IPART
New South Wales

Independent Pricing and Regulatory Tribunal

IPART submission to ACCC on its 8 January 2016 Consultation Paper

Australian Rail Track Corporation's 2016 Hunter Valley Access Undertaking

February 2016

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1 Summary

Thank you for the opportunity to comment on your Consultation Paper on the 2016 ARTC Hunter Valley Access Undertaking (HVAU).

IPART was responsible for price regulation of ARTC's Hunter Valley coal network between 2004 and 2011. Prior to that, IPART was responsible for regulating the NSW Government entities that provided access to this infrastructure network. Our experience in regulating rail networks makes us well-placed to comment on your Consultation Paper.

We generally support the approach set out in the proposed HVAU, however, we have concerns or suggestions in relation to the form of regulation, pricing principles and mechanisms to deal with the possible privatisation of ARTC.

These matters are discussed in detail below. At the end we provide answers, where appropriate, to the questions posed in the Consultation Paper.

2 Form of regulation issues

For its 2016 Hunter Valley network undertaking,[1] ARTC proposes several significant changes to the form of regulation. The key changes are:

1. extending the term from five years to 10.5 years with a further five year extension available at ARTC's discretion
2. an approval role over certain regulatory inputs for a group of coal access customers (the Rail Capacity Group, RCG), and
3. including a mandatory appeal to the Australian Competition Tribunal in the event that the ACCC does not agree with any changes to the undertaking that may be proposed by ARTC from time to time.

It is important to consider the most appropriate regulatory framework that would apply to both private and public owners.

We have concerns with these proposed changes, for reasons that will be explained below.

1 ARTC, Hunter Valley Coal Network Access Undertaking, 23 December 2015.

2.1 Extension of term

1 IPART recommends setting a five year term for the HVAU.

We consider that the proposed 10.5-year term for the 2016 HVAU is too long. We consider that costs and prices of monopoly infrastructure should be reviewed more frequently to mitigate the risks of prices and costs significantly deviating from forecast, causing windfall gains or losses to either the operator or to customers. IPART notes that some safeguards are proposed, including various forms of within-period correction to rates of return and other regulatory inputs. However, the proposed opportunities to correct the regulated price are too limited. A more appropriate solution is to have five-yearly reviews.

2.2 Approval Role of RCG

2 IPART supports the RCG (instead of the ACCC) approving variations of the HVAU such as capital works, insurance, contact details, service envelopes, network performance indicators and amendments to the costing manual.

3 IPART recommends that the approval of changes to the network infrastructure and track segments remains the responsibility of the ACCC.

4 IPART recommends that the RCG is not given authority to approve operating expenditure or asset management plans. Instead, that authority should be retained by the ACCC.

5 IPART recommends that the ACCC retain the power to revoke any decision-making authority of the RCG in the event that such authority is used in an anticompetitive manner by RCG members. This power should be recognised in the HVAU.

There are many matters of detail on which the customer group, represented by the RCG, is both directly affected and better informed than the ACCC. We consider it likely that it would be more effective and efficient for ARTC to seek RCG approval instead of ACCC approval on these matters of detail, including:

- insurance
- contact details
- the services envelope
- network performance indicators, and
- amendments to the costing manual.

We also note that the process whereby RCG approves proposed capital works appears to have worked well over the past several years.

However, the decision on incorporating new network infrastructure and track segments should not be made by the RCG. Changes to the track configuration have the potential to alter the way in which the ceiling test is performed. In particular, by adding or subtracting a track segment it is possible to change the

constrained group of customers (the one that determines the ceiling limit for prices). These changes may be subtle, and the RCG would lack the access to information (on costs and tonnages of other mines) and the expertise to evaluate them. For this reason, the ACCC's approval role over new network infrastructure should not be conferred on the RCG.

The proposed form of the 2016 HVAU places great responsibility on a customer group, the RCG, for various monitoring and approval functions that are normally undertaken by the regulator. Although it is not made clear, it is possible that these responsibilities may include an approval role for track maintenance and renewal expenditure, and review of asset management plans. However, RCG may not have the capacity to undertake this function and its composition may make it unsuitable for the task in future.

First, the RCG members lack the detailed information on costs, asset maintenance technology, and on the tonnage forecasts of their competitors to be able to exercise this oversight effectively.

