ARTC Submission on Submissions

QCA Declaration Review

July 2018

1 Introduction

Australian Rail Track Corporation (ARTC) welcomes the opportunity to comment on the submissions provided as part of the QCA Declaration review.

2 Australian Rail Track Corporation Ltd (ARTC)

ARTC was created in 1998 through an Inter-Governmental Agreement (IGA) signed by the Commonwealth, Victoria, South Australia, NSW, Western Australia and Queensland and is a company under the Corporations Act, whose shares are held by the Commonwealth of Australia. ARTC was established as a consolidated interstate rail track owner to create a single process for access. ARTC's charter at inception was to:

- Improve performance and efficiency of interstate rail infrastructure;
- Increase capacity utilization;
- Listen, understand and respond to the market;
- Operate on sound commercial principles; and
- Provide shareholders with a sustainable return on capital invested.

ARTC currently has responsibility for the management of around 8,500 route kilometres of standard gauge track, in South Australia, Victoria, NSW and Western Australia which includes the interstate freight network in those states as well as the Hunter Valley Coal Network in NSW. In Queensland, ARTC leases the section from the Queensland Border to the Acacia Ridge Terminal. Over these corridors, ARTC is responsible for:

- Selling access to train operators;
- Development of new business;
- Capital investment;
- Operational management; and
- Management of infrastructure maintenance

2.1 ARTC Undertakings

As a function of this structure, ARTC has two voluntary Access Undertakings in place approved by the Australian Competition and Consumer Commission (ACCC) under the *Competition and Consumer Act 2010 (Cth)*:

- The Hunter Valley Access Undertaking (HVAU); and
- The Interstate Access Undertaking (IAU).

Each of these undertakings can be thought of as broadly consistent with one of the declarations in place under the QCA; with the HVAU similar to Aurizon's Undertakings in respect of the Central

Queensland Coal Network (CQCN) and QR's West Moreton system; whilst the IAU is consistent with the QR declaration for its freight network given the strong competition from road freight on the interstate network.

Given these similarities, ARTC believe it has some relevant input to the QCA despite the fact it is not formally regulated by the QCA.

3 QCA Submissions

The submissions lodged largely reflect the position of the parties in respect of access negotiations – with the owners of access infrastructure recommending that the declaration should cease for their relevant asset and the users of that asset insisting that the declaration should continue.

Many of these submissions are accompanied by extensive independent expert reports which support the various positions. This QCA submission process therefore reflects the submission process for approval of Undertakings with "experts at 50 paces" and the extensive costs which are incurred in these efforts by all parties involved – costs which are outlined in detail in the Aurizon submission.

ARTC has reviewed the submissions of all parties, including the Deed Poll proposals provided by QR and DBCT Management. Based upon these submissions, ARTC believe that the following critical points can be made:

- Based upon the submissions of Glencore and Pacific National (PN) praising the benefits of the declaration on QR's Mt Isa and North Coast Lines in contributing to the value of their business, the critical aspect of the declaration is providing open access and NOT the determination of an Indicative Tariff
    - This is consistent with an economic framework reflecting the New Institutional Economics of Ronald Coase, Oliver Williamson and Elinor Ostrom (all whom won Nobel prizes) that efficiency is driven by the contractual allocation of property rights through negotiated (and court enforceable) agreements;
- QR's and DBCT's proposed Deed Polls and Access Frameworks are consistent with this framework:
    - These policies define enforceable arbitration principles to resolve disputes which allows the parties to make conscious decisions in respect of the merits of such arbitration;
        - This, too, is consistent with the NIE outcomes whereby the transaction costs are key to negotiated outcomes and efficiency of industries as parties will act to minimize transaction costs which include the risk of outcomes that are addressed in the contractual agreements;
- Although ARTC operates in a different regulatory environment than Aurizon and QR, where the costs of the ACCC in regulating the networks are not transparent and hence not understood, the cost of the regulatory process from ARTC's perspective is significant and covers:
    - Resources to develop the proposed undertakings and supporting documentation;
    - Resources to respond to extensive data requests to support analysis of the proposed undertakings;

- Resources to provide annual compliance reviews
- Independent experts to support positions proposed in the proposed undertakings;
- Legal, drafting expertise to draft undertaking documents.
- In addition, ARTC's HVAU model of ex post compliance creates a significant risk of time lag between costs incurred and approval; where the ACCC is currently still reviewing the 2015 Compliance submission.

4 Regulatory Process

All of these costs and risks are incurred to provide certainty on whether the price paid by customers is efficient – but efficient based on an academic assessment of a so called efficient return and benchmarked cost. This creates an academic and theoretical exercize contributing significantly to the costs of regulation, all designed to find the so called "efficient" price of access.

