Australian Rail Track Corporation's compliance with the financial model in the Hunter Valley Coal Network Access Undertaking for 2017

Executive Summary

Pacific National (PN) provides these comments as a Rail Haulage Provider interested in ensuring that the network is subject to reasonable regulatory scrutiny and sound management.

As part of prior HVAU reviews, PN has communicated its concerns to the ACCC over the level of transparency and scrutiny of ARTC's capital and operating expenditure. While the ACCC acknowledged PN's concerns, it is not clear that these concerns have been addressed in the current review.

Again, in this review, PN is concerned that there are some matters that the ACCC does not appear to have sufficient visibility of to ensure that ARTC's expenditure is prudent. Examples of sudden budget overspend just after assurances were made that its budget was on track, suggest that ARTC's planning and forecasting processes need to be improved.

Moreover, PN reiterates that the time from expenditure to regulatory review reduces the effectiveness of the review. The current review period is the 2017 calendar year. PN suggests that the period from the review period to review be significantly shortened. In June 2020, the review period should be the 2019 calendar year.

If ARTC wishes to assure network users and the ACCC that its expenditure is prudent, ARTC should be required to provide greater transparency about network defects and their cost of repair at the time of identification and works.

Introduction

Pacific National (PN) welcomes the opportunity to provide a submission to the ACCC assessment of the Australian Rail Track Corporation's (ARTC) compliance for the 2017 calendar year with the Hunter Valley Coal Network Access Undertaking (HVAU).

PN is not directly affected by the network charges imposed by ARTC on the Hunter Valley network, its customers pay network charges. Nevertheless, PN as a Rail Haulage Provider has an interest in the sound regulatory management of the network.
Under Section 4.10 of the HVAU, ARTC must submit documentation to the ACCC for an annual assessment of its compliance with the HVAU financial model. PN notes due to a lag in reporting and ACCC timeliness of previous assessments, this assessment relates to the 2017 calendar year.

The ACCC assesses whether ARTC has correctly applied its financial model for the purposes of the over and unders account (and Regulatory Asset Base (RAB) Roll-forward) and true-up-test (TUT) for determining rebates for undelivered contracted paths; ARTC submits an independent audit report as part of its compliance submission together with confidential spreadsheets. As the ACCC must accept

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all capital expenditure approved by the Rail Capacity Group (RCG) as prudent into the RAB. PN restricts its comments to operating expenditure efficiency.

Section 4.10(e) of the HVAU provides for the ACCC to assess the efficiency of ARTC's operating expenditure. It is particularly important as ARTC's cost structure is moving away from capital expenditure to operating expenditure. The RCG does not pre-approve operating expenditure and is subject to less scrutiny than capital expenditure.

ACCC assessment of PN's HVAU 2016 compliance submission

While the ACCC's assessment is restricted to the 2017 calendar year, it is important to recognise operating expenditure decisions made in one year will impact on future years. PN's submission to the HVAU 2016 compliance review raised a number of concerns which may have impacted on operating expenditure efficiency in the 2016 calendar year and future years. As we detail below, the ACCC failed to adequately assess these concerns. PN requests the ACCC review and respond to these concerns for the 2017 HVAU compliance assessment noting the nature of our concerns means they remain relevant for the 2017 compliance year (and beyond).

PN submission: ARTC claimed substantial costs for flooding – did ARTC hold appropriate insurance and did it claim on this insurance?

> "We note mudhole full track reconditioning costs for the network increased 122.1 per cent compared to the 2015 compliance period due to flooding events in April 2015 and January 2016.
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> Pacific National queries whether ARTC holds appropriate insurance to minimise the liability associated with events of this nature given it is passing on the costs to its customers. Customers would reasonably expect ARTC to hold an appropriate level of insurance and have access to insurance claims to reduce its exposure. These costs should not be approved where either insurance was not obtained or where ARTC's insurance policy provided it with cost relief (through its insurer's claims process)."

ACCC response: ACCC states it assessed ARTC's overall level of insurance in 2015 however PN cannot reconcile this comment as an answer to our concern above.

