation fee would discourage smaller rail providers, is inconsistent with offering equitable access by a monopoly supplier, and that any revenue from the fee should be offset by reductions in other charges, otherwise the introduction of the fee is effectively a real price increase.[267]

Assessment of Issues

The ACCC considers that capacity reservation or forward contracting of train paths provides certainty to access seekers, who can obtain preferred train paths before they finish coordinating other decisions on market entry, such as obtaining a base cargo clientele and investing in suitable train consists. Capacity reservation reduces the risk for access seekers of not being able to obtain their preferred train paths and increasing the likelihood of market entry. It may lead to larger long term increases in the use of the interstate rail network than would otherwise be the case. These benefits are achieved, however, through the ability to reserve capacity, rather than the infrastructure operator being able to charge for that right.

In analysing the capacity reservation fee the ACCC has assessed the two key justifications ARTC put forward for introducing the fee. First, whether there is an opportunity costs to ARTC when access seekers reserve capacity and whether ARTC should be compensated for that opportunity cost. Second, whether operators are likely to hoard unused capacity rights in the absence of the capacity reservation fee.

The opportunity cost of reserving capacity and capacity hoarding

The capacity reservation fee is paid by a rail operator that contracts for a train path into the future. The fee covers the reserved capacity between the time the capacity is contracted and the time it is used by the rail operator. ARTC claims that the central intention of the capacity reservation fee is to allow it to recover the opportunity cost of reserving capacity.

ARTC argues that in some situations the reserved train path is an opportunity cost to ARTC as it could prevent ARTC from awarding a train path to other operators who

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265 Queensland Rail, *Queensland Rail Submission to the ACCC: Response to ACCC Issues Paper on ARTC Access Undertaking – Interstate Network*, February 2008 (QR *February Submission*), p. 10; Freight Rail Operators' Group (FROG), *ARTC Access Undertaking – Interstate Network, Response to ACCC Issues Paper*, February 2008 (FROG *February Submission*), pp. 7-8.

266 FROG *February Submission*, pp. 7-8; SCT Logistics, *Australian Rail Track Corporation Rail Access Undertaking – Interstate Network*, 11 February 2008 (SCT *February Submission*), pp. 5-6, Pacific National *July Submission*, p. 13.

267 FROG *February Submission*, pp. 7-8; SCT *February Submission*, pp. 5-6.

may not be interested in signing a relatively short term agreement.[268] The capacity reservation fee thereby encourages train operators to place a value on the train paths they reserve and mitigates the risks associated with long-term service planning.

The ACCC considers that if the network is congested reserving capacity can have a significant impact on other operators who may also want long term access to the reserved path and, therefore, the opportunity cost of path reservation is potentially significant.

However, if reserving a train path does not reduce ARTC's scope to sell capacity, which is likely on segments or at times where long term capacity is still available in addition to the reserved paths, there is no opportunity cost to ARTC in reserving such capacity and according to this rationale the fee should be zero. Moreover, if capacity constraints are not uniform across the network then the extent of any opportunity costs would also vary significantly. In such cases, imposing a capacity reservation fee based on a uniform measure would fail to take such differences into account. There is thus an issue as to the whether the methodology for calculating the capacity reservation fee proposed by ARTC is appropriate.

The ACCC is also concerned about the potential for the capacity reservation fee to deter new entrants. The ACCC notes that ARTC has raised similar concerns regarding a reservation fee in a previous regulatory setting and stated that that it would need to 'carefully consider the application of such a fee.'[269] As noted above, new entrants will often benefit from reserving capacity in advance of commencing services as they are more able to demonstrate to potential customers that they will be able to offer a viable service and they have the certainty needed to invest in above rail assets. But new entrants are also the operators least likely to be able to sustain substantial up-front costs, such as a capacity reservation fee. There is, therefore, a question about the extent to which the benefits to new entrants of capacity reservation would be offset by the imposition of the charge.

As the capacity reservation fee is a charge payable for the reservation of capacity, it does provide a financial incentive for operators to give up rights that they do not use/value and not seek to secure rights unless they need them. It would therefore discourage hoarding. Although it should be recognised that in situations where there is plenty of available capacity there are fewer incentives to hoard and the cost of any such hoarding would be minimal.

Other Rail Access Regimes

In balancing these merits and limitations, the ACCC notes that the capacity reservation fee proposed by ARTC has precedence in the QR Access Undertaking, in which QR proposed a similar fee to the Queensland Competition Authority. QR sought to require

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[268] ARTC is more likely able to award a reserved train path to an access seeker if the reservation period is very long. However, if the reservation period is about two years, ARTC may only be able to award the train path as an *ad hoc* path during the reservation period.

[269] ARTC (2004) *QCA Investigation: QR's 2005 Draft Access Undertaking Response to Submissions – ARTC Comments*, accessed on 14 March 2008, at: http://www.qca.org.au/www/rail/2005%20DAU%20Response%20Submission_ARTC.pdf

access seekers to pay five per cent of the access seeker's maximum planned capacity for agreements entered into more than six months prior to the commencement of the service. As in the case of ARTC's proposed capacity reservation fee, the intention of the reservation fee sought by QR was to compensate QR for the opportunity cost of reserving capacity that may otherwise be purchased by another access seeker.

In its assessment of the QR access undertaking, the Queensland Competition Authority determined that the capacity reservation fee was inappropriate because:

- the fee may have an adverse impact on QR's ability to plan for all traffic by providing a disincentive for train operators to enter into access agreements until six months prior to the access rights being required;
- on a capacity-constrained system, a reservation fee may inhibit competition, particularly for small third-party operators requiring new rolling-stock;
- the fee will result in windfall gains to QR where capacity constraints are not evident; and
- while there may be an opportunity cost to reserving capacity, this consideration is outweighed by the possible adverse consequences a reservation fee may have on QR's ability to plan and on competition in the above-rail market.[270]

The ACCC notes that the Queensland Competition Authority considered the capacity reservation fee to be inappropriate, and required QR to incorporate a queuing system for rail access that provided an alternative mechanism by which capacity would be reserved. Under the queuing system, QR is obliged to reserve capacity for specific train paths during access negotiations. The Queensland Competition Authority considered that such a queuing system would be most relevant when two or more access seekers are seeking mutually exclusive access rights and that such a mechanism would provide access seekers with some surety over access rights under negotiation as well as assist with an access seeker's forward planning.

While there are merits to the queuing system adopted by QR, the efficacy of a queuing system in the case of ARTC is somewhat questionable given that the underlying intention of the queuing system was to limit the market power of QR. Given QR is a vertically integrated access provider, the Queensland Competition Authority was concerned that QR could use the negotiating process as a means by which access applications could be stalled in favour of QR's own above-rail operations. As ARTC is not vertically integrated, the ACCC considers there are fewer concerns to warrant the adoption of a queuing system.

Overall, while the ACCC recognises that there are benefits to access seekers from the ability to reserve capacity, it has concerns about the methodology proposed by ARTC

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[270] Queensland Competition Authority (2005) *QR's 2005 Draft Access Undertaking*, December, pp. 173-4. Accessed on 4 March 2008, at: http://www.qca.org.au/rail/2005-draft-undertaking/final-decision.php; see also: Queensland Competition Authority (2005) *Draft Decision: QR's 2005 Draft Access Undertaking*, pp. 170-1. Accessed on 4 March 2008, at: http://www.qca.org.au/rail/2005-draft-undertaking/draft-decision.php

to charge for this reservation. While there is a theoretical justification for a capacity reservation fee in situations in which capacity is scarce, ARTC's proposed methodology is much broader and is likely to result in the fee being imposed where there is little or no opportunity cost of reserving capacity and the costs of capacity hoarding are minimal.

The ACCC also notes the analysis of a similar issue by other rail regulators, which also concluded that a capacity reservation fee could discourage access seekers to enter into early contracts, inhibits competition and results in a windfall gain to the infrastructure owner when capacity constraints are not evident.

The ACCC's preliminary view is, therefore, that the disadvantages of a capacity reservation fee proposed by ARTC outweigh its advantages and that methodology in the December Undertaking is unacceptable under the criteria in the Act, as it would not be in the interests of access seekers, nor would it promote the efficient operation of the rail network.

Draft Decision

The ACCC's preliminary view is that clause 5.2 is unacceptable in terms of the requirements in s.44ZZA(3) of the Act.

Recommendation:

- Clause 5.2(b) be deleted from the Undertaking.

D.6.4. Capacity Allocation

ARTC's Proposal

In general, the granting of access is finalised by the execution of an access agreement.

The December Undertaking provides for two types of train paths — scheduled and *ad hoc*. Scheduled train paths are designed for regular services with a planned origin and destination. They can be routinely timetabled and are suited to the intermodal traffics that use the interstate network. However, bulk traffic (such as coal, grain and minerals) may require intermittent or less regular services, which cannot be readily timetabled.[271] The December Undertaking caters to these types of train services by providing *ad hoc* train paths.

ARTC intends to replace the flexible train path arrangements that currently operate in New South Wales with *ad hoc* pathing arrangements, once the December Undertaking applies to those components of the New South Wales rail network leased by ARTC.

[271] According to ARTC, there are two types of flexible arrangements for bulk traffics that operate in NSW, one that is used for grain traffic and one that pertains to minerals traffics.

The capacity allocation provisions in the December Undertaking also provide for the allocation of access rights between access seekers. Where two or more applicants are seeking access to mutually exclusive access rights, ARTC will finalise the terms and conditions for the access agreement that, in ARTC's opinion, are most favourable to it. ARTC makes this decision based on the access agreement that represents the highest net present value of future returns to ARTC while taking into account the risks to ARTC (clauses 5.3(a) and (b)).

As discussed in chapter D.2.5 of this draft decision, ARTC has not included provisions in the Undertaking allowing for the 'grandfathering' of access rights. That is, the Undertaking does not allow customers with existing train path rights to 'roll over' or perpetuate these access rights automatically when they expire.

Views of Interested Parties

Operators were of the view that the process for allocating mutually exclusive paths should be clear and coherent.[272] They submitted that ARTC should be obligated to choose between access seekers who seek mutually exclusive train paths on the basis of an appropriate balance of the legislative criteria and that path allocation should provide the flexibility and capacity required by the different types of traffic, along with appropriate transparent allocation processes.[273]

Operators were also concerned that the general path allocation methodology should be transparent.[274] QR submitted that there was ambiguity as to the process by which access paths would be re-negotiated within the 120 day period if more than one applicant sought access to the path.[275]

Flexible and Ad Hoc Pathing

A majority of interested parties (FROG, GSR, NSWMC, and PN) submitted that the 'one size fits all' approach to path allocation is inappropriate and that greater flexibility needs to be provided to account for different types of services, such as passenger and grain services.[276]

A key issue for interested parties was the pricing implications of ARTC's proposal to move away from flexible pathing in NSW. As a result of the proposed change, rail operators would be required to pay the fixed charge for unused paths unless they moved away from using scheduled paths and relied on *ad hoc* paths instead. FROG argued that a two-part tariff is not appropriate for non-indicative services. PN argued that while a 'multi-part access pricing structure does promote efficiency in certain circumstances,' namely, intermodal and passenger traffic which operate on the basis of fixed entry and exit points, the use of a flagfall component in the access charge does

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272 FROG *July Submission*, p. 4.

273 ibid., p. 14; Pacific National *July Submission*, pp. 48-49.

274 QR *February Submission*, p. 10; FROG *February Submission*, p. 12.

275 QR *July Submission*, p. 13.

276 FROG *July Submission*, pp. 14 and 18; Pacific National *July Submission*, p. 48; GSR *August Submission*, p. 35; NSWMC *August Submission*, pp. 3-7

not suit other types of traffic.[277] PN pointed out that bulk traffic from the Hunter Valley that traverses the interstate network has been priced under the NSW Rail Access Undertaking on the basis of a single variable charge.[278]

PN and FROG contended that the flagfall charge encourages maximum utilisation of a path with clearly defined entry and exit points. However, much traffic that uses the ARTC network requires use of the network on a 'needs basis' rather than according to a rigid schedule. It was argued that since rail movements of bulk commodities are part of a larger supply chain, the rail network should be responsive to the requirements of that broader supply chain. Furthermore, PN argued that the flagfall charge creates rigidities on the use of the network.[279]

To facilitate access by traffic that does not require allocation of fixed time paths, PN and FROG argue that access charges should consist of a single variable component, as has been the case under the NSW Rail Access Undertaking.

Assessment of Issues

Capacity allocation mechanism

The ACCC notes that the methods of rail capacity allocation have been the subject of extended academic and industry debate over the past decade. As indicated earlier, capacity allocation may occur through market or administrative mechanisms. Administrative mechanisms are most commonly used in Australia and use rules to govern capacity allocation, with those rules being administered by the infrastructure provider. Administrative capacity allocation mechanisms minimise transaction costs, allow greater control by the infrastructure provider and may provide greater certainty to operators in their long-term service planning.

Market mechanisms, on the other hand, promote economically efficient allocation of capacity on the basis of assigning capacity to operators who place the highest value on that capacity. Through well designed market-based auction mechanisms, for example, access providers can theoretically expect to assign capacity to those operators who value it most. According to the Productivity Commission, the auctioning of train paths:

- promotes flexibility in determining prices and demand conditions;
- provides incentives for the infrastructure provider to minimise costs and improve quality;
- allows for the infrastructure provider to maximise profit of the entire network by establishing the optimal mix of train schedules;
- ascertains the highest value and most efficient use of track infrastructure; and
- provides greater information on where track investment is needed.

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277 Pacific National *July Submission*, p. 21.

278 ibid., p. 19.

279 ibid., p. 16.

Nevertheless, market based allocation mechanisms and capacity based charges are not generally used in Australia because of practical difficulties, including the complicated ways in which train paths can be put together to produce a variety of types of service, and the fact that the value of a particular train path for a particular use depends on how other train paths are being used (i.e. the operation of complementary or competing trains). These difficulties associated with auctions include:

- strong interactions between train paths across different rail networks, owned or leased by other rail infrastructure providers and between preceding and succeeding train paths through time;

- contingent nature of bids in an auction; there may be significant value complementarities between services or significant value substitutability between train paths;[280]

- the returns from an auction process may most likely generate only a small fraction of the fixed costs needed for investment on congested segments of the network;[281]

- the track infrastructure provider may not have sufficient incentives to invest the realised scarcity rents for congested segments of the network, that come to light through bids;[282]

- auctions may produce inefficient bidding outcomes if there are few train operators that bid; and

- combinatorial bids involving preferred multiple train paths can rapidly become complex and efficiencies may be lost.

The ACCC also considers that it is difficult to utilise market mechanisms for the allocation of capacity when passenger services have legislated priority and frequently use network capacity that is sought by freight operators. Consequently, the ACCC considers the administrative mechanisms adopted by ARTC to allocate capacity do not raise any objections under Part IIIA.

Mutually Exclusive Train Paths

In its decision on the 2002 ARTC Undertaking, the ACCC considered that allocation of mutually exclusive capacity on a net present value basis was not inappropriate. However, the ACCC also noted that:

> The issue is whether the process for allocating scarce capacity is characterised by the necessary clarity and transparency to give operators confidence in the system and encourage access…the Commission considers that ARTC is unlikely to have an incentive to award

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280 Nilsson, J. (2001) *Towards a Welfare Enhancing Process to Manage Railway Infrastructure Access* pp. 16 and 18; Gibson, S. (2003) 'Allocation of Capacity in the Rail Industry,' *Utilities Policy*, 11, p. 42.

281 Affuso, L. (2003) 'Auctions of Rail Capacity?,' *Utilities Policy*, 11, p. 45.

282 ibid., p. 46.

> access rights to the applicant with the proposal of lower or lowest risk adjusted present value of returns. The Undertaking does not provide precise details on how the present value analysis will be carried out such that an access seeker would be able to have complete certainty about the methodology employed.

The ACCC maintains this position and considers, on balance, that the capacity allocation provisions satisfy the statutory criteria. By maximising its returns from its choice of access seekers for mutually exclusive train paths, ARTC is promoting economically efficient operation of and use of, the network by offering the train path to the access seeker who values it most.

