Review of the Western Australian Rail Access Regime

17 November 2017

Aurizon Operation's submission to the Western Australia Treasury Department Issues Paper

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Executive Summary

Aurizon Operations (**Aurizon**) welcomes the opportunity to respond to the Department of Treasury's consultation paper (**Issues Paper**) on the review of Western Australian Rail Access Regime (**WARAR**). While the *Railways (Access) Code 2000* (**the Code**) has been subject to periodic five yearly review in accordance with the requirements of the *Railways (Access) Act 1998* (**the Act**) this consultation process represents the first significant review of the overall performance of WARAR.

Aurizon has a significant presence in the Western Australia rail freight market following its acquisition of the Australian Railroad Group (**ARG**) in 2006. Since the acquisition Aurizon has expanded its operations in iron ore and bulk freight operations in regional Western Australia. Aurizon has also made significant investments in locomotives and facilities to support the state's regional employment and export earnings outcomes.

Aurizon has not made an application for access pursuant to the Code since its acquisition of ARG. Aurizon constructively engages Arc Infrastructure to develop rail freight prices and operations to provide competitive service offerings to its customers. Nevertheless, the current operation of the WARAR does not provide for a balanced negotiation given the significant investments that have been made in rollingstock and facilities. The financial performance and sustainability of these operations is dependent on a fair and reasonable price and terms of access. Therefore, while Aurizon may not have made application for access under the Code, the Code and its effectiveness provide an essential safeguard to Aurizon and its customers in securing efficient rail freight services.

The Issues Paper canvasses a range of issues previously identified by stakeholders over successive reviews of the Code by the Economic Regulatory Authority (**ERA**). The matters discussed in the Issues Paper and the reform options to be considered demonstrate that the Department of Treasury has a clear understanding of stakeholder concerns with the access regime. Aurizon is largely supportive of the prospective reform options as being consistent with the following outcomes:

- Establishing a framework which provides a more balanced negotiation between the access seeker and the access provider through increased transparency and recourse to timely and effective arbitration;
- Ensuring the access regime operates consistently and fairly across all market participants and an access seeker does not obtain a less favourable outcome compared to another access seeker/holder for a similar service by seeking access under the Code;
- The access regime provides for increased levels of performance, including through the disclosure of performance metrics and cost transparency to allow for greater levels of industry self-regulation allowing the market to hold the access provider accountable with the regulator focusing on ongoing compliance with the regime;
- The access regime provides effective controls, oversight and accountability of vertically integrated service providers and internal access charges are maintained based on a regulator approved methodology;

- The pricing principles supports the ability for an efficient rail operator to trade profitably in the rail haulage market on a sustained basis subject to achieving the revenue adequacy outcomes of the access provider;

- The access regime facilitates flexibility in the provision of access, including the negotiation of variations to an existing access agreement, to improve the productivity and efficiency of rail operations in order to lower costs and improve competitiveness; and

- The scope of negotiation is reduced through the publication of an indicative access agreement that has been endorsed by the regulator following a consultation process.

Aurizon has limited its response to the Issues Paper to only those matters that Treasury indicated an intention to address through the legislative reform process and where those matters are relevant to improving the efficacy of the regime for markets where there are clearly identified deficiencies in the performance of the Code. This is primarily related to the provision of access by structurally separated access providers where the market does not have the capacity to sustainably pay the full economic replacement costs.

Aurizon has also identified some additional areas for improvement in addition to the options discussed in the Issues Paper including:

- the publication of statement of reasons for arbitration decisions to inform the market on matters relevant to pricing between floor and ceiling costs;

- allowing for joint arbitration on the same matter and the appointment of the ACCC as an arbitrator on matters relevant to interjurisdictional train services;

- the need to protect the interests of users with expiring access rights and the continuity of operations during the arbitration process;

- the ability to refer disputes for variation of existing access agreement associated with productivity and other operational changes; and

- expanding the guidelines in clause 13 of Schedule 4 to require that the access price should be fair and reasonable and consistent with promoting a contestable market for rail operations.

Aurizon welcomes further opportunity to work with the Department of Treasury and other stakeholders to progress these important reforms.

Aurizon Operations in Western Australia

Aurizon has major iron ore and bulk freight operations in regional Western Australia, hauling a combined total of 58 million tonnes each year in the state. This comprises the railing of iron ore, alumina, nickel concentrate, bauxite, coal, caustic and other general bulk freight.

In 2016-17, Aurizon railed 23 million tonnes of iron ore from mines in the mid-west and central regions of the state to two export ports. The iron ore haulage comprises:

- 12 million tonnes from the mid-west to the Port of Geraldton; and

- 11 million tonnes from the central region of the state to the southern Port of Esperance.

Aurizon carries 12 million tonnes per year of alumina in the south-west of the state where it is carried to the Port of Kwinana and Bunbury.

Each year, the company hauls 650 thousand tonnes of nickel concentrate which is produced in the central region of Western Australia. Approximately 9 tonnes of bauxite are carried each year in the south-west region to the refinery in Kwinana and the Kwinana Bulk Terminal for export.

Aurizon has a substantial workforce in the state. Almost all employees are based in the regional centres of Albany, Calcine, Collie, Esperance, Kalgoorlie and West Kalgoorlie, Kwinana, Leonora, Narngulu, Picton and West Merredin.

The company also has either support facilities or rollingstock maintenance facilities in most of these regional centres.

Aurizon's haulage operations in Western Australia are a substantial component of the company's total freight operations, accounting for more than 22 per cent of the total volumes hauled by the company Australia-wide.

The company has a major focus on improving the performance of its bulk freight business and delivering more efficient freight services for our customers, recognising that all of Aurizon's customers are exporting into highly competitive global markets.

Improving the effectiveness of the Western Australian Rail Access Regime

The Issues Paper recognises that the current light-handed approach has several advantages but there are some limitations in the current structure and operation of the WARAR. Since its inception the WARAR has not been subject to a substantive review of its overall performance and effectiveness and Aurizon welcomes the commencement of this review. The Western Australian rail freight market has also undergone substantial changes over that same period and it is important to ensure the regime remains fit for purpose to reflect those changes and foreseeable developments in the rail freight market.

The purpose of the review is to identify areas for improvement to the existing regime suggesting an incremental approach to legislative amendments with the retention of the current structure of the WARAR. This can be contrasted with a more significant reform approach which would provide increased regulatory certainty to access providers and market participants through an access undertaking model. However, the implementation of this model would require a greater role for the economic regulator and would still require many of the issues identified in the Issues Paper to be addressed in preparation of these undertakings.

An appropriately balanced access undertaking model would assist consistency between the regulatory arrangements for Pilbara railways covered under WARAR and those that are subject to the National Access Regime.

It is also preferable that any access undertaking model be sufficiently and appropriately prescriptive to avoid the significant discretion afforded to the Queensland Competition Authority and the Australian Competition and Consumer Commission under the Queensland Rail Access Regime (**QRAR**) and the National Access Regime (**NAR**) respectively[1]. On balance, reforms could consider retaining the benefits

[1] Where the regulator maintains significant discretion in the approval of regulatory arrangements that are likely to have a material impact on the objects of the regime then strengthened appeal rights are necessary to provide effective regulatory accountability.

of the Code prescription and separation of policy of cost/price determinations within the framework of long term access undertakings. Given the potential for a hybrid principles/undertaking model to address the diversity and consistency issues identified in the Issues Paper it may be consistent with the review objectives to give consideration to reorienting the WARAR in this way. It may also provide a template model for broader national application.