PN submission: ARTC inappropriately claiming staff management costs which are solely within ARTC's control

> "ARTC claims a total business management cost of $25.8 million, an increase of $2 million from the previous year. The increases were attributed to internal staff transfers and industrial action associated with its enterprise bargaining agreement. These are risk management and business decisions solely within ARTC's control and ARTC has not established any linkage from these costs to any customer benefits. These costs should not be approved."

ACCC Response: noted but did not address PN concern.

PN submission: procurement risk allocation for cost overruns

> "Pacific National notes a number of instances where costs for procurement have vastly over run ARTC's initial budget. We note the ACCC raised concerns in the 2015 compliance review about a lack of visibility on how ARTC ensures compliance with its own procurement policies and procedures.
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> Based on the cost overruns in 2016, and the proposal to pass these costs onto its customers, the ACCC needs to be satisfied ARTC has explored all contractual avenues with its suppliers to mitigate against cost over runs on current contracts. It should also encourage ARTC to detail how its future procurement practices will ensure the appropriate allocation of risk (between suppliers and itself) in its future contracts to limit liability to its own operations and its customers."

ACCC Response: Did not address PN's concern about whether ARTC had explored contractual avenues to mitigate against cost overruns or whether ARTC provided any detail on the allocation of risk (between suppliers and ARTC).

Operating expenditure – 2017 HVAU compliance submission

Major Periodic Maintenance (MPM) and Routine Corrective and Reactive Maintenance (RCRM)

MPM and RCRM are important for safe and efficient above-rail operations. PN has reviewed ARTC's operating expenditure and makes the following comments. In the 1 June 2017 Cost Report – Maintenance and Corridor Capital Reconciliation, we note Major Periodic Maintenance (MPM) and Routine Corrective and Reactive Maintenance (RCRM):

> '… is currently $6.2m under forecast budget with an expectation that this will reduce to an underspend of $2.1m by 30 June 2017 ($3.8m under in MPM and $1.7m over RCRM).'[1]

However, in the 2 November 2017 Cost Report – Maintenance and Corridor Capital Reconciliation (4 short months later) MPM forecast $1.0M over budget and 2017 RCRM full year forecast $1.1M over budget.

According to the report, MPM was forecast over budget because of ballast undercutting and cleaning: 'Ballast undercutting is $1.9M over budget due to rectification of track geometry issues (mud holes) causing temporary speed restrictions at Port Waratah, Kooragang, Sandgate and Maitland' and 'Ballast cleaning is $2.3M over budget due to timing of work compared to the budget schedule.'[2] (by year end these figures were reported as over budget actuals of $2M and $1.8M respectively). However, ARTC reports this over budget was partially offset by favourable MPM variances in maintenance resurfacing expenditure of $1.4M (by year end this figure was reported as an actual of $1.6M[3]).

As noted above, in the 2 November 2017 Cost Report – Maintenance and Corridor Capital Reconciliation report, RCRM full year was forecast as $1.1M over budget. However, as reported in the 1 February 2018 Cost Report – Maintenance and Corridor Capital Reconciliation, this increased significantly, by the end of the year (one month later) the full year actual was $2.8M over budget. ARTC

[1] 1 June 2017 Cost Report – Maintenance and Corridor Capital Reconciliation, p 1.
[2] 2 November 2017 Cost Report – Maintenance and Corridor Capital Reconciliation, pp 1-2.
[3] 1 February 2018 Cost Report – Maintenance and Corridor Capital Reconciliation, pp 1-2 .

explains 'Rail defect removal was $1.0M above budget with the largest over-spends occurring in the Kooragang to Sandgate and Drayton Junction to Muswellbrook segments.'[4]

PN is concerned by the wide fluctuations in operating expenditure between these reporting periods which raises questions about ARTC's forecasting and budgeting but also the prudency and efficiency of the rapid expenditure increase (against forecast) in as little a month; it also raises questions about the efficiency of the expenditure more generally. We understand none of these works were classified as emergency works.

ARTC reports ballast undercutting overspend was due to track geometry issues. Track geometry defects are a large contributor to temporary speed restrictions which in turn greatly impacts above rail supply performance and throughput on the network. PN notes above rail operators do not receive track geometry data from ARTC so we have no visibility as to decision making on geometry defects. Given ARTC collects and controls this data, ARTC should bear the risk for addressing these types of defect. Alternatively, in the interest of transparency to users and the ACCC, ARTC should be required to provide information on track defects as and when it becomes aware of them and financial information when defects are repaired. As we explain below, ARTC underspent on measures to address track geometry issues and this led to additional expenditure that could have been avoided.

