



2 October 2012

Matthew Schroder
General Manager
Fuel, Transport & Prices Oversight Branch
Australian Competition and Consumer Commission
GPO Box 520
Melbourne Vic 3001

By Email: transport@accc.gov.au

Dear Mr Schroder

Response to the ACCC Consultation paper on the ARTC's HVAU Performance Incentive Mechanism

1. Introduction

Asciano welcomes the opportunity to make a submission to the ACCC in response to the Australian Rail Track Corporation's (ARTC) application to the ACCC to vary the Hunter Valley Access Undertaking (HVAU) to introduce a performance incentive scheme. Asciano has made a previous submission to ARTC on this issue in February 2012 in response to a consultation paper released by ARTC.

Asciano has a strong interest in the proposed performance incentive scheme via its Pacific National subsidiary, which is the largest rail operator in the Hunter Valley coal chain. While Pacific National is a rail operator it does not hold substantial coal rail access rights in the Hunter Valley and, to the extent that the proposed incentive mechanisms deal explicitly with access rights and access payments, Asciano believes that it is more appropriate for the access holders, rather than the operators, to make detailed comment on these issues.

Asciano believes that the major issue facing the Hunter Valley coal chain is track congestion. Asciano has strong concerns that there are insufficient incentives in place for ARTC to address this congestion. In particular Asciano believes that ARTC in the Hunter Valley operates within a regulatory framework which limits the potential for major revenue downside and upside, and given this ARTC is not necessarily driven by strong commercial incentives to increase capacity and improve efficiency.

Asciano recognises that in assessing the HVAU variation the ACCC needs to take into account matters set out in the Competition and Consumer Act. These matters include the interests of access holders and operators. Asciano believes that in regard to operators such matters include whether the proposed incentive scheme¹:

- encourages increased operating and capital efficiency within ARTC operations;
- encourages increased capacity and increased capacity utilisation within the coal

¹ Asciano believes that access holders are likely to have a broader range of concerns relating to the linkages between financial reward and performance which is relevant to access holders, linkages between financial reward and risk (including symmetry of financial rewards and penalties) and linkages between contract entitlements and the incentive scheme.

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supply chain; and

- is sufficiently well designed to ensure performance benefits are delivered. While Asciano supports the concept of a performance incentive scheme Asciano has concerns that a poorly designed incentive scheme will not encourage increased efficiency or capacity and will result in a further layer of reporting with no increase in performance relevant to operators or access holders.

Asciano supports any well-designed incentive mechanisms which drives improved efficiency, increased capacity utilisation and increased capacity within the ARTC's Hunter Valley network and operations. Asciano believes that an incentive mechanism which can achieve these outcomes will benefit all participants in the supply chain (including ARTC).

2. HVAU Requirements and Time Frames

The HVAU currently requires the ARTC undertake several actions with regard to incentive schemes, in particular;

- section 13.3 requires ARTC to develop and implement a performance incentive scheme which encourages ARTC to improve operating and capital performance. Asciano recognises that the current HVAU variation application is seeking to fulfil this obligation; and
- section 13.5 requires ARTC to develop a performance incentive scheme which encourages ARTC to improve its performance in making capacity available. The time frame associated with this process is such that there is likely to be no increase in capacity from this process for eighteen months at the earliest. The urgency surrounding track congestion requires a capacity performance mechanism to be developed and implemented in a shorter timeframe than that in section 13.5.

Asciano recognises that the current HVAU variation application moves towards increasing capacity via the development of the Additional Capacity Investment Innovation Incentive (ACIII), however Asciano has concerns with this concept, as outlined in section 3 below.

Asciano is concerned with changes currently being proposed to HVAU section 13.5 as these changes appear to weaken the obligation for the ARTC to continue to develop options for making additional capacity available. Asciano believes that a strong obligation on the ARTC to continue to develop options for making additional capacity available should remain in the HVAU, notwithstanding the fact that the current HVAU variation application makes some moves towards increasing capacity. In addition, the timeframes for developing these options for making additional capacity available should be shortened.

3. Comment on the Proposed Incentive Scheme

The incentive scheme proposed by ARTC in the HVAU variation application focuses on:

- the introduction of KPIs related to several ARTC controllable behaviours including cancelled services, lost transit time and track quality. ARTC receives incentive payments if certain threshold performance levels linked to these KPIs are met; and

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- the introduction of an ACIII, which applies when ARTC can increase capacity via innovation rather than “hard” infrastructure investment. When this occurs half of the value of the “hard” infrastructure investment that would be required to produce the same capacity will be added to the ARTC capital base (RAB). The Rail Capacity Group (RCG) has a role in assessing this incentive.