Second, the RCG members represent only coal freight users of the network. In the longer term, other user interests, including grain and container freight, as well as passenger operations may come to be more important users of the network than they are now, but these users are not represented on the RCG.

RCG could potentially make decisions in its role approving minor variations to the undertaking which might have an anticompetitive effect. For example, a future RCG might decide on the services envelope to which standard access prices apply in a manner that could disadvantage a particular train operator. If such a decision resulted in higher access prices to that operator that did not reflect cost differences, then it could be harmful to above-rail competition. If such a situation were to emerge in the future, the ACCC would need the power to revoke the RCG's authority to make such decisions. This power would need to be recognised in the HVAU.[2] While competition law could potentially offer some protection from such behaviour, this is not certain and any action taken under competition law would be time-consuming.

[2] We note that the draft undertaking provides for the ACCC to comment on proposed variations and the ARTC is required to consider the ACCC's comments before obtaining the RCG's endorsement of the proposed variation.

2.3 Mandatory appeal to ACT

6 IPART recommends that there should not be a mandatory appeal to the Australian Competition Tribunal in the event that the ACCC does not agree with any changes to the undertaking that may be proposed by ARTC. IPART recommends that the word 'must' in clause 2.3(e)(ii) of the undertaking be replaced with 'may'.

ARTC proposes that, six years before the end of the term of the undertaking, a mandatory review of regulatory settings be undertaken by ARTC.[3] It is proposed that the ACCC would then consider any proposals by ARTC to amend the undertaking. In the event that ARTC wished to amend the undertaking but the ACCC did not agree to the amendment, then an appeal to the Australian Competition Tribunal would be triggered. This process is set out in section 2.3.1 of the Explanatory Guide (December 2015, p 10), which states that:

> Following completion of the mandatory review, ARTC is obliged to seek ACCC approval to amend the undertaking, at least with regard to the calculation of depreciation and the rate of return. If the variation is rejected by the ACCC, ARTC has the obligation under the 2016 HVAU to apply to the Australian Competition Tribunal to review the ACCC's rejection and accept and incorporate the outcome of the Tribunal's decision by submitting a revised variation application to the ACCC consistent with the Tribunal's decision.

In IPART's view, it is unnecessary to have the requirement under s2.3(e)(ii) of the undertaking that ARTC must appeal to the Tribunal. Any appeal should be discretionary and not mandatory. For example in light of the ACCC's reasons for any refusal to amend the undertaking, ARTC may decide that an appeal is not necessary. Yet this peculiar requirement in s2.3 requires ARTC to lodge such an appeal, leading to wasted resources and time. This would not be either in the interests of ARTC or its customers.

3 Pricing principle issues

IPART notes that only relatively minor changes have been proposed to ARTC's pricing principles. For the most part, these changes should provide useful simplification without reducing the effectiveness of the undertaking. We do not support simplifying the combinatorial ceiling test as implemented. We believe that a Unit of Production methodology (explained below) would be preferable to the Weighted Average Life methodology for determining the mine life estimates used for depreciation, as discussed below.

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3 ARTC, 2016 Hunter Valley Coal Network Access Undertaking Explanatory Guide, December 2015.

3.1 Combinatorial ceiling test

7 IPART supports continued use of the combinatorial ceiling test and notes the importance of re-determining the constrained group of mines each year, so that changes to costs, tonnages and prices are properly taken into account.

ARTC has maintained the combinatorial ceiling test feature that was introduced in the original NSW Rail Access Regime. Various combinations of mines are examined to determine which combination generates the greatest surplus of access revenue over the relevant stand-alone cost. That combination is called the constrained group. This constrained group is the one for which the ceiling test determines prices, so the undertaking places great emphasis upon it.[4]

The constrained group can change as costs and tonnages change. It can also change when prices change, even if costs and tonnages remain the same. For example, prior to 2007-08, the constrained group (the one giving rise to what is called the "determining Ceiling Limit" in the Costing Manual) corresponded closely to the set of all mines in pricing zone 1. Since 2007-08, the constrained group has been the combination of mines in pricing zones 1 and 2.[5] In the near future, the constrained group (that is, the group of mines that comes closest to exceeding the ceiling) would be the combination of mines in pricing zones 1, 2 and 3.[6]

The constrained group is not a fixed set of mines, or of track segments. Therefore, the ceiling test should not be simplified by limiting it to the group that is currently constrained. Maintaining a ceiling test that is flexible will account for the possibility that the constrained combination of mines might differ from any grouping of the current pricing zones. The dynamic nature of the coal mining industry, and of costs to serve it, implies that a full combinatorial test should be done every year.

