# SOUTH AUSTRALIAN RAIL ACCESS REGIME
# REVIEW OF REGULATOR COMPONENTS
# ARTC SUBMISSION

## Background

The Essential Services Commission of South Australia ("Commission") is reviewing those components of the South Australian Rail Access Regime ("Regime") set out in Parts 3 to 8 of the Railways (Operations and Access) Act 1997 ("ROA Act") for which it has responsibility. The components under review include:

- Pricing principles
- Information provision to access seekers
- Regulatory reporting

The Regime relates to certain parts of the interstate network, including:

- Narrow gauge lines on the Eyre Peninsula
- Broad gauge lines in the Mid-North and metropolitan Adelaide
- Standard gauge lines in the Murray Mallee

ARTC notes that a section of track between Port Adelaide and Glanville is part of TransAdelaide's metropolitan network, and is owned, operated and maintained by TransAdelaide. On this section, ARTC has rights of transit and has traditionally been the sole seller of access. ARTC's involvement in this section does not enable ARTC to meet the criteria to be considered a 'provider' [of access] within the meaning of section 44ZZA of the Trade Practices Act (1974) ("TPA"), and, as such, ARTC is not able to make an undertaking to the ACCC in relation to this section of track under the TPA. ARTC understands that access to this section of track would be governed by the Regime.

The Commission has stated that, in conducting its review, it will have regard to the objects of the ROA Act and its own objectives, as set out in the Essential Services Commission Act 2002 ("ESC Act"). ARTC notes broad pertinent objectives, including:

- Promoting efficient, responsive rail transport in South Australia
- Facilitating competitive markets in the provision of railway services

In order to achieve a key objective of increasing utilization of the interstate rail network, ARTC has adopted a strategy of growing the use of rail for the movement of interstate freight in Australia by improving rail's competitiveness within the broader freight transport logistics framework. ARTC can only assist the industry in this way within the context of its role as a track manager, currently of only part of the interstate rail network (albeit a major part). Rail's competitiveness is also a function of the activity of rail transport operators (ARTC's customers) and the extent to which rail is able to effectively integrate and communicate with other elements of the transport and distribution supply chain within various interstate and international transport markets.

ARTC's strategy of growing freight volume on rail also underpins ARTC's approach to pricing, which has been endorsed by the ACCC. ARTC has sought to set access pricing at a level that will enable rail to be competitive with road in markets served by the interstate network. With the current level of utilization of ARTC's network, however, pricing at the level results in the amount of revenue collected by ARTC not being sufficient for the long-term economic sustainability of its network. It is ARTC's strategy to grow volumes in the long term, such that rail can remain competitive and achieve long-term sustainability of its asset.

ARTC considers that this strategy is the only realistic one available to achieve long term sustainability on the interstate rail freight industry in an environment where its main competitor (long haul, heavy road transport) is not paying for the full cost of the infrastructure it uses.

With regard to the other aims of increasing the extent of above rail competition on its network, ARTC has adopted the principles of efficiency, equity and openness in its approach to facilitating access to the network. ARTC's access undertaking largely encompasses these principles. The ACCC has endorsed ARTC unit maintenance costs as being efficient. These unit costs are significantly lower than that achieved on other parts of Australia's public rail network. In its access undertaking ARTC has voluntarily committed to making its access pricing publicly available and committed that the same pricing will be available to any train operator, regardless of ownership, operates under the substantially the same terms and conditions, and in the same end market as another train operator. ARTC sees these principles as providing confidence and encouragement to potential access seekers that they will be able to use the network on an even playing field with other competitors.

The various state regional networks are, by and large, operated by vertically integrated entities required to achieve varying degrees of structural separation (vis-à-vis institutional separation) as provided for under state based third party access regimes. The exception is NSW where institutional separation between above and below rail activity and an open access regime has been achieved.

Interestingly, the only significant above rail competition on regional networks was achieved in southern NSW grain markets where Freight Australia and Australia Transport Network hauled grain to Pt. Kembla and ports in Victoria (partly along the Melbourne - Sydney interstate corridor). These operations commenced prior to the privatization of National Rail and FreightCorp, and since the commencement of operations of Pacific National (PN), these operations have now been absorbed into PN's operations through acquisition.

There have been a number of attempts to enter regional markets in other states but, for various reasons, few have been successful. ARTC accepts that there are a number of elements, other than access to the network, necessary to compete in the rail freight service market including:

- availability and access to terminal and yard facilities,
- availability of locomotives and rollingstock, and,
- critical mass of specific operations and overall business to achieve commercial sustainability

Notwithstanding the clear difference in outcomes achieved in NSW as opposed to other states described above, ARTC accepts that it is difficult to draw a clear conclusion as to whether alternative structural and access arrangements on regional networks would have resulted in greater competition for rail freight services in other states.

Experience suggests that there has been little or no threat of third party entry to the regional networks in SA that are subject to the Regime. This would suggest that the existing Regime has not been successful in achieving the objective of the ROA Act being to facilitate competitive markets in the provision of rail services. ARTC notes that the Regime was developed some years ago, and does not appear to have been subjected to any formal review by a State or nationally based competition authority. Such reviews have, by and large, given rise to some improvements (although variable in extent) of access regimes in other states. Nevertheless, ARTC would recommend to the Commission that it now draws upon the experience of the significant regulatory analysis and consultation that has occurred over the past several years, in order to improve the effectiveness of the Regime going forward.

services under like terms and conditions. ARTC will not differentiate between like services operating in the same end market.

