Pacific National Submission on ARTC's 2019 Application to Vary the 2008 Access Undertaking (2019 Variation)

Pacific National does not support ARTC's proposed 2019 Variation and recommends. the ACCC not approve the proposed 2019 Variation. We are of the view that, for the reasons outlined below. ARTC has not sufficiently demonstrated that its proposed 2019 Variation has had appropriate regard to sections 44ZZA(3) and 44ZZCA of the *Competition and Consumer Act 2010* (**CCA**). We

Executive Summary

ARTC has sought to justify the proposed 2019 Variation on the basis that:

> *It is in the interests of operators using the interstate network and their customers that an undertaking remains in place and there is regulatory certainty as to access and pricing until the 2019 IAU is accepted by the ACCC.*
>
> *In the absence of an approved ACCC undertaking, parts of the interstate network will become subject to state based economic regulation which will add complexity and administrative burden for operators and ARTC which is not preferable for an interim period.*
>
> *The reconciliation mechanism will provide protection for operators and ARTC that the pricing for the period of the extension will be reconciled against the approved regulatory positions under the 2019 IAU, once accepted.*

Pacific National considers that:

1. the proposed reconciliation mechanism included in the proposed 2019 Variation creates pricing uncertainty for, and may adversely impact, rail operators (section 1);
2. ARTC's proposal to extend the 2008 IAU to 29 February 2020 does not provide sufficient time for ARTC to effectively consult with industry stakeholders and for the ACCC to conduct its formal regulatory review, thus creating further uncertainty for rail operators in respect of access in 12 months' time (section 2);
3. the proposed 2019 Variation seeks to impose ARTC's 2018 Standing Offer, however, ARTC has failed to establish that the pricing increases proposed by ARTC in its 2018 Standing Offer are efficient, justified or correct (section 3);
4. ARTC has failed to provide any economic justification for the price increases included in the proposed 2019 Variation (section 4); and
5. if the annual CPI adjustment contemplated in the proposed 2019 Variation is introduced, this has the potential to negatively impact customer perceptions of the competitiveness of rail freight in comparison with heavy vehicle haulage (section 5).

For these reasons, Pacific National is strongly of the view that:

- ARTC has not sufficiently demonstrated that the proposed 2019 Variation will provide rail operators with access on an efficient and cost-effective basis, or will improve access outcomes for existing customers or new market entrants; and
- the proposed 2019 Variation does not create certainty as to access and pricing.

Background

Access to the interstate below-rail network is essential for rail operators to compete with other freight transport businesses (road, rail, shipping and air freight services) to provide freight services (containerised, bulk (non-coal) and regional intra-state) as part of the national freight task.

As the monopoly provider of access to the interstate rail network, ARTC has a significant role to play in ensuring that rail freight supply chains are efficient, cost-effective, productive and competitive in comparison to the other market-based modal alternatives such as road and sea. Improved, service coordination, integration, reliability and performance will facilitate efficient freight outcomes for existing and grow the freight business by attracting new customers to move their freight by rail. An efficient national rail freight supply chain will improve the rail industry's long-term competitive outcomes, develop and open up new customer markets and enable the rail industry to grow its share of the national freight task.

1. The proposed reconciliation mechanism is commercially and practically unworkable

ARTC's proposed reconciliation mechanism results in significant uncertainty and economic inefficiencies for rail operators and may adversely impact Pacific National and other rail operators seeking to provide rail haulage services to end customers. In particular:

- it is unlikely rail operators will be able to fully pass through ARTC's proposed FY2020 prices, leaving rail operators bearing the full cost of the proposed price increase;
- rail operators would not be able to pass through any future "backdated increases" (via the reconciliation mechanism) to customers on existing contracts, leaving rail operators fully exposed to the "unknown and unquantified" regulatory risk;
- the commercial uncertainty of the reconciliation mechanism is a contingent liability and it is unlikely rail operators would be able to include an access contingent liability provision in any new haulage contracts;
- rail operators (both existing and potential new entrants) do not all have the balance-sheet strength to continue to indefinitely roll-forward an access liability into future financial year budget cycles, leaving rail operators exposed to "wearing" any potential future cost adjustment; and
- there is no mechanism for ARTC to compensate rail operators for existing and new customers which are lost to road due to the higher access prices being imposed during the transition period.