In responding to the Issues Paper Aurizon has also given consideration to the revised guidelines in the *Intergovernmental Agreement On Competition And Productivity-Enhancing Reforms* dated 9 December 2016[2] to which Western Australia is a signatory. All subsequent references to the Competition Principles Agreement (**CPA**) in this submission refer to their replacement in Appendix C.1 of the Intergovernmental Agreement On Competition And Productivity-Enhancing Reforms.

Aurizon submissions to the WA Access Code Review

Aurizon supports the access regime principle of commercial negotiation in the first instance. This overarching principle informed Aurizon's submissions to the Economic Regulatory Authority's 2014 Review of the *Railways (Access) Code 2000* (**2014 Code Review**). Aurizon is encouraged that the scope of the Issues Paper and Treasury's proposals largely seek to address the issues raised by stakeholders from that consultation process. Therefore, it is unnecessary for Aurizon to replicate the arguments and evidence provided in that process within this submission but respond more directly to the substantive matters identified in the Issues Paper.

Consistent with Aurizon's submissions to the 2014 Code Review access regulation should seek to address those matters relevant to achieving the objects of the regime. A point of difference in this submission and those made to the 2014 Code Review is whether the regime should retain the access seeker's option to opt out of the regime. Aurizon's experience in negotiating recent access agreements has identified where potential outcomes between access seekers under the code, and those outside of the code, may be contrary to the objects of the regime.

Aurizon also supported a continuation of a light-handed approach to economic regulation which is supplemented with reforms that largely address the imbalance in negotiating power arising from information asymmetry, lack of transparency and accountability, and the uncertainty of arbitration outcomes. That is the framework requires an increased level of prescription by way of principles and oversight in order for the light-handed approach to work effectively as opposed to the regulator prescribing detailed outcomes or compliance tasks. This submission is largely consistent with this vision.

Aurizon's experience with the Code

While Aurizon has been an above rail operator in the Western Australian rail freight market for an extensive period of time and is party to multiple access agreements, it has not submitted an application for access under the Code.

Aurizon acquired the above rail assets of the Australian Railroad Group Pty Ltd in 2006 as a part of a consortium with Babcock and Brown who acquired the related below rail business of WestNet Rail. It was not necessary for Aurizon to seek access under the Code following the acquisition as the access arrangements prevailing at the time were largely reflected in long term commercial agreements negotiated on structural separation which has since expired.

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[2] https://www.coag.gov.au/about-coag/agreements/intergovernmental-agreement-competition-and-productivity-enhancing-reforms

In recent years there has also been shift in shipper preferences to take greater control of their supply chain logistics and negotiate access arrangements directly with the access provider. The timeframes, uncertainty of outcomes and the prospects of obtaining expansions or extensions of the railway also represent barriers to the use of the Code in negotiation access. The wide range in floor and ceiling costs relevant to most rail traffics and the incentives of the access provider to maximise the arbitrated price (as setting the benchmark for other traffics and negotiations) also means that an access seeker is likely to obtain a more favourable outcome negotiating outside of the Code as it is currently drafted.

The preparedness of an access seeker to negotiate and accept the more favourable, but still suboptimal negotiated terms and conditions outside of the Code, can be contrary to the access regime's primary objective of facilitating a contestable market for rail operation if above rail returns do not allow for contestable entry or sustainable investment in replacement assets.

Lessons from the CBH negotiations

To the best of Aurizon's knowledge CBH is the only access seeker to arbitrate an access dispute following an application for access under the Code. It is also fortuitous that this arbitration process is expected to conclude within the review period as it is likely the efficacy of the access regime can be considered in the context of an actual dispute as opposed to a hypothetical construct of the regime's application.

Of particular emphasis will be the matters the arbitrator has had regard to in determining access charges for a bulk commodity where the rail transport costs do not support recovery of the full economic cost for above and below rail services.

For many bulk commodities the market structure for rail involves double marginalisation and capacity to pay or affordability issues which impact the primary producer or miner's ability to compete against competing domestic supply chains or international competition. This also often involves conflicting objectives in balancing the revenue adequacy of the below rail service provider and promoting above rail competition and efficiency in sub-scale supply chains.

The problem of lack of predictability of arbitration outcomes is not unique to Western Australia with the access arrangements for all major structurally separated railways providing broad floor and ceiling cost bands. The limited scope of pricing guidelines regarding the matters relevant to resolving the double marginalisation problem and lack of any relevant rail arbitration precedents increases the uncertainty of a likely arbitrated outcome.

It is also unfortunate and contrary to the public interest that a determination by the arbitrator will be confidential. While it is not necessary for the outcomes from the determination to be disclosed, the relevant facts and matters to which the arbitrator has given weight should be disclosed given the broader benefits obtained in informing market participants about the application of the regime. In this regard, Aurizon recommends that the WARAR be amended to include a requirement for the publication of a determination summary as included in the following regimes:

- Section 127 of the QCA Act requires the QCA to maintain a register of access determinations including the authority's reasons for the determination but not must not include details that are likely to damage the commercial activities of the parties to the determination; and

- Section 44ZNB of the CCA requires the commission to prepare and publish an arbitration report which must include principles and methodologies applied in the making of the determination and includes a mechanism for claims of confidentiality to be addressed.

As the object of the Act is also limited in its scope in facilitating a contestable market for rail operations, this may preclude consideration of how access, or the price of access, might be relevant to the

competitiveness of a supply chain in the global export markets. This can be contrasted with the broader focus in the CPA that a State access regime should seek to promote effective competition in upstream and downstream markets.

Areas for improvement

In responding to the Issues Paper Aurizon Operations has an emphasis on realising the following improvements to the WARAR through this review process:

- Establishing a framework which provides a more balanced negotiation between the access seeker and the access provider through increased transparency and recourse to timely and effective arbitration;
- The access regime should operate consistently and fairly across all market participants and an access seeker should not obtain a less favourable outcome to another access seeker/holder for a similar service in seeking access under the Code;
- The access regime should provide for increased levels of performance and cost transparency to allow for greater levels of industry self-regulation. This would allow the market to hold the access provider accountable with the regulator focusing on ongoing compliance with the regime;
- The access regime should provide for effective controls, oversight and accountability of vertically integrated service providers and be required to determine and maintain internal access charges based on a regulator approved methodology;
- The pricing principles should support the ability for an efficient rail operator to trade profitably in the rail haulage market on a sustained basis subject to achieving the revenue adequacy outcomes of the access provider;
- The access regime should facilitate flexibility in the provision of a access, including the negotiation of variations to an existing access agreement, to improve the productivity and efficiency of rail operations to lower costs and improve competitiveness; and
- Reduce the scope of negotiation through the publication of an indicative access agreement that has been endorsed by the regulator following a consultation process.

Balance of power in access negotiations

Aurizon supports the Issues Paper statement that, '*A negotiation process that re-balances information asymmetries and bargaining power is essential to resolving such issues in a way that achieves rail access objectives*'. This is particularly relevant to the access regime's object of encouraging the efficient use of, and investment in, railway facilities by facilitating a contestable market for rail operations. An imbalance in bargaining power can result in inefficient prices and/or unfair price differentiation between access seekers which undermines competition in the downstream rail haulage market.

Reform Option 1. Make the non-discrimination requirements mandatory for all access negotiations whether executed inside or outside of the Code.

Aurizon supports this proposal.

