

11 March 2019

Ms. Clara Cuevas
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Submitted by email: regulatoryreform@treasury.wa.gov.au

Dear Ms. Cuevas

Submission to Review of the Western Australian Rail Access Regime – Draft Decision Paper

Pacific National welcomes the opportunity to provide a submission on the Western Australian Rail Access Regime review (the review) – Draft Decision Paper (draft decision).

Pacific National's November 2017 submission on the review issues paper detailed areas for improvement to ensure an effective access regime in Western Australia (WA). In particular, the need for indicative tariffs for reference services and a regulator approved access agreement on the Kalgoorlie – Perth rail line which is operated by arc infrastructure.

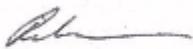
Under the current approach, the access pricing and contracting of a freight train from Melbourne to Perth (interstate) is regulated via an indicative tariff and a regulator approved access agreement. However, once a freight train traverses the arc infrastructure network (regulated only by a negotiate-arbitrate approach), it is subject to a pricing increase of up to 25 percent. The negotiate-arbitrate approach leads to the perception of monopoly rents, particularly as access seekers have limited information to substantiate the costs.

We would like the WA regime to more closely align with the economic regulation of the interstate network, however if a model regime were to be adopted (as a wholesale replacement of the current arrangements) – the Queensland access regime with its mandatory undertaking requirements where the prices are set by the regulator under a revenue cap is best practice in rail access in Australia.

Pacific National notes the draft decision makes a number of recommendations which improve the current arrangements, in particular recommendations requiring railway owners to publish a standard offer (when required by the regulator) and regulator approval of a standard access agreement.

Unless explicitly stated otherwise in the submission, we agree, or have no issue with the majority of the recommendations as they relate to the current arrangements. However, we include suggested amendments, additional recommendations and additional information to inform some of the recommendations prior to the release of the final decision.

Yours sincerely



Robert Millar
Regulation and Policy Manager

Introduction

Competitive and efficiently priced access to below rail networks is essential for above rail operators to compete with other freight transport businesses (road, shipping and air freight services).

As noted in Pacific National's November 2017 submission, railways in WA, particularly railways serving interstate supply chains and bulk product markets in regional areas, have the inherent characteristics of natural monopoly infrastructure. Pacific National's experience of negotiating for rail access in WA has proven this natural monopoly position can be used to seek substantial access price increases above efficient costs.

A regulated price determination process is essential to balancing the position of the railway owner with the interests of the access seeker (and its customers).

Pricing guidance

The current WA rail access regime (Code (Schedule 4 clauses 7 and 8)) requires the establishment of a floor price (effectively a price based on incremental cost) and a ceiling price (effectively a price based on stand alone cost), and the access seeker and railway owner then negotiate the final access price between these two price limits.

Pacific National strongly believes the floor and ceiling pricing approach is inadequate as it requires the use of a negotiate-arbitrate access approach between two distant price benchmarks. This negotiate-arbitrate access approach is also problematic as it requires access seekers to negotiate with a natural monopoly railway owner.

The draft decision seeks to enhance the negotiate-arbitrate approach through the development of a standing offer. The regulator will only intervene to set a standing offer where there are one or more actual or potential operators on a route with similar freight tasks, with similarity in freight tasks assessed in relation to train length, axle load and freight type. This criterion is quite limiting as it does not account for the current situation where the railway owner has little incentive for commercial negotiation as evidenced by the 25 percent price differential on the network operated by arc infrastructure.

In the WA regime, Pacific National believes the regulator should have the power to approve tariffs for defined reference services, with these being the default tariffs for these reference services. However, the access seeker and railway owner should be able to negotiate away from these tariffs if there is agreement. The indicative tariff would be reflected in the price initially offered by the railway owner, and the tariff, coupled with the standard terms and conditions, would guide any negotiation of price with the access seekers, and would be considered in any subsequent arbitration.

The structure of the indicative tariffs should include mandatory and negotiable provisions (like the arrangements in the ARTC Hunter Valley Access Undertaking). These arrangements are designed to be flexible, so the final access charge can vary from the indicative charge to better reflect the access proposal, and the associated cost and risk profiles.

As originally suggested in the review prototype paper, the railway owner would submit a draft access agreement, or standard terms and conditions to be met to access the indicative tariff. In assessing the proposal, the regulator would consider the reasonableness of the proposal in the context of the railway's characteristics, its users and other pricing guidance in the regime¹.