In relation to the KPIs linked to ARTC controllable behaviours Asciano has several concerns including:

- the ARTC may focus its activities on addressing issues related to cancelled services, lost transit time and track quality. Other issues which may arise over the course of the HVAU which impact on operations and capacity availability may not be addressed as the incentive scheme is focussed only on these three activities;
- the determination of the KPI target values. Asciano understands that ARTC are basing the KPI target values on the 50th and 75th percentile of historic ARTC performance. Asciano has concerns with this approach, as using ARTC historic performance at these percentile levels is unlikely to provide strong incentives to fundamentally improve performance and efficiency and increase capacity.

Further to this issue, to the extent that the KPIs are set at levels within the bounds of the contracted entitlements of access holders then Asciano does not believe that ARTC should be additionally rewarded for meeting its already agreed contractual commitments;

- the KPI target values appear to be set values for the term of the HVAU. Asciano has concerns that these values may be easily attainable when additional focus is brought to bear on these areas of performance. Asciano believes that it may be appropriate to review ARTC performance against the KPIs to assess whether the values need to be reset.

Overall Asciano believes that the proposed performance incentives which are linked to KPIs for cancelled services, lost transit time and track quality will not drive large increases in efficiency and capacity within the Hunter Valley network. Asciano believes that the methodologies by which the KPIs are set, and the levels at which the KPIs are set are unlikely to result in an increase in efficiency and capacity within the Hunter Valley network. Asciano believes that more challenging performance targets are required.

In relation to the proposed ACIII Asciano has several concerns including:

- the linkages between innovation and the RAB. The role of the RAB in the “building blocks” regulatory approach is to be used as a primary input (along with the WACC) in determining the cost of capital for use in revenue cap calculations. Adjusting the RAB for non-capital activities seems to run counter to the principles of the regulatory approach and may provide opportunities for regulatory gaming, (particularly as increasing the RAB results in a long term increase in revenues and the incentive scheme revenues may be outside the revenue cap).

In addition, Asciano is concerned that the “hard” capital expenditure figure used to increase the RAB may be very large resulting in large increased returns to the ARTC.

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However, such returns may not be commensurate with the actual innovation activity undertaken. For example removing inefficient trains from the network may result in substantial capacity gains but such a simple operating decision should not be rewarded by a large long term return on an increased capital base;

In addition linkages between innovation and the RAB may create issues if innovations are not successful or result in unintended costs. For example if an ARTC innovation unexpectedly results in reduced capacity (via increasing congestion) then this could result in the RAB being reduced.

- problems in assessing the level of the additional capacity created, the sustainability of the additional capacity created and the capital costs that otherwise would have been required to create this capacity. While the RCG is involved in this assessment process Asciano queries if the RCG necessarily has the expertise or resources to adequately assess the level of the additional capacity created and the capital costs that otherwise would have been required.

In addition Asciano has particular concerns that the capacity created may not be fixed and / or permanent, and to the extent that any capacity created is not fixed and / or permanent then the RAB will need to be adjusted accordingly at some time in the future. Such an adjustment may result in further assessment problems.

- the potential for the creation of capacity via innovation to impact on other parties such as miners or operators. For example the ARTC may seek to create capacity by changing mine load-out procedures or reducing headway between trains. Such innovations may be costless to ARTC and may reward ARTC by increasing its RAB but the implementation of such innovations may impose both explicit and implicit capital and operating costs on other parties which may not be fully recovered via the ACIII process;
- the fact that if such capacity can currently be created by innovation without capital investment then why is the creation of capacity being held back when congestion is such a large issue in the Hunter Valley coal chain.

In principle Asciano supports the concept of a performance incentive scheme which increases capacity but Asciano believes that the currently proposed ACIII requires further development before it can be implemented. Notwithstanding the further development of the ACIII, if capacity can currently be increased by use of improved systems and management then such systems should be implemented now to address current congestion.

Asciano notes that earlier in the development of the performance incentive scheme the ARTC considered incorporating safety into the incentive mechanism, but that ARTC now takes a view that safety performance should not be subject to an incentive mechanism. Asciano supports the current ARTC position, as Asciano believes that safety should be addressed as an absolute rather than as an input into a commercial incentive regime.

Overall Asciano supports the principle of performance incentive mechanisms which will drive improved efficiency and increase capacity in the Hunter valley coal chain; however Asciano believes that the current ARTC application to the ACCC to vary the HVAU to introduce a performance incentive scheme should not be accepted at the current time. Further work

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should be undertaken to improve the proposed performance scheme.

Feel free to contact me on 02 8484 8056 to discuss this submission.

Yours faithfully

A handwritten signature in black ink, appearing to read "Stuart Ronan", written over a light grey rectangular background.

Stuart Ronan
Manager Access and Regulation

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