24 March 2022

Mr Matthew Schroder
General Manager
Infrastructure & Transport – Access & Pricing Branch
Australian Competition and Consumer Commission

Email: transport@accc.gov.au

Copy: Mr Justin Martyn
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Infrastructure & Transport – Access & Pricing Branch
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Dear Mr Schroder,

Australian Rail Track Corporation's compliance with the Hunter Valley Coal Network Access Undertaking for 2019 and 2020

I write on behalf of the Hunter Rail Access Taskforce (**HRATF**) in relation to the ACCC's assessment of the Australian Rail Track Corporation's (**ARTC**) compliance for the 2019 and 2020 calendar years with the Hunter Valley Coal Network Access Undertaking (**HVAU**).

Access to the ARTC financial and tariff models are needed to enable stakeholders to constructively respond to the ACCC consultation

The HRATF appreciates being consulted as part of the ACCC's compliance review process.

In this brief submission, we highlight some issues of concern that are apparent from our review of the ARTC materials that have been made publicly available. In particular, we note that there have been continued increases in ARTC's operating expenditure and corporate overheads, which raises questions about the prudency and efficiency of that expenditure. These issues warrant careful analysis by the ACCC.

However, as previously noted, the HRATF feels constrained in how it can participate in the compliance review process, due to a lack of transparency around the ARTC financial and tariff models.[1] Without access to the underlying models, the HRATF is unable to meaningfully comment on key aspects of the compliance review. For example, without access to the confidential spreadsheets submitted by ARTC, the HRATF is unable to respond to the ACCC's consultation question regarding the allocation of 'unders and overs' (question 1 in the Consultation Paper).

The HRATF feels similarly constrained in its ability to test the efficiency and prudency of ARTC's expenditure, and the appropriateness of its cost allocation methods. The industry therefore remains substantially reliant upon the ACCC to test prudency and efficiency of operating expenditure in particular, and compliance with the financial model more generally.

[1] HRATF submission in response to draft Hunter Valley Access Undertaking consultation, 24 February 2021, section 6.3 and 6.6.

Some examples of this issue, which are discussed further below, include:

- ARTC's operating expenses continue to increase in real terms, but it is unclear to us why that is occurring or what benefits are being delivered by this additional expenditure;
- the most significant increase in operating expenditure in 2019 and 2020 was, again, maintenance expenditure – and yet limited explanation has been provided for this increase; and
- there continues to be a lack of transparency around ARTC's treatment of business unit management costs and corporate overheads – including allocation of overheads between business units and the shifting of costs between these two categories.

Based on the information that has been made publicly available by ARTC, the HRATF is unable to meaningfully comment on whether these increases in operating expenses, maintenance costs and overheads are justified. In particular, without better information on ***unit cost*** trends, it is difficult to identify the extent to which overall cost increases are simply attributable to volume movements, lack of efficiency, or other factors.

More generally, the HRATF finds it difficult to identify and test the "value proposition" associated with increases in operating expenditure, including any operating / capital expenditure trade-offs or long-term benefits associated with expenditure programs.

The HRATF has previously noted that, in other regulated sectors – such as telecommunications and energy – it is common for financial models to be published.[2] The HRATF does not consider that there is any commercial or legal reason for not making ARTC's financial modelling available on an appropriately confidential and anonymised basis.

The HRATF of course acknowledges that certain information in ARTC's models may be confidential and/or commercially sensitive. However these issues can be addressed through an appropriate confidentiality regime, which may include anonymising or aggregating certain information, provision of confidentiality undertakings and/or limited access to certain sensitive information by external advisors only. Again, these types of arrangements are common in other regulated sectors.

This issue has been raised by the HRATF on numerous occasions, including in reviews of the HVAU and compliance review processes. However ARTC has made no attempt to address industry's concerns.

