



**AUSTRALASIA RAILWAY  
(THIRD PARTY ACCESS)  
CODE: GUIDELINE REVIEW  
DRAFT DECISION**

**May 2008**



## **REQUEST FOR SUBMISSIONS**

The Essential Services Commission of SA (the Commission) invites written submissions from interested parties in relation to matters arising from this paper. Written comments should be provided by **13 June 2008**. It is highly desirable for an electronic copy of the submission to accompany any written submission.

It is Commission policy to make all submissions publicly available via its website ([www.escosa.sa.gov.au](http://www.escosa.sa.gov.au)), except where a submission either wholly or partly contains confidential or commercially sensitive information provided on a confidential basis and appropriate prior notice has been given.

The Commission may also exercise its discretion not to exhibit any submission based on their length or content (for example containing material that is defamatory, offensive or in breach of any law).

Responses to this paper should be directed to:

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### ***Public Information about the Commission's activities***

Information about the role and activities of the Commission, including copies of latest reports and submissions, can be found on the Commission's website at [www.escosa.sa.gov.au](http://www.escosa.sa.gov.au).

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## GLOSSARY OF TERMS

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ABOVE-RAIL OPERATOR	The operator of locomotives, carriages, wagons and the like
THE ACCESS ACT	<i>AustralAsia Railway (Third Party Access) Act 1999 (SA &amp; NT)</i>
ACCESS PROVIDER	A party providing, or able to provide, railway infrastructure services – sometimes referred to as a below-rail operator
ACCESS SEEKER	An Above-Rail Operator seeking access to the Railway
APT	Asia Pacific Transport – the Access Provider for the Railway
ARTC	The Australian Rail Track Corporation Ltd
CIRA	Competition and Infrastructure Reform Agreement
COAG	Council of Australian Governments
THE CODE	The AustralAsia Railway (Third Party Access) Code contained in the Access Act.
THE COMMISSION	Essential Services Commission of South Australia,
DORC	Depreciated Optimised Replacement Cost
EXISTING RAILWAY	The section of the Railway between Tarcoola and Alice Springs
NEW RAILWAY	The section of the Railway constructed between Alice Springs and Darwin
NT	Northern Territory
THE RAILWAY	The AustralAsia Railway to which the Code applies, being the whole of the railway from (a point near) Tarcoola to its end in Darwin (in the Port of Darwin), and so comprising the Existing Railway and the New Railway
RAILWAY INFRASTRUCTURE ASSETS	The infrastructure facilities necessary for the operation or use of the Railway, including railway track, signalling, train control and communications
SA	South Australia



# 1 INTRODUCTION

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In 2006, on behalf of the responsible SA & NT Ministers,<sup>1</sup> the Essential Services Commission (the Commission) conducted a review of the rail access regime set out in the AustralAsia Railway ('Third Party Access') Code ('the Code'), which is itself a Schedule to the *AustralAsia Railway (Third Party Access) Act 1999* (SA & NT) ('the Access Act').

The AustralAsia Railway ('the Railway') runs from Tarcoola to Darwin.

The Code has been certified as an 'effective' State-based access regime in accordance with the principles set out in clauses 6(2)-6(4) of the Competition Principles Agreement.<sup>2</sup>

Clause 5 of the Code appoints the Commission as the regulator under the Code.<sup>3</sup>

While no changes to the Code resulted from the above Ministerial Review, the Commission identified in its report that it would, after that Review, examine the various guidelines it had made under the Code to ensure they remain up-to-date and relevant.<sup>4</sup>

## 1.1 Review process

The Commission is conducting this guidelines review pursuant to clause 45A(1) of the Code, which empowers the Commission, from time to time as it thinks fit, to vary or revoke guidelines developed and published under the Code, or to develop and publish new or substitute guidelines.

When considering the adoption or variation of a guideline, clause 8 of the Code requires the Commission to undertake a public consultation process.

An Issues Paper published in November 2007 commenced the review.

The Issues Paper highlighted three particular issues for consideration, namely:

- ▲ in relation to Guideline No. 1: the merits of the current approach to reference prices and whether more detailed direction is required;
- ▲ in relation to Guideline No. 2 (and 3): whether any asset roll forward should be adopted, and if so what form it should take; and
- ▲ in relation to the guidelines generally: the degree of alignment with ARTC's access undertaking<sup>5</sup> and the implications of the COAG Competition and Infrastructure Reform Agreement (CIRA) for the guidelines.<sup>6</sup>

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<sup>1</sup> The relevant Ministers are: in South Australia, the Minister for Transport and, in the Northern Territory, the Minister for the AustralAsia Railway.

<sup>2</sup> The Competition Principles Agreement is one of the agreements comprising the National Competition Policy. It can be accessed via [www.ncc.gov.au/publication.asp?publicationID=99&activityID=39](http://www.ncc.gov.au/publication.asp?publicationID=99&activityID=39).

<sup>3</sup> Note that Clause 5 actually nominates the South Australian Independent Industry Regulator (SAIRR), which is the Commission's predecessor. Schedule 2 of the *Essential Services Commission Act 2002* provides the appropriate succession arrangements.

<sup>4</sup> The report: *Ministerial Review of the AustralAsia Railway (Third Party Access) Code: Final Report, May 2006*, is available at: [www.escosa.sa.gov.au/site/page.cfm?u=128&c=1657](http://www.escosa.sa.gov.au/site/page.cfm?u=128&c=1657).



2.4. Submissions were received from:

- ▲ Asia Pacific Transport Pty Ltd (APT), the track operator;
- ▲ Australian Rail Track Corporation Ltd (ARTC); and
- ▲ a downstream transport operator who requested its submission be treated as confidential.

## **1.2 Next steps**

This Paper represents the Commission's Draft Decision on whether or not it should vary the guidelines initially developed and published under the Code. It includes proposed amendments to the guidelines.

The Commission will consider all comments received on this Draft Decision, and prepare a Final Decision by July 2008.

The Commission also intends, at the completion of this review, to incorporate the resulting guidelines into a single Information Kit to provide ready access to the full suite of regulatory materials under the Code.<sup>7</sup>

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<sup>5</sup> The ARTC Access Undertaking is available on the ARTC website at [www.artc.com.au](http://www.artc.com.au).