The Code itself should not represent a source of market power such that the likely negotiated outcomes under the Code are any less favourable from those negotiated outside of the Code. In most supply

chains market participants will have sunk investments that can facilitate the transfer of economic profits or rents to monopoly service providers given the inability to write a complete access contract for the life of complimentary investments.

The uncertainty of outcomes, the timeframes for completion associated with arbitration under the Code, and the need to address key factors such as capacity and expansions, provides strong disincentives for negotiations to progress under the Code.

As the Code explicitly only applies to negotiations conducted under the Code this can also permit differential pricing between similar services negotiated outside of the Code and between a similar service negotiated inside or outside of the Code. Therefore, the Code may not protect the interests of an access seeker when negotiating under the Code if it is subject to less favourable terms than a competitor who negotiates outside of the Code.

The access provider will also be incentivised to maximise the arbitrated price under the Code thus reducing an access seeker's willingness to utilise the Code provisions due to those concerns of discriminatory access price outcomes relative to competitors. Section 21 of the Code allows a proponent to apply to the regulator for an opinion on whether or not the price sought is consistent with the principle in Schedule 4 clause 13(a):

> *there should be consistency in the application of pricing principles to rail operations carried on or proposed to be carried on in respect of a route whether by the railway owner or an associate or by another entity.*

As a Code negotiated price establishes a benchmark price for all further negotiations then the access provider will seek a higher price than it may be prepared to accept for a negotiation conducted outside of the Code.

The proposal to ensure the non-discrimination principles apply universally to all access negotiations for similar services with comparable costs and risks would avoid potential discriminatory price outcomes and also avoid the need for costly arbitration processes if a market based price has been negotiated outside of the Code.

However, it is also important to recognise that an access price negotiated outside the Code should be non-binding on the price to be determined by the arbitrator. This is because commercial negotiations may include consideration of a broad range of commercial issues or trade-offs that are not relevant to another access seeker and an arbitrator will not possess all information that was relevant to that negotiated price.

In addition to this concern, non-discrimination provisions can also be relied on by an access provider to inflate access costs over time. In Aurizon's experience in rail freight markets non-differentiation provisions and most favoured nation provisions can also lead to a ratchet effect where:

- access charges only go up (access providers are reluctant to offer price discounts to encourage marginal growth volumes or a new entrant with low scale if it would reduce revenue on existing contracts); or
- through sequential negotiations incremental price uplifts provide progressively higher benchmark prices which are imposed on access seekers on the basis is a mandatory requirement under the non-discrimination provisions).

This suggests that discriminatory price outcomes should be permissible in limited circumstances where the conduct is subject to approval by the regulator as promoting the objects.

In summary the non-discrimination obligations should:

- cap the terms that can be offered under a Code access agreement such that they are no less favourable to those agreed to outside of the Code for a similar service, other than for differences in cost or risk; and

- allow for discrimination in terms and condition of access for similar service where approved by the regulator.

Reform Option 2. Part 5 instruments apply regardless of whether or not an access agreement is negotiated inside or outside of the Code

Aurizon supports this proposal.

Aurizon considers the application of the instruments to all access arrangements is necessary to ensure the consistency of network operations and to facilitate the efficacy of the instruments. The consistent application of the instruments to all access arrangements does not diminish the effectiveness of the negotiate-arbitrate model as the instruments themselves do not relate to differentiation in the terms and conditions of access and do not determine the price. There are also interdependencies between some rules which require consistent applications.

1. Segregation Arrangements

The segregation arrangements are unworkable if they do not apply to all access arrangements. As activities performed by the access provider in the negotiation and provision of access outside of the code are largely indistinguishable from those activities used to provide access-related function for agreements negotiated under the Code. For example, section 24 of the Act requires the accounts and records to reflect only access related functions.

Aurizon has substantial concerns with the practical application of the segregation arrangements associated with the narrow application of access-related functions as being only those relevant to negotiations under the Code. The ERA's amended decision on Brookfield Rail's proposed segregation arrangements concludes that:

> *A definition of "Access-related functions" is provided at section 24 of the Act. "Access-related functions" are only those functions involved in arranging the provision of access to railway infrastructure under the Code;*
>
> *Arranging the provision of access outside the Code is not defined as a statutory function of the railway owner; and*
>
> *The Authority considered that references to access agreements "made outside the Code" should be removed from the document, as agreements made outside the Code are not access agreements, as that term is defined under the Code.*

The Act also defines an access agreement as 'an agreement under the Code between a railway owner and another person for access by that person[3]'. This gives rise to ambiguity as to what clauses and obligations would apply to an access arrangement negotiated outside of the Code. For example:

- duty of fairness in section 33 of the Act relates only to persons seeking access where access is defined as use of rail infrastructure and would apply to agreements outside of the code;

[3] Act clause 3(1)

- protection of confidential information in section 31 of the Act refers only to access or rail operators and would apply to agreements outside of the Code; and

- preventing or hindering access in section 34A of the Act only relates to access under an access agreement which would not apply to a person who has negotiated access outside of the Code. This appears contrary to the legislative intent of this provision.

Aurizon also notes that a circumstance may arise where a rail operator has negotiated access outside of the Code with a vertically separated railway owner who subsequently enters the above rail freight market. In this circumstance the commercial interests of that rail operator could be damaged if the modified segregation arrangements do not apply to those access arrangements.

2. Train Path Policy and Train Management Guidelines

It is appropriate for the train path policy to apply to all access negotiations and agreements including those inside and outside of the Code. This is necessary to ensure the interests of access seekers who are seeking access under the Code are not adversely effected by negotiations outside of the Code. For example section 16(2) of the Code only applies to Code negotiations or access agreements:

> *In the negotiation of access agreements the railway owner must not unfairly discriminate between the proposed rail operations of a proponent and the rail operations of the railway owner including, without limitation, in relation to —*
>
> *(a) the allocation of train paths;*
>
> *(b) the management of train control; and*
>
> *(c) operating standards*

There are unlikely to be any benefits arising from negotiating under the Code where the access provider is then able to unfairly discriminate on these aspects. While the provision relates primarily to discrimination between a third party operator and rail operator similar issues may arise between Code and non-Code access arrangements.

The ability for an access provider to discriminate between an access agreement under the Code and an access arrangement outside of the Code may create perverse incentives where the access provider perceives they may obtain more favourable price outcomes from a non-Code access arrangement through preferential provision of access in capacity allocation and network management.

Finally, as a general principle the train management guidelines are assumed to uniformly apply to all access agreements in order to ensure the efficient operation of the Network and any reform applying Part 5 instruments to Code and non-Code would not be expected to have any material effects.

3. Costing Principles and Overpayment Rules.

Section 4A of the Code provides the option for parties to negotiate agreements outside of the Code and that where the parties do so:

> *'nothing in this Code applies to or in relation to the negotiations or any resulting agreement'.*

This gives rise to some uncertainty and inconsistencies in the application of the Costing Principles and the Overpayments Rules. The ceiling price test in section 8 of Schedule 4 correctly identifies all costs associated with all rail operators and other entities regardless of whether access is negotiated inside or outside of the Code. This is a necessary condition given the operating and capital costs associated with the provision of below rail services is shared and common to all users. Therefore the costs and revenues

associated with agreements outside of the Code are relevant to the application of the price ceiling to agreement inside the Code. However, the floor and ceiling price tests would not apply to agreements outside of the Code.