For example, it underspent on maintenance resurfacing. Maintenance resurfacing has wide ranging impacts, particularly for track geometry issues.
We note ARTC states 'Track resurfacing (tamping) restores the track geometric parameters of top, line, superelevation and curvature by mechanised on-track machinery. Similar to ballast cleaning, the accumulated gross tonnage over the line segment determines the initial resurfacing scope'.[5]

Furthermore, expenditure on mud hole track reconditioning for 2017 decreased by $0.1M overall compared to 2016. As noted by ARTC, 'Track reconditioning includes subgrade treatment, the installation of structural earthworks, a capping layer and new ballast, followed by track and drainage restoration. The purpose being to effectively manage the risk to rail operations from track geometry deterioration.'[6]

We also understand ballast undercutting provides a short-term solution to mud hole removal where the track condition does not require a full track reconditioning. We therefore have difficultly reconciling the significant overspend on ballast undercutting with the reduction in mud hole track reconditioning/maintenance (track) resurfacing. ARTC does not appear to adopt an efficient approach as recommended in the ACCC's consultant report for its 2015 compliance assessment of operating expenditures which stated[7].

> 'Undercutting activities are also related to other maintenance activities like mud hole management, such as mud hole rectification and drainage. These two are primarily RCRM activities that require immediate and short-term implementation…'

[4] ibid, p 2.
[5] ARTC Hunter Valley Coal Network Access Undertaking 2017 Compliance Assessment Submission Attachment 1: HV Network Operating Costs, p 11.
[6] ibid, p 10.
[7] WIK – Consult Assessing the efficiency of ARTC's opex for 2015, p 36.

> 'Thus, a combination of both routine maintenance activities as part of RCRM and the reactive activity of ballast undercutting provides an effective and efficient method of removing mud hole induced defects.'

Furthermore, if ballast undercutting overspend is attributed to track geometry issues (for which ARTC holds and controls the data) and given ARTC appears to have deprioritised maintenance resurfacing and mud hole track reconditioning we submit ACCC should assess the efficiency of this ballast undercutting overspend. This is important given total ballast undercutting costs were $4.3M[8] meaning the overspend is a significant proportion of these costs.

PN raises similar concerns about ARTC's overspend on ballast cleaning (total ballast cleaning costs were at least $13.2M[9]). ARTC claims ballast cleaning costs were over budget due to timing of the works compared to the budget schedule. We note ARTC outsources its ballast cleaning and both the ACCC and PN have raised concerns about the efficiency of ARTC's procurement practices. Given ARTC's reason for over-spend is scheduling (which is within ARTC's and its contractor's control) the ACCC needs to assess the efficiency of this expenditure.

In terms of RCRM, we question how within one month the budget could increase by $1.7M – especially as we understand 60 per cent of ARTC's RCRM is provided inhouse[10]). ARTC claims the main reason is due to a $1M increase in rail defect removals. According to ARTC:

> 'Rail defect removal is the removal of surface or internal defects through replacing and welding in a new length of rail, generally 6-8 metres in length. Defects are identified through visual or ultrasonic inspections; increased tonnage, which the HV Network has experienced over the past few years, has an adverse impact on track formation and consequently results in additional track defects requiring attention to maintain track reliability.'[11]

PN questions the efficiency of this expenditure – ARTC holds data on defects and has invested in equipment to carry out ultrasonic inspections. We assert because these defects are caused by increased tonnage over time, a one month unexpected overspend would be unlikely. PN requests the ACCC thoroughly investigate the efficiency of this spend and whether there are systemic issues with either reporting, forecasting or its ultrasonic inspection regime/equipment (which in itself would be paid for by access holders and therefore subject to an efficiency review).

PN's review of operating expenditure suggests the significant overspends in ballast cleaning, ballast undercutting and rail defect removals (which occurred in a short period) cannot be explained by the cyclical nature of the tasks. Furthermore, we cannot understand how ARTC can claim the expenditure was efficient given it underspent in areas which could have addressed the underlying cause of the overspend.

