

# ARTC RESPONSE TO IPART NSWRAU ISSUES PAPER

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ARTC



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# BACKGROUND

ARTC was created in 1998 through an Inter-Governmental Agreement (IGA) signed by the Commonwealth, Victoria, South Australia, NSW, Western Australia and Queensland. ARTC was established as a consolidated interstate rail track owner to create a single process for access, consistent with the Competition Principles Agreement and the National Rail Summit Heads of Agreement.

The objectives of ARTC under the Inter-Governmental Agreement, which continue to apply, are to provide efficient and seamless access to the interstate rail network by:

- operating the business on commercially sound principles;
- pursuing a growth strategy for interstate rail;
- improving interstate rail infrastructure through better asset management and a program of commercial and grant funded investment; and
- promoting operational efficiency and uniformity on the interstate network.

The IGA reflected the impact of historic under investment on the performance of the rail freight network and provided for ARTC to have commercial performance incentives and the capacity to price, market and manage supply of its services flexibly in the context of a competitive transport market; whilst investing significantly in the network to upgrade its performance.

ARTC owns the interstate network for the area covered by Broken Hill in NSW, the SA-Victorian border and Kalgoorlie in Western Australia; and leases the network under agreements with the Victorian, NSW and Queensland Governments. NSW contains the Interstate and Hunter Valley Networks, where the Hunter Valley Coal Network is subject to a separate Hunter Valley Undertaking, which has now been extended to 31 December 2026.

Whilst ARTC has two voluntary undertakings with the ACCC in respect of some its NSW networks, it still maintains a number of network segments which remain under the regulatory coverage of IPART under the NSWRAU.

ARTC welcomes the opportunity to comment on IPART's Issues Paper in respect of the appropriate regulatory framework for the NSWRAU. Rather than address each individual question in the paper, ARTC is responding based on its view that the optimal regulatory framework is one which incentivizes and supports commercial negotiation on around service and risk, but with key protections of independent (and expert) dispute resolution and transparency of pricing and performance.

## REGULATORY PRINCIPLES

IPART have defined 5 key principles to guide their regulatory approach:

- Proportional – constraining market power without imposing unnecessary regulatory burden;
- Efficient – incentive to operate and invest in the network to meet users' needs;
- Flexible – allow for innovation, policy evolution and climate change;

- Regulatory Certainty – allowing efficient decisions; and
- Enforceable – protects the rights of all parties

ARTC supports these principles and believes they are key to any regulatory principle. ARTC further believes that the current NSWRAU largely meets all of these principles, aside from enforceability.

## **REGULATORY FRAMEWORK**

The NSWRAU as it stands, covers all rail lines in NSW. This involves a large range of utilization and network standards; from lightly used and timber sleepered regional networks to complex urban systems. The history of the NSWRAU in applying to such a diverse range of networks highlights its proportionality, in that the regulatory burden imposed has been proportionate with the risk.

The ability of the undertaking to survive to date given that range of coverage reflects positively on its flexibility. However, the changing global economic environment warrants a review of the underlying principles. Whilst the positive approach taken by IPART in the 2019 RML review to reflect changing market dynamics and risks was welcome; the approach was somewhat constrained by the level of prescription within the NSWRAU. Providing greater ability to achieve an appropriate allocation of market risks would improve the flexibility of the framework and should therefore be a priority of an updated NSWRAU.

ARTC believes that the key focus of any undertaking should be its ability to promote the optimal balance in the trade-off between risk and service offering (including price) and therefore be responsive to the relevant competitive environment. This is reflected in the Efficiency principle above, where the undertaking should provide the incentives for network operators to negotiate a service offering that meets the needs of Users within an acceptable risk tolerance; and providing appropriate compensation for that risk.

Finally, the term of the NSWRAU and the transparent approach adopted by IPART as regulator delivers regulatory certainty to all stakeholders, ensuring a further key principle is met.