The ACCC also notes that these types of administrative rules are adopted in other rail access regimes, such as in Queensland. The QR Access Undertaking provides that, in situations in which two or more access seekers are seeking access to the same capacity (mutually exclusive access), a queue for access to the mutually exclusive train paths is formed. QR then assesses applications for network access on the basis of the contribution access seekers will make to the commercial performance of below rail services.[283]

Flexible and Ad Hoc Pathing

The ACCC considers that the combination of scheduled and *ad hoc* train paths, adopted by ARTC, promotes efficient operation of the network in two respects. First, *ad hoc* pathing provides access around committed network capacity (scheduled train paths). Replacing unused scheduled train paths with *ad hoc* train paths would necessarily improve allocation of ARTC's track capacity,[284] and increase the number of train paths available to access seekers and competing train operators. The improved capacity allocation also makes investment more efficient by avoiding unnecessary investment in additional network capacity.

Second, the decision to take up *ad hoc* train paths in place of irregularly using scheduled train paths is an economic decision made by train operators. If operators do not value the level of certainty of having access to a fixed scheduled train path, as highly as the flagfall, they can replace it with an *ad hoc* train path which has a lower flagfall component. This is likely to mean that train paths are available to the operators that value them the most. The imposition of a flagfall for unused train paths also encourages train operators to rationalise their use of the network and again improves capacity allocation, frees up available train capacity for competing operators, potentially improves capacity utilisation, and avoids the need for unnecessary investment.

The ACCC recognises that there may be some significant adjustment costs associated with the change to the pricing of flexible train paths, and that some operators are still uncertain how the changes proposed by ARTC will affect some of their traffics. The

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283 Queensland Rail, accessed on 26 March 2008, at: http://www.networkaccess.qr.com.au

284 The arrangement of allowing train operators to run irregular services within a block of train paths comprising a capacity entitlement uses more capacity than the same number of fixed scheduled train paths within the capacity entitlement. Therefore, the arrangement of fixed scheduled train paths complemented by *ad hoc* train paths results in an improved allocation of capacity when compared to the flexible train path arrangements by definition.

ACCC's preliminary view is, however, that the long term benefits of combined scheduled and *ad hoc* train paths outweigh the short term costs.

The ACCC also considers that efficient use and operation of the network has been strengthened by the removal of 'grandfathering' train path provisions. Grandfathering rights detract from efficient utilisation of the network as they guarantee that incumbent operators have absolute security in their access to sought after train paths, and those rights cannot be acquired by other entrants. This change is balanced against the extended time (120 days) that is now allowed for existing operators to renegotiate their contracts. The ACCC considers that the new provisions appropriately balance existing operators need for certainty with the benefits of flexibility that can facilitate competition from new operators.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 5.3 setting out ARTC's capacity allocation do not raise objections under Part IIIA of the Act.

D.6.5. Capacity Transfers

ARTC's Proposal

ARTC proposes that where a holder of capacity rights has under-utilised their capacity, the assigned capacity may be reduced or cancelled (the 'use it or lose it' rules) (clause 5.4(a)). Under these provisions contracted capacity not utilised seven out of 12 times may be withdrawn by ARTC (clause 9.5(a) of the IAA).

Customers may reduce capacity entitlements by cancelling train paths upon written notice to ARTC (clause 5.4(b)) and in accordance with specified notification periods for the cancellation (clause 9.9 of the IAA).

ARTC also proposes that capacity can be transferred between a Customer and a third party, provided that ARTC approves assignment to the third party (clause 5.4(c)).

Views of Interested Parties

Operators raised concerns about the 'use it or lose it' rule and the flexibility provided by the capacity transfer provisions.

In regard to the 'use it or lose it rule,' FROG and QR stated that while the threshold test for removing train paths (i.e. seven out of 12) is the same for the QR Access Undertaking, they pointed out that the QR Access Undertaking has more extensive processes for resuming paths and more avenues of appeal for train operators.[285]

[285] FROG *July Submission*, p. 11; QR *July Submission*, p. 30.

Similarly, PN submitted that bulk traffics which require flexibility in train paths would continually trigger the use it or lose it rules of clause 5.4(a).[286] PN also argued that the use it or lose it rules would be automatically triggered by late running of trains.[287] The NSWMC suggested that the capacity transfer provision (clause 5.4(a)) should allow the terms of the access agreement to provide for underutilisation due to force majeure events, tolerances for normal fluctuations in train running and for access holders to retain a train path if it is not sought by another operator.[288]

In regard to the flexibility in the capacity transfer provisions, NSWMC considered that the provisions should provide flexibility for the management of capacity entitlements, as well as facilitate new entry and competition between existing access holders. According to NSWMC, this is particularly important for coal traffic that uses the segments of the interstate network contiguous to the Hunter Valley network.[289]

QR argued for inclusion of a clause allowing for end user initiated transfers, similar to those provided for in the QR Access Undertaking.[290] The latter allows sole end users as well as 100 per cent of all customers collectively to transfer their capacity from one train operator to another operator. QR argued that this would improve contestability of the above rail market, because it limits the ability of incumbent operators to stagger the expiry of their access agreements with ARTC and the expiry of its haulage agreements with its end users, effectively preventing competitors from challenging their market share.[291] NSWMC argued for a similar arrangement.[292] QR was also of a view that, in practice, customer initiated transfers are unlikely to occur.[293]

Assessment of Issues

The 'use it or lose it' rule of clause 5.4(a) is designed to prevent capacity hoarding by incumbent train operators. The application of the clause 5.4(a) by ARTC appears on paper to be automatic, and there are no provisions to take into account a variety of possible other relevant factors such as tolerance for fluctuations in demand, late running of trains, or force majeure. The ACCC understands that the application of the use it or lose it rules may free up available capacity to be used by new access seekers or competing train operators and so potentially allows for an increase in actual (rather than nominal) track capacity. This provides efficiency benefits, particularly when capacity hoarding occurs in the context of network congestion.

In periods of congestion, the replacement of hoarded capacity which is under-utilised with capacity that is used implies that the capacity goes to access holders that value the train paths more than the access holders that underutilise train paths. Furthermore, the

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286 Pacific National *July Submission*, p. 39.

287 ibid.

288 NSWMC *August Submission*, p. 27.

289 ibid.

290 QR *February Submission*, p. 11.

291 ibid., p. 31.

292 NSWMC *August Submission*, p. 27.

293 QR *July Submission*, p. 31.

enforcement of capacity resumption in periods of congestion results in an improved allocation of train paths, which in turn provides more accurate information about the actual capacity utilisation of the network and leads to more efficient investment decisions.

The use it or lose it rules pursuant to clause 5.4(a) are designed to counter capacity hoarding by incumbent train operators and to aid access seekers in entering the above rail market. They also foster competitive tension between incumbent train operators and aids market expansion by competing train operators. In the circumstance where there is no alterative demand for the train path, the use it or lose it rule is not applied by ARTC, but the application of the flagfall component of the access charge on the unused train paths goes some way in countering capacity hoarding.

The ACCC considers that enforcement of clause 5.4(a) by ARTC when there is alternative demand for its underutilized train paths, allows ARTC to maximize its realised earned revenue from its existing track capacity. Whereas the choice not to enforce clause 5.4(a) when there is no alternative demand for the path also maximizes ARTC's realised revenue from its existing track capacity through the application of the flagfall component.

While the ACCC considers that the 'use it or lose it' provision promotes network utilisation and efficiency, it also notes a number of concerns regarding the application of the provision. In the first instance, there does not appear to be any provision in the use it or lose it rules to allow tolerance for fluctuations in service demand.

In a related sense, the ACCC notes PN's submission that late running of trains could automatically trigger the capacity resumption clause 5.4(a). This could certainly occur if ARTC enforce clause 5.4(a) when there is alternative demand for the train path. To demonstrate this, the IAA clause 9.5 states that ARTC would resume the scheduled train path if the access holder has failed to operate 7 or more times out of any 12 consecutively scheduled services. Furthermore, failure to operate is defined as failure to present a train at the scheduled entry point onto the network or failure to complete the journey in conformance with the locations, days, times set out in the scheduled train paths applicable to such service. That is a train service has failed if it has failed to arrive or leave the network at the appointed time. There does not appear to be any tolerance for lateness such as the 15 minute tolerance which forms part of the definition of a healthy train in the key performance indicators and network transit management principles. Thus, presumably if a train service was running late for seven train services out of 12 consecutive services on a particular path or even the train service ran late for a seventh train service path out of the twelve services, the path would be resumed by ARTC.

However, since the ACCC has no evidence that ARTC has enforced the capacity resumption clause 5.4(a), the impact of resuming train paths due to late running of trains on operational efficiency is a matter of conjecture. Technically, persistent late running of trains by train operators means that the operator is using another operator's train path, or an available train path, while its own scheduled train path is not used. This imposes costs of operational inflexibility on ARTC as well as other train operators, similar to those operational inflexibilities imposed by train path reservation. It also represents hoarding of capacity. Thus, resuming the train path may improve

operational efficiency, especially if there is alternative demand from a more reliable operator for the train path.

However, another way ARTC could deal with persistent lateness of trains is not to resume the train path but to invoke IAA clause 9.6. This allows ARTC to negotiate with the operator, and amend the train path schedule, so that the schedule more closely reflects the actual timing of the train path over the previous three month period. This is subject to availability of train paths, and constraints on ARTC with regard to efficient and safe operation of the network.

It appears that the force majeure clause of the IAA (IAA clause 20) suspends the obligations of a party during the time and extent that it is prevented from or delayed in complying with its obligations for reasons of force majeure. This means that if a scheduled train path is under utilised due to reasons of force majeure, then ARTC could not enforce the capacity resumption in the IAA (IAA clause 9.5(a)).

Clause 5.4(a) is reasonably clear and the details of the associated resumption policy are best left to the access agreement to provide ARTC and operators with greater flexibility in negotiations. It is emphasised in the clause that any capacity resumption decision by ARTC is subject to the dispute resolution provisions of the relevant access agreement.

The ability to cancel a train path is also a critical issue for access seekers (clause 5.4(b)). It allows rail operators to effectively manage their business and save on access charges. It also makes train paths available for other access seekers, facilitating new entry.

Finally, the ACCC notes that clause 5.4(c) allows end-users who do not operate above-rail services to acquire capacity rights and then be sub-contracted to an above-rail operator. This has the potential to promote efficient use of, and investment in, the network. These benefits are discussed in more detail in section D.3.7.

Overall, the ability to transfer capacity rights is crucial to the efficient use of, and investment in, a rail network. As previously noted, market based mechanisms theoretically provide efficiency benefits, but also have problems. It is worth noting that the Office of Rail Regulator in the United Kingdom considered and rejected bilateral secondary trading in train paths as impractical due to the non-homogeneity[294] of train paths. Given the constraints on more competitive market based mechanisms, the ACCC considers that ARTC's approach to allow for the transfer of train paths does not raise objections under the Part IIIA criteria. While administration processes for transferring and relinquishing capacity will always be cumbersome, the ACCC's preliminary view is that the Undertaking does provide for such transfers and therefore does not raise objections against the Part IIIA criteria.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 5.4 setting out ARTC's approach to capacity transfer do not raise objections under Part IIIA of the Act.

[294] Train paths for slow or services that frequently stop cannot be used for fast or express services.

D.7. Investment, Network Connections, Additions to Capacity, and Network Transit Management

Summary

Part 6 of ARTC's Undertaking outlines the conditions by which ARTC will invest in additional network capacity under its own volition or at an operators' request. In assessing ARTC's approach to providing additional network capacity, the ACCC conducted a high level review of the processes used by ARTC to determine its standard, scope and cost of proposed capital expenditure. As part of this review, the ACCC assessed the processes and criteria adopted by ARTC to identify, determine and prioritise capital expenditure relating to additional network capacity. The ACCC's preliminary view is that the processes and criteria adopted by ARTC in regard to providing additional network capacity appear to reflect industry practice and are likely to promote efficient investment in the network.

However, the ACCC considers that ARTC's industry consultation process is somewhat opaque in that even if stakeholders are provided with the opportunity to provide their views on particular capital expenditure strategies, ARTC may provide no reasoning as to why it may consider the views of stakeholders to be inappropriate or invalid. The ACCC's preliminary view is that ARTC should be obliged to consult with industry stakeholders and to make publicly available its reasoning in cases where it considers the views of operators to be unreasonable or not commercially suitable.

Part 7 of the Undertaking outlines the network transit management scheme ARTC will adopt to manage train transit onto and off the network, as well as train transit on the network. The ACCC's preliminary view is that the network transit management rules could be further refined so that there is scope for industry to be consulted at appropriate intervals to ensure that they continue to be appropriate. Overall, however, the ACCC considers that ARTC's proposed approach to network transit management does not raise any issues that would cause the ACCC to conclude that it is inappropriate to accept the Undertaking.

D.7.1. Introduction

Part 6 of the December Undertaking outlines ARTC's approach to network connections and to the provision of additional capacity. The clauses of Part 6 comprise:

- the conditions governing other owners of track wanting to connect their infrastructure to the ARTC interstate network and the processes ARTC must used to notify the Applicant if it does not consent to the connection (clause 6.1);

- the conditions governing ARTC's consideration of an access seekers requests for ARTC to provide additional capacity, ownership rights to that capacity and how the costs of that additional capacity would be met (clause 6.2);

- the process that ARTC would follow if it invested in new capacity that benefited the rail industry and wanted to seek ACCC approval to vary indicative access charges to reflect the cost of that additional capacity and the criteria the ACCC would use to assess such an application (clause 6.3); and

- cost recovery arrangements if ARTC is required to finance improvements and extensions to the network arising from obligations imposed by the *Victorian Transport Act 1983* (clause 6.4).

The IAA also:

- sets the basis of access charges for extensions to the network financed by ARTC (clause 4.7).

In assessing ARTC's December Undertaking, the ACCC has reviewed ARTC's proposed capital expenditure program and the processes and criteria for determining that program, and the provisions in the Undertaking that directly relate to investment decisions and the allocation of the costs of that investment.

D7.2. Proposed Investment Program

D.7.2.1. Reasonableness of planned investment

ARTC's Proposal

Schedule H of the Undertaking outlines ARTC's proposed capital expenditure for the financial years 2006-07 to 2011-12, including the SSFL. Capital expenditure is specified for each network segment and is disaggregated to forecast expenditure for improvement project works (for example, track works), train control and corridor infrastructure investment. Capital expenditure is also disaggregated to indicate expenditure on track investment, signalling and communications investment for each segment.

While Schedule H outlines ARTC's proposed capital expenditure over five years, the Undertaking has a ten-year term. ARTC proposes that, given the difficulty in reasonably forecasting capital expenditure over ten years, it will submit forecast capital expenditure for the financial years 2012-13 to 2016-17 to the ACCC by 31 December 2011 (clause 2.4(c)).

ARTC indicates that the Undertaking is intended to promote 'economically efficient investment' in the network (clause 1.2(c)(ii)(B)). In this respect, capital expenditure needs to be reasonable and prudent (clause 4.4(d)(ii)).

In its December Undertaking, ARTC amended the definition of 'prudent' to include specific considerations that it would have regard to when identifying and incurring capital expenditure. These considerations are:

- the need to meet market demand for capacity and performance of the Network, or the need to extend the economic life of the Network;

- whether the scope of works is consistent with that identified in the applicable ARTC Corridor Strategy current as at the Commencement Date or as varied from time to time;

- what is considered to represent an efficient means to achieve that demand or extend that economic life;

- what is consistent with the existing standard and configuration of adjacent and/or existing infrastructure with similar utilisation and market requirements, or its modern engineering equivalent;

- the expenditure incurred efficiently in implementing the project, in the context of prevailing access and operating requirements and input costs;

- adjustment to the timing of commencement and/or commissioning of projects; and

- support by the industry.

Views of Interested Parties

Operators raised a number of issues on ARTC's proposed capital expenditure. They were concerned that Schedule H, while informative, did not commit ARTC to making any capital investment. Further, it was unclear to operators what criteria would be used to determine the capital expenditure required. Operators argued that these concerns were important because the operators depend on continuing and efficient capital expenditure to maintain and improve rail capacity to compete with road and sea transport.

