24 March 2021

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

Email: transport@accc.gov.au

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Dear Mr Schroder,

Australian Rail Track Corporation's compliance with the Hunter Valley Coal Network Access Undertaking for 2018

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 2018 calendar year with the Hunter Valley Coal Network Access Undertaking (**HVAU**).

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

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 model.[1] The industry therefore remains substantially reliant upon the ACCC to test prudency of operating expenditure in particular, and compliance with the financial model more generally.

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 a concerning trend in ARTC's operating expenditure (particularly its fixed operating costs) which raises questions about the efficiency of that expenditure. These issues warrant careful analysis by the ACCC.

We continue to believe that the compliance review process could be more effective if there were greater transparency from ARTC around its financial model. If ARTC were to provide greater transparency around its cost and revenue models – as occurs frequently in other regulated sectors – stakeholders would be able to engage more effectively with the compliance review process and could have greater confidence in the outcomes of that process. This issue is also discussed further below.

Overall trends in ARTC operating expenditure

HRATF is concerned about significant year-on-year increases in ARTC's operating expenditure. Significant year-on-year increases, well in excess of CPI, raise questions about the efficiency of that expenditure.

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

The ACCC's consultation paper notes that overall operating expenditure increased by 11.8 per cent in 2018, including a 17.5 per cent increase for the Constrained Network and a 1.7 per cent increase for Zone 3.[2] This follows material increases in previous years. Between 2013 and 2018, ARTC's operating expenditure has increased by more than 50 per cent.

Of particular concern is the increase in fixed operating costs. Fixed operating costs represent 68 per cent of total operating costs in 2018 and therefore have a significant bearing on the total operating cost base.[3] Between 2012 and 2018, fixed operating costs grew at 10% per annum, compared with CPI growth over that period of around 2.4% per annum. Although ARTC has experienced growing volumes, this doesn't explain why fixed operating costs have been growing at four times the rate of inflation.

Maintenance expenditure

The most significant increase in operating expenditure in 2018 was for Routine Corrective and Reactive Maintenance (**RCRM**). There was a 31% increase (~ $8 million) in this category of operating expenditure.[4]

ARTC has provided little by way of justification for this significant increase in 'routine' expenditure, other than noting a general tightness in the contract labour market.[5]

The HRATF would encourage the ACCC to carefully analyse the prudency of ARTC's approach to conducting RCRM.

The HRATF would also appreciate investigation into the ballast cleaning and rail grinding costs, particularly given the large amount spent on consultants to advise on and procure a new rail grinding contract. There is insufficient detail in ARTC's public submissions to properly determine the efficiency of the rate changes to these items year on year. The HRATF acknowledges that some of these contracts may be commercially sensitive. We would be happy to work with the ACCC and ARTC to better understand these changes, while maintaining confidentiality around ARTC's maintenance contracts.

Treatment of asset disposals

The HRATF notes that a key driver of the increase in operating expenditure in 2018 was a significant increase in the 'loss on disposals' category. There was a 58% increase (~ $4.4 million) in this category of operating expenditure in 2018.[6]

ARTC notes that the significant increase in the 'loss on disposals' category in 2018 was "primarily" due to asset replacement programs – including track strengthening and rerailing activity.[7]

Under ARTC's methodology, where it replaces an asset that is not fully depreciated in the RAB, it treats the remaining RAB value of the replaced asset as an operating expense. In effect, ARTC receives the remaining value of the replaced asset immediately, rather than over its remaining life. The HRATF notes that ARTC's assessment of 'disposal value' is based on a 'deemed value' of the replaced asset,

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[2] ACCC Consultation Paper, p 12.

[3] We have estimated this based on ARTC's 2012 and 2018 compliance assessment submission to the ACCC. We have assumed that fixed operating costs comprises fixed track maintenance, loss on disposals, network control, business unit management costs and corporate overheads.

[4] ARTC Compliance Submission, Attachment 1 (Operating Costs), p 7.

[5] ARTC Compliance Submission, Attachment 1 (Operating Costs), p 6.

[6] ARTC Compliance Submission, Attachment 1 (Operating Costs), p 5.

[7] ARTC Compliance Submission, p 20.

not an actual value.[8] If ARTC ends up receiving more than the deemed value, it will receive a windfall gain.

