PRODUCTIVITY COMMISSION INQUIRY
POSITION PAPER

LEGISLATION REVIEW OF CLAUSE 6 OF THE COMPETITION PRINCIPLES AGREEMENT AND PART IIIA OF THE TRADE PRACTICES ACT 1974

AUSTRALIAN RAIL TRACK CORPORATION SUBMISSION

The Position Paper prepared by the Productivity Commission in relation to its inquiry into a legislation review of Clause 6 of the Competition Principles Agreement (CPA) and Part IIIA of the Trade Practices Act (TPA) 1974 was issued in March 2001. The inquiry gives effect to a commitment made, as part of the NCP, by the Commonwealth and States and Territories to review the national access arrangements after five years of operation. The paper covers such issues as current access arrangements, including the Part IIIA national access regime and industry specific regimes, the use of and rationale for the national regime, means of improving the regime, access, and the implication for any changes on Clause 6, industry specific regimes and other regulation. The Commission has sought comment on its position taken with respect to these issues as well as further questions raised by the Commission.

It is understood that the Commission will be coordinating its processes to ensure that relevant information is shared between this inquiry and a concurrent inquiry into telecommunications services addressing the industry specific access regime for those services. It is also recognised that there are overlaps between this inquiry and the inquiry into the Prices Surveillance Act (PSA) for which the Commission has recently released an interim report.

ARTC has made two submissions to the Productivity Commission in relation to the Issues Paper released in October 2000 in relation to this review. The major issues raised by ARTC in its submissions were:

- ARTC is of the view that there should be a single adjudicator with respect to regimes for access in Australia.
- ARTC is of the view that the differentiation of access regimes should be on the access providers' market and industry position
- ARTC is of the view that Industry Codes should be able to be departed from by an access provider as long as it can be demonstrated to the ACCC that the proposed regime satisfies the requirements of an access undertaking.

ARTC is pleased that each of these issues has been considered, to varying extent, by the Productivity Commission.

This paper will seek to make comment on the Productivity Commission's position with respect to each of these issues initially, then with respect to other issues covered in the position paper.

A single adjudicator with respect to regimes for access in Australia.

The Commission has proposed that only one body, preferably the ACCC, should administer Part IIIA and sees current ministerial involvement in the approval stage of the process (declarations/certifications) as adding little but time, uncertainty and inconsistency. It has proposed to end the role of Ministers in the process and make regulatory bodies the responsible body with respect to all paths for seeking access to monopoly infrastructure. Effectively, the ACCC would adjudicate over all Part IIIA processes.

In its initial submissions, ARTC indicated that it considered the current framework of having two separate national regulatory bodies adjudicating on access regimes as being inefficient and contrary to the principle of having an even playing field in like industry sectors. It proposed that the assessment of all access regimes involving industries whose operation has national implications should solely be a matter for the ACCC. Having a single adjudicator would significantly enhance the achievement of the aims of National Competition Policy by enabling the application of a consistent set of competitive principles across all regimes, the provision of a more coherent framework for the identification of markets, and the provision of a consistent framework for the application of access principles with like sectors regardless of the ownership of the access provider.

The Commission proposal appears to go further in providing for the ACCC to act as adjudicator with respect to all relevant infrastructure facilities, whether nationally significant or otherwise. On the other hand, the Commission has expressed some concerns with the approach in that it may result in a concentration of decision making power and may result in conflicts with the ACCC's consumer advocate role.

ARTC sees the concentration of decision-making power as offering significant benefits as described earlier. The Commission has proposed to incorporate as a key Part IIIA objective, the enhancement of overall economic efficiency by promoting efficient use of, and investment in, essential infrastructure facilities, as well as include pricing principles in Part IIIA. ARTC sees this objective as being consistent with both short and long-term consumer needs as well as balancing those needs with those of infrastructure facility owners.

With respect to ministerial involvement in the current three Part IIIA process, ARTC noted, in its submissions, inconsistency between the role of the State and Commonwealth Ministers in each process. ARTC proposed that the responsible Minister with regard to declarations should be the Commonwealth Minister, regardless of infrastructure ownership. Commonwealth Ministerial involvement in the undertaking process (not

currently the case) would then bring about similar Ministerial involvement in each of the processes. Consistency has been the ARTC's main concern in this regard.

The Commission has gone further by proposing to remove Ministerial involvement in Part IIIA processes altogether, thus conferring this responsibility on the ACCC. ARTC does not see this measure as detracting from the consistency aspect of the processes, and should provide some advantage with respect to the efficiency and certainty of the process. ARTC would therefore see some merit in the Commission proposal. **However, ARTC would like to stress that it sees the existence of only one body, the ACCC, being administrator of Part IIIA, as proposed by the Commission, as being a far more beneficial to the successful implementation of competition reform in Australia, than the removal of Ministerial involvement from the process.**

Regardless of whether there is Ministerial involvement or not, the Commission has proposed greater transparency and accountability in the decision making process. That is, a time limit be placed on decision making with respect to all process, lack of decision is deemed as acceptance, where Ministerial involvement is retained, and reasons for decisions should be published. ARTC supports this proposal.