In its recent decision to approve variations to the HVAU, the ACCC noted the HRATF's concern regarding lack of access to ARTC's tariff model, and expressed support for increased transparency. The ACCC noted:[3]

> *The ACCC considers there is merit in HRATF's request for a working version of ARTC's tariff model to become available to Access Holders. In other industries there has been significant advantages to having the regulatory models public.*
>
> *Understanding the likely pricing effects from proposed changes allows stakeholders to more accurately understand how the changes may impact their own operations. Providing the model on an appropriately anonymised and confidential basis should be possible and should ensure that individual customer data is protected.*

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[2] For example, nbn's financial models are published for the purposes of assessing compliance with its special access undertaking. Similarly in the energy sector, the AER regularly publishes financial modelling as part of periodic revenue reset processes.

[3] ACCC, *Draft Decision: Australian Rail Track Corporation's March 2021 variation to the Hunter Valley Coal Network Access Undertaking*, April 2021, p 30.

The ACCC supports ARTC and stakeholders engaging in discussions on the possible publication of the tariff model.

The HRATF wishes to again emphasise the importance of transparency around ARTC's financial and tariff models. We would be open to engagement with ARTC and the ACCC regarding an appropriate process for access to these models, including an appropriate regime for protection of confidential and/or commercially sensitive information.

Overall trend in ARTC operating expenditure

The HRATF wishes to re-emphasise its concern with continued and significant year-on-year increases to ARTC's operating expenditure, as expressed by HRATF in its submission on ARTC's 2018 compliance review, and by HRATF members prior to that.

In the last nine years, ARTC's operating expenditure has increased by 57% in real terms.[4] The increase in operating expenditure implies an average growth rate of 6% per annum in real terms, with jumps of 9% and 8% in 2018 and 2020 respectively. The consistent increase in real operating expenditure occurs in both Pricing Zone 3, and Pricing Zone 1 and 2, with annual increases of 21% and 4% per annum respectively since 2012.

The HRATF is particularly concerned with the increase in real cost per Gross Tonne Kilometre (GTK). As shown in the ACCC's consultation paper, ARTC's real operating expenditure per GTK has risen to $7.40/GTK as at 2020, the highest level since 2012.[5] This suggests that ARTC's real variable unit costs are increasing, and/or real fixed operating expenditure are increasing, but it is unclear why that is occurring.

The HRATF are unclear on the long-term benefits attributed to the increase in real operating expenditure

The HRATF understand that increases to real operating expenditure in itself does not suggest lack of prudency or efficiency. However, the HRATF believes that any proposed increase to operating expenditure should be accompanied with cost benefit analysis, demonstrating that benefits outweigh the proposed costs. HRATF members in general are not provided with sufficient detail to assess the overall prudency or efficiency of any increase in operating expenditure, or whether such increases are justified.

In ARTC's 2019 and 2020 compliance review submission, the HRATF appreciates ARTC has provided some explanation of the benefits of past increases in operating expenditure. ARTC noted that increases to rail defect removal costs resulted in a reduction in network reliability losses from rail breaks and defects, and signalling and points failures, between 2018 and 2020.[6] However, there is still a significant lack of detail:

- The HRATF is unclear on whether increased rail defect removal is delivering tangible net benefits to users. HRATF would need to see a longer-term trend in loss reduction, or data that show the anticipated long-term benefits from network loss reductions outweigh the costs of achieving them.

- The HRATF is also unclear on the benefits of various other initiatives where operating expenditure has increased. For example, ARTC has implemented a new tamping approach, ballast undercutting program, and increased its PTP consultant expenditure, that it believes will increase tamping quality, improving ballast reliability, long-term maintenance requirements, and improve current procurement systems. However, based on the information that has been

[4] ACCC Consultation Paper, p.15

[5] ACCC Consultation Paper, p.16

[6] ARTC, *Hunter Valley Coal Network Access Undertaking 2019 and 2020 Annual Compliance Assessment*, p.7

provided to HRATF members, we are unable to say whether these increases in expenditure are justified.