ARTC has proposed a reconciliation mechanism which simply assumes ARTC will backdate any future ACCC approved pricing schedule to 1 July 2019. However, there is no guarantee that ARTC's proposed reconciliation mechanism will be given effect as the ACCC is not empowered to mandate that outcome in the discharge of its legislative obligations under the CCA. For example, should the ACCC not approve ARTC's proposed pricing schedule in the proposed 2019 access undertaking, ARTC is under no obligation to re-submit a subsequent replacement access undertaking to give effect to the ACCC's recommended pricing position.

Accordingly, ARTC's proposed reconciliation mechanism:

1. does not provide rail operators with any certainty in relation to:
   - the expected timing for the reimbursement of any 'over-recovery' by ARTC;

- ensuring ARTC does not obtain any windfall gain from the reconciliation mechanism (i.e. there is no late payment or interest charge) should any delay to the ACCC's consideration of a new replacement access undertaking occur beyond 28 February 2020;
- the timing of the new replacement access undertaking to be approved by the ACCC;
- the provision of rail freight services into the national freight task as it requires rail operators to compensate ARTC in the event the access charges approved by the ACCC under a new replacement undertaking are higher than the charges proposed under the 2019 Variation; and

2. cannot be implemented among rail operators in a non-discriminatory manner, with the potential for rail operators to be differentially impacted depending on whether they compete in the East-to-West freight market, North-to-South freight market, and whether they are able to pass-through the costs to their existing customers; and
3. is only triggered by approval of a new replacement access undertaking (and therefore there is no protection for rail operators if a new replacement access undertaking is not approved by the ACCC and ARTC does not subsequently submit an access undertaking to give effect to the ACCC's recommended position).

2. 2019 Variation extension of term to 29 February 2020

ARTC's proposal to extend the 2008 IAU to 29 February 2020 does not provide sufficient time for:

- ARTC to consult with rail operators, end customers, key stakeholders and the ACCC on the development of a new replacement access undertaking prior to lodgement with the ACCC; and
- the ACCC to conduct a formal regulatory review of that replacement access undertaking, inclusive of the additional timeframes involved in the event the ACCC does not approve this subsequent replacement access undertaking.

In the circumstances, Pacific National considers that ARTC's proposal to extend the 2008 IAU to 29 February 2020 creates additional uncertainty for rail operators.

3. ARTC's proposed 2018 Standing Offer

The proposed 2019 Variation focuses only on imposing ARTC's 2018 IAU Standing Offer (published September 2018) on rail operators outside the normal regulatory process whereby the ACCC approves the pricing schedule to apply to an access undertaking under Part IIIA of the CCA.

Pacific National does not support the price increases proposed by the ARTC in its 2018 Standing Offer published on its website. ACCC's draft decision on the 2018 IAU raised serious questions in relation to the pricing framework underpinning the 2018 Standing Offer and questioned ARTC's base assumption that the access tariffs in the 2018 Standing Offer were significantly below the regulatory ceiling threshold. Specifically, the ACCC:

- questioned whether annual CPI adjustments to capital and operating costs as well as to access tariffs were efficient;
- advised ARTC it had provided no economic justification for imposing a 2% real price increase on train services traversing the Adelaide to Kalgoorlie section of the network;
- identified major issues with each of the key elements of ARTC's proposed pricing approach in the 2018 IAU;
- proposed a lower WACC (from 8.97% to 7.28% nominal post tax);

- suggested changes to the asset roll forward that could significantly reduce the value of assets used to calculate the ceiling tariffs;
- asked ARTC to provide its customers with the key assumptions ARTC used to derive the separate floor and ceiling prices on each freight corridor;
- did not approve ARTC's proposed 10% margin on operating and maintenance costs;
- requested significantly more detail on the prudency of its capital investments and maintenance costs; and
- noted a range of errors and inconsistencies in ARTC's pricing model.

The long-term impact of the above issues will not be clear until ARTC has responded to the ACCC's draft decision on the 2018 IAU. Pacific National considers that the ACCC's draft decision raises significant concerns and unresolved issues in relation to the approach adopted by ARTC in the 2018 IAU, including with respect to ARTC's published 2018 Standing Offer pricing schedule. In the circumstances, Pacific National submits that the proposed 2019 Variation, which reflects ARTC's is based on the approach adopted in the 2018 IAU, cannot reasonably be accepted.