This could give rise to circumstances where the commercially negotiated outcomes outside of the Code and the revenue under the Code exceed the price ceiling limit which would then require application of the overpayment rules. In this situation, the overpayment rules could require either:

- the entire overpayments to be returned to access agreements under the Code in order to ensure the price ceiling limit is not breached; or
- a proportion of the overpayments are returned to access agreements under the Code with the access provider retaining the excess as is currently reflected in the approved overpayment rules[4] and the access provider would retain monopoly rents.

The difference between whether the costing principles and overpayment rules apply to agreements inside and outside of the Code is fundamental to whether the regime operates on the basis of a maximum revenue limit as appears to be the intent of the drafting of Schedule 4 of the Code. The review process should clarify the statutory objectives of the overpayments rules.

The reference in the definition of incremental costs to Access-Related Functions would require only those costs that can be attributable to the provision of below rail services for Code agreements. Where the access arrangements are the only Code agreements then the incremental costs relevant to the floor price would be the entire business overhead costs in operating the network as they would be avoidable without Code access agreements.

Aurizon considers that the effectiveness of the regime would be improved through the consistent application of the Part 5 instruments to all access negotiations. However, the consistent application of Part 5 instruments to all negotiations does not preclude an access seeker from electing to commercially negotiate in the first instance and not follow the structured approach outlined in the Code. It also does not constrain the price that an access provider can earn for a service subject to the relevant combinatorial ceiling limits.

In summary, Aurizon notes that that application of the Costing Principles, including the overpayment provisions to all access arrangements, is not contradictory to the objectives of negotiating outside of the Code as the Costing Principles do not establish a price but merely establish the boundaries for that price.

Reform Option 3. Allow a negotiation which commences outside the Code that is brought within the Code to progress straight to arbitration provided the nature of the access rights sought remains unchanged.

Aurizon supports this proposal.

Allowing the access seeker to issues a dispute notice for a negotiation which commences outside of the Code to progress directly to arbitration under the Code would improve the efficiency and effectiveness of the access regime. This is most appropriate when negotiating a renewal of existing access rights where a floor and ceiling cost determination may not be highly relevant to the arbitration process. For example, where the current access charge falls well within the prospective floor and ceiling range or the dispute relates to a non-price term.

[4] If an Operator has negotiated access outside of the Regime then its share of the overpayments would go to WestNet.

Additional matters

Aurizon also recommends the WA Government consider further reform options which allow for:

- joint arbitration on the same matter;
- continuation of existing access rights where an arbitration has commenced; and
- variation of an existing access agreements should be classified as an access negotiation.

1. Joint arbitration

Presently, where two or more access seekers are concurrently negotiating access to a similar service and are in dispute on a matter in common the access regime does not provide the flexibility to allow for joint arbitration. For example, section 44ZNA of the CCA allows the ACCC to jointly arbitrate 2 or more access disputes where more than one matter is in common in those disputes.

Allowing for joint arbitration would improve the efficiency the arbitration process and avoid the prospect of inconsistent arbitration outcomes on the same or similar matters. On the 12 August 2015 Aurizon and SCT Logistics sought authorisation to collectively discuss and negotiate with Brookfield Rail the terms and conditions of the Access Agreements, including price, relating to the use of standard gauge railway infrastructure covered under Schedule 4 of the Code for the purpose of transportation of freight by rail which enters or exits the interstate rail freight network controlled by the Australian Rail Track Corporation[5].

The objective of this collective negotiation is to increase the efficiency of the negotiation process, improve the competitiveness of freight on rail and increase the bargaining power of the access seekers. This collective negotiation process also contemplates that a dispute may arise and that dispute would be common to all operators subject to the authorisation. However, the intended efficiencies of the collective negotiation process may not be realised without complimentary joint arbitration.

2. Continuation of access rights

Where an access negotiation relates to the renewal of existing services the access negotiations can become protracted and unresolved prior to expiry of the access agreement. The business continuity and commercial risks to the rail operator associated with contracted service obligations and sunk equipment arising from the cessation of access rights represents a substantial imbalance of negotiating power in the access provider's favour.

In order to address this imbalance the access regime should provide for an extension and continuation of the existing access arrangements where the access negotiations have been referred to arbitration. This would substantially reduce a railway owners incentives to delay the negotiation process.

3. Variation to existing access agreements

Aurizon is continually seeking to innovate and improve the efficiency of its rail operations through technology, investment or other operational changes. In addition, amendments might be necessary to the operating plan to accommodate additional volume growth or changes in the customers mining operations. However, long term access arrangements that are intended to provide price and capacity certainty may

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5 http://registers.accc.gov.au/content/index.phtml/itemId/1188496/fromItemId/401858/display/acccDecision

need to be renegotiated or varied to accommodate above rail efficiency and productivity improvements during their term.

If the rail operator has an existing access agreement then the negotiations required to vary that agreement may not meet the requirements of being a proposal made by an entity to a railway owner. If the rail operator is unable to dispute a negotiation to vary an existing access agreement this can substantially increase the bargaining position of the railway owner and result in:

- the transfer of the above rail efficiency gains to the railway owner and reduce incentives for rail operator to improve efficiency;
- over-compensate the railway owner relative to any change in cost or risk arising from the variation; or
- in the case of a vertically integrated railway owner lock a competing rail operator into a less efficient rail operation relevant to its related rail operator.

These outcomes are contrary to the CPA principle that access pricing regimes should provide incentives to reduce costs or otherwise improve productivity which extends to beyond the costs and productivity of just the railway owner.

For example, Aurizon is seeking to operate modern AC traction locomotives on various routes covered under schedule 1. These are a higher performance locomotive than DC traction locomotives and allow for increased train lengths and payloads with improved fuel efficiency. These locomotives may also impose higher actual maintenance costs due to lower track standards that may not be included in the ceiling costs for GRV which reflects a modern engineering equivalent. However, these issues, including the potential for any increase in maintenance costs, could be overcome through other engineering controls such as power notch limitations (i.e. applied tractive effort does not exceed the DC traction equivalent). If an access holder is unwilling to accommodate the requirements of the rail operator by negotiating a reasonable variation to the operating standard and the access agreement to allow the operation of these services then it may not be possible to refer the matter to dispute resolution.

Aurizon recommends that the WA Government consider appropriate amendments to the WARAR to ensure that where a party to an access agreement seeks to vary an existing access agreement then this could be considered increased access to the service[6].

Removing barriers to negotiation

The WARAR approach to placing the obligation on the access seeker to demonstrate the rail network has the capacity to accommodate the proposed access rights is contrary to common practice in rail access regimes within Australia. This becomes increasingly relevant where the party seeking access is not also a railway operator. Notwithstanding the implications for information asymmetry in hindering the progress of the access negotiation the increased costs associated with overcoming these asymmetries is inconsistent with the general principle of allocating costs and risks to the party best able to most efficiently manage them.

[6] Schedule 3 of the Code only provides for the resolution of disputes arising in carrying out the agreement and not resolution of disputes arising out of the negotiations to vary the agreement.

Reform Option 4. Reversing the onus to require that the railway owner must specify what, if any, extensions/expansions are required to accommodate the proposal

Aurizon supports this proposal.

The determination of what, if any, extensions or expansions are required to accommodate the proposal is not independent of the determination of network capacity. The issues in respect of capacity analysis is addressed in the discussion of reform option 5.