Operators were of the view that the Undertaking should have allowed for greater industry consultation on proposed capital expenditure. FROG submitted that the process by which ARTC's capital expenditure program is determined is unclear and there are no formal mechanisms by which operators can provide input into capital expenditure decisions.[295] Similar views were submitted by Asciano/PN.[296] PN included an alternative draft consultative investment process which includes investment criteria in its submission.[297]

FROG further submitted that it is difficult to determine the reasonableness of the capital expenditure in Schedule H, given that the ACCC and operators must rely on information supplied by ARTC. FROG proposes that this 'demonstrates ARTC's

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[295] Freight Rail Operators' Group (FROG), *ARTC Access Undertaking – Response to ACCC Issues Paper*, February 2008 (FROG *February Submission*), p. 2.

[296] Asciano, *ACCC Issues Paper: ARTC Rail Access Undertaking*, February 2008 (Asciano *February Submission*), p. 6.

[297] Pacific National, *Pacific National Submission to ACCC Re: Approval of ARTC Interstate Access Undertaking*, July 2007 (Pacific National *July Submission*), Appendix F.

unwillingness to provide a complete evaluation of the proposed investments.'[298] QR submitted that it supported the provisions regarding prudent capital expenditure.[299]

Some interested parties commented on the fact that ARTC's December undertaking only includes capital expenditure for five years. SCT, for example, supported the view that forecasting capital expenditure beyond five years is difficult and it accepted ARTC's approach to be reasonable, subject to validity and reasonableness checks. SCT also highlighted its view that forecasts of capital expenditure tend to overestimate short-term realised expenditure, but underestimate long term realised expenditure and that the capacity additions sought by ARTC should not lead to different access charges being applied, nor preference being given to certain operators.[300]

Other operators cautioned that care is needed to ensure the capital expenditure program does not result in capital biases that favour particular operators. QR submitted that there may be an operational bias inherent in the below rail infrastructure which is designed for shorter trains and only a small proportion of passing loops can accommodate maximum length trains of 1,500 metres. QR submitted that this provides an automatic default priority for long trains that cannot use the short passing loops, which may have consequences for operational efficiency as priority is given to longer trains rather than on the basis of actual performance.[301]

Assessment of Issues

Methodology

The ACCC conducted a high-level review of the capital expenditure program proposed by ARTC in Schedule H. The review focussed on ARTC's processes for generating the scope, standard and cost of ARTC's proposed capital expenditure for the interstate network. The ACCC considers that a high-level review is appropriate as the network is not expected to approach the revenue ceiling during the term of the Undertaking. Therefore, ARTC has commercial incentives to ensure that its capital expenditure is reasonable and prudent because it is reliant on the realisation of increased market shares arising from increased capital investment to reduce its costs and improve its profitability. This may mean that ARTC has greater incentives to use, and invest in, capital efficiently.

However, some scrutiny of ARTC's capital investment is appropriate. It is anticipated that approved capital expenditure will be rolled into ARTC's regulatory asset base and therefore, there is the potential for such expenditure to affect future access prices. Consequently, regardless of whether the network will approach the revenue ceiling during the term of this Undertaking, the proposed capital expenditure program outlined

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298 FROG *February Submission*, p. 3.

299 Queensland Rail, *Response to ACCC Issues Paper on ARTC Access Undertaking – Interstate Network*, February 2008, February 2008 (QR *February Submission*), pp. 11-12.

300 SCT Logistics, *Australian Rail Track Corporation Rail Access Undertaking - Interstate Network*, February 2008 (SCT *February Submission*), pp. 3 and 6.

301 Queensland Rail, *Queensland Rail Submission to ACCC on ARTC Interstate Access Undertaking 2007*, July 2007 (QR *July Submission*), p. 16.

in Schedule H may raise concerns under Part IIIA (particularly ss.44ZZA(3)(b) and (c)).

Furthermore, rail infrastructure is predominantly comprised of sunk assets. While some future capital expenditure may be directed at Greenfield projects, a majority is to improve the capacity or extend the life of existing infrastructure. These assets may not represent investments that would be considered efficient today and there is a potential concern that, even if revenue does not approach the ceiling, future capital expenditure should not exacerbate previous inefficiencies in rail investment. For example, capital expenditure on concrete re-sleepering of existing track segments may not be efficient in the long-term if the track configuration is inherently inefficient and these segments should be closed. Such inefficiencies can impose unnecessary costs on above-rail operators. In this respect, there is a need to balance the expectation that network revenue will not approach the ceiling and ARTC's commercial incentives to engage in efficient capital expenditure with the likely effects of any inefficient capital investment on current and future access seekers and the public interest.

While these issues indicate that an assessment should be made of ARTC's capital expenditure, there is not necessarily a requirement to assess Schedule H on a project-by-project basis. The ACCC's concern is that the processes and criteria adopted by ARTC to decide and implement its capital expenditure program should be reasonable and prudent. If these processes are reasonable and prudent, they should promote efficient investment in and use of, the network. The ACCC has therefore conducted a high-level review of the underlying processes and criteria used internally by ARTC, rather than reviewing the specific details on a contract by contract basis of individual capital expenditure projects.

In addition, the ACCC considers that an assessment of each individual project in ARTC's proposed capital expenditure program would be impractical given the time provided to assess the Undertaking and would unnecessarily impose costs on ARTC by requiring it to providing a large amount of detailed information to support the ACCC's assessment.

Finally, the ACCC notes that while submissions have raised concerns with ARTC's capital expenditure, these concerns have not identified issues with individual projects. Subsequently, an assessment of ARTC's capital expenditure on a project-by-project basis is unlikely to provide substantial benefits to the ACCC's assessment of the Undertaking.

Consequently, the ACCC considers that a high-level approach to assessing ARTC's capital expenditure is appropriate in regard to the interstate network covered by the December Undertaking. This assessment involved examination of ARTC's decision making processes for the planning and commissioning of investment, including whether the processes are designed to ensure reasonable, prudent, and cost efficient investment.

The ACCC also considers that an appropriate process for incorporating prudent and efficient capital expenditure into the RAB would:

- involve a broad *ex-ante* check on the reasonableness of proposed ARTC funded capital expenditures in Schedule H and, if the expenditures are found to be reasonable, then they will be rolled into the RAB in the year the forecast expenditure is commissioned; and

- establish a capital expenditure allowance based on the forecast capital expenditures that are found to be reasonable. At the end of 5 year capital expenditure term, the ACCC will check *ex-post* any capital expenditures incurred that are greater than the allowance. If the additional expenditure is found to be reasonable then that expenditure and any the return on the expenditure would be rolled into the RAB.

Reasonable and Prudent Capital Expenditure

Reasonableness and prudence are necessary conditions for efficient capital expenditure. 'Reasonable' and 'prudent' capital expenditure is that which promotes efficient investment in and use of, the network. Other regulatory regimes in Australia have had regard to reasonable and prudent capital expenditure, including the National Electricity Rules (s.6A.2.2) and the National Gas Code (s.8.48). Access undertakings have also specifically incorporated the term 'prudent' as a requirement for regulatory approval of capital expenditure, including QR's current access undertaking (Schedule FB, clause 2) and the Dalrymple Bay Coal Terminal Access Undertaking (clause 12.5(m)).

Prudent capital expenditure has been broadly defined by the Queensland Government as investment which is:

- efficiently configured and represents the least-cost means of service provision;

- required to meet reasonable forecast demand;

- offers net benefits that justify any rise in tariffs to recover the cost of the investment; or

- necessary to comply with legislated requirements (e.g. safety, security of supply or service quality).[302]

It is standard practice among some regulators to consider prudent capital expenditure in regard to the scope, standard and cost of that capital expenditure.

The scope of capital expenditure is the extent and number of capital projects. The reasonable and prudent scope of capital expenditure is that which:

- is appropriate given the geographic definition of ARTC's network and the forecast size of the market for above-rail services;

- does not include capital biases;

- is commercially sound; and

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[302] Queensland Government Treasury (2006) *Discussion of Proposed Amendments to the Queensland Competition Authority Act 1997*, July, p. 16.

- has been subject to effective consultation with relevant stakeholders (discussed in chapter D.7.1.2).

The standard of capital expenditure is the technical and operational characteristics of capital projects. Technical standards refer to industry recognised 'best practice' specifications applied to particular capital. Operational standards refer to quasi-technical specifications for the regular use of capital such as the daily maximum allowed trains on a given segment.

Technical and operational standards are important as they have implications for short and long term maintenance costs. This assessment, however, is frequently complicated by practical requirements and the inherited standards adopted through a firm's particular internal practices. Furthermore, there is a close relationship between standard and scope, such that the scope of capital projects may not necessarily result in optimal standards being adopted.

The reasonable and prudent standard of capital expenditure is that which:

- is not over-designed or excessive for the proposed traffic level;
- meets a specified level of construction quality that is consistent with normal industry practice and is suitable for the network given the proposed traffic level; and
- does not allow for an unwarranted level of investment.

The cost of capital expenditure refers to the financial cost of the capital projects. Capital expenditure costs are reasonable and prudent if they reflect scope and standards that are appropriate for the proposed traffic level. The efficiency of cost estimates may also be independently assessed using industry costing benchmarks or global book values for equipment (such as signalling). Given the intent of the high-level review of ARTC's processes for producing capital expenditure estimates, the ACCC has not conducted a detailed review of cost estimates in Schedule H using industry costing benchmarks or global book values. However, such an approach may be warranted as ARTC approaches the revenue ceiling.

Framework for Assessment

To assist the ACCC to conduct its high-level review of the processes and criteria ARTC uses to develop it capital expenditure program, ARTC provided the ACCC with information on its internal processes for identifying, determining, prioritising and reviewing capital expenditure projects. The ACCC also reviewed publicly available information on ARTC's investment strategies, the stated objectives of capital works, and the implementation of capital expenditure programs.

The processes examined each component of ARTC's governance mechanisms and the structures that determine firstly, how capital expenditure requirements are identified and prioritised and secondly, how capital expenditure projects are approved and reviewed.

Scope of the Capital Works

The ACCC assessed the scope of the capital expenditure proposed by ARTC, including whether the processes and criteria used are likely to identify and prioritise capital works projects that are reasonable and prudent. The ACCC considers that the scope of capital works should be determined by market requirements, in that capital expenditure is warranted when it promotes efficient use of the network. ARTC indicated that its objective is to increase network utilisation and to expand network capacity (a factor which ARTC claims will promote service reliability and reduced transit times).

The capital expenditure outlined in Schedule H indicates that a majority of expenditure is dedicated to the North-South corridor and, more specifically, to track improvement works within this corridor. ARTC is of the view that the overall objective for capital expenditure on the North-South Corridor is linked back to efficiency and market requirements in that:

> …strategies for investment in the network must be driven by market need, not by what might be engineeringly [sic] elegant. This means that the focus of the company is very much on identifying what the market will respond to and developing the infrastructure to suit.[303]

In determining the scope of its capital expenditure, ARTC adopts separate processes for capital projects that are intended to enhance the network (enhancement projects) and for those intended to maintain or extend the life of capital (renewal projects). There are two elements to ARTC's approach to enhancement and renewal projects:

- the objective is to achieve the largest possible increase in rail gtk for the available investment dollars; and
- investment must be grounded in an understanding of the factors that drive market movement between modes.

The processes adopted by ARTC to determine and approve enhancement and renewal projects appear to support these objectives. The scope of capital expenditure is subject to numerous governance mechanisms. The ACCC notes that the capital projects require budget and project approval at a number of operational levels in ARTC and are subject to internal committee review. Capital projects are also subject to financial analysis and review in accordance with ARTC's Project Evaluation Approval Procedure. This procedure is then assessed by ARTC's Investment Committee, which evaluates investments projects to ensure their financial viability and alignment with corporate objectives.

Capital expenditure projects in excess of $500,000 are evaluated by ARTC's Investment Committee and are generally approved by the board of directors. The commercial evaluation conducted by the Investment Committee emphasises the financial viability of capital projects and their alignment with corporate objectives. The Investment Committee assesses whether capital projects are commercially sound on the following criteria:

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[303] ARTC (2007) *North-South Corridor Strategic Investment Outline*, September, p. 2.

- whether the capital works will expand revenue;
- whether cost reductions will be achieved as a result of the capital expenditure;
- whether the capital project will reduce risks associated with the operational performance of the network;
- whether the capital expenditure is allocated to enhancement or renewal projects on a net present value basis;
- whether the capital project will promote the business objectives of ARTC; and
- whether the capital projects are in accordance with statutory requirements.

The assessment of commercial soundness of capital projects thereby appears to involve consideration of issues that are likely to promote efficient investment in the network. Given the numerous governance processes in place, including those processes prior to the approval of capital expenditure by the Investment Committee and board of directors, it appears that the Investment Committee's assessment of whether capital projects are commercially sound reflect industry practice.

Therefore, overall, governance mechanisms appear to be robust. It also appears that the criteria used by the various decision-making bodies within ARTC charged with reviewing capital expenditure are intended to promote efficient capital expenditure. In this respect, the ACCC notes that the broad criteria are that capital expenditure should promote network safety, transit time, reliability, capacity, and yield.

An overview of the North-South corridor investment strategy proposed by ARTC indicates that many capital expenditure projects aim to decrease transit times (such as passing lanes on the Junee-Melbourne segment) rather than directly enhance capacity. The ACCC considers that there is an inherent inter-relationship between reduced transit times and both network capacity and network utilisation. Reduced transit times, reduce train headway times, which in turn increases network capacity. The ACCC notes that capital projects on the Melbourne-Sydney corridor will reduce transit times from approximately 13.5 to 10.7 hours, and from 19.4 to 15.5 on the Sydney-Brisbane corridor. As such, the scope of ARTC's capital expenditure projects aimed at reducing transit times would appear to be appropriate, given the geographic definition of ARTC's network and the forecast size of the market for above-rail services.

Geographic definition of the network and the forecast size of the above-rail market are important factors affecting the scope of capital works. Broader geographic definition will necessitate both greater capital expenditure on more widely dispersed infrastructure and less homogenous infrastructure specifications arising from more varied terrain or topography. The forecast growth in the market for above-rail services will similarly necessitate capital expenditure to enhance network capacity and, depending on the extent of forecast demand, investment in particular infrastructure over another (e.g. concrete re-sleepering or passing lanes).

The ACCC considers that the processes and criteria adopted by ARTC are likely to promote capital expenditure that is appropriate given the geographic definition of

ARTC's network and the forecast size of the market for above-rail services. In the first instance, proposed capital projects are subject to multiple and seemingly robust capital evaluation and selection processes. In the absence of evidence that the processes adopted by ARTC are inconsistent with industry practice or that capital expenditure has resulted in unwarranted capital projects, ARTC's internal processes appear to promote a reasonable and prudent scope of capital expenditure.

An additional concern surrounding the scope of capital expenditure is whether such expenditure will result in (un)intended capital biases. A pertinent aspect of an assessment of capital expenditure is to assess whether there are biases in ARTC's investment program that inappropriately favour the operations of a particular above rail operator over another. This could occur if the infrastructure provider invested in crossing loops which were suitable for short trains and not for longer trains, and so gave the long trains default priority, regardless of track performance. If an operator had longer trains on average compared to its rivals then it may be favoured. On the other hand, if the ARTC investment program included building a series of longer crossing loops to cater for longer trains, this may address, to some extent, any historical bias in the configuration of the network. Such concerns have been raised by industry participants.[304]

In its Draft North-South Corridor Strategy Version 2, ARTC recognised the potential for operational benefits to flow to different train operators from a capacity expansion program. It stated that its current solution allows operators to adopt whatever transit time and train length combination they believe meets market needs.[305]

It appears that train length can be an operational constraint for some train companies given the configuration and length of crossing loops and passing loops, as the longer train may receive default priority. According to ARTC, this is being rectified by building more spaced crossing loops and lengthening existing passing loops.

The ACCC considers that, to some extent, unintended capital biases will emerge as result of ARTC's intention to accommodate standard train lengths that have increased from 1,500 metres to 1,800 metres. However, there is no evidence that ARTC has deliberately sought to engage in capital expenditure projects related to extended train lengths that will result in the exclusions of shorter trains from the network. ARTC does not require operators to provide services of minimum train length and may choose use shorter trains if this is more efficient. As such, while capital expenditure intended for longer trains may promote services that use 1,800 metre trains, this reflects the greater economies derived from longer services and does not represent an inherent capital bias on the part of ARTC.