This process creates an adversarial environment that ensures parties will not negotiate an outcome because they are constantly reviewing what the regulator would find to be the academic theoretical price – ensuring that despite a stated intent to see negotiated outcomes, the regulatory presence actually ensures such an outcome is unachievable.

As it currently stands, the role of an Economic Regulator is designed to impose efficient pricing on what is deemed a natural monopoly; by virtue of the fact that the economic theory associated with National Competition Policy in Australia suggests that efficiency can only be achieved in workably competitive markets. Therefore, the role of economic regulation is to impose pricing outcomes on "natural monopolies" that would otherwise be attained in "workably competitive" markets.

This creates a significant theoretical exercize to determine what such an outcome would be – through the development of a building block model, the estimation of an efficient rate of return and the assessment of what efficient operating and maintenance costs should be. Each and every step involves substantial theoretical exercizes and the use of judgement in determining every parameter. The recent approach by the Australian Energy Regulator in conducting a transparent expert forum on WACC parameters demonstrates the variance in expert opinions and the use of judgement by the Regulator in reaching a conclusion.

4.1 Regulatory Variances

What is relevant in this context is not so much the decisions that Regulators take in respect of these decisions but the extensive variance that exists between the decisions of different economic regulators covering Queensland, the Commonwealth, NSW and WA (where WACC estimates are published). Using mid 2017 as a reference point, the following table summarizes the spread:

	QCA	ACCC	IPART	ERA
Pre-Tax, Real WACC (%)	3.55% (UT5 Draft Decision Dec 2017)	4.60% (HVAU Draft Decision April 2017)	6.3% (bi annual update Aug 17)	7.52% (freight) 10.56% (resources)

These variances are driven by different interpretations and applications of the methodology to arrive at the same point – being an assessment of what the efficient rate of return for a rail infrastructure owner should be. The variances reflect, inter alia, differences in assumptions on:

- The risk profile of the asset (as reflected by asset beta in the WACC parameters);
- The calculation of market based rates such as risk free rate and market risk premia balancing long term averages and spot exposures;
- The relevant inflation estimate to use to balance this assessment; and
- The value of dividend imputation to shareholders.

In particular the interaction of assumptions to establish forecasts of inflation, risk premia and risk free rates show the potential for inconsistency in assumptions. For instance, the use of 20 day average spot rates for the risk free rate in conjunction with the RBA based inflation rate indicates a potential inconsistency. ARTC does not intend to revisit the theoretical debate in detail, however the following points can be made:

- The standing view is that investors can differentiate between long and short term views of inflation so therefore the long term RBA inflation target mid-point is taken to be the most reliable and stable estimate for inflation and not the spread between nominal and inflation indexed bonds which reflect short term drivers;
- Yet that same investor is taken to use (effectively) the spot bond rate as its determinant of the long term risk free rate in its calculations; and
- In the decisions of the ACCC, establishes an MRP over a long term average of 6%.

Whilst each of these decisions is potentially supportable in isolation, in combination they are inconsistent. If the investor can differentiate between long and short term inflationary expectations, and establishes its MRP over the long term market average; why does it import market volatility into its yield decisions through the effective use of the spot rate for the risk free rate?

A further difficulty arises in respect of the assessment of the rail specific investment risks being that there is no independent listed below rail entity that can provide one comparator for market analysis; let alone the number required to provide statistical significance to the analysis. The lack of local comparators was raised in the AER Expert forum as an issue, and for rail the issue is more acute as there are neither current nor historical firms that can be used for effective analysis at both the local and international level.

The use of inconsistent WACC calculations and the lack of appropriate investment comparators therefore create the potential for return calculations that distort investment decisions and are substantially different than the outcomes which would be reached by commercial negotiation.

The reality of these outcomes, and their impact on the negotiation process, entrenches the adversarial process outlined above and imposes substantial costs on the industries that are subject to regulation. The fact that the application of the regulatory WACC methodologies invariably leads to lower WACC outcomes than where the methodologies are consistent (as they are in WA and NSW), in turn makes the approach between regulator and infrastructure owner itself adversarial – which raises potential concerns as raised in the decision by the Australian Competition Tribunal in Re East Australian Pipeline Limited [2004] ACompt 8 at [33] (highlight added):

> *33 As the decision in relation to the ICB must be set aside in any event, it is not necessary for the purposes of this decision to*

> *come to any conclusion in relation to the contention put on behalf of EAPL that the ACCC was reasoning towards a predetermined conclusion. It would, of course, be wrong of a regulator to justify a decision taken for a particular reason by reference to other reasons. A regulator in the position of the ACCC has a delicate task. It must be conscious of the interests of parties other than the proponent of the access arrangement and is bound to scrutinise carefully the information provided in support of it.* ***On the other hand, it must have regard to the legitimate business interests of the proponent and should not put itself in an adversary position in relation to the proponent so that it may be perceived as a champion of other interests such as those of consumers.***

4.2 Investment Efficiency and Regulatory Model

The structure of the industry being regulated is relevant to the regulatory decisions made. In essential industries, such as electricity and water, where the regulator is negotiating on behalf of the consumer, such decisions are potentially reasonable; especially where the cost decisions have a direct impact on economic activity. Even then, however, the regulatory process can have potential impacts on efficiency.