HRATF acknowledges that ARTC has recently improved its maintenance expenditure reporting and engagement with users. However this only affects reporting from 2022. Given the lag in the compliance review cycle and paucity of information made available to HRATF members for prior years, we continue to rely heavily on the ACCC to test the prudency and efficiency of ARTC's operating expenditure in the current review. HRATF believes that if ARTC is able to improve its reporting on operating expenditure, particularly around the justification of that expense, that would better equip HRATF with the information to assess prudency and efficiency in future reviews, and potentially reduce the regulatory burden on the ACCC.

The HRATF believes that improvements to reporting should include detailed data on historical and forecasts of unit costs. Such reporting should go beyond aggregate cost per GTK, and be based on the key drivers of cost categories such as ballast cleaning, rail grinding, and rail defect removal. This information would enable HRATF members understand and evaluate the prudency and efficiency of future operating expenditure, and ARTC's performance on its ability to achieve efficient operating expenditure.

As an example, more detailed reporting of operating expenditure would help HRATF members to understand and evaluate the benefits of the ARTC Network Control Optimisation (ANCO) program. The HRATF understood one of the benefits that justified the commercial case for the ANCO program was a reduction in network control operating expenditure through automation of some manual work tasks. However, from 2018 to 2020, network control costs have actually risen by 28% in nominal terms, the majority driven by ANCO related costs. More detailed information would help HRATF members understand the underlying cause of the rise in costs, and whether and how the purported benefits of major expenditure programs are being realised. As part of any review of ANCO-related costs, it should also be considered whether any implementation costs treated by ARTC as operating expenditure should properly be treated as capital expenditure.

Maintenance expenditure

The most significant increase in operating expenditure in 2019 and 2020 was, again, maintenance expenditure. On top of the 31% increase experienced in 2018, there was a further 11% and 6% increase for 2019 and 2020 respectively.[7]

Consistent with ARTC's 2018 compliance review, ARTC has provided little by way of justification for this increase, other than a tight contract labour market caused by increased demand for specialist civil engineering and signalling contractors.[8] The HRATF would like to re-emphasise that the ACCC should carefully review the prudency of maintenance expenditure, to ensure that it is not inefficiently incurring and passing on cost increases to the HRATF members. Based on the information that has been made publicly available by ARTC, the HRATF is unable to determine whether the cost increases are justified.

The HRATF considers that the ACCC and stakeholders would be greatly assisted by regular reporting on key efficiency metrics for maintenance activities – for example, one metric may be expenditure per metre for re-railing activities. Reporting at this level would allow for a better assessment of trends in ARTC's efficiency. It may also facilitate benchmarking of ARTC's efficiency against other rail network operators.

[7] ACCC Consultation Paper, p.17

[8] ARTC, *Hunter Valley Coal Network Access Undertaking 2019 and 2020 Annual Compliance Assessment*, p.7

Treatment of disposals

The HRATF notes that a key driver of increases to operating expenditure in 2020 was, again, losses on disposals. In 2020, losses on disposals were $11.5 million, a 121% increase compared with 2019 in real terms.[9] ARTC has said that the increase in disposals is due to an increase in scope for rerailing, track strengthening, and turnout replacements in Zone 1 and Zone 3.[10] The HRATF notes that ARTC gave a similar explanation as in its 2018 compliance review submission.

ARTC's approach to disposals is that, where it replaces an asset that's not fully depreciated in the RAB, the remaining value of the disposed asset can be immediately expensed. This means the recovery of cost occurs immediately, rather than over the remaining life of the asset. The issue is that ARTC estimates disposal value based on 'deemed value', not actual disposal price. The HRATF's concern is that if ARTC receives more than the deemed value, ARTC will receive a windfall gain.

The HRATF raised the same concern in its submission on ARTC's 2018 compliance review. The HRATF noted that although RCG is consulted on asset replacement scope and costs, any associated losses on disposals are not discussed. Although in the past year, HRATF members observed that there had been some discussion on improved disposals reporting, limited changes to reporting have occurred in the 2019 / 2020 documentation. There continues to be limited transparency on the cost implications of asset disposals.

The HRATF would appreciate that the ACCC place greater emphasis on this issue in the 2019 and 2020 compliance review. ARTC should also be required to implement greater discussion of disposals reporting, in line with discussions it had in the RCG.