In summary, ARTC's proposed adjustments to the administrative and decision-making processes covered by Part IIIA are largely designed to improve the consistency and certainty in the process.

Differentiation of access regimes should be on the access provider's market and industry position.

The Commission, in its paper, noted that there were two schools of thought regarding the sort of essential facilities that access regulation should cover. That is, the 'Hilmer' model which contended that only vertically integrated facilities should be covered, with other monopoly power issues addressed through other forms of prices oversight, and the current approach which contends that coverage should be based on the facility's bottleneck position in the market rather than whether or not it is integrated into adjacent markets.

The Commission's position is that eligible services provided by both vertically integrated and non-integrated facilities should be covered in Part IIIA. It considered that trade practices law does not normally provide remedies against monopolistic behaviour such as the collection of monopoly rents, unless anti-competitive intent is demonstrated.

Further, exclusion of non-integrated facilities from Part IIIA may provide incentive to separate, inefficiently, merely to escape more stringent scrutiny afforded by Part IIIA.

The Commission also found that Part IIIA should continue to focus on addressing market power arising from natural monopoly technologies that leads to denial or monopoly pricing of access, rather than market power generally (including power arising from such sources as unfair trading practices, legislated monopolies and network externalities). It noted that monopolistic behaviour arising from unfair trading practices could (or should) be dealt with in Part IV or legislative reform respectively. Market power brought about by network externalities (where a large incumbent provider of services on a network may deter the entry of rival providers) is in most cases likely to be considered as displaying natural monopoly characteristics. It also noted that natural monopoly technology may not give rise to market power if substitute services are available (this occurs in the rail freight industry), although the definition of 'market' is important in assessing whether a facility based on a natural monopoly possesses market power.

In its submissions, ARTC proposed that there should be differentiation between access regimes based on the access providers' market and industry position. Specifically, the characteristics of an access regime are different when applicable to a service provider related to entities operating in upstream or downstream markets vis-à-vis a provider with no such interest, on the basis that the commercial motives of the two providers are different and such motives governed the way the providers operate. Secondly, the characteristics of an access regime differ where the extent to which provision of services utilizing a natural monopoly facility confers market power on the provider of the services.

ARTC notes that the Commission appears to draw the same distinctions between the industry and market position of the access provider. ARTC agrees that to exclude entities from coverage of Part IIIA on the basis of industry structure alone may create some undesirable outcomes as described above. ARTC also agrees that the provision of services utilizing a natural monopoly facility does not necessarily confer market power, assuming an appropriate market definition. ARTC considers the competitive forces in the markets from which it derives a significant portion of its revenue do not permit it to conduct its business with market power.

Whilst ARTC is supportive of a more inclusive view with regards to the coverage of services under Part IIIA, at the risk of some cost and inefficiency to industry, it is ARTC's view that these risks can be mitigated by more formally addressing the market and industry position differences between access providers.

In its submissions, ARTC proposed two types of regime. A **third party** access regime applicable in circumstances where the access provider is related to entities with upstream or downstream market significance (vertically integrated) is more prescriptive and covers a range of issues including access application, negotiation and pricing, dispute resolution, service performance, anti-competitive conduct, accounting separation and ringfencing. This is necessary to minimize the anti-competitive behaviour that such an entity has a

commercial imperative to engage in. An **open** access regime would apply in circumstances where the access provider has no upstream or downstream interests, has access revenue as its principle source of income and has a commercial imperative to promote competition in the use of the facility in order to grow the market. The primary regulatory concern here relates to monopoly pricing, where the provider has market power.

Within each of the two types of regimes, the extent of issues covered and the degree of prescription is largely dependent on the extent of market power that the access provider has. A highly prescriptive third party regime would be applicable with respect to a vertically integrated provider with significant market power. On the other hand a flexible open access regime (or no regulation at all) would be applicable to a separated provider with little or no market power. Figure 1 below illustrates.

Figure 1

Structure \ Market Power	Significant → None	
Vertically Integrated	**Third Party Access Regime** Highly Prescriptive Focus on anti-competitive behaviours and monopoly pricing	**Third Party Access Regime** Highly Prescriptive with respect to anti-competive behaviours. Less prescriptive with respect to pricing.
Vertically Separated	**Open Access Regime** Only prescriptive with respect to denial of access and monopoly pricing.	**Open Access Regime** Little or no prescription

A formal differentiation of regimes in Part IIIA will create more efficient outcomes in that regimes could be tailored to specifically address the market and industry position of the provider. Further, unnecessary costs of regulation can be minimized.