It is important to distinguish between the expansion of the existing rail network and a geographical extension of the rail network. In many instances, the geographical extension is likely to be a spur or branchline specific to a customer and requiring the acquisition of rail corridor land. Where this type of extension is 'contestable' and the network owner is not required to own or operate the spur or branchline then it would not be necessary for the railway owner to determine the requirements for the extension. As a siding or spur is only rail infrastructure if it is managed and controlled by the person who manages and controls the use of the network, then it would not be possible to require the railway owner to be responsible for determining the extension necessary to accommodate the proposal as it would not be subject to the regime if the railway owner is not also required to manage or control the siding or spur.

As the railway owner is required to own and operate an expansion of the existing railway network it must also assume contractual liability for any resulting capacity deficit or operational deficiencies if the scope and standard of the expansion is inadequate. Therefore, the access provider is best placed to determine the scope and standard of an expansion given the most probable outcome of an arbitration on these matters will be to protect the legitimate interests of the railway owner. The investment in rail infrastructure and negotiation process will be more timely and efficient where the railway owner is required to determine the expansion requirements.

Reform Option 5. Reversing the onus to require that the railway owner demonstrate whether a proposal can or cannot be accommodated on the rail network and whether a proposed extension/expansion is technically and economically feasible and safe

Aurizon supports this proposal.

The information requirements associated with assessing and determining the available capacity and what expansions of the network would be required to provide the necessary capacity can be quite extensive and is highly dependent on the quality of the information and inputs employed in the capacity model. Similarly, the access seeker would be required to incur considerable cost in developing a railway capacity model to represent the relevant network segments. This represents an unnecessary duplication of costs where the railway owner will already possess a capacity model and all relevant information and inputs necessary for application in that model.

There are foreseeable problems in replicating the network owner's capacity model including:

- there are potentially large differences between a static model of railway capacity and the dynamic model which takes into consideration the interaction of different elements of the supply chain;
- a robust capacity model will require details of the access arrangements and operational information of all existing users and the network owner would be prohibited from providing this confidential information to a third party; and

- an arbitrator is unlikely to possess the necessary technical expertise to determine whether the network owner or the access seeker's capacity model provides a more accurate representation of capacity.

The current requirements increase the market power of the access provider by allowing it to leverage information asymmetry in providing the necessary services for negotiations outside of the Code but hindering information provision for negotiations under the Code.

The proposal to reverse the onus of proof to require the network owner to:

- determine whether the network has the capacity to provide the access rights being sought; and
- where there is insufficient capacity, determine what expansions of the network are required to provide those access rights;

will significantly reduce the transaction costs of negotiating access and mitigate a significant barrier to use of the Code. It is common, reasonable and consistent with the pricing principles for the network owner to be compensated for all costs incurred in complying with this obligation

Removing other barriers. Floor and Ceiling Cost Determinations

Schedule 4 of the Code includes two mechanisms for the determination of floor and ceiling costs for a particular route:

- section 9 allows for the regulator to make a floor and ceiling cost determination where he or she considers it likely that a proposal will be made; or
- section 10 requires a floor and ceiling cost determination to be made in response to a proposal where a determination has not been made under section 9.

The objective of a section 9 determination is to provide for a determination of costs to reduce the timeframes for the negotiation period where a proposal is likely to be made. This is largely a legacy of the Code design and application to a vertically integrated railway where it sought to avoid imposing a regulatory burden on a railway owner where there was minimal prospect of a proposal from a third party. However, the reliance on the need for a proposal to be made under the Code means that a floor and ceiling cost determination is unlikely to be made until a proposal is actually received even though a route has multiple operators currently operating that are likely to negotiate renewal or new access rights at some point.

The Costing principles are also a barrier to negotiations under the Code. The absence of standing floor and ceiling costs applicable to the foreseeable demand unnecessarily increases the timeframes for the negotiation where these bookends need to be determined. While the Code requires the regulator to make a determination on the floor and ceiling costs within 30 days of receipt this does not appear to occur in practice as the CBH proposal required 6 months for ERA to make a determination. This was a contributing factor in Aurizon's decision not to seek access under the Code for the renewal of its intermodal services given the prospective timeframes for the completion of the cost determination and the expiry date of the access rights.

Aurizon also consider that the preparation of floor and ceiling costs for an individual proposal under section 10 are exclusory for existing access holders or prospective access seekers who may later seek to negotiate under the Code. This occurs because Clause 8(2) of Schedule 4 requires that the ceiling costs are:

- for the whole route and associated railway infrastructure; and

- to be the same for all operators.

The second limb essentially binds a section 10 determination for a proposal to all future access seekers. However, the confidential nature of the determination process effectively prejudices the outcomes for access seekers who were unable to effectively participate in that determination but are likely to be adversely impacted by its precedent. While the regulator can review its section 10 determination under section 12 the access seeker will not have access to the relevant information to identify where material regulatory errors may have occurred.

A floor and ceiling cost determination informs all access negotiations including those conducted outside of the Code and promote a more effective access negotiation.

Aurizon recommends that appropriate amendments be made to section 9 to narrow the regulator's discretion on when a floor and ceiling cost determination should be made. Importantly, a section 9 determination for a particular route should be made where a railway operator unrelated to the railway owner is using, or is likely to use, rail infrastructure (as opposed to likely to make a proposal under the Code).

Improving accountability within the access regime

Aurizon recognises that an effective access regime needs to strike an appropriate balance between transparency and confidence in the railway owner's adherence to its obligations and the consequential regulatory burden imposed on the railway owner. This balance is informed by a range of factors including the economic harm or consequence arising from non-compliance, the level of upfront or ex-ante prescription (reduction in discretion) and costs associated with measuring and monitoring performance.

In practice many aspects of a compliance monitoring and information disclosure framework will involve cost to the business, that should be fully recoverable through the access revenue. Costs for these activities are largely minimised by ensuring the regulatory reporting obligations are aligned with the railway owner's internal data collection and reporting frameworks. Overall, compliance monitoring and supporting reporting should be seen as good regulatory practice

The public disclosure of standard performance metrics can reduce the costs of contract negotiations as the performance measures of importance to railway operators are likely to be common across all access seekers. Consistent reporting and auditing of these performance measures improves the efficiency of contractual performance monitoring. It also reduces the prospect of the railway owner seeking to inflate and transfer the costs of contract performance monitoring to an individual access seeker in order to avoid the inclusion of performance obligations in the access agreement.

Aurizon also considers that if the WARAR retains the differential treatment of access arrangements inside and outside of the Code then the compliance and reporting obligations for a structurally separated railway owner should be comparable with those of a vertically integrated railway with respect to discrimination between code and non-code access.

Reform Option 6. Providing for more regular and consistent reporting of the railway owner's compliance with all of the Part 5 instruments

Aurizon supports this proposal.

An effective auditing regime is essential to ensuring a railway owner complies with the obligation to not unfairly differentiate in favour of a related operator. In most circumstances instances of discriminatory conduct are unlikely to be detected by competing rail operators as they will not be immediately aware.

Therefore, without compliance auditing third party operators will not have confidence that their interests will be protected or that instances of non-compliance will be identified and remedied.

The segregation arrangements currently in place do not include formal periodic compliance audits and rely extensively on the regulator exercising its powers to obtain information under section 21 of the Act. For example ERA stated a preference to rely on these powers in approving the Arc Infrastructure segregation arrangements[7]:

> *The Authority considers that it is appropriate for the Segregation Arrangements to refer to the powers of the Regulator to investigate railway owners' compliance with the Segregation Arrangements at any time, and to require amendments to be made to the Segregation Arrangements.*

The regulator's exercise of these powers is highly dependent on acting on a specific complaint made by an access seeker or railway operators under an existing access agreement, and only to the extent the party is aware. Aurizon recommends that the regulator's existing powers to investigate compliance at any time be reserved for investigation of a specific complaint or concern. The ongoing compliance monitoring should be undertaken through periodic and mandatory independent audits of compliance with the Part 5 instruments.