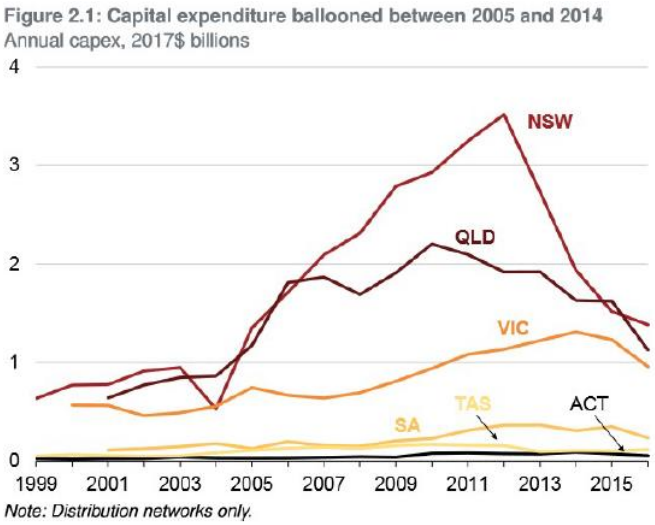
To demonstrate this, consider the examples of two industries natural gas and electricity.

4.2.1 Natural Gas Transmission Investment

In natural gas transmission, where pipelines were largely unregulated following the EAPL decision and then the revocation of coverage of the Moomba to Adelaide Pipeline System in 2007, access seekers and pipeline owners were able to negotiate access contracts and capacity expansions to ensure that capacity demand and supply were met. Whilst the ACCC (notably not participant companies) expressed some concern at the rates charged by pipeline companies, the investments were made, capacity expanded and a large interconnected system covering an area (soon to be) from Darwin to Adelaide and Gladstone to Tasmania has been created.

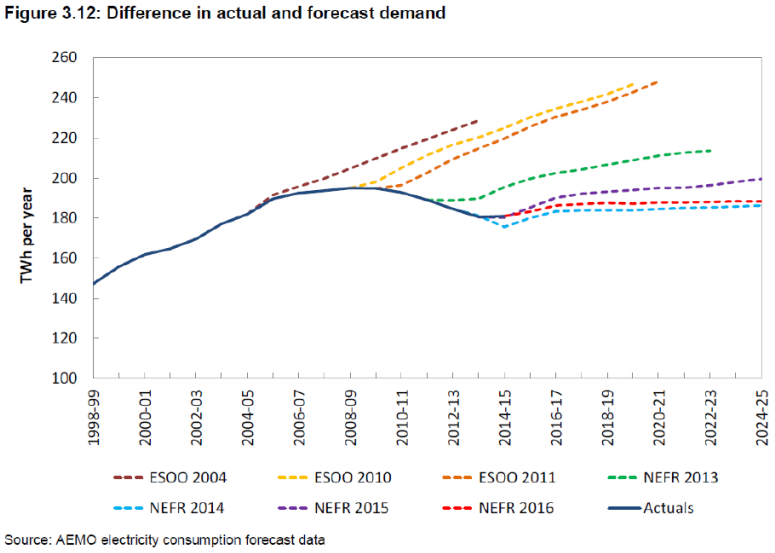
4.2.2 Electricity Network Investment

In respect of the fully regulated electricity network system, however, there have been examples of significant over investment in the system. As was highlighted by the Consumer Challenge Panel Number 16's submission in May 2018 to the AER's Rate of Return Guideline Review (p32) growth in capital expenditure ballooned between 2004 and 2014 in what has come to be referred to colloquially as the "gold plating of the system":



An alternative reason for this however could be viewed by the regulatory process where capital was approved 5 years in advance based on the proposed undertaking and utilizing the independent forecasts of the market operator to establish its requirements. Another consumer submission to the AER Rate of Return, Consumer Reference Group submission, provides the context of those forecasts where it took until 2014 for AEMO to recognize the reality of demand changes and adjust its forecasts appropriately:

Figure 7 Aggregate electricity consumption[24]



Therefore the so called over investment of the networks correlates significantly with the forecasting errors of the market operator; so it could be said that over investment is a function of the regulatory process that relied on forecasts and independent efficiency assessments to determine ex ante capital profiles for the future term of Access Undertakings.