Departure of regimes from an Industry Code

With respect to whether generic regulation or industry specific regulation is appropriate, the Commission's position is that the current 'dual' approach (both a general regime in Part IIIA and the ability to develop an industry specific regime) draws on the strength of both approaches (uniformity, yet flexibility), while avoiding some of the pitfalls of a uni-dimensional approach. The Commission also found that some changes to Part IIIA would be required in order to strengthen its framework role and encourage convergence of industry specific regimes. A general principle is that Part IIIA and industry regimes diverge only where specific circumstances make this absolutely necessary.

ARTC supports the Commission's position in this regard. Industry codes are developed by incumbent industry participants, and can result in a regime that is designed to preserve the current industry structure and competitive positioning. Principles included in Part IIIA should seek to prevent this from occurring. The use of a single adjudicator of access regimes will further support this approach.

The Commission has proposed that Part IIIA should specify that access prices should (among other things) generate revenue across a facility's regulated services as a whole that is at least sufficient to meet the efficient long-run costs of providing access to these services (including a return on investment commensurate with the risks involved), and should not be so far above costs as to detract from efficient use of services and investment in related markets. Whilst it is reasonable that the commercial interests of an existing access provider be protected in this regard, inextricably linking access pricing to costs may serve to prohibit more entrepreneurial approaches to pricing where market growth is seen as a means to mitigate pricing risk. This may be the case with respect to new assets, with substantial capacity shortfall, where the access provider may seek to take market risk by offering initial market based pricing to encourage utilization of the asset.

In addition, the entry of new providers wishing to take such an approach, can be thwarted by incumbent participants who seek 'coverage' of the asset under an existing industry code that provides for cost based, prescriptive pricing only. The motivation of incumbent participants in this case is to protect their current competitive position. This can be to the detriment of the efficient operation of the market and ultimate benefit to the community.

ARTC has noted significant concerns raised, primarily by state governments, about the availability of dual access routes. Particular reference has been made to the ability of a new entrant (with a new pipeline) seeking approval of an undertaking through the ACCC, whilst still at risk of being required to be 'covered' under the Gas Code, leading to possible double regulation. Some of these parties have proposed that the option of filing an Access Undertaking be removed in the case of gas pipelines.

An intending participant seeking to apply a more entrepreneurial approach to pricing and access with respect to a new asset should have the option of falling in under an existing industry code, or applying for approval of a separate undertaking to the ACCC. A separate undertaking would be considered by the ACCC in the light of all public submissions (including those of incumbent market participants) and assessed on its own merits. On the other hand 'coverage' (in the case of the gas industry) is merely assessed against similar criteria to that for declaration under the Act.

ARTC proposes that Part IIIA should include pricing principles that do not preclude the more entrepreneurial approaches to access pricing which see the access provider voluntarily take on commercial risk with respect to a new asset with substantial excess capacity, in order to promote growth. Further, ARTC is of the view that Part IIIA should not permit an industry code to give incumbent participants the ability to seek coverage of rival assets under the existing code, which may not be geared to provide for market growth based approaches to pricing, where a prospective provider is willing to take on additional market risk. Such a provider should have the option of falling under an existing code or seeking approval of a separate Part IIIA undertaking by the ACCC.

In summary, ARTC fully supports the Commission's position that Part IIIA should provide the lead as a framework for access regimes by creating pressure to eliminate unwarranted differences in individual access arrangements and by encouraging regimes to replicate desirable features of the national regime, which should not inhibit entrepreneurialism. ARTC believes that a provider should have the option of seeking ACCC approval of a separate Part IIIA undertaking or falling under an existing code. If this were not achievable, a preferable solution to closing off the undertaking option within the generic regime would be to modify industry regimes to bring them into line with Part IIIA to the extent that double regulation or duality of access routes might be undesirable.

Other issues raised in the position paper

In its overview, the Commission identified a number of elements underpinning the proposals made. Broadly, these included:

- A key role for Part IIIA to provide a framework for, and discipline on, industry-specific regimes.
- The current dual approach, with Part IIIA operating in tandem with industry specific regimes representing a compromise between the advantages of a generic approach and the flexibility to deal with specific circumstances.
- The inclusion of clearly specified objectives and pricing principles in Part IIIA and commonality in the criteria applying to various access routes within the regime.

- Coverage criteria and pricing principles should give proper regard to the need for investors to have a reasonable expectation of earning a return commensurate with the risks involved.
- The regimes operational requirements should take account of the difficulty in the regulators task where information is limited and instruments available to balance competing interests are imperfect.

As can be seen from the previous comments, ARTC is, by and large, in support of the general direction of the Commission's position paper. In addition to the above, ARTC offers the following specific comments.

Objectives and Coverage of Part IIIA

The Commission has identified a number of deficiencies of the current regime being:

- A lack of over-arching objectives and pricing principles
- An emphasis on promoting competition rather than efficiency
- Variability in criteria applying across different routes to access
- Cumbersome/time consuming administration.

To address these, objectives to be included in Part IIIA, proposed by the Commission include the enhancement of overall economic efficiency by promoting efficient use of, and investment in, essential infrastructure facilities, and the provision of a framework and guiding principles for industry specific regimes.