4 ARTC, 2016 Hunter Valley Coal Network Access Undertaking Explanatory Guide, December 2015, p 27.

5 IPART, Statement of Reasons for decision on the compliance of the Australian Rail Track Corporation pursuant to clauses 5(b)(i) and 5(b)(ii) of Schedule 3 of the New South Wales Rail Access Undertaking for the 2007/08 financial year, p 4, notes the inclusion of the Ulan and Wilpingjong sectors in the constrained group and the removal of the Muswellbrook to Dartbrook sector from the constrained group in that year.

6 IPART, Statement of Reasons for draft decisions on the compliance of Australian Rail Track Corporation with the New South Wales Rail Access Undertaking for 2012-13 and 2013-14 for the Gap to Turrawan sector, p 5, notes that access revenue for the Gap to Turrawan sector (ie, pricing zones 3 and 4) exceeded 80% of the full economic cost. Crossing this legislative threshold indicates a strong possibility that future growth in coal traffic there may result in the ceiling test beginning to constrain prices for that sector.

This requirement is not unduly onerous. Prior to the transition from the NSW RAU to the ACCC undertaking, ARTC routinely submitted annual ceiling tests of this type to IPART.[7]

Finally we note that the ceiling test should take into account combinations of access customers that include non-coal traffic wherever the access prices charged to those customers exceeds the direct cost of providing access to them.

3.2 Mine life

8 IPART recommends that the mine life estimate is based on a Unit of Production methodology, rather than the Weighted Average Life methodology. If a time-based depreciation charge must be used, we recommend the Longest-Lived Substantial Mine (LLSM) methodology in preference to the Weighted Average Life (WAL).

The economic life of the coal export business, rather than wear and tear, should determine the horizon over which the assets should be depreciated.[8]

In ARTC's 2016 HVAU (as in its 2011 HVAU), the proposed method for establishing mine life is to calculate a weighted average of the expected lives of the mines that use a particular railway line. There are, however two alternative methodologies for determining the depreciation profile that better reflect economic consumption of the coal.

The first alternative methodology is for the depreciation charge to be based on the remaining life of the mines measured in tonnage rather than time. Under this units of production (UOP) approach the annual depreciation charges are highest when tonnages transported are high, and lowest when there is low tonnage. The UOP methodology could not be used under the NSW Rail Access Undertaking because the wording of that particular undertaking required time-based depreciation. However, the UOP approach could be proposed under the 2016 review of the HVAU based on economic efficiency grounds and it minimises the risk of premature line closure and of stranding coal reserves.

The second alternative methodology is to make depreciation charges time-dependent based on the life of the LLSM on a given line. The concept is that the economic life of a section of rail infrastructure would be established by the life of the longest-lived mine of substantial size that requires that rail line to transport its product. The emphasis on the substantial size of the mine arises because a long rail line would not be kept operational unless there was sufficient tonnage. As long as the long-lived mine is a substantial mine, however, then the railway line would remain operational for the balance of that life. This approach better

7 It is also worth drawing to the ACCC's attention an inadvertent mis-statement of the ceiling test that is contained in s5.2 of the Costing Manual. The second sentence says "*In concept, every combination of Segments within the Network has a separate Ceiling Limit.*" This should say that every combination of customers or mines has a separate Ceiling Limit.

8 ARTC agrees with IPART on this principle. See clause 4.7(b) of the proposed undertaking.

reflects the decision to keep open or mothball a railway line as the mines on it run out of coal. It is unlikely that a rail line would be closed on the day that the weighted average life is attained if there is still substantial coal to be transported.

4 Privatisation with vertical integration

9 In the event of privatisation of ARTC to an organisation with interests in either coal mining or train operations (vertical re-integration), IPART recommends that the HVAU would require amendment to contain an explicit requirement that access to third parties is provided in a competitively neutral manner.

The Consultation Paper notes at s2.12.1 the possibility that ARTC will be privatised during the life of the 2016 HVAU. It poses several questions concerning the potential interaction between the 2016 HVAU and private ownership of ARTC.