<sup>6</sup> The CIRA is available on the COAG website at [http://www.coag.gov.au/meetings/100206/attachments\\_a-h.pdf](http://www.coag.gov.au/meetings/100206/attachments_a-h.pdf).

<sup>7</sup> The Commission has already adopted this approach in its capacity as regulator under the South Australian Rail Access Regime, refer: [www.escosa.sa.gov.au/webdata/resources/files/061006-D-SARailInfoKit.pdf](http://www.escosa.sa.gov.au/webdata/resources/files/061006-D-SARailInfoKit.pdf).

## **2 BACKGROUND TO THE GUIDELINES**

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### **2.1 The Railway**

The Railway comprises both the recently constructed line from Alice Springs to Darwin (the 'New Railway') and the pre-existing line between Alice Springs and Tarcoola (the 'Existing Railway').

The date of commencement of operations on the New Railway was 15 January 2004.

Asia Pacific Transport (APT) is the track operator and hence is the access provider for the Railway.

APT presently has the benefit of concessional rights to operate the Railway, under the AustralAsia Railway Project Concession Deed between APT, the AustralAsia Railway Corporation (AARC) and the SA and NT Governments. Broadly, the Concession Deed provides for the grant to APT of the concession to build, operate and then transfer back to the AARC the Railway after 50 years, being the period of the concession.

Freight Link Pty Ltd (FreightLink) is the main above-rail operator on the Railway and is a related body corporate of APT.<sup>8</sup>

Commercial operations are now into the 4th year of the 50 year concession period. Since commencement:

- ▲ around 90% of general freight business between Adelaide and Darwin has switched from road to rail transport;
- ▲ three major bulk minerals haulage access agreements have been settled for the transport of materials north to the Port of Darwin; and
- ▲ access agreements covering passenger services have also been settled, most notably involving Great Southern Railway Ltd, operator of The Ghan passenger service between Adelaide and Darwin.

To date, there have been no access disputes.

### **2.2 The Code**

#### **2.2.1 Code objectives**

Neither the Code, nor the Access Act, contain objectives or an objects clause. However, being an effective access regime suggests that the objectives of the Code are aligned with those underlying clause 6 of the Competition Principles Agreement. In essence, the clause 6 principles:

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<sup>8</sup> In essence, both FreightLink and APT are part of the same joint venture and come under a single organisational umbrella.

- ▲ identify the type of infrastructure services that should be subject to access regulation; and
- ▲ establish principles that the regulatory framework should embody.

The National Competition Council has described the overall goals of access regulation in the following terms:<sup>9</sup>

*The application of an efficiency objective in access regulation has the following three broad components:*

- *first, ensuring the efficient use of natural monopoly infrastructure, especially by denying infrastructure owners the opportunity to misuse market power (in either the market for these services or in related markets) by refusing access to, and monopoly pricing of, infrastructure services;*
- *second, facilitating efficient investment in natural monopoly infrastructure, especially by ensuring:*
  - *infrastructure services are maintained and developed appropriately;*
  - *infrastructure owners (and potential owners) earn sufficient returns to provide incentives for efficient investment; and*
  - *incentives for inefficient development of competitive infrastructure and for inefficient investment in upstream and downstream activities (that is, overinvestment and underinvestment) are minimised; and*
- *third, promoting competition in activities that rely on the use of the infrastructure service where competitive infrastructure services are not economically feasible.*

## 2.2.2 Key features of the Code

The Code unbundles railway services (both freight and passengers) into:

- ▲ below-rail services (relating to the provision of track and associated infrastructure); and
- ▲ above-rail services (running rolling stock, or trains, on the below-rail infrastructure).

The Code regulates the provision of below-rail services only. It establishes a right for above-rail operators to negotiate access to the below-rail services of the Railway.

The Code sets out the rights and responsibilities of above-rail operators (access seekers) and the access provider (APT), and covers matters such as the negotiation process, dispute resolution, and the terms and conditions of access.

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<sup>9</sup> National Competition Council, *The National Access Regime: A Guide to Part IIIA of the Trade Practices Act*, Part C Certification of Access Regimes, February 2003 p.11 – available at [www.ncc.gov.au/pdf/DEGeGu-003a.pdf](http://www.ncc.gov.au/pdf/DEGeGu-003a.pdf).

The Code establishes a right to negotiate access to the Railway. The Code follows a negotiate/arbitrate model, where parties first attempt to agree on an access arrangement, with dispute resolution processes available if necessary.

This negotiate/arbitrate access regime was put together as part of the broader railway project and reflects its nature and distinguishing characteristics, such as:

- ▲ The existing transport companies that provided freight services over the same route as the Railway (or between the same destinations) are in competition with rail freight.
- ▲ On the transport corridor between Alice Springs and Darwin, rail is the new entrant. Since rail is the new mode competing with incumbent road, sea and air operators, any advantages of incumbency that exist in the freight market lie with these other modes.
- ▲ The 'greenfields' nature of the rail project sees the owners and operators of the Railway bearing substantial demand risk, as the Railway needs to win demand from alternative and incumbent modes of transport, such as sea, road and air. As a result, the Railway starts with little revenue or profit in the early years, and may only make a profit after many years of operation. This position is different to other utilities and even other rail infrastructure built to serve an established market.
- ▲ The railway is owned and operated by the private sector on a Build, Own, Operate and Transfer (BOOT) basis. The concession period expires 50 years after construction.
- ▲ Three Governments have also contributed to making the Railway financially viable. Government support for the project has been principally provided in the form of asset contributions. The Governments do not require a return on the capital invested in these contributed assets at any time during the concession period. They do, however, require the contributed assets to be returned to them at the end of the concession period along with the transfer of all project-funded assets.

Enforceable dispute resolution processes back access negotiations. The arrangements in the Code recognise that some issues may be small or time sensitive so that above-rail operators may not take them to arbitration, given the time and costs it involves. Without a less costly means of dispute resolution, many small or time sensitive disputes could go unresolved. This could discourage access.

The Code provides several levels of dispute resolution including:

- ▲ advice provided by the regulator on whether a negotiated outcome is consistent with the Code;
- ▲ voluntary conciliation by the regulator; and

- ▲ full arbitration.

The Code includes a Pricing Schedule which provides considerable direction for access pricing in different circumstances.