Reform Option 7. Require the railway owner to publicly report on a regular basis on the progress of access applications.

Aurizon supports this proposal.

This requirement is consistent with annual reporting arrangements in rail access undertakings and provides information on how the regime is performing. For example, if the timeframes for particular processes are routinely extended then this can identify issues with the regime or identify areas requiring business process improvement.

Reform Option 8. Requiring the railway owner to publicly report on a regular basis on service quality matters.

Aurizon supports this proposal.

As noted above the publication of service quality information can support lower transaction costs in the negotiation and monitoring of performance under an access agreement. Aurizon recommends that the Code should require the regulator to publicly consult on the service quality metrics to be included in the railway owner's reporting obligations. The performance indicator reporting in the ARTC Interstate Access Undertaking represents the minimum benchmark standard for performance reporting[8].

Aurizon notes that if the WARAR retains the GRV approach to asset valuation then it needs to be accompanied by appropriate asset condition reporting to overcome the information asymmetry relevant to application of the pricing guidelines in section 13 of Schedule 4. In regard to the south-west rail freight network the reported asset condition information should be comparable to the broader audit and reporting obligations contained in the network lease. In addition an access seeker should be able to make a reasonable request for information relevant to making an application for access to a particular route which

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7 https://www.erawa.com.au/cproot/14483/2/BR%20SA%20Amended%20Decision%20-%20Track%20Change%20for%20Publication.pdf p. 19.

8 https://www.artc.com.au/customers/access/access-interstate/performance-indicators/reporting/

allows the access seeker to assess the quality of the service it might reasonably expect to obtain. This would include matters such as route maintenance history and asset renewals, track recording information, etc.

Reform Option 9. Allow for merits review of regulatory decisions made under the Code.

Aurizon supports the inclusion of merits review where a regulator has significant discretion and the implications of regulatory error in the exercise of that discretion would have a material effect. In terms of principles advocated by the Administrative Review Council on what decisions should be subject to merits review[9] the regulatory decisions under the WARAR are likely to be legislatively unstructured in that the legislation only prescribes the general factors that are relevant for consideration in the exercise of a decision-making power.

The parties likely to be effected by a regulatory decision under the WARAR will be sufficiently resourced and have the capacity to identify where a regulatory error might arise. In this regard, the common argument that merits review is biased in the favour of the railway owner as only decisions adverse to that party would be reviewed does not carry weight. Importantly, merits review was supported by users and railway owners alike in the 2014 review of the Code.

Aurizon also considers that the establishment of an opening asset value for the purpose of implementing a Depreciation Actual Cost model under a building blocks approach must be subject to formal merits review given its significance and the consequence of regulatory error on all subsequent regulatory decisions. As noted in the 2015 Competition Policy Review[10].:

> *Decisions to declare a service under Part IIIA, or determine terms and conditions of access, are very significant economic decisions where the costs of making a wrong decision are likely to be high.*

Merits review will also need to be limited to those matters that are less likely to adversely impact an access negotiation. In this regard the ex-ante floor and ceiling cost determinations under section 9 of Schedule 4 are suitable for merits review. A limited merits review of the decision-makers original decision by an appropriate review panel with relevant technical and judicial expertise, comparable to the Australian Competition Tribunal, would be expected to make a determination within fixed time limits. In contrast, an application for Judicial Review to the Supreme Court may take considerably longer timeframes.

The matter to be addressed is not whether merits review would involve further delays in the negotiation of an access arrangement but what decisions can be made by the regulator exogenously and pre-determined prior to an access negotiation to reduce the prospect of a review having a direct impact on a negotiation In this regard, Aurizon considers that a determination of floor and ceiling costs under Section 9 through extensive and public consultation would address the concerns regarding the impact of a review of that decision, Judicial or merits review, on the timeframes for arbitration.

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9 https://www.arc.ag.gov.au/Publications/Reports/Pages/Downloads/Whatdecisionsshouldbesubjecttomeritreview1999.aspx

10 The Final Report also included in recommendation 42 the proposal that the Australian Competition Tribunal should be empowered to undertake a merits review of access decisions, while maintaining suitable statutory time limits for the review process. Aurizon is supportive of COAG state members determining a workable and efficient merits review framework for access decisions under state based access regimes.

Reform Option 10. Include Final Recommendation 4 from the ERA's 2011 Code Review

The Issues Paper discusses whether the following recommendations by the ERA in the 2011 Code review should be implemented:

- Section 42 should be revised to only require public consultation for variations to segregation arrangements considered by the Authority to constitute a material change.
- Section 45 should include the costing principles and over-payment rules in order to ensure consistency in the public consultation process across all Part 5 instruments.
- A new provision should be added to provide for the review of all Part 5 instruments every five years or as otherwise determined by the Authority; and

Aurizon supports the amendment to the Code to implement these recommendations.

It is reasonable for the railway owner and the regulator to address minor variations of an administrative nature without the need for public consultation. However, the Code should provide guidance on what does or does not represent a material change such that only amendments relating to the administrative operation of the segregation arrangements are excluded from public consultation.

Periodic review of the Part 5 instruments allows for material changes in market conditions or circumstances not envisaged at the time of their original development, or from the last review, to be reflected in the relevant instruments so that they continue to advance the statutory objectives. However, changes should not be required to address matters that are minor or inconsequential in nature. This ensures that variations are required to address a clearly demonstrated deficiency in the Part 5 instrument in promoting the objects of the regime. The railway owner should be able to propose amendments to the Part 5 instruments at any time in the same manner that a provider of an access undertaking pursuant to the National Access Regime or the Queensland Rail Access Regime may submit a variation or amendment at any time.

Five years represents a reasonable timeframe for the review of part 5 instruments and provides an appropriate balance between regulatory certainty and efficacy.

Facilitating timely and efficient expansion of the network

The National Access Regime (**NAR**)and the CPA includes appropriate and necessary legal safeguards associated with protecting the legitimate business interests of the access providers. The Productivity Commission (**PC**) describes the economic rationale for the ACCC to direct an extension as:

> *prevent[ing] service providers undermining the objective of the Regime by deliberately delaying infrastructure investment, or constructing facilities with suboptimal capacity, to limit competition and extract monopoly rents*[11]*.*

Aurizon notes the PC's comments that the access providers legitimate business interests are likely to be broader than the capital cost of extensions, and include adverse effects on the service provider's operations arising from the directed extension. The safeguards are also effective in the sense that they

[11] Productivity Commission (2014) Review of the National Access Regime – Inquiry Report

provide an appropriate limit on the regulator's power in order to protect the investment incentives of the access provider.

The safeguards outlined in appendix C.1 of the Intergovernmental Agreement on Competition and Productivity-Enhancing Reforms includes the requirement that the dispute resolution body should not make a determination which have any of the following effects:

- result in the third party becoming the owner (or one of the owners) of any part of the facility, or of extensions of the facility including expansions of the capacity of the facility and expansions of the geographical reach, without the consent of the provider;
- require the provider to bear some or all of the cost of extending the facility (including expanding the capacity of the facility and expanding the geographical reach of the facility) unless the determination is consistent with a voluntary commitment offered by the provider in an approved access undertaking; and
- require the provider to bear some or all of the costs of maintaining extensions of the facility (including expanding the capacity of the facility and expanding the geographical reach of the facility).