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[8] ARTC Hunter Valley Coal Network Access Undertaking 2017 Compliance Assessment Submission Attachment 1: HV Network Operating Costs p 5.
[9] 1 February 2018 Cost Report – Maintenance and Corridor Capital Reconciliation, p 3.
[10] WIK – Consult Assessing the efficiency of ARTC's opex for 2015, p 40.
[11] ARTC Hunter Valley Coal Network Access Undertaking 2017 Compliance Assessment Submission Attachment 1: HV Network Operating Costs, p 13.

Business unit management and overheads – operating expenditure

PN notes business unit management costs increased $3.9M compared to 2016 (as lodged) and $3.6M against 2016 restated. According to ARTC, one of the major drivers for the cost movements was:

> '$1.4m of costs were incurred in 2017 for the development of an operating cost efficiency mechanism. This was a key element for both the ACCC and Customers for the renewal of the 2017 HVAU at the time. ARTC worked closely with a working group of Customers in developing the proposed mechanism and shared considerable information with those Customers on ARTC's cost base and drivers.'[12]

While PN accepts both the ACCC, ARTC and some access holders were supportive of the operating cost efficiency mechanism in ARTC's proposed 2017 Hunter Valley Access Undertaking (2017 HVAU undertaking), ARTC ultimately withdrew the undertaking after the ACCC draft decision.

PN's concerns with the mechanism stem from the potential for it to adversely impact on rail operators who carry the haulage risk but do not benefit from financial rewards which accrue to the customer or network. Rail is different to other network infrastructure regulatory regimes which have implemented an operating efficiency mechanism as the risk/rewards and responsibilities are clearer i.e. no risk bearing middle entity, just two parties – the customer and the network. Moreover, as we noted in our submission on the proposed 2017 HVAU undertaking[13]:

> 'Pacific National is concerned the 2017 HVAU does not include a requirement for ARTC to consider submissions from non-Access Holders on the development of its Opex efficiency mechanism. Pacific National considers above-rail operators should be directly involved in the development of the mechanism because it is above-rail operators, not Access Holders, that will be directly impacted by changes in operations and maintenance as a result of changes to Opex.
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> Pacific National also reiterated the views put forward in its submission on the 2016 HVAU. Namely, its concern that the Opex efficiency mechanism will incentivise ARTC to underspend on operating and maintenance functions at the expense of future track quality over the term of the 2017 HVAU.
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> Pacific National noted that in recent years, ARTC has not spent on maintenance activities at the level required for efficient train operations. Pacific National is concerned that the Opex efficiency mechanism may reduce track quality resulting in unplanned delays and increasing costs to above-rail operators and Access Holders.'

In terms of the 2017 HVAU compliance assessment, PN accepts ARTC incurred some business unit management costs for the development of the mechanism: ARTC engaged 'two consultants to assist with the development of the mechanism–one to develop a maintenance and operations cost forecasting and benchmarking report, and the other to develop an overheads cost forecasting and benchmarking report.'[14] However, we believe the ACCC should assess the efficiency of these costs including the timing of when the expenditure was incurred and whether the reports were developed/released in 2017.

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[12] Ibid, p 17.
[13] Pacific National, Pacific National Submission to the ACCC on the ARTC Proposed 2017 Hunter Valley Access Undertaking, 3 February 2017, p .17.
[14] ACCC Draft Decision Australian Rail Track Corporation's 2017 Hunter Valley Access Undertaking p, 226

For example, we note the ACCC's draft decision on the 2017 HVAU undertaking stated 'the ACCC cannot assess the appropriateness of the Opex efficiency mechanism until it is submitted in full by ARTC in April–May 2017'[15].

Given the lack of detail for ACCC assessment of the mechanism, we question whether the full ARTC expenditure claim for the development of the mechanism in the 2017 calendar year business unit costs is efficient. We are also concerned ARTC may try to repackage these costs as part of its HVAU 2022 undertaking submission – noting the ARTC paid for consultants to develop the aforementioned forecasting and benchmarking reports but to our knowledge has not released them. Accordingly, the ACCC should assess the efficiency of the 2017 business unit management cost compliance claim.
In terms of ARTC's claim for corporate overheads, we note a '$1.0M decrease in Hunter Valley insurance costs due to 'favourable insurance market conditions at the time of reassessment and renegotiation of insurance'[16]. While we support reduced premiums and making the most of favourable conditions, the ACCC has not addressed PN's concerns about ARTC's insurance raised in PN's HVAU 2016 compliance submission.