ARTC supports the Commission position that the inclusion of overarching objectives in Part IIIA would result in greater consistency and certainty in competition reform. ARTC notes that many participants (including ARTC) saw a need for Part IIIA objectives to seek a balance between short-term and long-term efficiency objectives (in accordance with Hilmer's approach). ARTC supports the Commission view that Part IIIA 'must seek to promote efficient use of essential infrastructure, but in a way which does not discourage investment' and that 'it is appropriate to lean towards ensuring that long-term efficiency is not jeopardised'. The proposed objective described above would appear to adequately represent these views.

The paper noted that greater competition is employed as a proxy for improving community welfare and experience in a wide range of circumstances has shown that the promotion of competition is usually compatible with improved community welfare. On the other hand, competition should be seen as a means rather than an end in itself.

It was argued in ARTC's previous submissions that where the promotion of competition is seen to be contrary to community welfare (as is the case with services to regional Australia), such services are likely to have been supported by some form of cross-subsidisation (with, say, services in the urban sector). It is ARTC's view that such cross-subsidisation should be made more transparent to the community. Further, the

introduction of competition to such markets should not be impeded in order to protect cross-subsidisation. Instead, the cross-subsidy should be funded outside of the competitive framework and competition **for** the provision of the subsidised service should be encouraged in order to maximize efficiency of its provision to the community.

ARTC has previously commented with respect to the inclusion of pricing principles in Part IIIA, and on how various types of entity could be treated under Part IIIA.

Declaration and Arbitration

In dealing with the criteria for declaration as it currently exists, the Commission position seems to focus on two issues, the scope for declaration where the competitive impact might be trivial, and whether services without substantial or sustainable market power should be covered. It is proposed that the existing criteria require 'substantial' competitive impact to be established, and that it be uneconomic for a **second** facility to be developed to provide the service (so ruling out duopolies and oligopolies from the threat of declaration).

ARTC considers that merely patching the current wording (as described above) may result in greater inconsistency. ARTC agrees that much greater benefit to the process could be derived from a re-structuring of the criteria.

The Commission has attempted to restate most of the declaration criteria by incorporating four tests (as a Tier 2 proposal).

- A screening test – 'The service is of significance to the national economy and the entry of a second provider of the service would not be economically feasible'. ARTC supports the use of term 'service' rather than 'facility' (as is the case in the current criteria) in principle. The test 'significance to the national economy' is imprecise. ARTC had previously proposed that, in order to reduce the extent of judgment that might be required here, a number of criteria (including this one) might be appropriate. Criteria suggested by ARTC in its previous submission included:
    - 'Does the service provided by the facility have a bearing on the national economy? This may be a test of the significance of the impact of the service on, say, national GDP.
    - 'Does the service have any impact on activity outside of the state in which the related facility is located? That is, does the service have any impact on interstate or international trade?

  Other tests could be revenue or value related. The existence of several criteria would not enable a party to either seek or avoid declaration by merely demonstrating satisfaction (or otherwise) of one criterion. The balance over all criteria should be considered. Greater prescription will result in more certainty and consistency.

- An essentiality (market power) test – 'No substitute service is available under reasonable conditions that could be used by an access seeker. Competition in related markets is insufficient to prevent the provider of the service from exercising substantial market power.' ARTC supports having this test.

- A materiality test – 'Addressing the denial of access, or the terms and conditions of access, to the service concerned is likely to improve economic efficiency significantly. ARTC supports having this test but seeks more precise definition as to what constitutes 'significantly'.

- The remaining tests relating to the existence of other effective access regimes and the public interest test mirror the current declaration criteria. ARTC has suggested in its previous submission that the certification path to access be abandoned. On this basis, a test for the existence of other 'effective' access regimes ceases to become relevant. Evidence of an undertaking approved by the ACCC avoids the threat of declaration. ARTC notes that the public interest test remains stated in the negative. As stated above, where the introduction of competition is demonstrated to be contrary to the public interest (as has been argued with respect to services in regional Australia), the service is likely to have been supported by some form of cross-subsidisation (with, say, services in the urban sector). The negative test places this issue at the foot of the NCC/ACCC to be dealt with under the competitive framework. It is ARTC's view that such cross-subsidisation should be transparent to the community and un-commercial activities should be funded outside of the competitive framework. This would render a negative interest test unnecessary as any activity deemed to have negative impact could be handled outside the competitive framework. Competition should not be impeded by the protection of cross-subsidies. ARTC notes that the Commission has suggested that the 'primary declaration criteria should seek to establish whether or not declaration would provide a community benefit', leaving a negative test as a final opportunity for the access provider to identify factors which might mitigate against the provision of access. Notwithstanding an underlying premise that competition is a de-facto for efficiency and, so, community benefit, ARTC does not see any specific part of the primary criteria which may seek to establish a community benefit. If this is the intention, a positive public interest test, 'access to the service would result in a benefit to the community', may be appropriate.