Aurizon supports these principles and the continuation under the WARAR for the railway owner to extend or expand the network to accommodate the access seeker's application if required, at the cost of the access seeker. There are considerable operational, commercial and legal considerations in the direction of an expansion which are likely to be project and customer specific and not amenable to a prescriptive process. Therefore, Aurizon considers the light-handed principles based approach to be more effective than a detailed process.

Reform Option 11. Apply a high level set of principles to guide the expansion process in an access negotiation.

Aurizon supports this proposal.

The Central Queensland Coal Network and the Hunter Valley Coal Network markets are characterised by a large number of users with a high degree of product and service homogeneity. The level of detail in these regimes is unlikely to be appropriate to the frequency of negotiations and expansions in Western Australia.

Aurizon also notes the PC's recommendation 8.9 proposed that:

> *the Australian Competition and Consumer Commission (ACCC) should develop and publish guidelines on how its power to direct facility extensions would be exercised in practice such that it is expected to generate net benefits to the community. The guidelines should be developed by the ACCC using a process that includes the public release of draft guidelines, and is informed by stakeholder consultation.*

This review, when completed, could provide template guidelines relevant to application under the WARAR.

Aurizon notes the most significant issue to be addressed in directing an extension/expansion to the network are the tax issues arising from capital contributions and a change in tax law is necessary to enable Third Party funding to be undertaken in a tax neutral and efficient manner[12].

Third Party Funding under the current tax regime often does not result in Tax Neutrality (a component of the wider competitive neutrality) for the Owner/Operator or the Third Party Funder – that is, the Owner/Operator's tax profile is affected by the capital contribution and the Third Party Funder is not placed economically in the same net position as the Owner/Operator when they fund. Overall, this results in a net higher transaction cost for Third Party Funding compared to where the Owner/Operator funds.

Overcoming this policy misalignment between tax lax and competition law and taxing capital contributions to the railway owner on the same basis as if it had funded the expansion is of paramount importance to a regulator being able to direct an expansion or extension of the network.

Reform Option 12. Include a detailed expansion process in the Code.

Aurizon does not support this option for reasons outlined above.

Reform Option 13. Allow a proposal of an extension or expansion to be made at any time after making the initial proposal.

This option would only be required if the reform option 5 is not implemented and the access seeker remains responsible for determining the expansion requirements. It is reasonable to expect that the expansion requirements cannot be determined without an accurate understanding of the available capacity of the network. It would be inefficient to require an access seeker to determine the expansion requirements at the time of making the proposal only to have to withdraw and submit a new proposal with an alternate scope of for expansion works after discovering what capacity was available.

Aurizon considers this option is unnecessary where the preferred reform options 4 and 5 are implemented.

Alignment of pricing mechanisms with the regime's objectives

A matter raised by stakeholders in successive Code reviews by the ERA is the role of the floor and ceiling costs in promoting the objectives of the regime. While floor and ceiling costs concepts are well understood their underlying foundation is to avoid cross subsidies between services provided by a multi-product firm. This provides limited useful guidance as to what represent a fair or reasonable price for the provision of access between those bookends which balances the interests of the railway owner and the operator and whether that price will facilitate a contestable market for rail operations.

[12] See Aurizon's submission to the Federal Government's 2015 Tax Whitepaper available at: http://bettertax.gov.au/publications/discussion-paper/submissions/

Reform Option 14. Application of Indicative Tariffs

Aurizon has consistently supported a continuation of the negotiate arbitrate model to determine the terms and conditions of access as a preference to the use of reference tariffs where the direct and indirect costs of maintaining a reference tariff exceed the benefits.

The Issues Paper identifies three circumstances where the application of indicative tariffs may be justified, including:

- where the service is priced at total cost;
- where there are a reasonable number of services using a route and they are relatively homogenous; or
- where the railway owner is vertically integrated.

The application of indicative tariffs have the following benefits:

- substantially reduces transaction costs from access negotiations;
- reduces enforcement costs of non-discrimination obligations;
- promotes competition in the market for rail operations by providing for shorter contract terms due to predictability of future prices; and
- limits price increases to relevant changes in cost or risk in the provision the service.

While there are concerns regarding the regulator imposing its view on what represents an efficient price and the implications of regulatory error setting the indicative tariff this outcome does not differ from an outcome where a partially informed arbitrator would be required to make a binding price determination. However, the process of developing an indicative tariff effectively substitutes a bilateral negotiation process which can be expected to identify opportunities for a more efficient value proposition and allocation of the gains between the two parties. This can also change the incentives of stakeholders where the costs of implementing an indicative tariff avoids the costs and difficulty of a bilateral negotiation process.

1. Service is priced at total cost

The use of indicative tariffs where the service is priced at total costs should be unnecessary where the framework operates effectively. An outcome of the overpayment rules should be that the maximum price that can be charged is self-regulating where a service is paying total costs.

In order for this self-regulating framework to work effectively:

- the service would need to allow for the negotiation of a long term access agreement so that the price would not be subject to material demand and volume risk;
- the route is subject to a ceiling cost determination;
- access charges for the same service are subject to non-discrimination obligations such that the market outcome is consistent with application of an indicative tariff; and
- the railway owner is required to maintain internal access agreements for its own operations with access charges that are fully accounted for in the overpayment rules.

If these conditions are satisfied then the revenue that is attributable to its own operations should be determined on the same basis as that of the third party railway operator and achieve the same outcome as an indicative tariff for the service. The overpayment provisions effectively operate as a weighted average price cap.

2. A reasonable number of homogenous services using the same route

Aurizon is of the view that the application of indicative tariffs may be beneficial to services which are subject to a high degree of competition across multiple users which are periodically renegotiated. The benefits in applying indicative tariffs in these conditions are largely two-fold:

- a significant reduction in the transaction costs through what effectively amounts to collective negotiation through a structured regulatory process; and
- promotes contestability for rail operations by ensuring uniform price and terms do not squeeze competitors.

Aurizon also considers that where these matters are relevant, the justification for indicative tariffs is further enhanced where the service:

- originates in another jurisdiction; and
- the access charges for that route represent a material proportion of the overall cost of access for the complete origin to destination route.

The application of indicative tariffs would allow for coordination of tariffs between the adjoining railway owners to ensure the total costs of access represent an efficient price. This outcome is also consistent with Clause 4 of the revised CPA which requires:

> *Where a State Party in whose jurisdiction a facility is situated has in place an access regime which applies to the facility, the regime should have regard to the influence of the facility beyond the jurisdictional boundary of the State.*

3. Vertical integration

There is likely to be limited circumstances where the application of indicative tariffs for a service based solely on the railway owner being vertically integrated would provide benefits which exceed the direct and indirect costs of its development and the prospect for regulatory error. This is likely to be particularly the case were the route has:

- low utilisation levels;
- the market has a low capacity to pay; and
- there are other effective forms of competition, such as road.

On balance, the regulator should have the appropriate discretion and the competence to determine under what circumstances the application of an indicative tariff would provide a net benefit.

Aurizon notes that with respect to existing services which become contestable the internal access charges in a related party access agreement provides an indicative tariff given the option for the proponent to seek the regulator's opinion on whether the price being offered is consistent with all rail operators. However, the WARAR does not currently mandate a requirement for internal access agreements on an arms-length basis. Clause 8(3) of Schedule 4 considers only the revenue that railway owner's accounts and financial statements show a being attributable to its own operations. It is unclear

whether the revenue that should be attributable to its own operations is based on internal access charges or an approved allocation methodology. In this regard the Costing Principles or the Overpayment Rules in effect under the regime, as approved by the ERA, make no reference to internal access charges.