4. No economic justification for the price increases in ARTC's 2019 Variation

ARTC has failed to provide the ACCC, rail operators or customers with a robust and defensible economic justification for either the CPI increase of all ARTC access tariffs, or the additional 2% real price increase on access tariffs between Adelaide and Kalgoorlie (being a 4.5% increase on this pricing segment).

Further, ARTC has failed to provide rail operators with any information on the market demand forecasts it relied on to determine that current East-to-West freight customers could pay higher prices without triggering a consequential fall in East-to-West rail freight volumes. In fact, market research undertaken by Pacific National[1] reveals a clear declining trend in East-to-West[2] rail freight volumes over the 5 years to 31 December 2018. Specifically, over the five-year period CY2013-2018, rail volumes [redacted]. In the same 5-year period, road freight volumes remained stable with [redacted] being hauled per annum. However, over the same time, the East-to-West freight volumes carried by sea increased [redacted]. This clearly demonstrates a growing and sustainable East-to-West modal shift away from rail freight towards sea freight.

It is unclear from ARTC's proposal why ARTC considers it appropriate to increase access charges on the East-to-West freight corridor but does not make a symmetrical downward adjustment on the access tariffs applying to the heavily competitive North-to-South freight corridor where the rail industry is consistently losing market share to road freight[3]. In the North-to-South freight markets, road freight operators have a clear competitive access advantage from the current PAYGO pricing model which underpins national vehicle registration and road user charges for trucks carrying freight by road. For example, the PAYGO pricing model means that trucking companies hauling freight on the Pacific

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[1] Based on PN internal data, the WA Department of Primary Industries and Regional Development, ARA commissioned Deloitte market research, and public data.

[2] Rail freight haulage services operating from the East Coast (Brisbane, Sydney, Melbourne and Adelaide) through to Perth.

[3] Sydney to Melbourne, Brisbane to Sydney and Brisbane to Melbourne freight transport corridors.

Highway have not had to contribute towards any of the $12 billion in capital costs the Commonwealth Government has invested since 1996, but these trucking companies have still been the primary beneficiary of a 2.5-hour reduction in travel time for trucks travelling between Sydney and Brisbane.[4]

Having regard to the matters discussed above, including the lack of market data in support of its proposed 4.5% price increase on the East-to-West pricing segment, Pacific National submits that ARTC has failed to demonstrate that the 2019 Variation has had appropriate regard to the legislative criteria in Part IIIA of the CCA.

5. Competitiveness of Rail freight versus Road freight

The intermodal rail freight industry competes directly with the road freight industry. As previously outlined, national heavy vehicle road charges have been established using the PAYGO model. Under the PAYGO model the National Transport Commission (NTC) calculates and recommends heavy vehicle registration and road user charges to the Transport and Infrastructure Council based on the pricing principles set by both the Transport and Infrastructure Council (the Council) and the Council of Australian Governments (COAG). This model takes the actual expenditure on roads by the state and territory road agencies over the past seven years, and derives a weighted average, with earlier years having a lower weighting than later years. Around 22 per cent of the total cost is assumed to be attributable to heavy vehicles, based on engineering and cost estimates. Critically there is no attempt by governments to charge users for the roads they use, and, since the PAYGO program was only introduced in 1995, the PAYGO pricing model does not attempt to recover the cost of assets built before 1995.

ARTC's proposal to increase its FY2020 rail tariffs by a minimum of CPI will have the effect of sending price signals to the national freight task that rail freight haulage prices will continue to increase more quickly than for those of its major freight competitor (trucking companies) for the foreseeable future. Of most concern is that

- ARTC's proposal to increase all rail tariffs by CPI lacks a clear economic justification and is not directly linked to changes in the costs of operating the network or the quality of the service offered.
- If the annual CPI adjustment contemplated in the proposed 2019 Variation is introduced, there is a real potential for this outcome to negatively impact customer perceptions of the competitiveness of rail freight in comparison with heavy vehicle haulage.
- ARTC's proposal to increase East-to-West rail tariffs by an additional real 2% (4.5% in total) provides no economic justification beyond ARTC's assertion that 'the market can bear it', with no reference to any independent evidence to support their position.

Accordingly, Pacific National does not consider that ARTC, in proposing the proposed 2019 Variation, has had proper regard to the objects of Part IIIA of the CCA, including that the access undertaking encourages the economically efficient use of, and economically efficient investment in, transport infrastructure.

[4] There has been not been a similar reduction in the transit time for trains travelling between Sydney and Brisbane over the same period.