All prices for access are to be struck within a floor/ceiling band, set in accordance with efficient, forward looking costs. Where competition from non-rail freight is sufficient to discipline rail operators to minimise their costs and prices, the Code's "sustainable competitive" approach uses the price of the competitive non-rail freight as the starting point for calculating the rail access price between the floor/ceiling band. This ensures that access prices are based on competitive principles.

The Code also recognises the importance of service quality, time-path allocation and reallocation policies and day-to-day train management. The access provider must develop policies on how it will manage these issues. These policies are to be consistent with guidelines developed by the regulator.

## **2.3 The Guidelines**

Key features of the Commission's role as the regulator under the Code are:

- ▲ facilitating access negotiations and (with consent of the parties) settling access disputes;<sup>10</sup>
- ▲ monitoring and enforcing compliance with the Code as well as periodically conducting, or assisting with, reviews; and
- ▲ the development and maintenance of various guidelines, including:
  - arbitrator pricing requirements;
  - access provider reference prices and service policies; and
  - access provider information reporting requirements;

The Commission has issued the following guidelines:<sup>11</sup>

- ▲ Railway Industry (Tarcoola-Darwin) Guideline No. 1: Access Provider Reference Pricing and Service Policies;
- ▲ Railway Industry (Tarcoola-Darwin) Guideline No. 2: Arbitrator Pricing Requirements (incorporating the Commission's regulated rate of return determination);
- ▲ Railway Industry (Tarcoola-Darwin) Guideline No. 3: Regulatory Information Requirements; and
- ▲ Railway Industry (Tarcoola-Darwin) Guideline No. 4: Compliance Systems and Reporting.

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<sup>10</sup> In the event of an access dispute, the Commission is to appoint an arbitrator, who will be called upon to "set" prices through the arbitration process. Note that the Commission itself will not be the arbitrator – the Code keeps separate the role of regulator and arbitrator.

<sup>11</sup> Each guideline is available from the Commission's website: [www.escosa.sa.gov.au/site/page.cfm?u=126](http://www.escosa.sa.gov.au/site/page.cfm?u=126).

### 2.3.1 Guideline No. 1

Clause 9(1) of the Code obliges the access provider to provide, on application of any person, information reasonably requested by the person about:

*“(a) the extent to which the Access Provider’s Railway Infrastructure Assets are currently being used;*

*(b) technical details and requirements of the Access Provider, such as axle load data, clearance and running speeds;*

*(c) time-path allocation and reallocation policies for the Railway;*

*(d) service quality and train management standards; and*

*(e) relevant prices and costs associated with railway infrastructure services provided by the Access Provider, prepared by the Access Provider for reference purposes in accordance with guidelines developed and published by the Commission.”*

Clause 9(3) provides that the access provider must, for the purposes of clauses 9(1)(c) and (d), develop and maintain time-path allocation and reallocation policies and service quality and train management standards in accordance with principles contained in guidelines developed and published by the Commission.

Guideline No. 1 is published by the Commission to fulfil the requirements for guidelines in both clauses 9(1)(e) and 9(3). It sets out requirements for reference pricing, train-path policy, train control and service quality.

The distinguishing feature of Guideline No. 1 is that it provides guidance to the access provider (APT).

### 2.3.2 Guideline No. 2

In the event of an access dispute, the Code requires an arbitrator – appointed by the Commission – to determine an access price payable to the access provider by an access seeker for a railway infrastructure service.

At various points in the Pricing Schedule to the Code, an arbitrator is obliged to apply particular principles and methods in accordance with guidelines developed and published by the Commission.

When developing such guidelines, the Pricing Schedule also empowers the Commission to include provisions that the Commission considers appropriate in addition to those specifically nominated in the Pricing Schedule.

Guideline No. 2 is published by the Commission to fulfil the guidelines requirements of the Pricing Schedule. It sets out requirements for ceiling pricing, floor pricing, arbitrated pricing (both with and without sustainable competitive prices) and rate of return parameters.

The distinguishing feature of Guideline No. 2 is that it involves guidance directed at any arbitrator appointed by the Commission in the event of an access dispute.

### 2.3.3 Guideline No. 3

At various points in the Code an access provider is obliged to keep and/or report certain information to the regulator or an arbitrator in the furtherance of their functions under the Code, including:

- ▲ clause 15(1) where the Commission, and an arbitrator, would apply the Code's pricing principles for the purposes respectively of undertaking conciliations and arbitrations;
- ▲ clause 39(1) where an Access Provider responds to requests for information issued by the Commission;
- ▲ clause 46 where an Access Provider must keep separate accounts and records, including in compliance with any guidelines issued; and
- ▲ clause 50(4) in relation to the Commission undertaking revenue reviews.

Any information sought by the regulator is done so pursuant to clause 39 of the Code. Information so collected is then protected by the confidentiality provisions of clause 40 of the Code.

Guideline No. 3 sets out the regular reporting requirements of the Commission in relation to regulatory accounts, detailed cost information, usage information and various related requirements.

### 2.3.4 Guideline No. 4

Clause 6 of the Code assigns to the Commission the function "to monitor and enforce compliance" with the Code. This compliance function is common to most of the Commission's regulatory roles (although it may be stated differently for different industries).

Guideline No. 4 sets out a process for the reporting of compliance by an access provider in a way that meets the Commission's requirements and demonstrates that appropriate compliance systems are in place. Taking this approach reduces the need for exhaustive testing and investigation by the Commission of compliance systems by providing an appropriate level of assurance and reporting of compliance issues. This allows the Commission to fulfil its clause 6 obligation while maintaining a relatively light handed approach to the Code.

Notwithstanding this approach, the Commission considers effective compliance systems, and the associated assurance, as being an important part of its regulatory responsibilities. This is particularly so for an access regime such as that in the Code, where compliance problems may remain otherwise undiscovered until a dispute arises, causing an effective failure of the regime.

## 3 ASSET ROLL FORWARD

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### 3.1 Background

The Pricing Schedule to the Code states that, for both ceiling price (section 2(7)) and floor price (section 3(4)) purposes:

*The guidelines must—*

- (a) ...adopt an approach for valuing capital assets which reflects the Depreciated Optimised Replacement Cost [DORC] of those assets; ...