At current levels of pricing, ARTC revenue is insufficient to recover the full regulatory economic cost of its network. On its east-west network, ARTC currently derives a return on the DORC value of its assets of around 1-2%. On each of its pricing segments, ARTC revenue falls at a comparable level between floor and ceiling limits for each segment. As such, neither ARTC nor its customers subsidise less profitable parts of the network with more profitable parts of the network. The ACCC has endorsed this approach on ARTC's current network, enabling users to be confident that they are only paying for those parts of the network that they are utilizing.

The determination of floor and ceiling pricing limits adopted by the Regime is carried out on a similar basis to that used by ARTC. These limits result in bounds to any pricing negotiation, except that revenue obtained from other users of the relevant part of the network is deducted from the applicable ceiling. This effectively places a revenue cap on that relevant part of the network for all users as well as a cap on negotiated pricing for each user. This approach is also similar to that used by ARTC.

The paper raises an issue as to whether, given the wide range between floor and ceiling bounds, there is any merit in not having pricing principles and, for arbitration purposes, just relying on a requirement that pricing reflects the costs, legitimate business interests and investments of the access provider. Given the vertically integrated structure of the access provider and jurisdictional consistency, ARTC considers that prescriptive pricing principles are appropriate.

<u>Floor price</u>

ARTC considers it appropriate that incremental (or avoidable cost) should be used to determine floor pricing. Incremental costs included in ARTC floor revenue limit means the costs that could have been avoided if a relevant segment was removed from the network. The implied timeframe for avoidability in this case is the time over which any cost associated with the relevant segment could be avoided. ARTC considers that a reasonable proxy for the appropriate timeframe for avoidability associated with a particular use (incremental) of the network would be the term of the associated access agreement. For short term traffics, where avoidable cost is lower, there is nothing in the regime that prevents ARTC from charging a price lower than would recover floor cost (calculated using the approach described above) to better reflect the marginal nature of the business.

on the network is encouraged, and differences often reflect the integrated, or otherwise, nature of the access provider, where the motivation for encouraging competition is different.

- The use of reference pricing simplifies the negotiation process and can act to stimulate market confidence and encourage third parties and competition.

- Transparency in pricing (published pricing) further enhances market confidence with regard to equitable treatment, particularly in a vertically integrated environment.

- The structure of pricing can influence the behaviour of network users and also impact on third party entry. Two part pricing, as is used in many regimes serves to apply a balance between two competing objectives, being the desire to encourage efficient use of the network (by existing users) and encourage new entry. The fixed or flagfall component of pricing (as a proportion of total pricing) should be set at a sufficiently high level to encourage the user of longer heavier trains (more efficiently use capacity) but not be so large as to unreasonable increase the access cost to a new entrant operating smaller trains whilst business builds up. ARTC proportion of flagfall revenue is around 30% of total revenue, which the company has found to be successful in balancing these competing objectives. This is lower than the proportion of fixed cost to the company and, as such, ARTC is taking market risk in order to encourage new entry to the network, and market growth. The proportion is different in other jurisdictions and, not surprisingly, is higher on vertically integrated networks and lower where the access provider is vertically separated.

The extent to which a regulator can bring about open, transparent pricing, structured to encourage competition, in a vertically integrated environment is likely to positively influence the extent to which third party competition on the network materializes.

## Information about Access

ARTC notes, and supports, the requirement for an information brochure to be made available to an industry participant, more importantly an access seeker, by the access provider. Providing up-front information to an access seeker will help simplify the process of proposing access and negotiating access.

The Regime suggests a cost based approach to reference pricing, where the reference price is effectively the average cost (excluding capital charges) of the service to be provided. If this price were paid by the third party, then no contribution towards long term asset sustainability is being made, limiting any incentive for long term investment.

In a vertically integrated environment, it is most important to demonstrate to the market that a new competing entrant will be able to compete with the vertically integrated access provider, and other third parties on a fair and equitable basis. As such, the starting point for the developing of reference pricing for services should be based on the 'notional' pricing that the access provider is charging it's related above rail operator or other third parties for services currently being provided. This pricing should be demonstrated to, and approved by, the regulator. To this end, rigorous accounting separation principles are required in the access regime. ARTC sees no reason why a full set of prices for all services currently on the network could not be established, and published together with the characteristics of the services to which they apply. This is not to say that end markets need to be identified. Service distinction could be made in terms of the physical characteristics of the services operated. When a different type of access is proposed, the negotiated price arising could be published and made available to any other party operating under the same terms and conditions.

Charges for information provided

ARTC accepts that certain information can only be prepared following an access application. ARTC currently makes no charge for providing such information, as its objective is to encourage access to the network. In a competitive market for railway services, the access provider would be likely to recover the cost of providing this service through a direct charge or through broader access charges, even though the alternative mode of transport does not require a process of access application and negotiation.

As such the access provider should be permitted to charge for the preparation of such information up to a maximum of the efficient cost of preparing the information, so long as the cost is not recouped by any other means such as access pricing.