Users are generally consulted on asset replacement programs through the Rail Capacity Group (**RCG**). However as part of this consultation, the 'loss on disposal' cost associated with asset replacement is not specified, either for major projects or corridor capital. For major projects, ARTC's practice has been to provide the justification for asset replacement and the estimated value of assets to be removed from the RAB, although not the estimated proceeds to be realised from such disposals, whereas for corridor capital, neither the estimated written down value to be removed from RAB nor the estimated loss on disposal are provided. This is despite corridor capital accounting for the bulk of ARTC's capital expenditure in 2018.

There is therefore limited transparency around the cost implications of asset disposals associated with most of ARTC's capital expenditure (particularly corridor capex) as part of the RCG process. As the ARTC compliance submission demonstrates, these cost implications can be very significant. Where an asset replacement program involves disposal of assets that have not yet reached the end of their life, the immediate expensing of any 'loss on disposal' can have the effect of significantly increasing the cost of that replacement to users.

Given the increasing costs in this area, HRATF would appreciate some focus from the ACCC's review on this issue, including whether ARTC takes proper account of the proceeds of sale of any surplus assets. ARTC should also be required to identify any circumstances where it has been able to re-deploy assets that have been replaced and demonstrate this has been done so at an appropriate rate.

Network Control costs

ARTC's Network Control costs increased by $1.6 million compared to 2017 (as lodged). ARTC states that this is primarily due to new operating costs relating to the Network Control Optimisation (ANCO) Project and higher labour costs associated with a new staff roster implemented in response to feedback from employees and the Office of the National Rail Safety Regulator (ONRSR).[9]

The HRATF would like to see some further scrutiny of these increases in Network Control costs, particularly the changes to shifts following the employee / ONRSR feedback. In relation to the ANCO Project, the HRATF would like to understand whether (and if so, when) it is expected to deliver cost savings, not just cost increases, for users.

Increases in procurement costs and professional fees for business unit management

HRATF notes significant increases in expenditure in other categories of operating expenditure, including:[10]

- Procurement-related costs, including implementation of a new procurement manual and associated procedures company wide ($0.9 million increase);
- marketing and communication costs relating to ARTC's corporate branding and promotional activities ($0.4 million increase);

[9] ARTC Compliance Submission, Attachment 1 (Operating Costs), pp 18-19.

[9] ARTC Compliance Submission, Attachment 1 (Operating Costs), pp 18-19.

[10] ARTC Compliance Submission, Attachment 1 (Operating Costs).

- professional fees for business unit management (including $0.7 million in professional fees for the continual implementation of the Asset Management Improvement Project, and a further $0.5m of professional costs to secure a long term outsourced rail grinding contract); and
- costs associated with the Capacity Fastrack Initiative, including costs of professional consultants and 'idea generation sessions'.

In the absence of further detail from ARTC, it is difficult for the HRATF to assess the prudency of these costs. However, given the size of the increases in these cost categories, close scrutiny by the ACCC is warranted. In particular, the ACCC should test whether the additional costs incurred in these categories is expected to deliver material benefits to users.

Based on the information presented in the ARTC submission, it is not clear that these increases in expenditure are delivering benefits for users. For example, ARTC spent $0.5m of professional costs to secure a long term outsourced rail grinding contract, which it says was intended to deliver "a step change in rail grinding productivity in order to minimise track time, maximise quality and reduce operational costs".[11] Yet, as noted above, overall rail grinding costs increased in 2018, by 6% overall and 16% in Zone 1.[12]

Costs associated with the new procurement manual and procurement transformation project (PTP) should also be considered in light of any sharing of these resources with other ARTC networks (such as the upcoming Inland Rail Project). ARTC notes that these projects were "company wide" and involve "a multiyear large-scale functional transformation covering end to end supply chain management across the organisation".[13] The HRATF would therefore expect that any prudently incurred costs associated with these projects would be appropriately allocated between the Hunter Valley Network and ARTC's other business units.

Allocation of overhead costs to the Hunter Valley business unit

ARTC notes that more than $1 million of the increase in corporate overheads was "due to the impact of lower non-Hunter Valley allocator values which has the effect of increasing the share of costs being allocated to the Network".[14]

ARTC has not provided detail around this change in allocation. Given its material impact on the amount of corporate overheads allocated to the Hunter Valley Network, this should be tested by the ACCC. The HRATF notes that there have been additional overhead or business unit management costs allocated to the Hunter Valley Network in a number of recent years. These increases in overhead allocation can be difficult to reconcile over a multi-year timescale.

Particular attention should be paid to ARTC's allocation of overhead costs between the Hunter Valley Network, Inland Rail and other business units. If the Inland Rail Project is giving rise to significant increases in ARTC's overall overhead costs, these increases should not be borne by users of the Hunter Valley Network. Rather, any increase in overhead costs associated with Inland Rail should be allocated to that project.