This allows the two industry outcomes of gas and electricity to be juxtaposed – where the capacity expansions and access negotiations that have been underpinned by contracts in gas have created the efficient outcome to meet capacity requirements; whilst the independently assessed and regulated capacity expansions has resulted in over investment and inefficient expansion. This demonstrates that negotiation between parties is what drives investment efficiency. This conclusion, that negotiation not regulation drives efficient capacity outcomes, is further affirmed by the AEMC's decision that the concept of capacity rights is required to be introduced in the Victorian Gas Transmission system to deliver efficient capacity investment.

4.3 Regulatory Process - Conclusion

This discussion on regulatory process highlights that industries that freely negotiate for access on terms that meet the needs of both sides of the negotiation, unencumbered by the exercize of specific regulatory discretion, deliver efficient investment in capacity in the network. The negotiation process benefits from transparency and a binding dispute resolution process; but that process must reflect commercial realities and not academic discretion.

5 Negotiated Outcomes

The comparison between the capacity investment in gas and electricity infrastructure appears consistent with the view that efficiency in investment is driven by negotiated outcomes and not by regulatory imposition.

The WA Rail Access Code has been designed to promote negotiated outcomes outside of the code and has proven successful to the extent that no agreements have been required to be arbitrated within the code.

This provides a strong suite of examples of infrastructure access reaching efficient negotiated outcomes in the absence of regulatory pricing outcomes:

- The statements from PN and Glencore that their business profitability relies on declared access; but notably in the absence of a regulated price so prices must be negotiated;
- The absence of a regulated price on ARTC's segment from the Queensland Border to Acacia Ridge so no change in pricing behaviour when rolled into the ARTC network and negotiated outcomes were achieved;
- Natural gas pipelines expanded and connected the transmission network between Darwin, Adelaide, Gladstone and Tasmania based on negotiated outcomes in the absence of regulated tariffs (and offers a stark comparison to the efficiency of regulated electricity development); and
- WA rail access has been based on negotiated not regulated pricing outcomes.

ARTC therefore strongly supports the proposals from network owners in Queensland to move towards a structure which promotes negotiated outcomes rather than adversarial regulatory processes that are based on abstract, subjective, and theoretical positions, divorced from the commercial positions of the participating companies.

ARTC believes that such a process can only prove successful if the process allows for:

- Timely, strong and binding dispute resolution procedures that give both sides confidence that the requisite decisions will be based on reasonable commercial (not theoretical) principles;
- The ability for access seekers to hold infrastructure owners to account for the delivery of the promised services and at a reasonable (commercial) price; but not in a manner that exposes the owner to significant, retrospective, operational risks;
- Transparency of negotiated outcomes to ensure that entrants have certainty on their competitive access position vis a vis their competitors and giving credence to the principle of non-discriminatory access; and
- A nationally consistent approach to transport access such that decisions on reasonableness of outcomes only reflect variances in the risk profile of assets and not the location or theoretical approach of the regulator;
    - Given the competition from road, this approach must reflect road pricing too.

In the rail industry, be it in either the coal or the freight transport sectors, there are a very limited number of highly informed, well-resourced and large counterparties (including many of the largest mining companies in the world) who exercize significant counter vailing bargaining power against the infrastructure owners. In addition, in the freight sector, rail faces a significant competitive constraint via competition from road. The statements by PN and Glencore highlight that these constraints ensure that competitive tariffs can be negotiated for rail access in both resource and freight environments and economic benefits achieved via negotiation rather than regulation.

ARTC recognizes that to be effective, such a framework would require the acceptance of Access Seekers and Access Owners. ARTC therefore does not offer specific comments on the proposed Access Framework Deed Polls examples provided by QR and DBCT, however supports these as a framework for discussion with customers to achieve a nationally consistent access framework that benefits owners and customers alike.

6 Conclusion

The Coasian economic framework that efficiency is driven by access negotiation rather than regulation is shown to apply in the rail industry. ARTC therefore supports the development of a system which promotes negotiated outcomes whilst providing the critical protections of binding commercial dispute resolution, transparency and national consistency of commercial transport regulation. This framework requires acceptance of owners and users alike to ensure there is confidence that it delivers the optimal outcomes for the rail industry.

ARTC would welcome the opportunity to engage with both Access Seekers and Infrastructure owners to build a consensus mechanism that delivers on these issues whist removing the regulatory cost burden on Australia's railways.