Amended recommendation (2): Pacific National submits the recommendation to establish a standing offer (in very limited circumstances) should be changed to regulator approved indicative tariffs with standard terms and conditions to underpin them, including service standards associated with the price.

CPI escalation

Regulators typically allow escalation of annual price increases by CPI. However, this approach does not consider the declining competitive position of rail to its main competitor road. In contrast, it is estimated heavy vehicle operators have enjoyed only a 0.3 per cent increase in road user access charges from 2012-13 to 2017-18². This increase for rail is an order of magnitude higher and significantly hampers the establishment of an efficient national competitive freight market across transport modes.

¹ Western Australia Department of Treasury Prototype of an improved Rail Access Regime p, 9

² National Transport Commission (NTC): PAYGO – Heavy Vehicle Charges Model. Version 2.2 (25 May 2018).

Moreover, CPI is not appropriate where there is doubt about the efficiency of the starting point. ACCC Chairman Rod Sims made the follow observations³ which Pacific National agrees with:

‘On the face of it, using a benchmark such as CPI may seem like a reasonable outcome. However, simply defaulting to CPI price increases does not necessarily mean that prices will reflect efficient costs over time. Firstly, what is the starting point; initially prices may not reflect efficient cost. Further, increasing volumes could mean that the average cost of providing services may actually decrease over time while, at the same time, revenues may increase due to both higher volumes and prices. This could increase the gap between costs and revenues and (potentially) monopoly rents.’

Pacific National notes the asset valuation recommendation below should address the underlying efficiency level but it is nevertheless important to ensure road and rail are escalated competitively i.e. by the same rate. We would expect to see commentary in the final decision on escalation.

Asset Valuation

The underlying philosophy of monopoly regulation articulated in the Queensland Competition Act (s. 168A(a)) (and echoed in the WA regime) is the expected revenue for the access provider (railway owner) should 'include a return on investment commensurate with the regulatory and commercial risks involved' (s. 168A(a))⁴. Consistent with other jurisdictions, the QCA Act does not prescribe a mechanism to achieve this but when the initial asset valuation is undertaken, regulators typically use a DORC methodology. Under the negotiate-arbitrate model with an initial asset valuation, the ceiling price effectively becomes a regulatory building blocks calculation.

Under the draft decision recommendation, we understand the initial regulatory asset base (RAB) would be calculated for each railway owner (and each route listed in Schedule 1 of the Code) using the DORC methodology. Secondly, a depreciation profile would need to be established (and approved) to allow the RAB to be rolled forward on an annual basis.

³ Ports: What measure of regulation', Rod Sims, Port Australia Conference, Melbourne, 20 October 2016

⁴ Queensland Competition Authority Queensland Rail's 2013 Draft Access Undertaking, Draft Decision, p xvi.

Pacific National agrees with draft decision recommendation to change the asset valuation methodology to DORC. It is a good approximation of cost a new entrant would face to enter the market and provide the same level of service. However, the mechanics of the DORC methodology need to remain flexible enough to allow consideration of the life and conditions of the assets. For example, in its decision on Queensland Rail valuation, the Queensland Competition Authority (QCA) placed a zero value on assets whose actual life exceed their expected useful life. This is because it is reasonable to consider these assets have already been fully depreciated and including them would amount to double counting⁵ and excessive returns.

The valuation of a RAB needs account for circumstances where governments have gifted assets to railway owners at peppercorn rates. These should be treated as contributed assets for pricing purposes otherwise if they are included at market rates they would represent windfall gains to the asset owner - effectively the asset owner can seek a return of capital (depreciation) on the contributed assets at the same time as earning a return on capital. In addition, the valuation of the RAB for rail freight access should exclude expenditure directed at passenger services or otherwise undertaken for macro-economic or political purposes.

Amended recommendation (1A): Pacific National recommends the asset valuation methodology allow a DORC valuation methodology flexible enough to account for the issues raised above.

Rate of return

Setting the rate of return for monopoly infrastructure providers has been a source of significant debate between access seekers and access providers with both sides of the argument often presenting detailed independent advice but with the regulator having to make the ultimate judgement call.