Presentation of information by ARTC

The HRAFT members would appreciate if ARTC could present compliance data including multiple prior years of actual data, shown in both aggregate amounts and as appropriate unit rates, as well as the budgets for the activity ARTC had assumed. This would provide HRAFT with a more concise picture of

[11] ARTC Compliance Submission, Attachment 1 (Operating Costs), p 20.

[12] ARTC Compliance Submission, Attachment 1 (Operating Costs), Table 3A (p 7) and Table 3B (p 8).

[13] ARTC Compliance Submission, Attachment 1 (Operating Costs), p 21.

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

the history of cost elements without having to reconstruct multiple years of data, as well as providing some understanding ARTC's assumptions utilised for the setting tariffs at the commencement of a year.

Greater transparency is required from ARTC

As noted above, the HRATF feels constrained in how it can participate in the compliance review process, due to a lack of transparency around the ARTC financial model. At present, the HRATF is largely reliant upon the ACCC to test for any over or under-recovery within the Constrained Network, and to audit ARTC's application of the true-up test. In relation to efficiency of operating expenditure, the HRATF finds it difficult to identify and test the "value proposition" associated with increased expenditure, including an opex / capex trade-offs or long-term benefits associated with expenditure programs.

By way of example:

- We are unable identify from ARTC's public submissions all of the reasons for under-recovery in 2018, nor are we able to reconcile ARTC's calculation of the under-recovery amount. ARTC's submission notes that, of the total under-recovery amount of $30.7 million, almost half ($13.7m) was due to lower than forecast volumes, a further $7.2 million was due to the differential between forecasted and actual loss on disposal expense, and $4.2 million was due to higher than forecast spending on infrastructure maintenance.[15] However approximately $6 million is left unaccounted for in this explanation. Without access to ARTC's calculations, the HRATF is unable to fully test ARTC's calculation of the under-recovery amount.

- We are also unable to test ARTC's allocation of operating costs, without access to the confidential "mapping" document referred to in ARTC's submission.[16]

- The HRATF is unable to identify how much expenditure in the "other activities" category within infrastructure maintenance is MPM, and how much is RCRM.[17]

- In some cases, it is difficult to identify what is covered by ARTC's expenditure categories. For example, ARTC refers to a "$0.2m increase in Plant Charges due to the timing difference between financial and calendar year plant recoveries".[18] The HRATF does not understand what "plant charges" are, or why they would be impacted by such timing differences.

- ARTC notes that it has provided the ACCC with an update to the confidential spreadsheet utilised with previous submissions that provides a split between MPM and RCRM, forecast MPM and RCRM and the actual and forecast expenditure for the top six maintenance activities.[19] It would be beneficial for users to also have access to this information.

The HRATF acknowledges that transparency has improved since the inception of the HVAU. However there remains room for improvement.

The HRATF considers that the process could be substantially improved if ARTC were to provide greater transparency around the financial modelling underpinning its compliance submissions. At a minimum, ARTC should be required to make available to stakeholders working versions of its cost and revenue models, for the purposes of the compliance assessment.

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[15] ARTC Compliance Submission, p 24.

[16] ARTC Compliance Submission, p 7.

[17] ARTC Compliance Submission, Attachment 1 (Operating Costs), p 10.

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

[19] ARTC Compliance Submission, p 8.

In other regulatory contexts, it is common for financial models to be published. For example, as part of monitoring compliance by nbn with its special access undertaking, the ACCC publishes spreadsheet models prepared by nbn to demonstrate compliance with its revenue constraint and price caps.[20]

The HRATF do not consider that there is any commercial or legal reason for not making a model available on an appropriately confidential and anonymised basis (i.e. or with volumes suitably aggregated or removed) and with functionality (i.e. formulae), to enable stakeholders to engage better in the annual compliance process.

The HRATF also considers that greater transparency could be provided around ARTC's forecasts of expenditure, which are used to set tariffs for each year. Under section 4.20 and 4.21 of the HVAU, ARTC is required to provide users with forecasts of operating and capital expenditure underpinning its determination of tariffs for each year, and users may raise a dispute in relation to ARTC's determination of tariffs within 20 business days. However, currently, users are provided with insufficient information to allow for proper testing of ARTC's forecasts.

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 or Frank Coldwell (Frank.Coldwell@glencore.com) 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

[20] For example: https://www.accc.gov.au/regulated-infrastructure/communications/national-broadband-network-nbn/nbn-co-special-access-undertaking/ltrcm-2019-20.