  In summary, it is ARTC's view that the introduction (or increase) of competition should result in benefit to the community but, on the other hand, competition should not be impeded where there are negative impacts, such as cross-subsidies. Such impacts should be handled outside of the competitive framework.

In the main, ARTC supports a re-statement of the declaration criteria as proposed (Tier 2) by the Commission vis-à-vis a 'fine tuning' of the current criteria.

To align with the Part IIIA objectives described above, the Commission has proposed to promote the efficient use of, an investment in, essential infrastructure as the key aim in the arbitration of the terms and conditions of access. This places some order of priority on the guiding principles (as stated in the Competition Principles Agreement) for arbitrators. ARTC agrees that additional focus should support the guiding principles in order to provide greater certainty for all participants.

The Commission has also sought views on the merits of providing scope to use price monitoring as an alternative, or complement, to declaration, and on the most appropriate institutional arrangements to give effect to such monitoring. The Commission considered that such an alternative to declaration has 'merit in-principle' where market power was not clear and could equally apply to the coverage decision under industry regimes. ARTC agrees with the Commission where the access provider has no related market interests (vertically separated) and where revenue from access is the principle source of income. On the other hand, a vertically integrated provider, even without significant market power should still be subject to a Part IIIA 'third party' access regime (as described earlier), which is highly prescriptive with respect to other anti-competitive behavior. Figure 1 above illustrates.

Certification and Undertaking

ARTC has proposed that the certification path to access be made redundant on the basis that the ACCC become the sole adjudicator of access. Effectively, the current process of seeking certification of an access regime via the NCC would be replaced by submitting an undertaking to the ACCC. This would result in greater consistency between regimes across like industry sectors. The certification process is primarily used by state owned or controlled entities seeking to avoid regulation of their assets by the ACCC. This often results in access to different facilities in like industries, and where government facilities are in competition with privately owned facilities, being made available in inconsistent ways. Creating a single mechanism for both public and privately owned facilities in like industries will create a more even playing field.

The Commission has proposed that there should be scope under Part IIIA for an access provider to lodge an undertaking after a service has been declared. ARTC agrees that allowing post-declaration undertakings, as an alternative to arbitration would result in economies in regulation and would provide more extensive and timely information for access seekers. Such lodgement should remain voluntary (as is the case with all other undertakings) and the advantages described above outweigh any potential disadvantage where an access provider may use a lodgement and strategic withdrawal as a delaying tactic. The existence of an undertaking would be of benefit to the access provider, giving greater certainty than arbitrations.

ARTC supports the need to provide greater guidance on the criteria for assessing undertakings. The incorporation of objectives and pricing principles in Part IIIA will

assist in this regard. The Commission has proposed that the criteria for certification as detailed in Clause 6 of the Competition Principles Agreement (and improved) be incorporated in Part IIIA and that the criteria for assessing undertakings be aligned as far as is practical with these criteria, and those applying to arbitrations for declared services as already incorporated in Part IIIA. Abolishment of the certification process does not mean that the criteria for certification, suitably modified, wouldn't serve as a reasonable foundation for the assessment of undertakings. Having said this, ARTC has previously indicated that it does not believe Clause 6 and possibly parts of Part IIIA has provided a clear mechanism by which consistency of access to the national rail network can be achieved. Part of a Commission Tier 2 proposal to modify the certification criteria is a requirement that the regime includes provisions to facilitate consistency across multiple State and Territory access regimes applying to a particular service. ARTC considers this to be less prescriptive than the current Clause 6 requirement, which provides for a single process to seek access, a single dispute resolution body and a single forum of reinforcement.

The Commission is seeking views on the scope and mechanisms for modifying the undertaking arrangements so that persons other than the owner or operator of the facility used to provide the service could lodge an undertaking application. This is in response to the concerns raised in ARTC's submission regarding what may be an inability to submit an undertaking with respect to those parts of the national interstate rail network which it does not own or lease, given that ARTC may not be considered the owner or operator of the facility (on these parts of the network) given the degree of control over access currently conferred upon ARTC under proposed wholesale arrangements.

As previously stated by ARTC, and noted by the Full Court of the Federal Court in Rail Access Corporation v NSW Minerals Council (1998) 158 ALR 323, the difficulty arises in that the provider is defined as the owner or operator of the facility that is used to provide the service. In some cases, the party that provides the service (has an agreement for access with the user and is obliged to provide and manage access to the facility for payment) may not be the owner or operator of the facility.

ARTC is pleased that the Commission has endorsed ARTC's concerns in this area.

Access Holidays

In a previous submission, ARTC has stated a preference for calling an access holiday for 'what it is' rather than structuring a regime to encourage such an outcome. If an access holiday is to be granted, it should be done so only where there is a resulting net public benefit, and the maximum extent of the holiday should be such that the present value of the public benefit over the life of the project remains positive. The net public benefit would be the public benefit in having the project proceed, less benefits lost as a result of the access holiday less any public contribution to the project.