In the heavily regulated energy sector, the Council of Australian Governments moved to amend the laws to replace the non-binding rate of return guidelines with a binding rate of return instrument. As a binding instrument, it must set out the precise value for the rate of return, or set out a method for calculating the rate of return that can be applied automatically without exercise of discretion on future regulatory determinations⁶.

⁵ Queensland Competition Authority Queensland Rail's 2013 Draft Access Undertaking, Draft Decision October 2014, p 138.

⁶ AER Rate of Return Instrument Explanatory Statement, December 2018, p 13

The binding guideline is informed by different consumer and industry stakeholders and a review by an independent panel of five highly-qualified members.

The panel members have diverse backgrounds and areas of expertise including regulatory, legal, economic, finance, consumer perspectives and institutional investment⁷.

It is likely infrastructure regulators in other sectors, including rail, will at least reference this guideline in their own regulatory decisions. Further comment is provided in the regulator accountability section of this submission.

Capacity extensions and expansions

A key component of an effective rail access undertaking is an efficient, transparent and accountable capacity and investment framework to underpin the development and investment in extensions and expansions to the rail network. It is important to have an effective and balanced standard user funding agreement (SUFA) framework.

The QCA developed three overarching principles⁸ required for developing an effective SUFA which could be applied as to the recommendations in the draft decision.

(a) workable – a SUFA must achieve the intended outcome with an appropriate allocation of risk and liabilities. It must recognise the legitimate business interests of the access provider and be in the interests of access seekers and investors in the network. It must be able to be executed by all parties without negotiation, if necessary

(b) bankable – a SUFA must be financeable by access seekers and third-party financiers with recourse to the funded assets and rights. This requires there be a high level of confidence that the expected returns will be delivered and that the asset will be appropriately operated and maintained over its lifecycle

(c) credible – a SUFA must not create unnecessary risks and uncertainties for users and potential financiers or overlay unnecessarily high transaction, tax or finance costs on an extension project otherwise the funding agreement can never be a credible alternative to Network undertaking the extension itself.

⁷ AER Rate of Return Instrument Explanatory Statement, December 2018, p 12

⁸ Queensland Competition Authority Queensland Rail's 2013 Draft Access Undertaking, Draft Decision October 2014, p, 158.

Improve efficiency of the regulatory process

Publishing a standard information package and regulator approved access agreement

Currently under the Code (clause 6) the access provider's standard access agreement (as determined by the access provider) must be provided to the access seeker. Pacific National believes the access provider's standard access agreement should be approved by the regulator for the defined reference services, with these agreements being the default access agreements. This ensures the regulator approved indicative tariffs are consistent with the regulator approved access agreements.

As noted above, the access seeker and railway owner should be able to negotiate away from these agreements if there is mutual agreement.

Stand track access agreement

Pacific National notes the recommendation allowing the regulator to approve a standard access agreement. To achieve this, Pacific National recommends a requirement in the final decision for the standard access agreement (STAA) to contain the following:

- The STAA should include standard access principles.
- The STAA should include an appropriate pricing dispute mechanism so the STAA remains relevant and effective over the life of the agreement.
- The STAA should provide an option for access seekers to execute long term access agreements, say 10 years.
- The STAA should apply a commercially balanced approach to allocating risks to the contracting parties best placed to manage or mitigate the risks.
- The STAA should include a maintenance obligation. The railway owner should be obliged to maintain the network in a condition which allows the rail operator to provide train services in accordance with the access agreement.
- The STAA should provide certainty regarding the railway owner's minimum service standards to provide access to the contracted train paths over the life of the access agreement

- The STAA should establish transparent and clearly defined processes through which access rights can be varied (including renewal, relinquishment, transfer, suspension and/or termination).

Pacific National considers operational performance levels should be included in the STAA. This KPI regime should provide an opportunity for rail operators and end users to monitor the network's compliance with, and its performance against, its obligations and responsibilities in the STAA. As a provider of a monopoly service, the network should be measured and incentives should be applied to provide strong incentives for performance to be approved. The types of KPIs that could be considered in assessing performance levels include:

- contracted vs scheduled vs actual train services;
- network availability, including planned and unplanned maintenance, planned and unplanned track closures and planned and unplanned speed restrictions;
- below rail transit time.

More details on incentive regimes is provided below.

Amended recommendation (9A): Pacific National recommends a requirement in the final decision for the STAA to include the detail outlined above.