Allocation of overhead costs to the Hunter Valley business unit

The HRATF wishes to reiterate its previously expressed concern around ongoing increases in the amount of overhead costs allocated to the Hunter Valley Network. There was another 9% increase in corporate overheads allocated to the Hunter Valley Network in 2020.[11] As the ACCC notes in the Consultation Paper, this continues a trend of increases in corporate overheads since 2013.[12]

Again, a key concern for the HRATF is a lack of transparency around ARTC's allocated overheads. ARTC has provided some information on the key cost categories that are contributing to the increase in allocated overheads. However, the HRATF is unable to test whether these costs have been properly allocated to the Hunter Valley Network.

The HRATF notes that allocation values appear to move around significantly from year to year. ARTC notes that there was an increase in non-Hunter Valley allocator values in 2019 and 2020 (and therefore a decrease in the share of costs being allocated to the Hunter Valley Network), which partially offset the effect of increases in its total overhead costs.[13] However this followed a material decrease in the non-Hunter Valley allocator values in 2018. [14] It is unclear to the HRATF what is driving these significant changes in allocated values from year to year. Without a detailed explanation of the cost allocation methodology, such movement may appear random and arbitrary.

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[9] ACCC Consultation Paper, p.18

[10] ARTC, *Hunter Valley Coal Network Access Undertaking 2019 and 2020 Annual Compliance Assessment*, p.31

[11] ARTC, *Hunter Valley Coal Network Access Undertaking 2019 and 2020 Compliance Assessment Submission, Attachment 1: Hunter Valley Network Operating Costs*, p 39.

[12] ACCC Consultation Paper, p 21.

[13] ARTC *Hunter Valley Coal Network Access Undertaking 2019 and 2020 Compliance Assessment Submission, Attachment 1: Hunter Valley Network Operating Costs*, p 43.

[14] ARTC 2018 Compliance Submission, Attachment 1 (Operating Costs), p 22.

We would again emphasise that particular attention needs to be paid to ARTC's allocation of overhead costs between the Hunter Valley Network, Inland Rail and other business units. To the extent that ARTC has greater market power on the Hunter Valley Network compared with other networks, it will have an incentive to increase the costs allocated to the Hunter Valley Network. If other parts of ARTC's operations (such as the Inland Rail Project) are giving rise to significant increases in ARTC's overall overhead costs, these increases should not be borne by users of the Hunter Valley Network.

It is for these reasons that we strongly support the Arup Australia review. However we would emphasise the following matters which must be taken into account as part of this review:

1 **Multi-year increases**. As noted above, the significant increase in overhead costs in 2020 is not just a one-off change. This is a continuation of an upward trend that has been observed over more than 5 years. Given these multi-year increases, it is important that the Arup review take a multi-year view – Arup should be asked to review ARTC's overhead costs and allocation methods back to 2013, when the upward trend began. This multi-year review could potentially be extended up to 2021, given that actual data for 2021 is likely to now be available.

2 **Interaction with Business Unit Management**. ARTC's submission highlights the potential for shifting of costs between the 'Business Unit Management' and 'Overheads' categories – one example of this is the human resources function, which was shifted out of 'Overheads' and into the 'Business Unit Management' line in 2019.[15] Given these interactions between 'Overheads' and 'Business Unit Management' costs, Arup should be asked to review *both* ARTC's overheads *and* its business unit management costs.

The Arup review process should be open and transparent. Any reports prepared by Arup should be made available to stakeholders for review and comment.

Next steps

The HRATF would welcome further engagement with ACCC and ARTC around the compliance review process, including any improvements that could be made to this process going forward.

Please contact me if you would like to discuss this matter.

Yours sincerely,

[redacted]

Simon Muys
Partner, Gilbert + Tobin (as adviser)

On behalf of the Hunter Rail Access Task Force

[15] ARTC, *Hunter Valley Coal Network Access Undertaking 2019 and 2020 Compliance Assessment Submission, Attachment 1: Hunter Valley Network Operating Costs*, p 37.