Regarding the DORC value of the railway infrastructure assets calculated for ceiling price purposes ('value of the Railway'), section 2 of Guideline No. 2 provides that it:

*... is to be established and/or verified by an experienced and independent valuer using valuation principles and methodologies consistent with the principles and methodologies applied in the independent valuation of ARTC's Interstate Network assets approved by the ACCC.*

The value of the Railway is the value of all associated railway infrastructure assets – whether funds invested by APT or contributed by governments. This is because the ceiling price reflects the stand alone, or bypass, cost of the Railway.

On 4 April 2005, in accordance with section 2 of Guideline No. 2, the Commission finalised its acceptance of the value of the Railway as at the date of commencement of operations. The valuation was prepared by Booz Allen Hamilton for the railway operator APT in line with directions from the Commission. In accordance with the Code (and Guideline No. 2), the valuation is based on the DORC methodology.

The value of the Railway as at 15 January 2004 was \$1,696.9 million (in dollars of 1 July 2003).<sup>12</sup>

Section 5 of Guideline No. 2 also sets out the asset valuation to be used for arbitrated prices where there is no sustainable competitive price. For this purpose, the relevant value is the value of the capital invested in railway infrastructure assets by the access provider, being the value of the Railway less the value of government-contributed assets and other government financial assistance.

The value of the capital invested in railway infrastructure assets by the access provider required under section 5 of Guideline No. 2 ('value of the Capital Invested') as at the date of commencement of operations was not directly determined at the time that the value of the Railway was determined.

Guideline No. 2 is also silent on how either the value of the Railway or the value of the Capital Invested is to be updated over time.

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<sup>12</sup> This valuation comprised of a value of the New Railway of \$1,159.1 million (in dollars of 1 July 2003) and a value of the Existing Railway of \$537.8 million (in dollars of 1 July 2003).

In the Issues Paper, the Commission invited comment on the asset value roll forward methodology that could be applied.

### **3.2 Views in submissions**

In its submission, APT indicated that it:

- (a) *supports the proposition that a new DORC valuation could be required over time*
- (b) *considers that a new DORC valuation will become necessary over time, in order to accurately reflect the future value of Railway assets, taking into account relevant factors affecting use of the Railway assets subsequent to the January 2004 DORC valuation;*
- (c) *agrees with ESCOSA's observation that there is merit in adding roll forward provisions to Guideline No. 2, provided however that any such variation does not adversely impact APT's ability to achieve a positive (or an appropriate) return on investment over the 50 year concession period under the Concession Deed;*
- (d) *notes ESCOSA's observation that roll forward provisions involve adjustments over time for depreciation, additions, disposals and, inflation, and is supportive of Guideline No. 2 being varied in conjunction with those principles; and*
- (e) *considers that the objective of any amendment to Guideline No. 2 to incorporate roll forward provisions should be such that the application of the DORC valuation methodology at any point in time:*
  - (i) *is based on updated data that determines an accurate value of Railway infrastructure assets at the relevant time;*
  - (ii) *takes into account all relevant factors affecting the use of the Railway assets subsequent to any previous DORC valuation;*
  - (iii) *is not based upon outdated data that may have a resulting (inaccurate) impact on ceiling pricing calculations under the Code;*
  - (iv) *does not result in an artificially lowered ceiling price (upon application of the arbitration processes under the Code); and*
  - (v) *does not inequitably impact upon the access provider's ability to achieve a positive (or an appropriate) return on investment during the concession period currently in place for the operation of the Railway.*

In its submission, ARTC indicated that it:

*... supports the use of DORC as the method for valuation assets under the Code. This is consistent with most other rail regimes in Australia.*

*In relation to the notion of asset roll-forward, ARTC 2002 Access Undertaking contemplated a roll forward of the regulatory asset base (by the application of CPI and depreciation) between regulatory resets. ARTC took this approach on the basis that the 2002 Access Undertaking also provided for ARTC's relevant assets to be re-valued every five years. This approach was endorsed in the circumstances by the ACCC at the time.*

### 3.3 Commission's analysis

#### 3.3.1 Commencing value of the Railway

Section 2 of Guideline No 2 presently establishes the process for placing a DORC value on the railway infrastructure assets calculated for ceiling price purposes ('value of the Railway'), namely that:

*The DORC value of the Railway Infrastructure Assets calculated for Ceiling Price purposes is to be established and/or verified by an experienced and independent valuer using valuation principles and methodologies consistent with the principles and methodologies applied in the independent valuation of ARTC's Interstate Network assets approved by the ACCC. (section 2)*

Since the guideline was made, the Commission has approved the value of the Railway as at the date of commencement of operations of the Railway prepared in accordance with section 2 of Guideline No. 2.

The Commission proposes to insert this commencing value of the Railway into a varied Guideline No. 2.

#### 3.3.2 Value of capital employed

The Commission acknowledges that the value of the Capital Invested in railway infrastructure assets by the access provider required under section 5 of Guideline No. 2 ('value of the Capital Invested') as at the date of commencement of operations was not directly determined at the time that the value of the Railway was determined for the purpose of section 2 of Guideline No. 2.

The relevant value is the value of the Railway less the value of government-contributed assets and other government financial assistance.

While information is available to calculate this value of Capital Invested as at the date of commencement of operations (15 January 2004), the Commission considers that it is appropriate to include the resultant value in section 5 of Guideline No. 2.

The government contribution of the Existing Railway is specified in the Concession Deed. Rather than being gifted outright, this government asset contribution is in the form of a highly concessional, long-term leasing arrangement.

The Government Works Agreement provides for the government-funded construction of certain components of the New Railway.<sup>13</sup> These then form part of the concession granted to APT. The government improvements are, in essence, those parts of the New Railway paid for by government financial assistance. Under the Government Works Agreement, the government improvements have a total

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<sup>13</sup> Examples of the government improvements include: site preparation for construction of the new railway, earth retaining structures and culverts, bridges, access roads, signalling, and yards and freight handling facilities at Berrimah, Katherine and Tennant Creek.

agreed value of \$427.5 million (in dollars of 1 July 2003). The individual contributions are detailed below:

\$ Millions	TOTAL
Commonwealth Government	165.0
Northern Territory Government	137.5
South Australian Government	125.0
<b>TOTAL</b>	<b>427.5</b>

As the value of New Railway as at the commencement of operations (15 January 2004) was determined as \$1,159.1 million in 1 July 2003 prices, the total agreed value of government improvements to that New Railway of \$427.5 million represents 36.882% of the value of the New Railway.