IPART notes at the outset that it has no objection in principle to private ownership of monopoly infrastructure that provides essential services. There are many examples of successful private provision of such services in Australia.

Historically undertakings of the HVAU type have worked because of the vertical separation of the track ownership function from upstream and downstream interests. In the event that privatisation led to vertical integration, then it would be necessary to ensure that the Undertaking includes appropriate competitive neutrality obligations.

Firms with interests in coal mining, train operations, port operations or coal end uses (power generation or steel production) would likely place a higher value on ownership of ARTC than firms lacking any such vertical linkages. Vertically linked firms may be in a position to bid higher to acquire ARTC.

In the event that vertical integration were to result from privatisation of ARTC, obligations in the Undertaking that ensure access to third party train operators parties would require strengthening to ensure that third party access is provided on a non-discriminatory basis.

There could well be efficiency arguments in favour of a degree of integration between port and rail infrastructure. However, integration between ARTC and coal mining, or between ARTC and above-rail operations may lead to reduced competition in the mining sector.

The Competition and Consumer Act, notably s50, empowers the ACCC to review merger proposals and to deal with various forms of anticompetitive behaviour. This Act is certainly a more appropriate place to deal with such concerns than in the drafting of the ARTC HVAU.

However, we submit that, in the event of a privatisation of ARTC that leads to any degree of vertical integration between rail infrastructure and either coal mining or train operating interests, the form of regulation applying to ARTC would need to be revised to ensure third party access is not constrained. The current type of undertaking, which implicitly assumes vertical separation, would need to be revised or possibly replaced by an alternative instrument that provided explicit guarantees of competitive neutrality.

This need arises, in part, from the extreme difficulty of monitoring compliance with competitive neutrality obligations when one dominant firm is vertically integrated while its direct competitors are not.

5 Responses to ACCC questions

1 Is the initial 10.5 year undertaking term an appropriate duration?

No. It is too long. We recommend a five year duration. See s2.1 above for reasons.

2 Is the alignment of the 2016 HVAU to calendar years appropriate?

[No comment.]

3 Is a periodic review of elements of the undertaking six years prior to the termination of the HVAU appropriate? Are there concerns with the proposed process for ARTC's completion of the periodic review? Is the process sufficiently robust to take into account and if required implement any stakeholder concerns?

There are several problems with this proposal. First, it presupposes an acceptance of the 10.5-year term of the undertaking. As noted in our answer to question 1 above, we do not accept that term. Second, we do not support the proposal for a mandatory referral to the Australian Competition Tribunal when the ACCC does not accept an ARTC proposal for variation to the undertaking. See s2.3 above for details.

4 Is the reoccurring option to extend the 2016 HVAU for an additional five year term appropriate?

No. It provides insufficient opportunity for regulatory oversight. See s2.1 above for further reasons.

5 Is a mechanism which allows for RCG endorsement of minor variations of certain provisions of the 2016 HVAU appropriate?

In principle, the RCG endorsement of some minor variations is appropriate. Like the RCG endorsement of the prudency of proposed capital expenditure, this endorsement has the potential to place decision-making power with those parties most knowledgeable and most directly affected by minor variations.

Subject to the caveat mentioned in our answer to question 6 below, the RCG endorsement mechanism appears to be appropriate in principle.

IPART notes, however, that the ACCC should retain the power to revoke the RCG's decision-making authority if it finds that this authority is being used in an anticompetitive manner. This power should be recognised in the HVAU.

6 Do stakeholders have any concerns about the scope of the matters that may be varied under this process without ACCC consent?

Yes. Schedule B (Network) and Schedule E (Segments) should not be varied without ACCC consent, as changes to these schedules may affect the way that the ceiling test is conducted. Members of the RCG may lack the expertise to properly evaluate the consequences of such changes. See s2.2 above for further reasons.

7 Do stakeholders have any concerns with the RCG endorsement threshold for minor variations?

[No comment.]

8 Is the retention of loss capitalisation for Pricing Zone 3 in the 2016 HVAU appropriate?

IPART supports in principle to the retention of loss capitalisation in Pricing Zone 3. The purpose of loss capitalisation is to permit recovery of prudent capacity expansion costs that must be incurred in advance of demand growth. Refusal to allow this recovery would result in a reluctance to provide new capacity in a timely manner.