Pricing Principles

As stated earlier, ARTC supports the inclusion of pricing principles in Part IIIA, so long as there is sufficient flexibility to allow for some entrepreneurialism in pricing approach and commercial activity. The principles as proposed by the Commission are:

'... access prices should:

- generate sufficient revenue across a facility's regulated services as a whole that is at least sufficient to meet the efficient long-run costs of providing access to these services, including a return on investment commensurate with these risks involved,
- not be so far above costs as to detract significantly from efficient use of services and investment in related markets,
- encourage multi-part tariffs and allow price discrimination when it aids efficiency, and,
- not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, unless the cost of providing access to other operators is higher.'

ARTC has stated earlier that it sees scope to differentiate between access regimes based on the industry structure and market position of the provider. As part of this differentiation, respective pricing principles could be differentiated (although some commonality would apply where say revenue adequacy would apply). Pricing principles found in an open access regime should be less prescriptive and could allow greater scope for flexibility and entrepreneurialism in pricing to promote growth. The need for cost based pricing, price ceilings, multi-part tariffs and price discrimination may not be quite as great in this regard. On the other hand, the need for all of these (or the limiting of them) would be required in the case of a third party access regime.

ARTC, in its undertaking recently submitted for approval to the ACCC, has proposed a floor/ceiling approach to pricing where pricing will be such that resulting revenue generated will be no less than the incremental cost, and no more than the economic cost, associated with the relevant parts of its network. Floor and ceiling limits are based on efficient long-term operating and maintenance costs as well as, in the case of the ceiling limit, a return on its asset base, commensurate with all risks involved in conducting the business. Given the nature of ARTC's markets, which, by and large, face strong intermodal competition, pricing is further limited by what its markets can afford to pay,

so as to remain competitive. On all parts of ARTC's network, pricing is limited by the market to levels well below cost based ceiling limits. To mitigate against this, ARTC is seeking to grow its markets in order to sustain investment in the network.

ARTC does not support a pricing regime that links prices inextricably to costs. ARTC is presuming from the first two proposed principles (specifically with reference to the coverage of 'long run' costs), that entrepreneurial pricing regimes that are designed to stimulate and promote market growth, but where the provider chooses to take some earlier market risk with the prospect of higher long term returns, is permitted. That is, a pricing regime which may offer pricing initially below efficient cost in order to stimulate market growth then, following growth, extract revenue resulting in higher returns to investors, but so as to cover efficient long run costs (over the life of the investment). Essentially, higher returns are derived from market growth rather than excessive pricing. ARTC supports the use of such growth oriented approaches to pricing, rather than limiting regimes to pricing approaches which are highly prescriptive, wholly cost based and often designed to maintain a provider's market position, possibly impeding wider industry and community benefits.

With respect to the proposed principles, ARTC would like to make the following further points:

- there is some inconsistency in the relationship between prices, revenue and costs. Either pricing generates revenue to be compared with costs or prices are compared with unit costs. The second principle compares prices with costs and should be re-stated so that 'access prices should generate sufficient revenue that is not so far above costs ...'

- ARTC does not support price discrimination insofar that the discrimination is based solely on the identity or ownership of the access seeker. Discrimination in pricing should only be made to the extent that the service provided impacts on the costs or risks faced by the provider. ARTC prefers the terminology price 'differentiation' rather than price 'discrimination, where this is the case.

With regard to the use of revenue ceiling limits as a means to limit prices, ARTC would like to express its concern with the use of so-called 'stand-alone' tests. In particular, it sees a difficulty arising from the use of a 'stand-alone' ceiling limit on revenue where part of the infrastructure carries predominant regulated business as well as a small component of contestable business. An example of this occurs with respect to the Hunter Valley rail network in NSW where the predominant coal business revenue is limited to a stand-alone limit for any particular mine. Sharing the network is other freight and passenger business for which access is priced at a level that enables rail to be competitive, but at a level below marginal cost. A CSO is received from the NSW government to sustain this business.

On the network, it would appear that the coal business, when considered on a stand-alone basis, is not considered to be causing capacity concerns requiring further investment in

the network. In reality, however, the presence of the other businesses mean that future growth in coal business will cause capacity problems. If the access provider were to invest to relieve such problems, it would be unable to extract additional revenue from the coal business without exceeding the stand-alone revenue ceiling because coal on a stand-alone basis would not require the investment, and the respective markets would not allow extraction of additional revenue from the other businesses. There would appear to be no commercial incentive for the owner to invest in the network. It would appear that the cost of any investment in the network could only be recovered via an increased non-commercial investment (CSO) from the government.

Incentive Based Regulation

The Commission has found that greater use of productivity based approaches for setting price caps would be desirable (vis-à-vis using the building block approach to setting price caps). Regulators should give priority to developing the external productivity benchmarks necessary to implement such approaches.