The final concerns with scope are whether capital projects are commercially sound and have been subject to effective stakeholder consultation. The issue of stakeholder consultation is discussed in chapter D.7.1.2.

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304 QR *July Submission*, p. 4.

305 ARTC (2005) *North-South Corridor Strategy*, 27 May, p. 6.

Overall, the processes and criteria adopted by ARTC to evaluate and determine the scope of capital expenditure appears to be robust and in accordance with industry practice. The ACCC thereby considers that the processes and criteria are likely to promote a reasonable and prudent scope of capital expenditure.

Standard of the Capital Works

The ACCC has assessed the standard of the capital expenditure proposed by ARTC, including whether the processes and criteria used are likely to identify and prioritise capital works projects that are cost efficient. A reasonable and prudent standard of capital expenditure is one that is not over-designed for the proposed traffic level, meets a specified industry level of construction quality, and does not allow for an unwarranted level of investment.

The standard of the capital works should not be over designed for the proposed traffic level over the economic life of the asset. ARTC has forecast annual compound volume growth over the twenty years from 2005 of 4.5 per cent on the Melbourne-Sydney corridor, 4.6 per cent on the Sydney-Brisbane corridor, and 4.7 per cent on the Melbourne-Brisbane corridor. Underlying market growth on these corridors is expected to be 3.5 per cent per annum, with total growth per annum estimated at approximately 8 per cent.[306]

ARTC's North-South Corridor Strategic Investment Outline (which accounts for a majority of ARTC's capital expenditure) indicates that ARTC has adopted design standards that relate to its forecast volume growth. Much of the design standard for the North-South corridor relates to the construction of concrete-sleepered track and passing loops (including installation of over 220,000 concrete sleepers in 2006-07).[307] The intention of concrete re-sleepering is to improve network capacity and efficient use of the network. This is achieved as concrete re-sleepering which:

> …will allow increased train speeds, reduce the incidence of temporary speed restrictions and delays due to track work, and eliminate speed restrictions imposed on high temperature days.[308]

Concrete re-sleepering also lowers on-going maintenance costs and has a longer economic life than timber sleepering.

In deciding capital work design standards, ARTC adopts a 'Five Step Holistic Approach to Track Maintenance.' This approach co-ordinates and prioritises work over the network so that consistent and acceptable standards are implemented for all network infrastructure. ARTC explains that the holistic approach:

> …minimises the maintenance input and costs, and lifts the infrastructure reliability of the network. It is based around managing the track as a system and not as individual components. Each of the components of a system interact with other components so that strengthening only one component to a level beyond the strengths of the other components will provide only incremental and inefficient overall strength improvement. Indeed, experience has shown

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306 ARTC, *North-South Corridor Strategy (draft)*, version 2, 27 May 2005, p. 8.

307 ARTC, *2007 Annual Report*, p. 22.

308 ARTC, *North-South Corridor Strategic Investment Outline*, September 2007, p. 11.

> that strengthening one track component only may degrade that component and other track components, quickly resulting in less track strength and capability overall.[309]

The ACCC understands that the five step holistic approach adopted by ARTC helps harmonise design standards across the network. These standards include:

- rail head smoothing and free of defects greater than 0.15mm in height or depth;
- concrete sleepers to be uniform in bending strength, size and mass so as to transfer a uniform load to the ballast and formation; and
- adequate drainage of ballast and formation.

The ACCC also considers that the stated standard of the capital works, coupled with the fact that project standards are reviewed under the processes and criteria that determine the scope of capital works, appear to be consistent with both the forecast traffic level and standard industry practice.

In terms of whether the standard of capital works meets a specified industry level of construction quality, the ACCC makes two observations. First, while the ACCC has not conducted an audit of ARTC's specific design standards, it has no information before it to believe that ARTC's design standards do not comply with either the requirements of the Australasian Rail Association's National Codes of Practice or relevant Australian design standards. Furthermore, the ACCC has no reason to believe that ARTC's design standards raise concerns with the Rail Industry Safety and Standards Board.

Second, the construction standards, particularly the intended harmonisation of network standards, are intended to promote efficient use of the network. This is evident in that the standards relating to track behaviour will increase network capacity (for example, by increasingly the carry of heavier loadings and improving rail grind profiles). Furthermore, the construction standards are likely to reduce maintenance activity and costs in the longer term (for example, by improving ballast loadings and preventing rail bending), which in turn will enhance the capacity of the network.

Given ARTC's intention to increase traffic growth and utilisation of the network, the design standards adopted by ARTC do not appear to be unreasonably over-designed or excessive for the proposed level of traffic over the term of the Undertaking.

Cost of Capital Works

The ACCC examined the cost efficiency of capital expenditure forecast for the first five years of the Undertaking term (Schedule H of the December Undertaking). The total forecast capital expenditure over the period 2006-07 to 2011-12 is approximately $1.6 billion with approximately $920 million contributed via grant funding from the Federal Government and approximately $670 million funded by ARTC. This latter amount includes the proposed SSFL.

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[309] Mc Malcolm Owens, ARTC General Manager for Engineering and Infrastructure, cited in Knutton, M. (2004) 'Back-to-Basics Approach Lowers Cost: Australian Rail Track Corporation's Track Maintenance Strategies are Based on Treating Track as a Whole Structure Rather than Individual Components,' *International Railway Journal*, August.

Of the $1.6 billion in capital expenditures, $1.23 billion is allocated to the enhancement of the North-South rail networks (North-South Corridor Investment Strategy), about $187 million is allocated to network wide train control and communications while investments on other corridors, including East-West, totals about $157 million.

ARTC is not seeking a return on capital for the capital expenditure that is funded through grants, but it is seeking depreciation on the communications and signals component of this grant funded capital expenditure (about $190 million). In addition ARTC will incur routine and major periodic maintenance expenses for the remaining non communications and signals capital expenditures of about $1.4 billion.

The assessment of the cost efficiency of investment focuses on the ARTC funded investment of $670 million as ARTC is only seeking to earn a return on these expenditures.

The ACCC makes a number of observations on the cost of proposed capital works outlined in Schedule H. First, the majority of capital expenditure is allocated to the first three financial years covered by the term of the Undertaking. As such, the ACCC is concerned that the capital expenditure cost estimates are likely to over-estimate required expenditure over the initial years of the Undertaking and under-estimate expenditure in later years. That said, cost estimates are frequently difficult to define precisely several years in advance and are a function of the project scope definitions. The issue of importance is whether the processes and criteria adopted by ARTC in developing capital expenditure estimates are reasonable. In this respect, the ACCC considers that as the processes and criteria used to define the scope and standard of capital expenditure projects are reasonable, and as these processes also drive the cost estimates, the cost estimates of these projects is also likely to be reasonable.

Second, capital projects on the North-South corridor are currently managed through a three year alliance agreement (established in October 2005) between ARTC, Barclay Mowlem Construction, and Balfour Beatty Australia. This arrangement also includes a sub-alliance arrangement with Maunsell.

ARTC has indicated that it assesses the cost efficiency of different project delivery mechanisms on a project-by-project basis. ARTC broadly favours an alliance model for major capital projects because it allows for a competitive selection process, provides a guarantee of available services and known rates and allows for flexibility in the execution of projects. ARTC has indicated that its guiding principles endorse an alliance approach when:

- specialist or scarce resources are required;
- projects have an uncertain scope and significant potential latent conditions; and
- projects need to be delivered in a relatively short timeframe.

ARTC favours a tender approach when project scope is well defined, site conditions well understood, and there is likely to be reasonable competitive tension in bidding.

Given these conditions, the ACCC considers that the guiding principles used by ARTC to decide appropriate project delivery mechanisms appear to reflect appropriate

industry practice. In addition, as the processes and criteria used to determine the standard and scope of capital expenditure also reflect industry practice. The ACCC concludes that the cost estimates in Schedule H do not raise concerns under Part IIIA.

Government Grants

The available evidence suggests that ARTC will use the government grants to fund investments in the North-South rail corridor as part of the lease arrangements for tracks in NSW. The ACCC notes that ARTC is not seeking a return on capital for the capital expenditure that is funded through grants, but it is seeking depreciation on the communications and signals component of this grant funded capital expenditure (about $190 million). This is a relatively small proportion of ARTC's overall costs.

The government grants provided to ARTC have recently been reviewed by the Australian National Audit Office. This review recommended further tightening of ARTC's reporting requirements in regard to government grants, including that ARTC report,

> …to shareholder departments quarterly providing a detailed breakdown of its capital infrastructure programme which includes the progress of works and the expenditure of funds provided as special grants.[310]

The ACCC considers that such reporting requirements and accountability to government departments provide reasonable oversight of ARTC's government grant related capital expenditure projects. ARTC has indicated to the Australian National Audit Office that it will comply with its recommended reporting requirements in that,

> ARTC has no objection with providing appropriate information to its shareholder representatives in relation to the investment program in the context of periodic reporting to shareholder representatives.[311]

Given these findings and ARTC's actions to address the Auditor's recommendations, the ACCC considers the processes and criteria used to define the scope, standard and cost of capital expenditure reflect appropriate industry practice and the ACCC is of view that the capital expenditure associated with government grants does not raise any objections under Part IIIA.

Draft Decision

The ACCC's preliminary view is that Schedule H setting out ARTC's proposed capital expenditure does not raise objections under Part IIIA of the Act.

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[310] Australian National Audit Office (2008) *Administration of Grants to the Australian Rail Track Corporation*, Audit Report No.: 22, Canberra, p. 75.

[311] ibid., p. 74.

D.7.2.2. Role of Industry Consultation

ARTC's Proposal

ARTC states that it engaged extensively with industry participants and other stakeholders in developing its proposed capital expenditure program and that it has 'undertaken significant consultation with the industry since 1999 in order to develop an optimal investment strategy on the corridors in the context of the desired market outcomes to be achieved' and that such consultation 'is consistent with prudent investment in the Network.'[312]

Views of Interested Parties

Several submissions raised issues concerning ARTC's decision making processes for implementing new capital investment, specifically about a perceived lack of consultation between ARTC and above rail operators.[313]

PN argued that provisions governing general capital investment should be included in the Undertaking that are similar to those in the QR 2005 Draft Access Undertaking and the 2004 NSW Rail Access Undertaking. The proposed provisions call for an annual publication of a network investment plans for the forthcoming five financial years and compulsory consultation with access seekers on that plan prior to its publication every year. While PN proposed that ARTC does not have to be bound by the results of consultation, it argued that ARTC should give reasonable consideration to the preferences of access seekers in formulating its Network Investment Plan. PN also proposed alternative investment criteria covering safety and technical requirements, forecast demand, efficiency, meeting existing infrastructure standards, existing capacity, created capacity and return on investment.[314]

Similarly, FROG submitted that capital expenditure could be more efficiently managed if the Undertaking included a process for ARTC to consult with network users to determine annual capital expenditure. Similar views were expressed by Asciano/PN.[315] Asciano noted that suppliers normally consult with customers before undertaking major investment to ensure such investment delivers outcomes sought by customers.[316]

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312 ARTC, *Explanatory Guide to the June Undertaking*, June 2007, pp. 19 and 63, c.f. 23.

313 FROG, *ARTC Interstate Access Undertaking 2007 – Freight Rail Operators' Group Submission to the ACCC*, July 2007 (FROG *July Submission*), p. 20; Pacific National, *Pacific National Submission to ACCC Re: Approval of ARTC Interstate Access Undertaking*, July 2007 (Pacific National *July Submission*), p. 37; New South Wales Mineral Council, *NSW Minerals Council Hunter Rail Access Task Force – Response to Australian Competition and Consumer Commission Issues Paper Regarding Australian Rail Track Corporation 2007 Access Undertaking For Its Interstate Rail Network*, August 2007, p. 29.

314 Pacific National *July Submission*, pp. 70-73.

315 Freight Rail Operators' Group (FROG), *ARTC Access Undertaking – Response to ACCC Issues Paper*, February 2008 (FROG *February Submission*), p. 3.

316 Asciano, *ACCC Issues Paper: ARTC Rail Access Undertaking*, February 2008 (Asciano *February Submission*), p. 6.

Austrak also suggested that there has been insufficient industry consultation and that further consultation with industry is required.[317]

Assessment of Issues

A key concern for the ACCC is whether, in deciding its capital expenditure program, ARTC has consulted interested parties who are likely affected by that program, because it will affect their costs, the services they receive or have implications for their investments in above rail. ARTC proposed that it has significant commercial imperatives to consult with stakeholders about new network investments, particularly if it does not recover its stand–alone costs and faces inter-modal competition, which constrains its access prices. ARTC argues that the only way it can increase its revenues and eventually recover stand–alone costs is through volume growth, facilitated by new investment. Thus, to effectively model demand growth, encourage complementary above rail investments and to ensure that investment is cost efficient and prudent, ARTC must consult with stakeholders.

The ACCC notes that ARTC consulted with interested parties through various stages of the development of the investment program for the North-South corridor. ARTC's consultation process consisted of:

- consultation with PN, RailCorp, ARG, SCT and QR on growth projections and operating patterns;
- draft North–South Improvement Strategy placed on the Internet (February 2005);
- revised Strategies consulted on and placed on the internet (May 2005);
- consultation identified a demand for train paths with longer train lengths to satisfy projected market demand;
- final modelling based on ARTC current train plan plus additional trains that operators had identified:
  - fleeting of more trains is accommodated;
  - spacing of more trains is accommodated; and
  - market can adapt to whichever it desires.
- internal ARTC meetings and workshops to test methodology, assumptions and options; and
- draft and revised strategy placed on the ARTC internet and comments sought.

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317 Austrak Management and Consulting, *Submission to the ACCC Regarding the Draft ARTC Access Undertaking Submitted on 20 December 2007*, 8 February 2008 (Austrack *February Submission*), p. 5.

According to ARTC, the outcome of such consultation is that the proposed capital expenditure program suits current operations and growth and is enhanced by providing an opportunity for fleeted and spaced operations,[318] without over-investment in rail infrastructure.

The ACCC further notes that ARTC's consultation on capital expenditure and its broader investment strategies commenced with the Interstate Rail Network Audit in 2001. This audit was undertaken with the support of industry (such as the Interstate Rail Operators Group) and government. Industry participants, such as QR, RIC and Westnet were consulted on this process.

Since the Interstate Rail Network Audit, ARTC developed several corridor specific investment strategies in consultation with industry and made these strategies available for industry comment. ARTC also made presentations to industry and sought industry feedback and support on proposed investment strategies.[319]

The ACCC further notes that ARTC's internal processes and criteria for approving capital expenditure projects require consideration of stakeholder endorsement/recommendations. While the degree to which such stakeholder consideration affects capital expenditure decisions may not be quantifiable, the fact that ARTC's internal processes and broader investment strategies require stakeholder consultation indicates that there is a degree of industry consultation incorporated into that process.

In submissions to the ACCC stakeholders have, however, cited a range of examples where their views have been requested by ARTC but they are not confident that those views have being taken into account or they have not been provided with reasons on why their views have been rejected or why ARTC has chosen its preferred option.

Overall, ARTC has engaged in a series of processes that involve providing information to or requesting feedback from industry. Despite these processes, there is considerable industry concern about whether consultation is effective. These concerns are primarily about the *effectiveness* of consultation, rather than the extent of consultation (for eg issuing papers for comment). Thus, while the ACCC considers that ARTC should not be obliged to address all industry concerns, nor should it be bound to engage in on-going and iterative industry consultation that is more likely to reflect the interests of individual access seekers than promote industry efficiency, it does believe that effective

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318 ARTC states that: 'Fleeting basically refers to an operating pattern where a number of trains seek to follow each other in a relatively short time window. A spaced pattern is one where trains leave at something more like regular intervals around the day' (see ARTC *North-South Corridor Draft Strategy*, 27 May 2005, p. 4.)

319 See, for example:

- www.artc.com.au/article/detail.aspx?p=6&np=4&id=36
- www.artc.com.au/article/detail.aspx?p=6&np=4&id=45
- www.artc.com.au/article/detail.aspx?p=6&np=4&id=47
- www.artc.com.au/article/detail.aspx?p=6&np=4&id=48

consultation and industry confidence in the effectiveness of consultation processes is important.