## **COMMERCIAL FLEXIBILITY**

The ability to develop commercially flexible outcomes requires network owners and users to agree the appropriate service offerings, risk allocations and pricing structures to deliver the optimal outcome. Ultimately, this is a negotiation based on individual (or collective in some instances) valuation of risks and assessment of the service offering by each side. Access frameworks, and regulators, can impact this outcome by delivering clarity on the negotiation framework and providing an outlet for dispute resolution; but ideally without intervening in the negotiation process itself.

Given that the services and risk allocation discussions evolve over time, an important attribute for regulatory frameworks is to recognize this evolution, and the commercial trade-offs which have occurred, and support their continuity. This aspect affects both flexibility and certainty, as the framework should be flexible to accommodate changes to risk determination

whilst delivering certainty that past negotiated outcomes on service offerings and relative pricing will be acknowledged in future periods.

The outcome achieved in the 2021 renewal of the HVAU highlights the ability of asset owners and users to negotiate effectively on the balance of service offering and risk. In particular this required a framework that promoted the negotiation process without regulator intervention and an acceptance by all stakeholders that the acceptable balance of service offering and risk is an outcome of that process and cannot be simply defined by a set of equations.

## **REGULATOR ROLE**

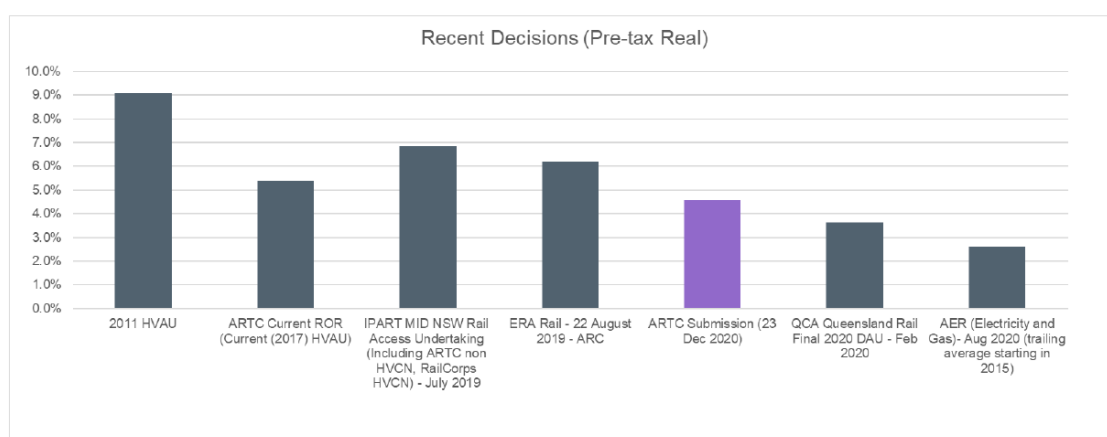
ARTC acknowledges the key point under the proportional principle that the framework needs to constrain market power; however, it should not do this to the extent it removes the incentive for parties to negotiate risk and service trade-offs. An essential aspect of this is that parties have the ability to negotiate and also that both sides are prepared to respond to issues and not to adopt a “take it or leave it” approach from the outset. For essential services provided to domestic households (such as electricity or water), a household is unable to individually negotiate with network owners and detailed regulatory determinations will be required. However, for networks with large, well-informed and capitalized companies with experience in managing complex supply chain risks, the role of the regulator and framework should be to promote the negotiation rather than deliver explicit outcomes.

The description of the 2021 HVAU process above clearly demonstrates the ability of parties to deliver negotiated outcomes supported by all stakeholders. The role played by the ACCC in the renewal process, particularly the decision not to intervene in the negotiation whilst providing direction to both sides on expectations of process rather than outcome, was a key factor in achieving the outcome. Given the increasing market uncertainties and the consequent impact on service requirements and risks, a flexible regulatory framework that promotes the process of negotiation without regulatory intervention will be critical to deliver efficient outcomes.