9 Are the changes to section 4.4 of the 2016 HVAU (Regulatory Asset Base) appropriate?

[No comment.]

10 Is it appropriate to roll over the existing mine lives from the 2011 HVAU, meaning an average remaining mine life of 16 years from 1 July 2016?

It would be preferable to base depreciation on the remaining life of mines measured in tonnage rather than time, as set out in s3.2 above. If time must be used, then it would be preferable to use the Longest-Lived Substantial Mine methodology, rather than the Weighted Average Life methodology. See s3.2 above for details.

11 Is ARTC's proposed Costing Manual an appropriate replacement for existing provisions under the 2011 HVAU?

Yes. The Costing Manual is intended to identify the mechanisms by which assets and costs shared across divisions within ARTC are to be attributed or allocated. The cost allocation mechanisms proposed reflect cost causality to the extent possible. Where it is not possible to employ a causal allocation method, the Costing Manual makes reasonable suggestions.

12 Are the cost allocation provisions included in the Costing Manual an appropriate replacement for existing provisions on the allocation of Non-Segment Specific Costs?

Yes. As noted in our answer to question 11 above, the allocations reflect cost causality as far as possible, and makes reasonable suggestions where causality cannot be established.

13 Is it appropriate that the RCG be tasked with approving ARTC's changes to the Costing Manual rather than the ACCC?

Yes.

14 Does ARTC's proposed Costing Manual address transparency concerns?

Yes.

15 Are there any other comments on ARTC's proposed changes to the Access Pricing Principles?

[No comment.]

16 Are the key assumptions underpinning the WACC parameter values appropriate?

IPART's has extensively consulted on its WACC methodology. Our objective in determining the WACC for a regulated business will be to set a WACC that reflects the efficient cost of capital for a benchmark firm operating in a competitive market and facing similar risks to the regulated business.

We publish a biannual market update to help our stakeholders replicate and predict our WACC decisions. We release market updates biannually in February and August each year.

17 Is ARTC's proposed rate of return appropriate?

See above.

18 Is the move to path based pricing in the 2016 HVAU appropriate? How will this change affect users?

In principle, path based pricing seems to be a useful simplification which would preserve the incentives for operators to use train paths efficiently. The question of user impacts is one for access holders.

IPART has no comment on questions 19 – 41. These are largely matters for access holders and train operators that relate to the detailed implementation of the undertaking.

42 Under the current terms of the 2016 HVAU, in what circumstances would a change in ARTC's ownership cause concerns? What are the specific issues that are likely to arise?

See s4 above for detailed explanation of the concerns and specific issues.

43 Should the 2016 HVAU be amended to deal with these matters? What could these provisions look like?

In the event that a privatisation resulted in vertical integration, it would be necessary to replace the HVAU with an alternative instrument that provided explicit guarantees of competitive neutrality. See s4 above.

44 Are there other legislative or regulatory mechanisms that would alleviate these concerns (for example, section 50 of the Act)? Please give reasons why or why not.

As noted in s4 above, s50 of the Competition and Consumer Act would be an essential safeguard of competition in the event of privatisation of ARTC. While this and other sections of that Act would provide a strong level of protection, two points should be borne in mind.

First, the Competition and Consumer Act is undergoing revision as a result of the Harper Review, and it is possible that changes to, for example, s46 dealing with unilateral anticompetitive conduct, could lead to a period of uncertainty of application.

Second, as noted in s4 above, the HVAU type of undertaking, which implicitly assumes vertical separation, would no longer be appropriate if privatisation led to vertical integration.

45 Should the term of the 2011 HVAU be extended until the 2016 HVAU is accepted by the ACCC? Are there alternative approaches that would provide sufficient certainty for industry?

[No comment.]

46 If the 2011 HVAU is extended, should the current rate of return continue to apply? Alternatively, should an alternative rate of return apply, and a reconciliation process conducted once a final figure is settled on in the 2016 HVAU? What mechanism could be used to conduct this reconciliation?

In IPART's view, the interim rate of return should be adjusted to reflect current market conditions. Given the long delays that have been experienced in the past, legacy WACC settings should not be the default.

47 Is the proposed approach to the final annual compliance assessment under the 2011 HVAU appropriate?

[No comment.]