There is at least an industry perception that there are deficiencies in ARTC's consultation processes. Furthermore, the consultation process is somewhat opaque in that even if stakeholders are provided with the opportunity to provide their views on particular capital expenditure strategies, ARTC provides no public reasoning as to why it may consider the views of stakeholders to be inappropriate or invalid. That is, it is not clear what the results of consultation are nor how ARTC has taken industry views into account.

The ACCC, therefore, considers that building an obligation into the Undertaking for transparent consultation on ARTC's capital expenditure program has potential benefits in that it would clearly establish the obligation to consult effectively, increase industry confidence in the consultation process and improve the transparency of the outcomes of that consultation.

Draft Decision

Recommendation

The ACCC's preliminary view is that the ARTC Undertaking should be amended to and include a provision in Part 6 to the following effect:

6.5 Industry Consultation

In regard to Additional Capacity sought in accordance with clauses 6.2 and 6.3, ARTC must:

> *(i) provide above Operators with a reasonable opportunity to present their views to it regarding Additional Capacity sought by either an Applicant or by it; and*
>
> *(ii) circulate a summary of the results of consultation to stakeholders including reasons for disagreeing with Operators' views (where applicable).*

D.7.2.3. Scope to Increase Capital Expenditure

ARTC's Proposal

In the December Undertaking ARTC outlined the limitations to capital variations in capital expenditure, proposing that any variation would be limited to changes that result from:

- the addition of a capital or renewals project by ARTC needed to meet market demand for capacity and performance of the Network, or needed to extend the economic life of the Network;

- an increase in the scope of works identified in the applicable ARTC Corridor Strategy current as at the Commencement Date or as varied from time to time;
- the addition of a capital or renewals project by ARTC resulting from what is considered to represent an efficient means to achieve that demand or extend that economic life;
- a change in what is consistent with existing standard and configuration of adjacent and/or existing infrastructure with similar utilisation and market requirements, or its modern engineering equivalent;
- whether expenditure is incurred efficiently in implementing the capital or renewals project, in the context of prevailing access and operating requirements, and input costs;
- adjustments in relation to the timing of commencement and/or commissioning of projects; or
- the removal or addition of a capital or renewals project by ARTC that is supported by the industry. (clause 4.4(e))

Clause 4.4(e) of the December Undertaking also provides that ARTC will obtain the ACCC's approval for any increase to capital expenditure exceeding 20 per cent of capital expenditure on the network for any one year.

Views of Interested Parties

Operators suggested that the limits to capital expenditure variation should impose an obligation on ARTC to only include efficient costs in the RAB. In its submission on the December Undertaking, FROG submitted that, clause 4.4(e)(v) is unclear in that the clause should state that only efficient expenditure would be included in the regulated asset base. FROG further submitted that this efficiency clause should apply to all types of expenditure, such as additional capacity sought by industry.[320]

QR submitted that, while it generally supports the variation to capital expenditure provisions in the December Undertaking, the 20 per cent buffer provided to ARTC for capital expenditure variation is too generous. In this respect, QR proposes that a lower threshold would require ARTC to adopt a more rigorous approach to cost management.[321]

Assessment of Issues

The ACCC considers that capital expenditure should be reasonable and prudent with the intent of promoting efficient use of the network. It notes that clause 4.4(e) of the December Undertaking provides that ARTC will obtain the ACCC's approval for any increase exceeding 20 per cent of capital expenditure on the network for any one year.

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320 FROG *February Submission*, p. 5.

321 QR *February Submission*, p. 7.

This provision provides scope for the ACCC to assess the cost efficiency of any substantial capital variation over the term of the Undertaking.

The ACCC also notes the submissions which state that the 20 per cent buffer before ACCC approval is required for an increase in capital expenditure is too large. This concern implies that there may be a risk that ARTC could inefficiently increase its capital expenditure within the 20 per cent buffer and avoid the need to obtain ACCC approval. The ACCC makes the following observations on this point. First, the five year term of the capital expenditure program creates some uncertainty, which combined with capital intensive and 'lumpy' nature of rail investment, means that exogenous factors that affect the demand for rail services could require substantial investment that may not have been reasonably foreseen. While ARTC has conducted forecasts of market demand, network capacity and associated capital expenditure, there may be legitimate reasons for ARTC to increase capital expenditure, so it needs some ability to change its investment program if this proves necessary.

Second, clause 4.4(e) limits the reasons for an increase to capital expenditure and therefore the clause does not provide ARTC with unlimited discretion to increase it capital costs.

Third, an assessment of any increase to capital expenditure could be a lengthy process. The ACCC considers that a 20 per cent buffer provides a balance between a need to assess the efficiency of increased capital expenditure with minimising the administrative costs or delays to capital expenditure projects that may be associated with any such review.

Further, the *ex-ante* assessment of ARTC's capital expenditure program indicates the prudence and reasonableness of the processes and criteria used to identify, approve and prioritise capital expenditure projects. Consequently, the ACCC considers that increases to capital expenditure within the 20 per cent buffer are likely to be cost efficient and consistent with the commercial incentives of ARTC to maximise network utilisation.

Overall, the ACCC's preliminary view is that a 20 per cent cap is appropriate as it balances the need for ARTC to respond to legitimate unforseen circumstances with an obligation to ensure that increases in capital expenditure are not unreasonably high.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 4.4 setting out ARTC's scope to increase capital expenditure do not raise objections under Part IIIA of the Act.

D.7.3. Network Connections and Additions

The provisions on network connection and additions cover a range of situations where capacity is either expanded or connected with other networks. These include:

- the conditions under which ARTC will agree to another rail network being connected to its network;
- additions to capacity sought by access seekers;
- additions to capacity sought by ARTC; and
- the conditions under which ARTC can recover to costs of improvements and extensions to the network arising from obligations imposed by the *Victorian Transport Act 1983*.

Each of these situations is discussed below.

D.7.3.1. Network Connections

ARTC's Proposal

Clause 6.1 of the December Undertaking states the conditions that ARTC may impose before it agrees to a physical connection to the interstate network for another rail network which is operated and maintained by another infrastructure provider. The other infrastructure provider must agree to bear the costs of the connection (clause 6.1(a)(vi)) and the resulting connection should not result in a fall in the capacity of the interstate network as a whole (clause 6.1(a)(ii)).

Views of Interested Parties

Interested parties expressed a number of concerns about the details in the provisions for network connection. NSWMC submitted that it should be made clear that clause 6.1 on network extensions and clause 6.2 on additional capacity are subject to the dispute resolution provisions of the Undertaking and that clauses 6.2 and 6.3 are more appropriately located in Part 5 (capacity management) of the Undertaking.[322]

NSWMC also suggested that clause 6.1(b) could provide more flexibility if it was amended to require that, if requested by the applicant, ARTC would notify the applicant of the changes to the connection that are needed to maintain capacity. It could also notify if any extra charges that may be levied to compensate for the capacity reduction engendered by the connection if accepted.[323]

In its submission, Austrak noted that network connections to terminal services and port facilities are essential to the viability of terminal operators and that the capital intensive nature of terminal businesses means that the rail track network must enable rail operators to co-ordinate pathways through adjoining networks and terminal slots,

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322 NSWMC *August Submission*, p. 27.

323 ibid., pp. 27 -28.

facilitate a mixture of uses on the network, provide certainty for new terminal connections on the network and enable terminals to contract for train paths.[324]

ACCC's Views

The ACCC agrees with those submissions that argued that the provisions for connections to the network are important for the effective provision of rail services.

The provisions in the December Undertaking covering such connections are not substantively different from those in the 2002 Undertaking, the exception being a clarification that network connections include tracks that are not part of the ARTC network. In its assessment of the 2002 Undertaking, the ACCC concluded that:

> It would appear reasonable to argue that given the desirability of increasing traffic on its Network, ARTC does not have an incentive to deny approvals for connections. This incentive, which arises from the effects of under-utilisation of its Network in the face of competitive pressures from road transport, acts as a constraint on its discretion.[325]

In the context of the December Undertaking the ACCC considers that many of the factors that led the ACCC to conclude in its 2002 assessment that the provisions on network connections are appropriate still hold and that there are few incentives for ARTC to hinder connection. The ACCC notes that ARTC could potentially benefit from an improvement in capacity by the connection, particularly if the connection encourages new traffic to use the network. This would increase network utilisation and, in turn, lower costs to operators and promote further network investment by ARTC.

In addition, as the direct costs of constructing and maintaining the connection are borne by the other infrastructure provider ARTC would obtain the benefits of the connection without a substantial increase in cost.

In response to suggestions that more information should be provided to infrastructure providers seeking to connect, the ACCC notes that whilst such information may facilitate communication, it is unlikely to be a threshold issue, as the lack of such a requirement in the current provisions do not appear to significantly undermine there operational or economic efficiency.

Finally, even in situations where the December Undertaking envisages that there may be legitimate reasons for ARTC to refuse a connection, the ACCC considers that, in practice these situations would be limited. For example, clause 6.1(ii) provides that ARTC can refuse a connection if it would reduce capacity on the interstate network. However, this is unlikely, particularly given that clause 6.1(a)(iv) states that the other track owners must ensure that all train operators should comply with the directions of ARTC train controllers regarding entry and exit to the network. This goes some way in ensuring the operational efficiency of rail traffic, which transit between two networks, is not compromised.

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[324] Austrack *February Submission*, pp. 3-5.

[325] ACCC, *Decision – ARTC Undertaking*, May 2002, p. 178.

Overall, the ACCC's preliminary view is that ARTC is likely to benefit from interconnections with other networks and such interconnection will frequently improve network efficiency and encourage increased traffic. The ACCC also considers the issues raised in submissions are unlikely to be substantial in practice and therefore do not warrant rejecting the Undertaking.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 6.1 setting out ARTC's network connections do not raise objections under Part IIIA of the Act.

D.7.3.2. Additions to Capacity Sought by Applicants

ARTC's Proposal

In the December Undertaking (clause 6.2), ARTC commits to considering any requests from access applicants for additional capacity as part of an access negotiation. ARTC would consent to providing additional capacity if it is in its overall business interests, the capacity is economically and technically feasible and the applicant agrees to meeting the cost. The Undertaking proposes a range of ways in which the applicant could reimburse ARTC for the additional capacity, including up-front or periodic payments. The addition to capacity would be ultimately owned and managed by ARTC.

Views of Interested Parties

Stakeholders' primary concern about the processes for ARTC considering requests for additional capacity is that the December Undertaking envisages that such negotiations would take place between ARTC and a single applicant. This raised several issues.

First, submissions argued that relying on negotiations between ARTC and a single applicant would reduce the effectiveness of the clause because it does not cater for the situation in which no individual access seeker can afford to fund additional capacity even if there is a demonstrated need for new investment. [326]

Second, several stakeholders argued that when there is a need for additional capacity all users of the network potentially benefit from that capacity and therefore all should contribute.[327] FROG and QR, for example, submitted that only allowing for an individual access seeker to fund additional capacity would hinder above rail competition. FROG commented that ARTC's approach does not recognise the opportunity costs of existing capacity and that capacity constraints result from the joint impact of all operators.[328]

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326 FROG *July Submission*, pp. 12-13; Pacific National *July Submission*, pp. 39-40.

327 Pacific National *July Submission*, p. 39.

328 FROG *July Submission*, p. 12, QR *July Submission*, p. 32.

FROG went on to argue that requiring the incremental access seeker to fund additional capacity not only restricts competition but can also be inefficient. It suggested that an access seeker that is incremental in its demand for access and triggers the need for additional capacity is only incremental in a temporal sense and not in an economic sense. Indeed, if the access charges paid by incumbent train operators are below the stand alone cost of the existing capacity, and if the costs of expanding lead to higher access charges to the access seeker, then the infrastructure provider could increase its returns by transferring the access rights of the incumbent train operator to the access seeker and not undertake the expansion. FROG claimed that this analysis indicates that if additional capacity is needed to accommodate the requirements of all users including the access seeker, then the cost should be borne by all users to avoid distortions in the above rail market.[329]

Third, the NSWMC submitted that if the economic life of the additional capacity is greater than the incremental access seeker's need for the capacity, then ARTC does not have sufficient incentive to bear the costs of the capacity enhancement.[330]

In addition, there were other concerns about the discretion the criteria in clause 6.2 can afford ARTC and whether the interpretation and application of the provision is clear. PN submitted that clause 6.2(a) gives a general commitment by ARTC to provide additional capacity on condition of the fulfilment of certain criteria. However, PN noted that clause 6.2(b) appears to give ARTC discretion in providing additional capacity. QR also raised concerns about the discretion ARTC would have in setting access charges to recover additional capacity costs.[331]

NSWMC was particularly concerned about the clarity of the provisions in clause 6.2 of the Undertaking and argued that that the criteria concerning ARTC's consent to additional capacity is confusing and mixes technical and economic factors. It also argued that the relationship between many of the clauses is unclear.[332]

PN was concerned about the incentives created by giving ARTC control over project management for the construction of additional capacity while the incremental access seeker pays the bills. PN stated that ARTC was the appropriate party to bear the risk as it manages the construction process and it has currently no incentive to contain costs, as it does not pay the bills.[333]

And finally, NSWMC submitted that clause 6.2(e) concerning provision of reasons for the basis of ARTC decisions on additional capacity should be provided at all times, instead of on request of the applicant. The reasons should include details of the ARTC

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329 Cited in FROG *July Submission*, p. 12.

330 NSWMC *August Submission*, p. 30.

331 QR *July Submission*, p. 32.

332 NSWMC *August Submission*, p. 30.

333 Pacific National *July Submission*, pp. 40-41.

assumptions on capital and other costs of additional capacity over its economic life, expected utilisation and any other relevant economic factors.[334]

Assessment of Issues

It appears clear, given the restriction in clause 6.2(a), that clause 6.2 is likely to be used only in very limited circumstances. The reasons why substantial levels of investment through this mechanism are unlikely are:

- the interstate network consists of a series of mainline (trunk) connections between major regional centres rather than branch lines, thus in general network capacity is not tied to the operations of a single user. It would be rare that a single operator would have the capacity to fund additional capacity without substantially damaging its competitive position relative to other operators not required to make such investments; and

- it is unlikely that an incremental access seeker would agree to fund the entire cost of additional capacity in the context of network which does not recover stand-alone costs for most segments and ARTC does not regard the investment as commercially viable.

In assessing the scope of this provision the ACCC has also considered whether parties could agree, or whether the ACCC could require, through arbitration, that the costs of additional capacity be spread over a larger number of access seekers.

There is scope in the Undertaking that would allow groups of access seekers to agree to fund additional capacity.

1. Clause 6.2(b)(iii) allows additional capacity to be funded by any mechanism agreed between ARTC and the applicant. There is no reason why this could not include contributions from other operators, so that it would be open to access seekers to jointly agree to fund additional capacity; and

2. Clause 6.3, discussed in the following section, allows ARTC to fund the investment and then seek approval from the ACCC to recover that cost from all access seekers through higher charges.

Both these options would require agreement from ARTC.

The ACCC also considered whether its powers in relation to arbitrating a dispute would extend to requiring ARTC to seek reimbursement for additional capacity from operators other than the access seeker. The ACCC considers that its powers in this regard are limited. First, according to s.44W(1)(e) of the Act, the ACCC cannot make an access arbitration determination that requires the access provider to bear some or all of the costs of extending or maintaining extensions to the facility. Furthermore, under the arbitration provisions of the Act, the arbitration only covers the parties joined to the arbitration and the ACCC cannot require a third party to pay.

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[334] NSWMC *August Submission*, p. 31.

Recognising these limits to the application of clause 6.2 the ACCC needs to consider whether:

1. ARTC is entitled, as an access provider voluntarily submitting an undertaking under Part IIIA, to seek reimbursement from an operator for investment in additional capacity as a condition of access;

2. the failure to provide a comprehensive process for operators to negotiate the scope and funding of investment in additional capacity means that the December Undertaking no longer meets the criteria in Part IIIA of the Act.

In regard to the first issue, the ACCC considers that it cannot reject clause 6.2, because the requirement to seek reimbursement of reasonable costs incurred for extensions to the Network or additions to capacity is acceptable under Part IIIA. The ACCC also notes that additional capacity provided by access seekers would not be included in ARTC's RAB, as the capital cost of this investment would have already been recovered.