Hence, the Commission proposes that the value of the capital invested in railway infrastructure assets by the access provider for the purposes of section 5 of Guideline No. 2 be:

- ▲ the value of the Railway for the purposes of section 2 of Guideline No. 2 (\$1,696.9 million in 1 July 2003 prices)
- ▲ less the value of the Existing Railway (\$537.8 million in 1 July 2003 prices)
- ▲ less the government-funded proportion (36.882%) of the value of the New Railway (\$1,159.1 million in 1 July 2003 prices).

The Commission proposes to insert this basis for measuring the commencing value of the Capital Invested into a varied Guideline No. 2.

Applying this formula as at the date of the commencement of operations (15 January 2004), the commencing value of Capital Invested for the purposes of section 5 of Guideline No. 2 is \$731.6 million (in 1 July 2003 prices).

The Commission proposes to insert this commencing value of the Capital Invested into a varied Guideline No. 2.

### 3.3.3 Annually updating asset values

Even after both the commencing value of the Railway and the commencing value of the Capital Invested are inserted into Guideline No. 2, at present that guideline is silent on how these valuations as at the commencement of operations (on 15 January 2004) are to be updated over time. There is no provision for an updating or roll forward of those values other than, by inference, by a revaluation process based upon the DORC concept as applied by an experienced and independent valuer using valuation principles and methodologies consistent with the principles and methodologies applied in the independent valuation of ARTC's Interstate Network assets approved by the ACCC.

The Commission acknowledges that more explicit updating or roll forward provisions would be useful to all parties.

The Code (section 2(7)(a) of the Pricing Principles Schedule) requires the Commission's arbitrated pricing guidelines to adopt an approach for valuing capital assets which "reflects" the DORC valuation of those assets.

The Commission has implemented this requirement by requiring the *initial* capital cost of the Railway – i.e., as at the date of commencement of construction of the New Railway – to be a DORC valuation. This emphasis on the *initial* capital cost of the Railway derives directly from the requirement of clause 21(b) of the Code that among the matters that an arbitrator is to take into account is the "the initial capital cost of the railway infrastructure facilities". It is also consistent with the emphasis at various points in the Code on circumstances prevailing as at the date of commencement of construction of the Railway, most notably the expected risks at that time.

This initial valuation of the Railway could be updated by either of two approaches:

- ▲ further DORC revaluations; or
- ▲ an annual roll-forward.

These two approaches would give identical results only in certain circumstances, namely:

- ▲ in the absence of any 'optimisation' (with optimisation usually providing scope to lower asset values but rarely to increase them);
- ▲ if remaining asset life assumptions are identical (with DORC revaluations often reopening the remaining life issue); and
- ▲ if asset price inflation on average over time equals general inflation (as measured by the consumer price index).

The optimisation process is a feature peculiar to the DORC valuation approach. (A roll-forward approach would only come close to mimicking a DORC valuation were it to include a "redundant asset" provision.) Dispensing with an optimisation process, as evident under a roll-forward approach without a redundant asset provision, has two main sets of attractions from a regulatory perspective:

- ▲ it is simpler and less costly (with DORC values being highly subjective and non-transparent); and
- ▲ it provides greater certainty all round (with optimisation increasing risks to investors, and a roll-forward approach effectively lowering such risks).

The DORC approach therefore creates considerable additional costs and uncertainty for the access provider and access seekers alike. By contrast, once the initial asset value is set, that value is set forever under the roll-forward approach, and there is no further reopening of that value. Updating asset values to reflect new capital invested and the return of funds to investors (regulatory depreciation)

provides greater certainty that investments made in the Railway will be recovered, and thus provides further incentive for investment. Likewise, from the perspective of participants in upstream or downstream activities, precluding the initial asset value from being reopened constrains the access provider from exploiting possible windfall gains over time at the expense of upstream and downstream development.

In this latter regard, the Commission's 'rate of return' determinations underpinning the regulated rates of return in section 6 of Guideline No. 2 allow for possible upsides in returns so as to ensure that the access provider is not prevented from earning a reasonable risk-adjusted return on capital invested in the Railway. It is noteworthy that the manner in which these regulated rates of return have been determined by the Commission forestalls any need for the potential for windfall gains to also be included in the asset valuation. As a result, the real capital gains component of the return on capital invested in the Railway only requires the initial amount of capital invested in the Railway to be escalated annually in line with actual inflation. In fact, any windfall gains that might be derived from DORC revaluations would in effect involve an element of economic rent to investors in the Railway.

The Commission therefore considers the DORC valuation of the Railway as at the date of commencement of operations to substantially meet the Code's requirement that asset values "reflect" the DORC valuation of those assets. Thereafter, this initial valuation of the Railway is best updated using the roll-forward approach.

In general, roll-forward arrangements involve adjustments over time for depreciation, additions, disposals and inflation.

The main point at issue in any roll forward relates to additions to Railway Infrastructure Assets.

First, any additions to the Railway must be consistent with the coverage of the Code.

Secondly, the value of the asset acquired or constructed must not have been otherwise recovered (for example by capital contributions and donations).

Finally, given:

- ▲ the greenfields nature of the Railway; and
- ▲ the existence of intermodal competition,

the Commission does not consider it appropriate to subject the actual amount of capital expenditure to any tests of efficiency or prudence. This is also consistent with latest regulatory practice.

Adding the requirement for the roll-forward approach to Guideline No. 2 will also require complementary variations to Guideline No. 3.

### 3.4 Proposed guideline amendments

Accordingly, the Commission proposes the following variations to Guideline No. 2 (and to make the consequential changes to Guideline No. 3).