Addressing information asymmetry

Access seekers and regulators face a significant information asymmetry if asset owners are not compelled to provide financial information. If the negotiate-arbitrate access model continues to be applied, then rail access negotiations and outcomes need to be improved by requiring rail infrastructure providers to supply a level of cost information which facilitates balanced negotiations. Other regulatory models either contemplate or mandate this level of detail.

For example, gas and electricity companies' applications to the Australian Energy Regulator for five-year regulatory revenue proposals and access arrangement decisions include their detailed financial model spreadsheets with workings⁹.

⁹ ACCC Draft decision Australian Rail Track Corporation's 2018 Interstate Access Undertaking 20 December 2018, p 116.

In the context of the assessment of the interstate network, the ACCC stated the asset owner (ARTC) should provide stakeholders (and regulators) sufficient information to assess the prudence of capital expenditure¹⁰ and this information should be audited. At a minimum it should include:

- Estimated capex to date and expected expenditure in ongoing projects.
- Explanations of the basis for the capex forecasts.
- Cost-benefit analysis for projects – ACCC expected network users could then rank projects in order of priority and provide input.
- Information on current and forecast prices and how they have been determined
- Expected information on the estimated impact on access prices of the proposed capital expenditure program would assist network users in assessing the potential financial implications of the capital expenditure program on their own operations.

Further an annual compliance assessment process would increase transparency over the capital expenditure undertaken and provide stakeholders with clarity and certainty the railway owner is complying with its financial model¹¹.

Pacific National recommends the final determination should include mandatory information provisions consistent with the regulatory regimes identified above.

In addition, Pacific National believes the information requirements necessary for a negotiate-arbitrate regulatory model include at a minimum:

- access tariff applying to the rail corridor for which access is sought, including the written down book values of the rail infrastructure relevant to the rail corridor.
- condition of the infrastructure comprising the rail corridor, including
 - train operational constraints such as maximum train speeds, maximum train length, sectional running times,
 - network operational constraints such as speed restrictions (with an adjustment factor to apply when speed restrictions impact sectional running times), planned possessions and unplanned possessions, and

¹⁰ ACCC Draft decision Australian Rail Track Corporation's 2018 Interstate Access Undertaking 20 December 2018, pp 85-86.

¹¹ ACCC Draft decision Australian Rail Track Corporation's 2018 Interstate Access Undertaking 20 December 2018, p 206.

- parts of the rail corridor where interaction with other train services would impact on the access rights being sought.
- weekly Timetable, as amended from time to time, and an assessment of whether there is sufficient available capacity to accommodate the access sought by the rail operator.
- The cost of access, including operating and maintenance costs, to ensure the rail corridor will deliver the contracted services for the term of the agreement.
- Safety systems.

The provision of information identified above as part of a recommendation in the final decision, will enable access seekers to assess the reasonableness of the proposed charges and associated expenditure proposals and will reduce the possibility of the railway operator from acting in a discretionary manner in the negotiation, and delivery, of access services to its customers.

In this context we note in the UK, Network Rail must produce a strategic business plan (SBP) as part of the consultation over its regulated charges. As the ORR notes:¹²

The SBPs will set out Network Rail's plans for operating, maintaining and renewing the network, and how it intends to improve its capability and efficiency. These plans will affect what the railway can deliver – and so have a significant impact on the service that train operators can offer to passengers and freight customers – and the future condition of the network.

New recommendation: Pacific National recommends the final decision should include mandatory information provisions consistent with the regulatory regimes identified above.

Confidentiality of information submitted to the regulator

In 2015 arc infrastructure proposed a 17.5% price increase (and CPI escalation) on the Kalgoorlie to Perth line. During this process, arc infrastructure claimed confidentiality over its submission which meant it was difficult for stakeholders to establish the basis for the cost increase. This follows an earlier ERA relaxation of the requirements for rail owners to provide floor/ceiling prices for certain lines.

¹²<http://orr.gov.uk/rail/economic-regulation/regulation-of-network-rail/price-controls/periodic-review-2018/pr18-consultations/consultation-on-draft-guidance-on-Network-Rails-strategic-business-plans>

The regulator needs to have sufficient and clear powers to collect and publish data as part of its responsibility for economic regulation of network access providers. Blanket or unsubstantiated claims of confidentiality should be prohibited.