In regard to the second issue, the ACCC is concerned that there may be disincentives for access seekers to request and agree to fund additional capacity investment because it is unlikely, given the topology of the interstate network, that a single access seeker can quarantine other access seekers from using its funded additional capacity. Furthermore, there are no mechanisms in clause 6.2 for an access seeker that funds additional capacity to be compensated by ARTC for access revenue earned from train operators, unless both ARTC and the other operators agree. Finally, it does not appear that there are access agreements between incremental access seekers and ARTC which cover the entire economic life of the additional capacity, making it less likely that it would be financially viable for an access seeker to fund such investment.

However, in order to reject the Undertaking based on these concerns, the ACCC would have to conclude that real distortions in the rail market are likely as a result from the application of clause 6.2. The ACCC considers that this is unlikely. The more likely outcome is that clause 6.2 would be rarely used and additional capacity would be funded through alternative mechanisms such as clause 6.3 (providing for ARTC to invest in the network and recover the costs of that investment) or through ARTC's broader investment program. Therefore, while the ACCC considers that the Undertaking would be improved by an effective mechanism for operators to negotiate and fund investment in additional capacity it does not consider that the concerns raised by clause 6.2 are sufficient to conclude that the outcomes would be inconsistent with Part IIIA of the Act.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 6.2 setting out ARTC's additional capacity sought by applicants do not raise objections under Part IIIA of the Act.

D.7.3.3. Additions to Capacity Sought by ARTC

ARTC's Proposal

Clause 6.3 of the December Undertaking allows ARTC to invest in additional capacity that is worthwhile and beneficial to the rail industry. ARTC may then apply to the ACCC to have that investment brought into the Undertaking so that the investment costs can be recovered through increased access charges (clause 6.3(a)). Under this clause:

- ARTC can apply to the ACCC to have additional capacity approved, including a variation to the indicative access charges at any time during the undertaking (clause 6.3(a);
- in considering such an application the ACCC must have regard to the pricing principles in the Act, the interests of ARTC, access seekers and the public interest, the market demand for capacity, whether the scope of works is consistent with ARTC's corridor strategy, the efficiency of the investment, its consistency with existing infrastructure standards, and any other relevant matters(clause 6.3(b);
- once approved the additional capacity would be treated as capital expenditure by ARTC(clause 6.3(c); and
- in determining any changes to indicative charges the ACCC may have regard to whether the expenditure was incurred efficiently(clause 6.3(d).

The ACCC may conclude that the additional capacity should be brought into the Undertaking and its costs reflected in access charges, regardless of whether it is supported by all operators.

These provisions are new in the December Undertaking and were not part of the 2002 Undertaking.

Views of Interested Parties

There were only limited comments on ARTC's proposed approach for it to initiate and invest in additional capacity and then potentially fund that capacity through increased access charges. In its submission on the December Undertaking, SCT argued that capacity additions sought by ARTC should not lead to different access charges being applied nor preference being given to certain operators, that is the rate should be identical for all operators.[335]

QR supported the provisions concerning additional capacity sought by ARTC and submitted that clause 6.3(b), which set the principles the ACCC would have regard to when assessing whether such investment should be brought into the Undertaking, provides reasonable protection for ARTC and access seekers.[336]

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335 SCT *February Submission,* p. 6.

336 QR *February Submission,* p. 11.

Assessment of Issues

The ACCC considers that the main effect of clause 6.3 is to simply clarify rights and processes that would exist anyway. Even without this clause, ARTC would have the right to invest in additional capacity and seek an amendment to the Undertaking to reflect the costs of that investment, and the ACCC would be required to assess that request. There are, however, two issues worth noting.

First, the provisions clarify that the focus of ARTC's investment would be on additional capacity that benefits the rail industry, not just a single operator.

Second, the criteria specified in the Undertaking differ from those in Part IIIA of the Act, under which the ACCC would normally assess applications to amend an Undertaking. The ACCC has reviewed these criteria and considers that they are not inconsistent with the criteria in Part IIIA.

Given that clause 6.3 simply codifies processes that are already allowed under the Undertaking and Part IIIA of the Act, the process for the ACCC to assess additional capacity is not inconsistent with that normally applied when assessing an amendment to an Undertaking. The ACCC's preliminary view is that ARTC's proposal in clause 6.3 does not raise any objections under Part IIIA of the Act.

In most cases, assessing an application from ARTC under clause 6.3 would involve the ACCC considering whether the proposed investment should be included in ARTC's regulatory asset base, whether it is legitimate for ARTC to earn a rate of return on that investment and, potentially, whether access charges should increase to reflect the cost of that investment. Such considerations raise a number of issues, many of which have been considered in this Undertaking in the context of the ACCC considering ARTC's investment program and its treatment of capital costs. In making that assessment the ACCC would apply the criteria in section 6.3(b) of the December Undertaking and seek to ensure that any investment that is rolled into ARTC's asset bases or incorporated in its prices is prudent and reasonable.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 6.3 setting out ARTC's additional network capacity sought by ARTC do not raise objections under Part IIIA of the Act.

D.7.3.4. Assessment of Clause 6.4 (Transport Act 1983 (Vic))

ARTC's Proposal

Clause 6.4 outlines the conditions by which the reasonable costs incurred by ARTC in providing network improvements or extensions will be payable by an operator if the operator becomes a train operator in accordance with s.10 of the *Transport Act* 1983 (Vic) and ARTC is given a direction by the Director of Public Transport which requires to make timetable changes which interfere with the train paths of existing operators.

Views of Interested Parties

There were few stakeholder comments about clause 6.4, though the NSWMC argued that ARTC has complete discretion to choose whether to invest in additional capacity in response to amendments to existing train paths caused by a direction by the Victorian Director of Public Transport. If ARTC chooses to invest, then train operators bear the cost of the additional capacity and if ARTC does not invest the access rights of train operators are compromised. According to NSWMC, ARTC lacks incentive to resist Victorian Government directives, seek compensation for the cost of preventing interference to existing train paths, or compensate the train operator for the costs imposed on it.[337]

Assessment of Issues

Clause 6.4 outlines a series of hypothetical events whereby a train operator is or becomes a train operator for the purposes of s.10 of the *Transport Act* 1983 (Vic.), which relates to passenger services priority. For clause 6.4 to be relevant there must be an agreement between the passenger train operator and the Director of Public Transport (s.10(1) of the Transport Act) which provides for the Director to require or approve a timetable change for the passenger service.

If the Victorian Director of Public Transport gives a lawful direction to a passenger service that requires a timetable change and that direction interferes with other train operators' train paths, then ARTC could minimise any disruptions to these train paths by building additional capacity. Clause 6.4 allows ARTC to recover the reasonable costs of building this additional capacity.

If, as a result of a timetable change which significantly affected train operators existing train paths, the only way that ARTC could recover operational reliability to its previous level is by building new capacity, then it is reasonable for ARTC to recover its reasonable costs from the passenger operator. Operational and economic efficiency could be affected by the mandated timetable change, and in this event, ARTC should be able to build new capacity to accommodate the timetable change, building such capacity would benefit existing rail operators who would be disadvantaged by the reduction in capacity and service reliability.

A mandated timetable change may also affect the competitive dynamics between freight train operators. By affecting the timing of train paths, timetable changes can reduce rail operators' ability to meet their customers' requirements for arrival and departure times. Such effects may not be uniform across all operators, disadvantaging some more than others. To restore the network's capacity to deliver the expected service quality standards, it may be necessary for ARTC to build new capacity. It is reasonable that ARTC can recover the reasonable costs of this investment.

ARTC's legitimate business interests are served by the clause in that it allows ARTC to recover its reasonable costs of building additional capacity to accommodate for the detrimental effects of a mandated timetable change. Also, clause 6.4 serves the interests of access seekers in that it explicitly provides an incentive for ARTC to invest in new

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[337] NSWMC *August Submission*, p. 31.

capacity to restore reliability and capacity of the network. The clause also requires ARTC to act reasonably, which helps mitigate concerns about it potential discretion.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 6.4 setting out ARTC's approach to the Transport Act 1983 (Vic) do not raise objections under Part IIIA of the Act.

D.7.4. Network Transit Management

ARTC's Proposal

The intention of the Undertaking's network transit management principles (Part 7) are to ensure that a service meeting its specified timetable will exit on time, while services that suffer above-rail incidents need to be managed so that further delays are minimised.

Views of Interested Parties

The main issue raised in submissions was about the inter-relationship between the network covered by the Undertaking and adjacent networks. Parties were generally concerned to ensure that the network management principles used by ARTC facilitate efficient traffic movement between networks, including the Hunter Valley coal lines.

FROG submitted that it has raised with ARTC the need for the Undertaking to explicitly recognise the horizontal interfaces between ARTC and the networks which it adjoins, particularly the Hunter Valley network.[338] The NSWMC submitted that it is crucial that network management principles facilitate the efficient operation of Hunter Valley coal traffic on the interstate network.[339]

PN also highlighted interface issues, arguing that the Undertaking lacks any recognition of the inter-relationship between the network covered by the Undertaking and adjacent networks. PN noted that there are few journeys on the interstate network that lie wholly within the jurisdiction of the Undertaking and this is poor given that ARTC sees itself as an industry leader and its Undertaking has been nominated by COAG as the model for all access regulation in Australia.[340]

In addition PN suggested that while it generally supported the proposed traffic decision matrix, it would be beneficial for ARTC to conduct a workshop of practitioners to go through the matrix.[341]

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338 FROG *July Submission*, p. 15.

339 NSWMC *August Submission*, p. 31.

340 Pacific National *July Submission*, p. 41.

341 ibid.

Assessment of Issues

The ACCC considers that reasonable network transit management provisions need to be clearly specified in advance, complete, capable of being understood by operators and applied by ARTC in a consistent and efficient manner. Subject to reasonable confidentiality, they should also be transparent. The ACCC considers that provided the particular rules meet these tests, then an operator would be able to structure its operations to maximise the utility they derive from access to the ARTC Network.

In the December Undertaking, ARTC's network management principles, including train decision factors (which determine train priority) and the rules that govern ARTC decision matrix, are all specified in some detail in Schedule F. These rules set objective decision making criteria that facilitate consistent application of the principles and assist industry understanding of network management processes. The ACCC, therefore, considers that the rules proposed by ARTC for network management are clearly specified, complete and able to be understood by industry, and are consistent with the criteria in Part IIIA of the Act.

The ACCC notes that submissions raised concerns regarding the need for the Undertaking to recognise and facilitate traffic to/from adjoining networks not covered by the Undertaking. In the December Undertaking ARTC sought to improve consistency across the interstate network and between the interstate and other parts of the NSW network by adopting the network management principles that have been operating in NSW across the whole of its interstate network. There are, however, still potential interface issues between ARTC's network and other rail networks.

The ACCC recognises that coordination of train paths between networks is complex but it is imperative that there is comparability between network transit management and capacity management rules to facilitate the operation of train paths that cross between networks. This is an issue that could be effectively managed thought the national processes that are currently looking at rail access issues.

The ACCC also notes submissions calling for further industry consultation on network transit management principles. In this respect, the ACCC maintains the view from its decision on the 2002 Undertaking that the network transit management rules could be further refined and that there is scope for industry to be consulted at appropriate intervals to ensure that they continue to be appropriate. Such consultation may also facilitate harmonious network transit management principles across networks to the benefit of both ARTC and access seekers.

Given the discussion above, the ACCC considers that ARTC's proposed approach to network transit management does not raise any issues that would cause the ACCC to conclude that it is inappropriate to accept the December Undertaking.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 7 setting out ARTC's network transit management do not raise objections under Part IIIA of the Act.

D.8. Performance Indicators

Summary

Part 8 of ARTC's Undertaking outlines the performance indicators to be adopted by ARTC during the term of the Undertaking. Performance indicators are incorporated in the December Undertaking to ensure information is provided on industry performance and ARTC's quality of service.

Other areas addressed in this chapter include the ACCC's concerns with the 'fit for use' conditions, performance indicators, and performance indicator benchmarks.

The ACCC's preliminary view is that Part 8 of the Undertaking does not raise any objections under the Part IIIA of the Act.

D 8.1. Performance Indicators

ARTC's Proposal

Clause 8.1, outlines ARTC's commitment to users that it will maintain the network in a condition that is *fit for use* so far as is relevant to providing operators the rail transport services reflected in their scheduled train paths. ARTC warrants that it will have regard to the terms of any applicable access agreements in implementing its commitment to maintain the network.

Clause 8.2 outlines ARTC's reporting obligations in relation to performance indicators. Clause 8.2(a) of the December Undertaking specifies that ARTC will publish the performance indicators set out in Schedule G of the December Undertaking on its website. The frequency of reporting is specified in Schedule G. The performance indicators aim to track industry performance over time but do not monitor the performance of individual operators.

Performance Indicators Reported Quarterly

Table 1 of Schedule G outlines the performance indicators that are to be measured quarterly. These indicators are grouped into five broad categories:

- reliability (6 performance indicators);
- network availability (3 performance indicators);
- transit time (4 performance indicators);
- temporary speed restrictions (1 performance indicator); and
- track condition (1 performance indicator).

The broad categories outlined above each contain a set of performance indicators that measure performance over the network for that category, according to a number of

definitions and caveats. The caveats and definitions are outlined in the footnotes to Table 1 in Schedule G of the December Undertaking. These caveats importantly, but not exhaustively, note that reliability, transit time and network availability will be subject to separate reporting on defined network segments. The caveats also define terms including 'healthy trains' and 'transit time'. [342]

ARTC's obligation to report performance indicators quarterly commences at least three months from the date that the ACCC accepts the Undertaking and relates to performance on the network during the first full calendar quarter.

Performance Indicators Reported Annually

Table 2 of Schedule G contains the performance indicators that will be measured annually. These indicators report ARTC's unit costs and measure:

- infrastructure maintenance ($/track km, $GTK) — total annual expenditure on outsourced infrastructure maintenance and ARTC's associated maintenance contract functions;[343]
- train control ($/train km) — total annual expenditure on train control and transit management function;[344] and
- operations ($/train km) — total annual expenditure on train control and ARTC's operations, planning and management functions.[345]

ARTC's annual reporting obligations commence at the end of the first full financial year of the Undertaking, that is at least 12 months after the December Undertaking is accepted by the ACCC.

Annual Audits and Reviews

Clause 8.2(b) of the December Undertaking specifies that ARTC will incorporate into its annual internal audit process a review of performance indicator reporting. The internal audit will be conducted by an independent internal auditor who prepares a written report outlining his or her findings on the process and the reporting of the Part 8 performance indicators. ARTC is required under clause 8.2 to publish the auditor's findings on its website and provide the report to the ACCC upon request. ARTC's audit obligations will commence 6 months after the ACCC accepts the December Undertaking.

Views of Interested Parties

Interested parties made a number of comments on the scope and usefulness of the performance indicators and reporting obligations. Some suggested additional indicators or modification to existing indicators that would provide additional information. For

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342 ARTC, *ARTC Access Undertaking*, December 2007, Schedule G, Table 2, Footnote 1, Footnote 6 & Footnote 10.

343 ibid., Schedule G, Table 2, Footnote 1

344 ibid., Schedule G, Table 2, Footnote 2

345 ibid., Schedule G, Table 2, Footnote 3

example, FROG noted that ARTC included transit time indicators, which could also be used to measure elapsed time and argued that the indicators of healthy trains could be more useful.[346]

Similarly, the NSWMC submitted that the performance reporting requirements for the Interstate Network should include:

- service quality performance by relevant subsections of the network;
- service quality performance by individual operators;
- service quality performance against benchmarks;
- ARTC unit costs by segment; and
- ARTC unit costs against benchmarks.[347]

Some were critical of the way ARTC defines and reports healthy and unhealthy trains. FROG and PN submitted that that the 'healthy' train concept was unhelpful, with PN suggesting that the 'healthy' train concept had a number of practical flaws that reduced the value of the resulting reports.[348] However, PN also submitted that the performance indicators have improved, in particular:

> The change in the definition of 'healthy' to allow for a train to regain its 'healthy' status is a significant improvement and is strongly supported by Pacific National. Previously, a train that became 'unhealthy' retained that status regardless of whether it later regained its timetable. Under that arrangement, the train was potentially disadvantaged even though it was ostensibly on time.[349]

But PN still considers that the reporting regime needs to address end-to-end journeys. While recognising that such reporting is difficult, PN submitted that a train entering the network late from an adjoining network should not automatically be considered unhealthy, as it is unhelpful to report a train as unhealthy if late entry is not the operator's fault.[350]

Finally, QR made some broad comments on performance reporting, arguing that the performance indicators proposed by ARTC are similar to industry standard but that

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346 FROG, *ARTC Interstate Access Undertaking 2007 – Freight Rail Operators' Group Submission to the ACCC*, July (FROG *July Submission*), p. 20.