## **WACC VARIABILITY**

This is an important principle as regulatory determinations have shown that a large variance in what is an efficient rate of return; with that variance driven by differing approaches on the calculation of market parameters more than assessments of the value of risk. This range was highlighted in Figure 3 (at page 50) of the ACCC’s Draft Decision to ARTC’s March 2021 variation of the HVAU

**Figure 3: Recent ROR outcomes (Pre-tax Real)**



Note: Queensland Competition Authority (QCA) decisions are post-tax nominal. To convert into a pre-tax real value, the ACCC has used 2.38% inflation, which is consistent with the inflation used by the QCA within the building block calculations.<sup>69</sup>

ARTC has previously strongly supported IPART's transparent approach to calculating rate of return; particularly its use of balanced long- and short-term measures for market rates (and the consistency this approach brings) rather than the mix used in other regulatory decisions which imports market volatility into return outcomes. The bi-annual update of expected WACC outcomes published by IPART also provides much needed transparency on potential outcomes.

The chart above highlights that there is a range of returns which are deemed efficient by independent economic regulators. This suggests a degree of subjectivity across regulators in defining efficient parameters. The optimal regulatory framework should reflect this variation and promote negotiations within the range rather than defining a specific outcome.

## **DEPRECIATION RECOVERY AND STRANDING RISK**

Whilst the above reflects negotiations for the return on capital, the framework for negotiations around the return of capital through depreciation are more problematic.

The Issues Paper highlights the defined approach to depreciation within the NSWRAU based upon the determination of a remaining mine life as a point in time and posits whether alternatives are required (such as a calculation of a \$/tonne). ARTC agrees that the current approach should be reviewed, however feels that a \$/tonne approach fails to address the key issue of demand uncertainty arising from climate change and the potential impact on future coal use.

Regulatory theory is clear that asset stranding risk is managed via asset depreciation rather than rate of return. For energy assets, the threat of demand disruption is increasing at an increasing rate, resulting in a growing level of uncertainty on future demand. The equations which underpin either a time or tonnage-based depreciation measure assess the relationship between reserves and production; and, importantly, assume that the demand for production is a given (with no distribution for the uncertainty of that demand). The demand risk from that equation therefore falls entirely on the network owner (as does reserves and production risk once defined); despite the network owner having no ability to manage these risks.



Ultimately, therefore, the recovery of capital through depreciation is a function of the views on stranding risk and demand uncertainty; which are optimally dealt with via a negotiated outcome between network owners and users. The regulatory framework needs to reflect this and allow for the reality that demand uncertainty is increasing at an increasing rate due to global responses to the risks of climate change.

The principle of flexibility therefore requires a framework that allows for the appropriate allocation of stranding risks driven by changing risks rising from climate change and the policy market and policy responses that arise from it.

The impact of climate change on demand uncertainty for energy networks was acknowledged by the AER in a recent paper titled Regulating gas pipelines under uncertainty information paper which concluded, on a preliminary basis, that “some form of accelerated depreciation would be appropriate if there is sufficient evidence to demonstrate and quantify the pricing risk and stranded asset risk arising from demand uncertainty” (p ix). ARTC agrees that management of demand uncertainty on asset life is best suited to depreciation; but believes the rate of depreciation (and impact on pricing and future production) is best agreed between the parties based on their specific risk appetites. That is, a formula or unit rate won’t pick up the complexities of increasing demand and supply side risks and is best negotiated between the parties.

The appropriate recovery mechanism therefore requires assessment within the context of the overall pricing outcomes, reflecting a trade-off between price and risk and the potential impact on the competitiveness of network users in the future. The valuation of these parameters is best understood by network users and owners. Therefore, a framework which supports the efficient allocation of service and risk will deliver the optimal outcome.

## **NETWORK DIFFERENCES**

For each of WACC and Depreciation, the risk and value profile will be different for each network. The regulatory framework therefore requires the flexibility to accommodate these differences and reflect the different risk profiles of network owners and users. This can also impact on the role of the regulator in each negotiation.

For networks with limited transport alternatives and utilization levels that approach full network capacity, a more active level of involvement may be required; whilst for networks with low utilization and /or competing modal alternatives a much more light-handed approach is required.

The Issues paper raises the regulatory framework that applies for gas pipelines. This presents a valid model for the rail industry to follow; not just for the NSWRAU, but across all jurisdictions to provide a nationally consistent approach.