The following words in “Section 2: Ceiling Price” of Guideline No. 2 are to be deleted:

*The DORC value of the Railway Infrastructure Assets calculated for Ceiling Price purposes is to be established and/or verified by an experienced and independent valuer using valuation principles and methodologies consistent with the principles and methodologies applied in the independent valuation of ARTC’s Interstate Network assets approved by the ACCC.*

and the following replacement words inserted:

**Value of the Railway as at the commencement of operations**

*The value of the Railway Infrastructure Assets calculated for Ceiling Price purposes (‘value of the Railway’) as at the commencement of operations (15 January 2004) is \$1,696.9 million (in dollars of 1 July 2003).*

**Establishment of the opening value of the Railway for each of the second and subsequent years**

*This sub-section applies to the establishment of the value of the Railway as at the beginning of one year on the roll forward of the value of the Railway to that year from the immediately preceding year.*

*“Year” means a 12 month period commencing 1 July, except for the 12 month period including the date of commencement of operations where the year is taken to be just the period of days and months from the date of commencement of operations through to the following 30 June.*

*The roll forward model for the purposes of this sub-section is as follows:*

*The value of the Railway as at the beginning of the second or a subsequent year (‘the later year’) must be calculated by adjusting the value (‘the previous value’) of the value of the Railway as at the beginning of the immediately preceding year (‘the previous year’) as follows:*

*(1) the previous value of the Railway must be increased by the actual amount of allowed capital expenditure on Railway Infrastructure Assets for the previous year, where allowed capital expenditure on Railway Infrastructure Assets is restricted to:*

- (a) any actual additions to the Railway that are consistent with the coverage of the Code, and*
- (b) the actual value of assets acquired or constructed that have not been otherwise recovered;*

*(2) the previous value of the Railway must be reduced by the actual amount of the annual regulatory depreciation on Railway Infrastructure Assets for the previous year (with “annual regulatory depreciation” being as recorded in the Regulatory Accounts consistent with the requirements of Guideline No. 3);*

*(3) the previous value of the Railway must be reduced by the actual disposal value of any asset included in that value where the asset was disposed of during the previous year; and*

*(4) the previous value of the Railway must be increased by an amount necessary to maintain the real value of the Railway as at the beginning of the later year by adjusting that value for the actual inflation rate (based on the consumer price index) during the previous year.*

The following words in “Section 5: Arbitrated Price where there is No Sustainable Competitive Price” of Guideline No. 2 are to be deleted:

*In an arbitration where there is no sustainable competitive price, and so where a reasonable price between the Floor Price and the Ceiling Price is to be based on the costs of providing a Service:*

*(a) the return ‘on’ and ‘of’ capital components of such costs are to be based on the capital invested in Railway Infrastructure Assets by the Access Provider, such that the DORC value of the Railway Infrastructure Assets is adjusted to exclude the value of the government-contributed assets but not the government-sourced project funding (the concessional loan facility and the Governments’ commercial investments); and*

*(b) the reasonable rate of return is to be calculated in accordance with the applicable rate in the Regulated Rates of Return section of this Guideline (section 6).*

and the following replacement words inserted:

*In an arbitration where there is no sustainable competitive price, and so where a reasonable price between the Floor Price and the Ceiling Price is to be based on the costs of providing a Service:*

*(a) the return ‘on’ and ‘of’ capital components of such costs are to be based on the value of the capital invested in Railway Infrastructure Assets by the Access Provider (‘value of the Capital Invested’); and*

*(b) the reasonable rate of return is to be calculated in accordance with the applicable rate in the Regulated Rates of Return section of this Guideline (section 6).*

*where*

*“the value of the Capital Invested” for the purposes of this section means the value of the Railway (as defined in section 2) less the value of government contributed assets and other government financial assistance, where “government contributed assets and other government financial assistance” means the sum of the value of:*

- the Existing Railway; and*
- the government-funded construction of certain parts of the New Railway.*

**Value of the Capital Invested as at the commencement of operations**

*The value of the Capital Invested for the purposes of this section as at the commencement of operations (15 January 2004) is \$731.6 million (in dollars of 1 July 2003), being comprised of:*

- the value of the Railway as defined in Section 2 (\$1,696.9 million in dollars of 1 July 2003)*
- less the value of the Existing Railway (\$537.8 million in dollars of 1 July 2003); and*
- less the value of the government-funded construction of certain parts of the New Railway (\$427.5 million in dollars of 1 July 2003).*

**Establishment of the value of the Capital Invested for each of the second and subsequent years**

*This sub-section applies to the establishment of the value of the Capital Invested as at the beginning of one year on the roll forward of the value of the Capital Invested to that year from the immediately preceding year.*

*“Year” means a 12 month period commencing 1 July, except for the 12 month period including the date of commencement of operations where the year is taken to be just the period of days and months from the date of commencement of operations through to the following 30 June .*

*The roll forward model for the purposes of this sub-section is as follows:*

*The value of the Capital Invested as at the beginning of the second or a subsequent year (‘the later year’) must be calculated by adjusting the value (‘the previous value’) of the Capital Invested as at the beginning of the immediately preceding year (‘the previous year’) as follows:*

*(1) the previous value of the Capital Invested must be increased by the actual amount of allowed capital expenditure on Railway Infrastructure Assets for the previous year, where allowed capital expenditure on Railway Infrastructure Assets is restricted to:*

*(a) any actual additions to the Railway that are consistent with the coverage of the Code, and*

*(b) the actual value of assets acquired or constructed that have not been otherwise recovered:*

*(2) the previous value of the Capital Invested must be reduced by the actual amount of annual regulatory depreciation directly attributable to the assets financed by the Capital Invested in railway infrastructure assets by the access provider for the previous year (with the total of such “annual regulatory depreciation” being as recorded in the Regulatory Accounts consistent with the requirements of Guideline No. 3);*

*(3) the previous value of the Capital Invested must be reduced by the actual disposal value of any asset included in the value of the Railway where the asset was disposed of during the previous year; and*

*(4) the previous value of the Capital Invested must be increased by an amount necessary to maintain the real value of the Capital Invested as at the beginning of the later year by adjusting that value for the actual inflation rate (based on the consumer price index) during the previous year.*



## 4 REFERENCE PRICES

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### 4.1 Background

Clause 9(1)(e) of the Code does not oblige APT as the access provider to publish reference prices, for example by publication on a clearly identified and publicly accessible page of the access provider's website.

The Code only requires the access provider to provide such prices on request.

Guideline No. 1 addresses the process involved in the request and provision of such prices. The access seeker is required to put its request for reference prices in writing, to be accompanied by the general information necessary for this purpose as published by the access provider.