347 NSW Minerals Council, *NSW Minerals Council Hunter Rail Access Task Force – Response to Australian Competition and Consumer Commission Issues Paper Regarding Australian Rail Track Corporation 2007 Access Undertaking for its Interstate Rail Network*, August 2007 (NSWMC *August Submission*), p. 32.

348 Pacific National, *Pacific National Submission to ACCC Re: Approval of ARTC Interstate Access Undertaking*, July 2007 (Pacific National *July Submission*), p. 42.

349 ibid.

350 ibid.

there is some ambiguity as to the administrative burden imposed on an infrastructure provider to provide comprehensive performance indicators.[351]

Assessment of Issues

As ARTC is a monopoly provider of essential infrastructure, performance indicator reporting is one means of curtailing the potential for ARTC to compromises its service quality in lieu of profit. Regular public reporting and auditing of performance indicators makes network performance more transparent, assisting users of the network and the regulator to identify if service deterioration is a problem, and aiding potential access seekers in their negotiations with ARTC, by providing a means of gauging reasonable expectations of service standards, which can be weighed against proposed access charges.

In this assessment, the ACCC reviewed the two provisions in the December Undertaking dealing with ARTC's performance indicators, clause 8.1, which commits ARTC to maintaining the network in a 'fit for use' condition, and clause 8.2, which outlines ARTC's service quality reporting. The ACCC also looked at issues raised on the definition of healthy and unhealthy services and considered whether ARTC should be required to meet performance benchmarks, rather than simply report performance indicators.

Maintenance of Network Condition

ARTC has changed its commitment to maintaining the network since the 2002 Undertaking. In clause 8.1 of the December Undertaking ARTC proposes to 'maintain the network (but insofar that the network is relevant to the operator's scheduled train paths) in a condition which is fit for use by the operator to provide rail transport services having regard to the terms of the access agreement.'[352]

In the 2002 Undertaking ARTC committed, during the term, to maintain the network in a condition which was fit for an operator's purpose to use the network to provide rail transport services having regard to the terms of the access agreements.[353]

The qualifying phrase *(but insofar that the network is relevant to the operator's scheduled train paths)* was omitted from the 2002 Undertaking but included in the 2002 IAA.

The ACCC considers that it is appropriate for ARTC to be required to maintain the network in a fit for use state. It also considers that the qualification added to the December Undertaking, that the network be maintained only so far as it relates to operator's scheduled train paths, does not significantly undermine this objective. The qualification appears simply to focus ARTC's obligation on those parts of the network that are used by operators, while not obliging ARTC to maintain segments of the network that may be unused.

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351 Queensland Rail, *QR Submission to ACCC on ARTC Interstate Access Undertaking 2007*, July 2007 (QR *July Submission*), p. 35.

352 ARTC, *ARTC Access Undertaking*, December 2007, Part 8, clause 8.1, p. 51.

353 ibid., Part 8, clause 8.1, p. 26.

Performance Indicators and Reporting Obligations

The December Undertaking includes a number of changes from the 2002 Undertaking in the performance indicator reporting obligations. In some cases the indicators reported are more disaggregated, reporting performance for different segments rather than for the network as a whole:

These changes to the performance indicators are welcomed by the ACCC as they improve transparency for access seekers and the accuracy of reporting, especially for train operators that only use parts of the interstate network.

A new performance measure has also been inserted into the December Undertaking namely, Network Availability. In particular, three new key performance indicators have been introduced under this measure:[354]

- '*Transit time – Infrastructure Configuration Capability'* — measures the simulated operation of a reference indicative service's transit time over the network, providing information on the transit time achievable for a given indicative service over the current infrastructure configuration (alignment, grades and associated permanent speed restrictions etc).[355]

- *Transit time – Infrastructure Practical Capability* – measures transit time given the 'Transit time – Infrastructure Configuration Capability' and maintenance requirements (including the transit time impact of temporary speed restrictions).[356] The inclusion of maintaining requirements, including temporary speed restrictions, gives transit times that reflect the practical capability of the network.

- *Transit time – Availability to Market* – measures the actual transit time offered to the market delivered by the infrastructure given its configuration, maintenance and network usage (i.e. scheduled delays for path interactions).[357]

ARTC notes in its June 2008 Explanatory Guide that the three new measures aim to 'inform the market in relation to the relative impact of network configuration, maintenance and network usage on capability and performance of the network.'[358] The ACCC believes that the new performance indicators on network availability will improve transparency for access seekers and the accuracy of reporting and welcomes their inclusion into the December Undertaking.

The ACCC also notes the following further changes to the performance indicators in the December Undertaking:

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354 ARTC, *ARTC Access Undertaking*, December 2007, Schedule G. See footnotes 7, 8 & 9 for the technical specifications used to measure transit time.

355 ARTC, *2007 ARTC Interstate Access Undertaking, Explanatory Guide*, June 2007, p. 32.

356 ibid., p. 33.

357 ibid.

358 ibid., p. 32.

- the track quality index (TQI) will be measured over 100m sections in the December Undertaking, as opposed to 200m sections in the 2002 Access Undertaking; and

- the reporting category 'number and percentage of unhealthy services that exit the network within tolerance' has been removed from the reliability performance indicators in December Undertaking, but was included in the 2002 Undertaking.

The ACCC's view is that removing the category 'number and percentage of unhealthy services that exit the network within tolerance' from the reliability performance indicators does not materially affect the usefulness of the performance indicators as this indicator will still be reported on in the December Undertaking.[359]

Overall, the ACCC recognises that performance reporting can be onerous and costly if indicators are not carefully designed. In this case, it considers that the indicators proposed should not pose unreasonable administrative costs on ARTC or operators. The majority of the performance indicators in the Undertaking will be sourced from ARTC and can reasonably be expected to form part of ARTC's existing internal monitoring processes. The performance indicators sourced from operators can also reasonably be expected to form part of an operator's existing internal monitoring processes and are thus unlikely to impose unreasonable administrative costs. In this respect, the ACCC considers that the performance reporting provisions of the Undertaking appropriately balance the need for publicly available performance information with the administrative costs on operators and ARTC of gathering such data.

On balance, the ACCC considers that the performance indicators are appropriate as they commit ARTC to an independent audit of its performance, broadly encourage performance improvement, and do not present an unreasonable administrative cost on ARTC or operators.

Healthy and Unhealthy Services

The definition of a 'healthy service' has been amended in the December Undertaking. In 2002 Undertaking, a healthy service '*is one which experienced no above rail related delay, within tolerance.* Tolerance is 15 minutes unless otherwise agreed. [360] The December Undertaking defines a healthy service as:

> A healthy service is train that:
>
> - presents to the network within tolerance, is configured to operate to its schedule and operates in a way that it remains able to maintain its schedule.
>
> - is running late only due to causes within the network, but only where the root cause is outside the rail operator's control*;* or

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[359] ARTC, *ARTC Access Undertaking*, December 2007, Schedule G.

[360] ARTC, *ARTC Access Undertaking 2002*, Part 8. The full definition of a 'healthy service also notes that delays are attributed by ARTC personnel following advice from relevant sources (including the operator). This attribution will determine the health or otherwise of the service.

- is running within tolerance regardless of previous delays.[361]

An unhealthy service is a train the falls outside of the definition of a healthy service. A train is within 'tolerance' if it is within 15 minutes of its scheduled train path time.'[362]

The ACCC notes submissions from FROG and PN which argued that the 'healthy' train concept was problematic. ARTC, on the other hand, takes the view that the healthy/unhealthy approach has allowed for separate identification of the performance of the track manager and the operator and that this approach is consistent with other rail regulatory frameworks.

The ACCC considers that the impact of the definitional change of a 'healthy' service is to allow for above rail delays due to train services employed by different operators outside the 15 minute tolerance period to be defined as 'healthy' if certain conditions are met. The new definition is tighter in scope than the 2002 definition and focuses on the behaviour of the operator of the train service in question, rather than capturing above rail delays attributable to other causes. While it may be difficult to achieve a precise definition of a 'healthy' train that addresses all possible causes of delay, the ACCC considers that the current definition is useful, provides a reasonable window for trains to enter the network on schedule and should improve train control and make the reported transit and reliability performance indicators more meaningful.

Performance Indicator Benchmarks

ARTC's obligation under the December Undertaking in respect of performance indicators is to report results rather than meet performance benchmarks. Such a regime improves transparency, but it does not necessarily guarantee that service quality in the same way as mandatory standards. However, in its consideration of the 2002 Undertaking, the ACCC argued that there was no need for benchmarks against which actual trends in performance are assessed because:

> 'there are sufficient legal protections given to above rail operators and access seekers through the ARTC and operator indemnity and insurance clauses contained in the 2002 ARTC Indicative Access Agreement (clauses 15 and 16)… These legal protections within the IAA ensue that ARTC maintains the Network to a high standard in order to avoid having to indemnify train operators in respect of losses to the extent that ARTC caused or contributed to that loss through degraded Network quality; and

In that assessment the ACCC also noted that if ARTC is seeking to increase capacity utilisation of the network it would need to maintain or improve service quality to attract additional traffic. In addition, the ACCC noted that degradation of service quality during the term of the Undertaking would affect the processes for renewing the Undertaking once it expires.

The ACCC considers that this reasoning remains relevant and that the absence of performance benchmarks in the December Undertaking is, on balance, unlikely to raise concerns against the criteria in the Act. As the rail market further develops, however, and ARTC moves closer to cost recovery on some segments, a regime with stronger

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361 ARTC, *ARTC Access Undertaking*, December 2007, Schedule G, Footnote 2.

362 ibid., Schedule G, See Footnotes 2 and 4.

incentives to drive efficiency may be needed. The ACCC could, therefore, change its view on the need for benchmark standards in future undertakings. With that in mind, the ACCC notes that the performance indicators in this Undertaking would provide a reasonable and robust means of developing performance benchmarks in a future undertaking, if this was necessary. Therefore, the current approach to performance indicators would not hinder the development of a more comprehensive performance management regime if it was needed in the future.

Draft Decision

The ACCC's preliminary view is that the provisions in clause 8 setting out ARTC's performance indicators do not raise objections under Part IIIA of the Act.

D.9. Schedules

Summary

ARTC's access undertaking contains a number of Schedules that provide further information relevant to applying for and negotiating access to the network. Schedule A and B contain information on lodging an access application. Schedule C details the core elements that must be contained in any negotiated access agreement and Schedule D contains the Indicative Access Agreement (IAA). Schedule E details those parts of the network subject to access and Schedule F sets out the principles for managing traffic on the network. Schedule G defines the service quality/key performance indicators and Schedule H outlines ARTC's forecast capital expenditure programme for the first five years of the Undertaking. The ACCC has reviewed each of these Schedules in the context of its assessment in earlier chapters.

The Schedule that attracted most comment from stakeholders was Schedule D — the Indicative Access Agreement (IAA), which is the focus of this chapter. The purpose of an IAA is to provide a 'pro-forma' contract that can be adopted by operators seeking access to the indicative service. Alternatively, it may be used as a starting point for access negotiations for services other than the indicative service, providing such agreements contain core elements of an access agreement which are set out in Schedule C.

The ACCC's preliminary view is that none of the Undertaking's Schedules, with the exception of Schedule E as noted in chapter D.2.1 of this draft decision, do not raise any objections under Part IIIA of the Act.

D.9.1. Schedules of the Undertaking

Attached to ARTC's access undertaking are nine Schedules that contain further information on the terms and conditions of access.

Schedules A to D cover information on the negotiation and finalisation of access agreements. Schedule A (Access Application) sets out the how requests for access are to be submitted to ARTC, whereas Schedule B (Information to accompany an Access Application) lists the information access seekers must include in such an application. Schedule C (Essential Elements of an Access Agreement) lists the provisions that must be included in an negotiated access agreement, unless otherwise agreed between ARTC and the access seeker. Issues relating to Schedules A, B and C are considered in chapter D.3. Schedule D (the Indicative Access Agreement) sets out a pro-forma contract that can be adopted by access seekers wanting to run the indicative service. This schedule is discussed below in D9.2.

Schedule E (Network) outlines those parts of ARTC's interstate network that are covered by the December Undertaking. Issues relating to the scope of network coverage were discussed in section D.2.1 of this draft decision and the network transit management principles (Schedule F) were discussed in section D7.4.

Schedule G (Performance Indicators) specifies the indicators ARTC will use to report on industry performance and ARTC's quality of service. These performance indicators are discussed in chapter D.8 of the draft decision.

Schedule H (Proposed Capital Expenditure) sets out ARTC's proposed capital investment programme for the financial years 2006-07 to 2011-12. Issues relating to Schedule H were discussed in chapters D.5 and D.7.

Finally, Schedule I (Segments) defines the components of the network that are distinguished for the purposes of charging and applying the floor ceiling test. Issues with the application of charges and the floor ceiling test are discussed in chapters D.4 and D.5

Draft Decision

The ACCC's preliminary view is that Schedules A, B, C, F, G, H and I do not raise objections under Part IIIA of the Act.

D.9.2 Schedule D — Indicative Access Agreement

ARTC's Proposal

As discussed in chapter D.3 of this draft decision, clause 3.11 of the December Undertaking states that the granting of access will be finalised by the execution of an Access Agreement. Providing an access seeker meets the prudential requirements of the Undertaking, ARTC proposes that an access seeker may take up one of the following:

- the Indicative Access Agreement; or
- any current available market terms and conditions as published on the ARTC website; or
- a negotiated Access Agreement.[363]

The IAA is a 'template' or 'pro-forma' contract that can be adopted by any access seeker.

ARTC states that the IAA is available to any access seeker wishing to operate an indicative service on the network and that this indicative agreement provides the baseline terms and conditions available to an access seeker. That is, where an access seeker operates an indicative service and agrees to the indicative terms and conditions, the indicative access charges will apply.[364] However, ARTC also notes that access seekers, including those wishing to operate a service other than the indicative service,

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[363] ARTC, *2007 ARTC Interstate Access Undertaking Additional Explanatory Guide*, December 2007, p. 7.

[364] ARTC, *2007 ARTC Interstate Access Undertaking Additional Explanatory Guide*, June 2007 p. 17.

may negotiate terms and conditions different from those specified in the IAA, subject to schedule C of the Undertaking.[365]

Views of Interested Parties

Operators expressed concerns that because the IAA is drafted as being specific to indicative services, ARTC may be free to negotiate on any basis it sees fit for non-indicative services. PN cites the front cover of the proposed IAA and states:

> it is instructive that the IAA applies only to "Indicative Services". This is a change from the IAA contained in the U2002 and the reason for the change should be explained.[366]

Similarly, Asciano (PN) submitted that it would be better to make the IAA the basis for negotiation of all access agreements, even though this would require amendments to the IAA.[367]

SCT argued that standard practice in the competing road industry is that there are standard terms and conditions for access to infrastructure. SCT believes that such a standard – non negotiable access terms approach is also sound for the rail industry.[368]

GSR on the other hand stated that there are a number of terms and conditions within the IAA which should be reflected in any access agreement.[369]

Assessment of Issues

The ACCC considers that the purpose of the Undertaking's negotiation framework is to assist access seekers to conclude a set of agreed access terms and conditions with ARTC. These terms and conditions are then embodied in a contractual relationship between ARTC and an operator known as an access agreement.[370]

In assessing whether the IAA is appropriate the ACCC has considered whether it balances certainty for access seekers with sufficient flexibility so access seekers can negotiate the terms and conditions that would best meet their needs. While some submissions argued that the IAA should set standard terms and conditions for all services, not just indicative services, the ACCC considers that this is not necessary to ensure effective negotiation and recognises that there are benefits in access seekers having the capacity to negotiate outside the IAA.