The framework that was recently defined in the Decision Regulatory Impact Statement ([https://web.archive.org/au/awa/20210603111129mp\\_/https://energyministers.gov.au/sites/pod.energycouncil/files/publications/documents/Pipeline%20Decision%20Regulation%20Impact%20Statement\\_1.pdf](https://web.archive.org/au/awa/20210603111129mp_/https://energyministers.gov.au/sites/pod.energycouncil/files/publications/documents/Pipeline%20Decision%20Regulation%20Impact%20Statement_1.pdf)) provided a 2 speed approach:

- Heavy regulation with decisions focused on a revenue ceiling based on the principle of economic efficiency and made by an economic regulator if legislated coverage criteria is satisfied; and
- A commercial arbitration framework with decisions made by an independent arbitrator (not a regulator) based on defined principles and supported by transparency of pricing and performance outcomes if not.

The current NSWRAU provides a close proxy to this, via the 80% threshold of revenue to full economic costs; where exceeding that benchmark leads to a full and detailed compliance exercise and below that is a more transparency and reporting outcome, with the option for arbitration if required.

Whilst this current approach provides limited burden on existing networks, establishing a DORC valuation for new networks would impose a cost on network owners which is unrecoverable where costs are below that 80% level. For the purposes of defining the 80% level, ARTC believes that a proxy for DORC based on actual construction costs could be utilized; with the extensive consulting costs of a full DORC valuation incurred only if the 80% benchmark is breached using the proxy valuation.

The significant difference in the gas and NSWRAU frameworks is the involvement of independent commercial arbitrators in resolving commercial disputes, a development which ARTC strongly supports and is consistent with the key regulatory principles outlined in the Issues Paper. ARTC would recommend a further extension of this principle to one that allows for commercial arbitration of disputes on setting a revenue ceiling in a heavily regulated network should the principle in dispute be one of commercial risk allocation.

This approach maintains legislative coverage of all segments in NSW, removing the uncertainty of coverage questions (which can be a lengthy and costly legalistic process); but with a proportional allocation of regulatory burden based on usage. The definition of clear guidelines on what approach is to be applied, and what is arbitrated for each approach, would aid regulatory certainty for stakeholders and should be subject to further consultation and review.

## **OPTIMAL FRAMEWORK**

Recognizing the value of commercially agile approach, an optimal regulatory framework should support commercial access price negotiations or reflect the ability to negotiate elements of that economic ceiling in the exchange of service and risk, depending on the relevant commercial framework. In respect of ceiling focused negotiations, where there is dispute on the elements of that trade-off, arbitration of economic WACC parameters (within the accepted range of efficient costs) and depreciation methodologies to define the ceiling should be permitted; whilst ensuring the key service elements are maintained.



# CONCLUSION ON NSWRAU FRAMEWORK

The NSWRAU should allow for the maintenance of negotiated service characteristics and provide for a process of dispute resolution on accepted economic parameters and depreciation against those service risks.

The preferred regulatory framework should therefore:

- Support commercial negotiations between Network Owners and Users on key matters of service and risk with limited regulator intervention; including the treatment of stranding risk via depreciation in a world of demand uncertainty;
- Provide outlet to independent dispute resolution processes with transparent and objective guidelines on how they are applied, with such disputes focused on either:
  - Economic cost matters, including depreciation recovery, that derive the ceiling where revenue is above the 80% of cost benchmark (as a proxy for meeting a coverage test) based on service risk; or
  - Commercial arbitration where revenue is below that mark.
  - Note that access to independent dispute resolution has been recognized as a significant constraint on the use of market power in negotiations;
- Promote transparency of pricing and network performance;
- Ensure continuation of historic negotiated outcomes in existing contracts (in respect of both service offerings and relative pricing) even where those contracts have been negotiated outside the NSWRAU; and
- Ensure decisions in respect of revenue over or under recovery in instances that require heavy regulation are enforceable.

Such a framework is consistent with all the key principles outlined in the Issues Paper and, critically, provides a base to pursue the critical goal of national consistency.

If you have any questions in respect of this paper, please do not hesitate Jonathan Teubner, Manager Economic Regulatory Development on [REDACTED] [REDACTED] to discuss.