ARTC agrees that the building block approach to setting price caps is information intensive and intrusive and CPI-X incentive regulation determined on this basis is little more than cost of service or rate of return regulation. ARTC would support CPI-X (incentive) where X is determined with reference to external measures of industry and/or economy wide productivity. A significant proportion of ARTC's business is priced at a level that enables rail to compete effectively with road. To maintain this competitiveness, rail productivity improvement must keep pace with that of road. Notwithstanding cost based revenue floor and ceiling limits, ARTC access pricing is not inextricably linked to cost of service. Annual price adjustment of ARTC prices, as detailed in its proposed undertaking before the ACCC, incorporates what it considers to be real ongoing productivity improvements factored into road pricing. It is a commercial matter for ARTC to ensure it that achieves cost productivity to match, or risk reduced profits and shareholder returns. It is unnecessary for the regulator to closely monitor ARTC service levels, as failure to maintain such levels will result in loss of market share and revenue, contrary to ARTC's business charter.

Capital Costs

The Commission has sought a greater understanding of the advantages and disadvantages of the key asset valuation methodologies. In particular, it sought comment on whether, in practice, outcomes under an inflated DAC approach would be significantly different from those under a DORC approach, whether adopting a DAC approach would yield appropriate investment incentives, and whether prudence reviews (by the regulator) would be a cost effective way of addressing concerns about cost padding under a DAC approach.

ARTC is pleased that the Commission has raised these questions in order to compare replacement and historical cost approaches. ARTC favours the use of an optimized

replacement asset valuation methodology over using a historical cost approach as it delivers a market outcome that more closely approximates that which would occur in an open market environment. In particular, the service provider has incentive to only invest in a way that produces an efficient market outcome, as would be the case for a company acting prudently in a competitive marketplace.

With regard to the questions raised by the Commission, ARTC would expect an inflated DAC valuation to be, in many cases, higher than a DORC valuation in practice. This would particularly be the case in an industry with very old, but still functional, assets and may lead to inefficient industry outcomes. Reasons are:

- Simply applying inflation to original asset and installation cost ignores productivity improvements in both the material production costs and installation costs. Simply, today's assets may well be cheaper to produce and install than yesterday's assets in real terms. ARTC would expect that the simple application of inflation to historical cost with respect to an asset would result in a higher value than the current cost of replacing that asset.
- Simply applying inflation to the original cost of existing assets ignores the possibility that the most efficient means of providing a service currently may involve the use of modern assets (which may be cheaper)
- The existing asset base may include excessive assets and non-optimal configurations in today's terms.

If an alternative asset base were set up in competition to the existing asset base, it is likely that the most efficient commercial outcome would be to utilize modern assets, optimally configured and capable of providing a service which meets market needs (in terms of growth and service standards) into the reasonably foreseeable future. An inflated DAC valuation is unlikely to replicate such an outcome.

Whilst it is possible that ongoing prudence reviews by the regulator of the service provider's investment program will reduce the possibility of unnecessary and inefficient investment in the future it does little to address the issue of prior cost padding. Prudence reviews would create an additional cost burden to the industry and may be seen as being unnecessarily intrusive on the reasonable commercial activities of the service provider. Having said this, the need for such a review would depend on the commercial motivation of the provider. Under a third party access regime, such regulatory review would be necessary on the basis of preventing anti-competitive behaviour.

With respect to the optimized replacement cost methodology, ARTC does have some concerns, not so much with the approach itself, but with the way it is being applied in practice. As is consistent with that which might occur in a competitive marketplace, ARTC believes that a valuation should be forward looking, both in terms of the volume requirements of the market into the reasonably foreseeable future, but also in terms of the standard of service required by the market. ARTC believes that many applications of the DORC approach so far tend to focus only on the reasonably forecasted volume growth of

the market. An example of the adverse impact of taking such a narrow interpretation is described below.

Consider the context of an airport operating at a certain level of capacity and at the ceiling revenue limit. Two ways of increasing capacity and service levels would be to develop improved techniques for slot management so that more slots would become available using the existing airport asset, or maintaining current techniques for slot management but investing in more runways to increase capacity. One would consider that the former approach represents a more efficient use of resources, but because the asset value is unaltered, an increase in task would necessitate lower access pricing. In the latter case, access pricing can be maintained with respect to the increased task by virtue of the inclusion of the investment in additional runways. There is no incentive for the operator to use the former approach, as he is unable to increase profit or returns as a result, despite a more efficient operation. The latter approach is a less efficient means to the end, yet is encouraged by the access regime.

Essentially, improved capability and performance is being extracted from assets that have been in place for some time and have previously operated at a lower standard (the engineering capability of the assets has been extended), with the same or higher ongoing maintenance cost. By taking a narrow view of future demand in a DORC valuation, only the existing assets are considered sufficient to meet current demand and growth (despite being previously considered insufficient without capital investment). There is no incentive for the infrastructure operator to seek ways of improving capability and performance of the existing asset base. In fact, if the infrastructure operator can achieve this at a lower cost of maintenance, it can be penalised via a lower access price. On the other hand, investment in the current asset base to achieve the same end is rewarded via an increased valuation, whether or not such an approach is the most efficient means to achieve that end.