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365 ARTC, *2007 ARTC Interstate Access Undertaking Additional Explanatory Guide*, June 2007 p. 29; ARTC, *2007 ARTC Interstate Access Undertaking Additional Explanatory Guide*, December 2007, p. 7.

366 Pacific National, *Pacific National Submission to ACCC Re: Approval of ARTC Interstate Access Undertaking*, July 2007, pp. 42-43.

367 Asciano, *Asciano Submission ACCC Issues Paper: ARTC Rail Access Undertaking,* February 2008, p. 3.

368 SCT Logistics, *Re: Australian Rail Tack Corporation (ARTC) Rail Access Undertaking – Interstate Network,* February 2008, p. 3.

369 Great Southern Railway Limited, *Submission RE: Australian Rail Track Corporation Access Undertaking,* August 2007, p. 34.

The Undertaking clearly provides for access seekers to negotiate outside the IAA and develop an agreement different to that of the IAA. Such flexibility can ensure access terms and conditions meets the needs of individual operators and respond to changing market needs over the ten year term of the December Undertaking. The risk of such flexibility is, however, that it could make the costs of negotiation high as negotiations may be open ended.

There are several factors in the December Undertaking and the IAA however which reduce this risk. First, ARTC has committed that when it negotiates terms and conditions that are different to those in the IAA (referred to in the Undertaking as current market terms and conditions) it will publish those 'market terms and conditions' on its website, noting that they are available to any other access seeker wishing to operate a like service. The publication of 'current market terms and conditions' should also increase transparency in the types of terms and conditions that have been negotiated by other rail operators and end users.

Second, the ACCC believes that, even for non-indicative services not covered by the IAA, the IAA will simplify and hasten the negotiation process by establishing a clear starting point from which to negotiate. If an access seeker negotiates an access agreement other than the IAA, the Undertaking provides that it must include the elements Schedule C of the Undertaking, unless otherwise agreed.[371] Schedule C was drawn from the IAA and, in this sense, the IAA still provides a reference point for access seekers wishing to negotiate access to non-indicative services.

Finally the ACCC points out that the IAA, as acknowledged by ARTC, forms part of the Undertaking and is enforceable against ARTC. The ACCC considers that where access seekers are frustrated in their attempt to gain access and an access dispute arises, even if that dispute is in relation to a non-indicative services, the ACCC may rely on the IAA to inform itself in resolving the dispute.

The ACCC's preliminary view is, therefore, that the Undertaking provides sufficient scope for access seekers to negotiate terms and conditions outside the IAA but still provides adequate information and guidance to ensure that the costs of negotiation are not excessive.

Draft Decision

The ACCC's preliminary view is that the level of guidance provided to access negotiations through the indicative access agreement does not raise objections under Part IIIA of the Act.

[371] ARTC, *2007 ARTC Interstate Access Undertaking Additional Explanatory Guide*, June 2007, p. 17.

D.9.3 Indicative Access Agreement Issues

The ACCC notes that some operators have raised specific concerns regarding certain IAA provisions and the way some aspects of the IAA have been drafted. [372]

While ARTC has sought to remedy some of the drafting matters in the IAA, the ACCC believes it is more appropriate that ARTC and operators seek to remedy any remaining concerns directly during access negotiations. In terms of the substantive concerns raised by stakeholders in regard to IAA, the ACCC has assessed most of these issues in the context of its assessment in previous chapters. There are, however, some remaining issues, which are discussed below.

The ACCC also notes that ARTC has addressed a range of consistency issues between the IAA and the Undertaking that were identified by interested parties in relation to the June Undertaking.

Invoices and Monthly Statement

Clause 4.4 of the IAA covers the provision of invoices and monthly statements and obligations on operators to pay the money invoiced by ARTC. In particular the clause provides that:

- ARTC will invoice the operator for each period from Sunday to the next Saturday inclusive, itemising the variable charges payable for each scheduled train path and the variable and flagfall charges for each *ad hoc* entitlement**;**
- the operator will pay ARTC the amount shown in the monthly statement in full within 21 days from the date of issue unless the payment is in dispute;
- where payment is in dispute, the operator will notify ARTC of the disputed amount within 21 days from the date of issue of the statement;
- the operator will pay the undisputed amount within 21 days from the date of issue of the statement;
- the disputed amount may be withheld until the dispute is resolved; and
- where the dispute is resolved in ARTC's favour, the operator shall pay the disputed amount to ARTC, plus interest.

PN argued that ARTC should be required to provide accurate invoices and submitted that there should be no obligation to pay outstanding amounts if they are the subject of a genuine dispute between the parties.[373]

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[372] Great Southern Railway Limited, *Submission RE: Australian Rail Track Corporation Access Undertaking,* August 2007, p. 34; Pacific National, *Pacific National Submission to ACCC Re: Approval of ARTC Interstate Access Undertaking*, July 2007, pp. 42 -43.

In the December Undertaking ARTC amended clause 4.4(b) of the IAA to only require payment of the undisputed amount pending resolution of a dispute, subject to interest also being payable if the dispute is resolved in ARTC's favour. The ACCC considers this provision is now satisfactory as it provides a process to question an invoice and only requires payment of the undisputed amount.

Indemnities and Instructions

Clauses 8.1 and 8.2 of the IAA provide for ARTC to issue instructions in relation to use of the network. In giving these instructions, ARTC must seek to minimise operator disruption, consult with the operator prior to using its locomotives to clear a network blockage and provide the operator with a written copy of the instruction.

Operators raised concerns about whether they should be responsible for damage caused by complying with an instruction from ARTC.[374]

The ACCC understands the definition of 'Instruction' within the IAA is not intended to be provide a unilateral unconstrained right for ARTC to issue instructions to operators. Rather, it ensures that ARTC has sufficient control and authority to address network issues, protect operators and rectify situations where the rail network is disrupted by an incident. The ACCC also notes that it is not practical to prescribe all situations that could occur on a network that would be relevant to the issuing of instructions by ARTC.

Clause 8.2 provides for mutual releases between the parties in relation to delays and costs arising from instructions where those instructions were properly given. Clauses 8.2 (e) and (f) are subject to clause 15 which provides for a liability and indemnity regime in relation to incidents. Where ARTC has breached the agreement and contributes to an Incident, the Operator has the benefit of the indemnity in clause 15.3. To this extent, the ACCC considers clause 8 to be appropriate.

Capacity Issues — IAA Provisions

Operators raised concerns with the treatment of capacity issues in the IAA. GSR and PN were concerned that clause 2.8 of the IAA ignores current practice for traffic that is charged on an output basis, such as coal. These charges are intended to be inclusive of ancillary movements such as light engines and repositioning movements and need to be accounted for in the agreement.[375]

The ACCC notes concerns regarding light engine movements and the inclusion of ancillary movements in access charges (clause 2.8 of the IAA). The ACCC considers that ancillary movements that utilise disproportionate train paths can detract from efficient use of the network and distort other services on the network. The ACCC consequently considers that clause 2.8 of the IAA is reasonable.

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373 Pacific National, *Pacific National Submission to ACCC Re: Approval of ARTC Interstate Access Undertaking*, July 2007, p. 57.

374 ibid., p. 53.

375 ibid.; Great Southern Railway Limited, *Submission RE: Australian Rail Track Corporation Access Undertaking*, August 2007, p. 34.

Part E Draft Decision

The Australian Competition and Consumer Commission's (ACCC) preliminary view is that it is appropriate to accept the Australian Rail Track Corporation's (ARTC) Interstate December Access Undertaking application subject to ARTC addressing a number of issues raised by the ACCC.

The issues are listed below:

D.1. Preamble

Recommendation:

- The ACCC's preliminary view is that clause 1.1(f) of the Preamble be moved to clause 1.2 to become an objective of the Undertaking.

D.2. Scope and Administration of the Undertaking

The ACCC's preliminary view is that clause 2.1 and the Schedule E, setting out the scope of the network covered by the Undertaking, is unacceptable in terms of the requirements in s.44ZZA(3) of the Act.

Recommendation:

- That the details provided on the geographic scope of the Undertaking for the NSW leased network be similar to that provided for the ARTC owned and Victorian leased parts of the network; and

- That the Undertaking include maps that delineate the network covered by the Undertaking.

D.2.2. Grant and Duration of the Undertaking

Recommendation:

- The ACCC's preliminary view is that the ARTC Undertaking should be amended to replace clause 2.2 with:

  ARTC undertakes to the ACCC that it will comply with the terms and conditions specified in this Undertaking in relation to the grant of Access to Operators to the Network for Services. This Undertaking takes effect twenty-one (21) days after it is accepted by the ACCC subject to section 44ZZBF of the Act and will continue until the earlier to occur of:

  (a) the expiry of the Term; or

  (b) withdrawal of this Undertaking in accordance with its terms and the Act.

Recommendation:

The ACCC's preliminary view is that Clause 2.2 of the December Undertaking should be amended to address the following:

- Three months prior to the expiry of the term of the Undertaking ARTC will submit to the ACCC a written statement outlining whether or not it intends submit a new voluntary Undertaking to the ACCC for its consideration;

- If ARTC intends to submit a new voluntary Undertaking to the ACCC for its consideration ARTC would also apply to the ACCC for an extension of the expiring Undertaking, pursuant to Part IIIA s.44ZZBB of the TPA;

- The extension application would include a proposed extension period which, in ARTC's view, reasonably estimates the time it would take for ARTC to formulate a new Undertaking and have that Undertaking take effect following approval by the ACCC;

- If ARTC does not propose to submit to the ACCC a new voluntary undertaking the recommendations above would not be applicable. Nothing in the clause would prevent ARTC from submitting a voluntary Undertaking to the ACCC at any time in the future.

D.2.4. Review of the Undertaking

Recommendation:

- That the Undertaking include a provision requiring ARTC to undertake a review, in consultation with stakeholders, of the Undertaking after five years.

D.3.6.1. Commencement and Cessation of Negotiation Period

Recommendation

- That Clause 3.10(b)(vi) of the December Undertaking be amended to require ARTC to provide written reasons to an applicant where it decides to issue a notice of intent to end negotiations.

D.3.7. Access Agreements

Recommendation:

- The ACCC's preliminary view is that the provisions in clause 3.11 should be amended to read as follows:

(a) The granting of Access will be finalised by the execution of an Access Agreement. The parties to the Access Agreement will be ARTC and:

(i) If the Applicant is an Accredited Operator, that Applicant; or

(ii) If the Applicant is not an Accredited Operator, that Applicant or the Accredited Operator or both (as the case may be).

(b) Subject to clause 3.11(c) ARTC may offer any of the following as an Access Agreement:

(i) the Indicative Access Agreement subject to the Applicant satisfying the prudential requirements in clause 3.4(d); or

(ii) the current available market terms and conditions as published on ARTC's website; or

(iii) an negotiated Access Agreement to reflect agreed amendments to the Access Agreement. A negotiated Access Agreement will, unless otherwise agreed between ARTC and the Applicant at least address the essential elements set out in Schedule C. The details of Schedule C do not provide an exhaustive list of the issues that may be included in an Access Agreement.

(c) ARTC must offer the Indicative Access Agreement to an Applicant if the Applicant:

(i) seeks access to Indicative Service; and

(ii) meets the prudential requirements in clause 3.4(d); and

(iii) either:

(A) the Network has sufficient Available Capacity to meet the Applicant's needs; or

(B) ARTC consents to provide Additional Capacity in accordance with clause 6.2.

(d) Once the Applicant has notified ARTC that it is satisfied with the terms and conditions of the Access Agreement as drafted, ARTC will, as soon as reasonably practicable, provide a final Access Agreement (or, if applicable, an amendment to an existing Access Agreement) to the Applicant for execution.

(e) Where the ARTC offers an Access Agreement and the Applicant accepts the terms and conditions offered in that Access Agreement, both ARTC and the Applicant will execute the Access Agreement. The parties will use reasonable endeavours to comply with this clause as soon as practicable.

D.4.5. Price Escalation

Recommendation

- The ACCC's preliminary view is that the ARTC Undertaking should be amended so that price increases for indicative services can only be implemented once a year.

D.4.6. Excess Network Occupancy Charge

Recommendation

The ACCC's preliminary view is that the ARTC Undertaking should be amended to include provisions to the following effect:

- A new provision committing ARTC not to apply the ENOC in cases where a new contract must include a schedule with excessive transit times because a better path is not available; and

- A new provision committing ARTC not to charge the ENOC when the reason why the contracted train path is not available is ARTC's fault.

D.5.3.9. The Utilisation Rate

Recommendation

- The ACCC's preliminary view is that the WACC parameters that ARTC has provided are broadly reasonable with the exception of gamma. The ACCC recommends that ARTC amend its gamma from 0.30 to 0.50.

D.6.3. Capacity Reservation Fee

The ACCC's preliminary view is that clause 5.2 is unacceptable in terms of the requirements in s.44ZZA(3) of the Act.

Recommendation

- The Capacity reservation charge de deleted from the Undertaking.

D.7.2.2. Role of Industry Consultation

Recommendation

- The ACCC's preliminary view is that the ARTC Undertaking should be amended to include a provision in Part 6 to the following effect:

  6.5 Industry Consultation

  In regard to Additional Capacity sought in accordance with clauses 6.2 and 6.3, ARTC must:

  (i) provide above Operators with a reasonable opportunity to present their views to it regarding Additional Capacity sought by either an Applicant or by it; and

  (ii) circulate a summary of the results of consultation to stakeholders including reasons for disagreeing with Operators' views (where applicable).

Appendix A

List of Parties Providing Submissions

Submissions to the ACCC issues paper – 22 June 2007

- Freight Rail Operators Group ('FROG'), *ARTC Interstate Access Undertaking 2007 – Freight Rail Operators' Group Submission to the ACCC*, July 2007 (FROG *July Submission*), received 24 July 2007;

- Great Southern Railway, *Submission RE: Australian Rail Track Corporation Access Undertaking*, August 2007 (GSR *August Submission*), received 7 August 2007;

- New South Wales Minerals Council (NSWMC), *NSW Minerals Council Hunter Rail Access Task Force Response to Australian Competition and Consumer Commission Issues Paper regarding Australian Rail Track Corporation 2007 Access Undertaking For Its Interstate Rail Network*, August 2007 (NSWMC *August Submission*), received 28 August 2007;

- NSW RailCorp, *Australian Rail Track Corporation (ARTC) 2007 Access Undertaking – RailCorp Comments*, 7 August 2007 (RailCorp *August Submission*), received before 20 July 2007;

- Pacific National, *Pacific National Submission to ACCC Re: Approval of ARTC Interstate Access Undertaking*, July 2007 (Pacific National *July Submission*), received 23 July 2007;

- Queensland Rail, *Queensland Rail Submission to ACCC on ARTC Interstate Access Undertaking 2007*, July 2007 (QR *July Submission*), received before 20 July 2007; and

- SCT Logistics, *Submission on the ARTC Undertaking*, July 2007 (SCT *July Submission*), received before 25 July 2007.

Submissions to the ACCC issues paper – 14 January 2008

- Asciano, *Asciano Submission ACCC Issues Paper: ARTC Rail Access Undertaking*, February 2008 (Asciano *February Submission*), p. received 8 February 2008;

- Austrak, *Submission to the ACCC Regarding the Draft ARTC Access Undertaking Submitted on 20 December 2007*, February 2008 (Austrack *February Submission*), received 8 February 2008;

- El Zorro, *Re: ARTC Issues Paper 2008*, January 2008, received 17 January 2008;

- Freight Rail Operators Group ('FROG'), *ARTC Interstate Access Undertaking 2007 – Freight Rail Operators' Group Submission to the ACCC*, February 2008 (FROG *February Submission*), received 8 February 2008;

- Great Southern Railway, *ARTC – Access Undertaking December 2007*, February 2008 (GSR *February Submission*), received 6 February 2008;

- Queensland Rail, *QR Submissions ACCC Response to ACC Issues Paper on ARTC Access Undertaking – Interstate Network*, February 2008 (QR *February Submission*), received 8 February 2008; and

- SCT Logistics, *Re: Australian Rail Track Corporation (ARTC) Rail Access Undertaking – Interstate Network*, February 2008 (SCT *February Submission*), received 12 February 2008; and

- SCT Logistics, *Letter from SCT Logistics*, dated 21 February 2008 and received on 22 February 2008.