While Guideline No. 1 is currently limited to matters of procedure, in developing the guideline the Commission acknowledged that it could provide guidance also on such matters as:

- ▲ the purpose to be served by reference prices (and the appropriate balance between the legitimate business interest of the access provider, the interest of the public and the interests of the access applicant);
- ▲ the nature of a standard service for reference pricing purposes;
- ▲ the appropriate structure of reference prices – and the extent to which reference prices could comprise a variable component, which is a function of distance and gross mass (\$/gtkm); and a flagfall component, which is fixed and specific to each service type and segment (\$/km);
- ▲ the rail sectors/segments to be used for pricing purposes; and
- ▲ the appropriate method for allocating non-segment specific costs to segments.

The Commission did not however pursue this broader approach on the basis that to do so might introduce some inflexibility into pricing negotiation. The Commission was particularly influenced, given the role played under the Code by the competitive imputation pricing rule, by the role to be played by market-based – as opposed to cost-based – pricing. Under competitive imputation, pricing can be expected to vary more markedly than under a cost-based approach. In such circumstances, the Commission considered that published reference prices might inadvertently hamper implementation of the competitive imputation pricing rule.

However, recent developments with the Railway have seen a focus on bulk traffic (e.g. minerals), which are less likely to trigger the competitive imputation approach to pricing (because there are less likely to be sustainable competitive modes for such traffic). A number of further bulk minerals haulage opportunities are also in prospect, as a result of

further mineral deposits being developed (or evaluated) in proximity to the Railway under the present mineral resources and commodity prices 'boom'.

In the Issues Paper, the Commission invited comment on the merits of its current approach to reference prices and whether or not more detailed direction is required.

## **4.2 Views in submissions**

Submissions from ARTC and a downstream transport operator both focussed on what is perceived as a lack of transparency in APT's (reference) pricing.

ARTC publishes indicative access charges for all its major track sections, and proposes to continue this in its 2007 Interstate Access Undertaking:

*... Indicative Access Charges relate primarily to intermodal type services on the ARTC network operated at a maximum of 21t axle load and maximum 110kph. The markets served by these types of services experience the most intermodal competition, and Indicative Access Charges are market (not cost) based. ARTC also commits to publish on its website Indicative Access Charges and any other charges for non-indicative services. To date there are charges for 4-5 different types of services published by ARTC.*

*ARTC has chosen to publish pricing as it believes greater pricing transparency and certainty, and resulting equity, help to stimulate market confidence, competition and growth. ARTC is, in no way, inhibited from differentiating pricing through negotiation for other types of services (and different access terms and conditions), and does not believe that its ability to negotiate differential pricing is constrained. It is unclear as to why an access provider would wish to negotiate a price that is differentiated from a published price for the same type of service in the same market, where the terms and conditions of access are substantially the same, unless it was seeking to discriminate based on the identity of the Access Seeker; a practice that is normally prohibited.*

*ARTC pricing is generally two-part, although ARTC may agree alternatives with an Access Seeker. ARTC does not believe that the structure necessarily needs to be prescribed, except where there is potential that the pricing structure can be used to discriminate between users.*

*ARTC's views largely revolve around the publishing of pricing, as opposed to the regulatory approval of prescribed reference pricing as may also be being suggested by the Commission.*

The downstream transport operator expressed particular concern with an aspect of APT's access pricing, namely the effective access price for sections of track between Tarcoola and Alice Springs in particular – being the sections where substantial increases in the bulk cargo traffic (predominantly associated with the mining industry) are focused – apparently being differentiated depending on whether the traffic involved is northbound or southbound.

APT rejected the case for changing the level of existing regulation regarding reference pricing at this stage:

- (a) *APT is not supportive of any proposal to vary the existing reference pricing model to increase levels of regulation or to make provision for more detailed direction regarding reference pricing disclosures under Guideline No. 1.*

- (b) *APT does not consider there are compelling reasons, at this point in time, to change the level of existing regulation regarding reference pricing.*
- (c) *APT does not consider that ESCOSA's original modelling underlying the current reference pricing requirements have been superseded by the emergence of bulk minerals freight on the Railway.*
- (d) *APT does not agree with the proposition that bulk minerals traffic is necessarily less likely to have sustainable competitive modes of transport available to it.*

In particular, APT argued that:

*...Changes to the regulatory regime so early into the concession period (particularly changes that increase regulation):*

- (i) risk destabilising present levels of certainty in negotiations for access to the Railway; and*
- (ii) may result in the access provider having less flexibility and resulting in a less innovative approach in attracting business to the Railway.*

### **4.3 Commission's analysis**

The Commission does not set or regulate prices for use of the Railway. Prices are instead negotiated within limits effectively set by the Code's pricing principles applying to any arbitration in the case of an access dispute and the Commission's associated guidelines to be observed by any arbitrator.

However, the Code does not prevent the Commission from ramping-up the degree of prescription regarding reference pricing beyond just the procedural matters currently covered in Guideline No. 1.

The Commission notes the concerns expressed by the downstream transport operator regarding the differentiated access prices between northbound and southbound traffic. In some situations, access prices that differentiate between the direction of traffic may not be cost based and may reflect the misuse of market power. In some instances, however, it may be a reflection of other factors. For example, differentiation between northbound and southbound pricing could simply reflect a high fixed component to APT's pricing. For bulk minerals traffic originating towards the southern end of the Railway, northbound traffic involves greater usage of the overall track and southbound traffic involves lower usage of the overall track.

Moreover, reference prices (being by their nature maximum prices) are unlikely to address the issue of differential pricing between northbound and southbound traffics, with APT still able to offer significant discounts to northbound traffic relative to southbound traffic.

No access seekers (including in relation to the transportation of bulk minerals) have indicated to the Commission that they have been disadvantaged by the absence of reference prices. While, unlike APT, the Commission is not sure that the absence of disputes indicates that the reference pricing arrangements are working to the satisfaction of all parties, the Commission would prefer to base its decisions on experience directly arising from access negotiations.

The Code (and the guidelines) ensure that bona fide access seekers are able to obtain the required pricing information in order to seek access to the Railway. The Commission cannot be confident that ARTC-like reference pricing would not serve to disadvantage access seekers in some situations and/or dissuade investment in some new projects if APT felt it had to set published reference (maximum) prices at sufficiently high levels to accommodate all contingencies.

Imposing ARTC-like reference pricing obligations on APT would be a substantial departure from earlier regulatory practice by the Commission, and would only be contemplated by the Commission if there were clear benefits.

On balance, the Commission remains of the view that it is too early to justify imposing ARTC-like reference pricing on APT via a variation to Guideline No. 1.