To this end, ARTC proposes that the wider view of current and future 'demand' should be taken in assessing the asset requirement to meet existing capacity. Where higher demand with respect to asset capability and service performance has been met through the extending existing engineering capability at no additional operating cost, the asset base for valuation purposes should include the alternative cost of investment that might have been made to achieve the same capability and performance had the existing asset not been 'sweated'.

Administrative and Procedural Matters

Role of Ministers and Transparency Issues

The Commission has proposed that the decision-making role of Ministers should be curtailed and should be the sole responsibility of designated regulatory bodies. If Ministerial decision-making is retained, decisions with respect to declarations and certifications should be subject to a 60 day limit, Ministers should be obliged to publish

reasons for decisions, and the absence of a decision should be deemed as acceptance. Where Ministerial decision-making is not retained, the designated regulator should be required to publish decisions. As described earlier, the Commission has also proposed (Tier 2) that a single regulator, preferably the ACCC, should be assigned the responsibility for regulating all aspects of Part IIIA. Finally, the provisions for appeal against declaration decisions should be abolished (whereas appeals against rejected applications should be retained).

Should all of these proposals be implemented, ARTC would see a single, consistent set of procedures, and a single regulator, with respect to all routes to access. This would be combined with a consistent approach to assessing applications under all three routes to access (as proposed earlier). ARTC sees such an outcome as being paramount to the ultimate success of competition reform in Australia, resulting in improved efficiency in the process and greater certainty and consistency in the outcome. This could only be seen as beneficial to all participants in the process.

Given the modifications to the Ministerial decision making process, and a single regulatory Authority, as proposed, ARTC would not have a problem with retaining Commonwealth Ministerial involvement in all routes to access.

With regard to the proposed appeal rights, ARTC sees the proposal as being somewhat inconsistent and weighted in favour of one side of the argument. Whilst it is understood that the Commission's proposal specifically relates to appeals against a decision to declare services under Part IIIA, ARTC believes that a right of appeal against Part IIIA decisions should be retained in the wider sense. One of the few appeals to date, being the recent appeal by Duke Energy to the Australian Competition Tribunal against a decision to cover the Eastern Gas Pipeline under the National Gas Code, has been upheld. This outcome provides a compelling argument for the retention of appeal rights both on both sides of a Part IIIA decision.

Duration of decisions and fast-tracking of second round regimes

The Commission has sought comment on the value of implementing a fast-tracking arrangement for second round certifications and undertakings.

The duration of any declaration, certification or undertaking decision must balance the need for certainty with respect to industry participants, as well as the need to be sufficiently flexible to move with a changing market environment.

Given that regimes generally provide for some adjustment in the event of a material change to industry circumstances, with regulatory approval, there is no real impediment to allowing a regime to have a duration sufficient to provide the necessary degree of commercial certainty reasonably required by industry participants. The duration of existing regimes would generally have been set by the regulatory authority after having considered the views of all parties, and presumably the outcome represents the consensus of these views. ARTC does not see a problem with what has occurred so far. Having

said this, ARTC would consider a period of ten years, with or without intermediate review opportunities, as a reasonable maximum needed to recognize changing industry needs.

Nevertheless, there is some merit in a process of fast-tracking second round regimes. The Commission has proposed an arrangement where the regulator would have the option to make changes based on the views of all participants at the time. If the regulator decided not to do so, extension for a duration the same as the initial arrangement would be automatic, subject to the facility owner not wishing to make changes. ARTC, however, does not agree that codifying such a process would provide greater certainty to facility owners and access seekers, as suggested by the Commission. The likelihood of regulatory change is no less under a fast-tracking approach than by application by the access provider of a regime (which might be identical to the original regime anyway). ARTC sees greater benefit in the cost effectiveness of the fast-tracking approach.

ARTC interprets the proposed approach as effectively enabling the service provider to have the right to apply for approval of an amended undertaking and, if the service provider did not exercise this right, then the regulator would have the option to do so after considering the views of all participants. Otherwise an automatic extension would apply.

Given that it is usually the service provider that faces the greatest disruption and cost in applying for approval of an access regime, ARTC considers the initial right of the provider to propose change as an important element in the process. This is particularly the case with respect to an open access regime where the service provider may seek to further stimulate the market by introducing more up-to-date and innovative approaches to access provision. In the case of a third party access regime, however, this right could be abused and measures would need to be implemented to ensure that abuse did not occur.

Given that a mechanism for fast tracking would primarily benefit industry by improving the cost effectiveness of regulation, maximum benefits would be achieved where the durations of regimes are shorter. The benefits with regard to longer-term regimes are less, and may be outweighed by the desires of parties to maintain the status quo competitive position. On this basis, ARTC proposes that a fast tracking mechanism should only be made available where the original regime has a duration of less than ten years.

In addition, the regulator should have discretion (after considering the views of all participants) over the duration of the extension, rather than an automatic extension of the same duration as the initial determination as proposed by the Commission, which could reduce flexibility.