As an example of best practice, the Australian Energy Regulator (AER) confidentiality guidelines requires the network provider to make a separate confidentiality claim for *each* piece of information it requires confidential¹³. This high threshold demonstrates the importance of stakeholders having access to sufficient information to enable them to understand and assess the substance of all issues affecting their interests.

New recommendation: Pacific National suggests the final decision should include a confidentiality recommendation specifying claims of confidentiality will only be allowed in very limited circumstances and require sufficient justification; blanket confidentiality claims should not be allowed.

Preventing frivolous access requests

The draft decision makes the assertion that railway owners are not currently protected from having to spend time and money on frivolous access requests. However, we note there is no evidence presented as to the degree that this is occurring. Given the already substantial power imbalances of an access seeker negotiating with a railway owner, Pacific National does not agree with recommendation to allow a railway owner to refer an access request to an arbitrator if they can establish a prime facie case that it is frivolous. Unless supporting evidence of a problem can be presented, this recommendation should be removed.

Remove recommendation (7): requiring a provision to allow a railway owner to refer an access request to the arbitrator if they can establish a prima facie case that it is frivolous.

¹³ AER Better Regulation, Confidentiality Guideline, August 2017, p 11.

Railway owner accountability

Reporting on service quality indicators

It is important for access seekers to have transparency about the service quality of the railway and therefore mandatory reporting on service indicators is very important. However, network performance incentives are a step further in establishing a best practice regulatory regime.

Network performance incentives

In Europe, most rail networks have a performance incentive scheme of some form in place, which typically relate to providing incentives to minimise delays. Other Australian regulated industries such as the energy sector have incentive schemes¹⁴ built into the regulatory framework which could be adapted for the WA access regime.

For example, the service target performance incentive scheme¹⁵ provides incentives to improve performance of network based on availability, reliability and market impact measures and ensure network businesses are not driven to reduce costs at the expense of service quality.

Network prices would be reduced where the network fails to meet targets, for example the network would not be allowed to recover revenue through take-or-pay provisions. Performance measures should have a direct link with individual service performance, not aggregate performance.

Above rail operators require:

- Improved network availability (more train paths, less cancellations).
- Improved network performance (on-time performance, less transit times delay and temporary speed restrictions).
- Cost reduction or productivity improvements (for example short-term transfer or slot trading mechanisms).

¹⁴ <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews>

¹⁵ *ibid*

Under a STPIS scheme, adapted for the rail industry, potential metrics per service could include:

- Decrease in planned possessions.
- Decrease in speed restrictions and/or average daily minutes caused by speed restrictions.
- Decrease trains cancelled due to network cause.
- Decrease in number of systems paths lost to planned maintenance.
- Decrease in number of systems paths lost to unplanned maintenance.
- Increase healthy trains on-time arrival.
- Increase unhealthy trains on-time arrival.

Other incentives schemes¹⁶ adaptable for the rail sector include:

- Capital expenditure sharing scheme: networks are entitled to retain revenue from any underspend and bear cost of overspend for a total of six years (regulatory period is 5 years) the scheme drives cost saving for users through lower future regulatory allowances.
- Operating expenditure: a similar scheme exists for operating expenditure; however, it uses a revealed cost forecasting approach to assess the base year (with inefficient expenditure removed).

New recommendation: Pacific National suggests a recommendation directed at establishing an incentive scheme(s) should be included in the final determination.

Up front direction and expert advice

Pacific National notes the recommendation to provide upfront direction to the regulator and to require it to obtain two expert reports for the initial decision on the RAB in certain circumstances. Consistent with this recommendation, Pacific National suggests the review considers how pre-existing rate of return advice such as the rate of return guidelines produced by the AER could inform the WA regime, without undertaking additional (and possibly) duplicative work. We would expect to see commentary in the final decision on pre-existing rate of return guidelines.

¹⁶ *ibid*

Consistency of standards

When Pacific National traverses across the interstate network it is required to meet different operating standards once it reaches the border of Parkeston WA. ARTC operates AC and DC traction, however arc Infrastructure (as the rail infrastructure manager) does not allow the use of AC traction. The basis for this decision needs to be reviewed as it severely impacts on operational efficiency. Ideally there should be one intermodal standard gauge network owner from Perth to Brisbane, but at least rail infrastructure managers should operate consistent standards to improve efficiency. Pacific National requests the review addresses the need for consistency across the interstate network as it relates to WA and arc infrastructure.