Nevertheless, in the circumstances, the Commission plans instead to commence (confidential) monitoring of APT's access pricing using its clause 39 powers to obtain information.

Such monitoring will better position the Commission to deal with any future requests for directions (under clause 12B) aimed at facilitating the conduct of future access negotiations involving bulk minerals haulage opportunities.

Such monitoring is also a prerequisite before the Commission could give consideration alternatively to amending section 5 of Guideline No.2 dealing with allowable and disallowable price differentiation in an arbitration where there is no sustainable competitive price. Currently, this guideline indicates – based on similar provisions in ARTC's undertaking – that:

*... the Arbitrator may differentiate price on the basis of:*

*(a) the particular characteristics of the relevant Service, including: axle load, speed, wheel diameter, Train length, origin and destination (including number and length of intermediate stops), departure and arrival times and days of the week;*

*(b) the commercial impact on the Access Provider's business, including the term of the Access Contract, the consumption of the Access Provider's resources and the credit risk associated with the business; ...*

*...[but] the Arbitrator should not differentiate price between circumstances where:*

*(a) the characteristics of the Services are alike, in terms of location, duration and quality of the train path, train configuration, characteristics of the service, longevity of access, arrival and departure times of the day and week; and*

*(b) the Above-Rail Operator is operating within the same end market.*

#### **4.4 Draft decision**

Accordingly, the Commission does not propose to vary Guideline No. 1 at this time.



## 5 ARTC UNDERTAKING AND CIRA

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### 5.1 *Background*

Clause 45A(2) of the Code requires the Commission to take into account “interface issues” with other access regimes when making or varying guidelines.

Interface issues are defined by the Code as those issues which directly affect two or more railways (including the Railway) and which relate to operating a freight service or a passenger service by means of such railways.

For this reason, Guideline Nos. 1 and 2 both refer to and require varying degrees of consistency with the ARTC’s Interstate Access Undertaking, noting that the Railway connects to the ARTC interstate system.

The purpose of such an approach is to ensure that rail operators do not face a dramatic change of arrangements merely because they move onto the Railway. That is not to say that no differences can arise, as clearly the nature of the project and the Code will result in some difference.

While the existing Guidelines nominate consistency in some areas (e.g. the approach to DORC valuation, train path policy, train control and service quality), the Commission has not included such provisions in relation to other areas such as reference pricing.

The Commission has indicated it might consider any changes in approach necessary to further align requirements on APT as the access provider with the requirements on ARTC in its Interstate Access Undertaking. In doing so, relevant considerations include:

- ▲ the emergence of minerals traffic, some of which will not interface with ARTC (i.e. some may move north to Darwin from points along the Railway); and
- ▲ the implications of proposed changes to the ARTC’s Interstate Access Undertaking.

The Commission is also mindful of the Competition and Infrastructure Reform Agreement (CIRA) entered into by the Council of Australian Governments (COAG) in February 2006 – after the four Guidelines were published.

The CIRA aims for a simpler and consistent national approach to the economic regulation of significant infrastructure such as railways. Where third-party access regimes are needed, the CIRA has resulted in changes to the Competition Principles Agreement to incorporate a number of principles, including that:

- ▲ all third-party access regimes include objects clauses that promote the economically efficient use of, operation and investment in, significant infrastructure;
- ▲ all access regimes include consistent principles for determining access prices; and

- ▲ railways that are agreed to be nationally significant adopt a simpler and consistent national system of access regulation, using the ARTC access undertaking as a model.

It is notable that the Code is quarantined from CIRA's specific requirements. Nevertheless, the regulatory principles involved provide a benchmark against which some of the discretions exercised by the Commission when it developed and published the existing guidelines could be reconsidered.

In the Issues Paper, the Commission invited comment on the degree of alignment necessary with the ARTC access undertaking, and the implications of CIRA for the guidelines.

## **5.2 Views in submissions**

In its submission, ARTC indicated that it:

*...considers that it is important that access regimes (including pricing approach) within each jurisdiction in Australia are consistent to the maximum extent possible, whilst recognizing structural differences between providers in each jurisdiction. COAG has, through CIRA, strengthened its commitment to achieving greater consistency of economic regulation on the national rail network focusing specifically on the interstate network, but including significant regional networks where the benefits outweigh the costs. To date, ARTC has actively participated in moving this agenda forward, and all jurisdictions are currently working towards achieving desirable outcomes.*

In its submission, APT argued that there was no need for the guidelines to be impacted by any of the CIRA implications:

- (a) *APT is supportive of the high level principle of consistency between access regimes that govern the Railway and the ARTC system under the ARTC undertaking.*
- (b) *APT considers that the existing provisions in Guideline No. 1 and 2 regarding consistency with the ARTC undertaking are generally adequate, and that no further level of regulation is presently necessary.*
- (c) *APT is not supportive of principles of consistency regarding reference pricing between the Railway and the ARTC system.*
- (d) *APT is not supportive of the proposition that the emergence of bulk minerals traffic on the Railway is a relevant consideration in an investigation regarding the merits of promoting consistency between the Railway and the ARTC system.*
- (e) *Although APT is not averse to 'nationally significant railways' adopting a similar and consistent system of access regulation (except in so far as reference pricing is concerned), APT considers that there are not compelling reasons why ESCOSA should take into account matters relevant to CIRA, when reviewing the Guidelines. ...*

## **5.3 Commission's analysis**

Clause 45A(2) of the Code requires the Commission to take into account "interface issues" with other access regimes when making or varying guidelines.



While the CIRA principles call for consistency in access pricing (and regulation) across railways, the Railway is specifically quarantined from the obligations which CIRA places on access regimes.<sup>14</sup> Moreover, most of the inconsistency in pricing regulation between the Railway and ARTC's interstate network are the direct result of the Code. The Commission does not have the power or discretion to address these pricing and regulatory inconsistencies.

Also, it is too early to analyse proposed changes to ARTC's Interstate Access Undertaking. Such changes are still under consideration by ARTC. For now, there is little that the Commission can do to further align the guidelines to ARTC's Interstate Access Undertaking.

#### **5.4 Draft decision**

Accordingly, the Commission does not propose to vary the guidelines at this time aimed at achieving CIRA objectives or to reflect changes to ARTC's Interstate Access Undertaking

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<sup>14</sup> Refer clause 1.3 of the CIRA.