Corridor capital

As part of its operating expenditure claim, ARTC details its corridor capital (approved by the RCG and entered in the RAB).

ARTC states its focus in 2017 was on reliability given the top three infrastructures loses for 2017 were rail breaks, bridge defects and points failures (due to heat). It states rail breaks (due to welding issues) and points failures have factored at the top of the reliability impacts each year, but bridge defects are increasingly causing infrastructure losses[17]. ARTC presented its approach to all three issues to the RCG; ARTC will address rail breaks as part of its new rerailing program (corridor capex) and bridge defects and points failure will be the focus of new inspection regimes (Points Condition Monitoring). Despite the above, ARTC report corridor capital expenditure on rerailing activities decreased by $20M against 2016[18].

PN has concerns ARTC does not adopt a wholistic approach to its maintenance and operating expenditure – it does not appear to recognise a reduction in one expenditure category (i.e. track resurfacing) may cause a corresponding increase in another expenditure category (i.e. ballast cleaning and undercutting). We submit this may be the same for corridor capital. As an example, it may be possible to combine track resurfacing (MPM) with rail break rerailing activities which would result in more efficient outcomes. PN notes it may be difficult for stakeholders to appreciate where there might be efficiencies when corridor capital is aggregated for the purposes of RCG approval.

In its assessment of operating expenditure efficiency, the ACCC should consider whether ARTC's maintenance and operating expenditure approach is capable of planning for work designed to address inter-related efficiencies (synergies) and whether the treatment of corridor capital precludes this assessment. We note ACCC's consultant report for its 2015 compliance assessment of operating

[15] ibid p, 225
[16] ARTC Hunter Valley Coal Network Access Undertaking 2017 Compliance Assessment Submission Attachment 1: HV Network Operating Costs, p 18
[17] RCG Monthly December 2017 report, p 14.
[18] ARTC Hunter Valley Coal Network Access Undertaking 2017 Compliance Assessment Submission Attachment 1: HV Network Operating Costs, p 15.

expenditures (WIK-Consult report) did not consider these issues in any detail (other than the efficiency of combining ballast undercutting with RCRM activities noted earlier in the submission and a general comment about the substitutability of capital and operating expenditure). PN submits for the 2017 compliance assessment, the ACCC may need to re-classify some of the capital corridor expenditure as MPM or RCRM or vice versa in its assessment of total operating expenditure.

Furthermore, in the development of the new HVAU2022, ARTC should strengthen the role of above rail operators in its operating expenditure decisions. As noted by WIK-Consult[19]:

> 'The close relationship between capital works and maintenance activities makes closer participation of stakeholders desirable. The review of ARTC's capitalisation policy has shown that ARTC applies standardised approaches for expensing and capitalisation and does not provide any indication for double counting of expenditures as capex and Opex. The analysis showed that there is a close interrelation between Opex and capex. Particularly, there is substitutability of both as, for example, investments in new or upgrades of existing infrastructure may reduce maintenance requirements. While the HVAU set out the process and obligations for industry consultation on capital expenditures, there are no requirements for the ARTC to provide detailed information on current or planned maintenance activities. Due to the close relationship between capital works and maintenance activities, a higher level of transparency and closer participation of stakeholders seems desirable'…

Conclusion

PN submits it is not appropriate for the ACCC to approve the full operating expenditure amount for the expenditure referenced in this submission under section 4.10(e) of the HVAU. This is because we are not confident ARTC has incurred efficient costs and efficient operating expenditure in accordance with section 4.5(b) of HVAU. The ACCC will need to assess the operating expenditure and determine the change to; the total unders and overs amount or allocation; and closing RAB and RAB Floor Limit that results from economic cost only including efficient operating expenditure.

[19] WIK – Consult Assessing the efficiency of ARTC's opex for 2015, p iii.