Aurizon recommends that the Government consider including a requirement within WARAR to mandate internal access agreements and internal access charges.

Reform Option 15. Replace the GRV approach with an Established Asset Value

Aurizon considers that implementing an Established Asset Base (**EAB**) would improve the effectiveness of the WARAR.

The Issues Paper notes that the GRV approach is unique to the WARAR and that the Depreciated Optimised Replacement Cost (DORC) is the method most commonly applied in other rail access regimes. In practice most other rail access regimes apply a Depreciated Actual Cost (DAC) once the initial asset value has been determined with the application of regulatory asset base roll-forward with or without loss capitalisation provisions. The use of DORC in these frameworks is primarily to draw a line in the sand to assess whether the railway owner will earn revenue which is at least sufficient to provide a return on investment.

There are various feasible valuation methodologies which could be applied to establish an EAB, as suggested by ERA. These include:

- depreciated historic costs which may be more suited to recently constructed greenfield railways, or geographical extensions of railways occurring after the commencement of the relevant lease. This rail infrastructure would be expected to:
    - reflect modern engineering standards;
    - be subject to minimal physical asset depreciation; and
    - avoid the need for consideration of asset condition;
- depreciated optimised replacement costs would be more suited to rail corridors where current and projected demand and revenue conditions are expected to recover the resultant valuation over the economic life[13]. DORC based approaches would not be well suited if there is limited prospect of recovering the asset value or where capitalised losses (or deferred depreciation) produce continuously compounded economic losses. The scope for wins or gains from transition from GRV are also likely to be minimal with this approach under the limited circumstance of revenue adequacy and an average physical asset life (minimises the GRV to DORC variances at the extremes of old or new rail corridors).
- earnings based valuation implies an asset value based on the foreseeable demand and the expected earnings from escalated access prices. This approach is expected to involve a high degree of subjectivity and be susceptible to material regulatory error; or
- invested capital approach which involves a consideration of the railway owner's acquisition price and investment in the rail network from the acquisition date. This approach is expected to be well

[13] In most instances where DORC has been applied the railway is revenue adequate. In other instances adjustments to the DORC valuation have been made to reflect historical circumstances and recognition that the assets were funded under government ownership on the expectation they would never recover the full economic costs.

suited to rail corridors that are not likely to achieve revenue adequacy from a DORC approach and there is an observed acquisition price solely relating to the below rail infrastructure that can be used to establish the EAB at the acquisition date. The EAB is then rolled forward on the basis of actual capex incurred and economic depreciation.

The divergent economic conditions and utilisation of the railways covered under the Code suggests that the preferred approach to determining the EAB should be at the regulator's discretion subject to satisfying a range of decision criteria. This would be consistent with the view of the National Competition Council when assessing the application for certification of the WARAR:

> *Prescribing the costing methodology in the Code is not the preferred approach. The Council considers that it is advantageous for the regulator to have the discretion to determine the appropriate methodology on a case by case basis, particularly given the recent, and likely future, application of the Code to greenfield developments*[14]

Aurizon notes the DAC approach and the invested capital approach are more closely aligned to the requirements of the Competition Principles Agreement that:

> *regulated access prices should:*
>
> *A. be set so as to generate expected revenue for a regulated service or services that is at least sufficient to meet the efficiency costs of providing access to the regulated service or services; and*
>
> *B. include a return on investment commensurate with the regulatory and commercial risks involved.*

The second limb infers that the prices should reflect the investment made in providing the regulated service which would have regard to:

- an EAB that is in place at the date of acquisition or at the time of privatisation; or
- the actual investment incurred in acquiring the facility used to provide the service; and
- the investment made in the facility since the acquisition/privatisation date.

Aurizon notes that the potential for windfall gains or losses arises not because the valuation methodology applied but due to the need to for continued revaluation of the assets each time a cost determination is made under section 9 or 10 of Schedule 4. The main advantage of applying an EAB approach is that it removes a large component of the price ceiling determination which would substantially reduce the timeframes required to make a cost determination. The revaluation approach may also result in regulated access prices not satisfying the pricing principles if the revenue on the lower GRV valuation does not allow for a return on investments actually made.

The application of the EAB will also provide increased transparency of the efficient costs of providing rail services as they will be more closely aligned to the costs actually incurred by the railway owner and therefore Aurizon supports the application of a cost reflective EAB and operating costs.

The Issues Paper also discusses the challenges posed by the application of the GRV approach to pricing of major expansions. The identification of incremental and total costs are relatively clear prior to the

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[14] National Competition Council (2011) Draft Decision. Application for Certification of the Western Australian Rail Access Regime, p.45

expansion with respect to the capital component as it aligns to a 'with and without' test. In addition to the concerns raised in the Issues Paper regarding the impact of the expansion and increased demand on the average unit costs for maintenance and operating costs there is additional concern with respect to the transparency of the expansion costs in subsequent GRV valuations.

The CPA requires that when deciding on the terms and conditions for access, the dispute resolution body should be required to take into account, among other matters the "*value to the provider of extensions including expansions of capacity and expansions of geographical reach whose cost is borne by someone else*'. The use of an EAB which clearly and transparently identifies the costs of the contributed capital over its economic life reduces the complexity and uncertainty in how the dispute resolution body would have regard to the value of this contribution relative to the GRV revaluation approach.

Lastly, the use of the EAB and identification of the expansion costs would also reduce the uncertainty to an access seeker as to how the price of access might change over the life of its complimentary investments. The ability to roll-forward the EAB and estimate the revised ceiling costs associated with an expansion is expected to assist the negotiation process.

Expanding the Guidelines for the Negotiation of Prices

Section 13 of Schedule 4 to the Code includes guidelines which should be applied in the negotiation of prices for the provision of access.

Aurizon considers that the Guidelines do not adequately reflect key matters which should be relevant to the dispute resolution body and should be expanded to include:

1. ***Promoting a contestable market for rail operations***. This ensures alignment with the over-arching objective and requires the railway owner to consider whether the access price level and structure represent a barrier to entry for an efficient rail operator. The object clause is also framed as efficient utilisation and investment by contestable rail operations placing a primary emphasis on the access price impacts on rail haulage markets[15].

2. ***Must not exceed a price which can be fairly asked***. A fair price is one which would allow an efficient rail operator to sustain profitable rail operations. While the guidelines refer to the principle of fair and reasonable they do so only with reference to apportionment of costs and not whether the access price itself is fair. A fair price would also balance the interests of the railway owner by ensuring it is able to recover its costs of providing the service including a return on its actual invested capital ('*revenue adequacy*'). This would avoid access prices squeezing operator margins to improve the profitability on a hypothetical asset valuation.

Aurizon notes that the following summarised principles from Schedule 3 of the Railways (Access, Management and Licencing of Railway Undertakings) Regulations 2016[16] (United Kingdom) may be relevant to the content of the guidelines:

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[15] Aurizon notes this also consistent with the arbitration principles recommended by the Gas Market Reform Group in the Final Design Recommendation on 'Gas Pipeline Information Disclosure and Arbitration Framework' which states:

> *When assessing the reasonableness of the offer for these types of services, the arbitrator is to have regard to the cost of providing the service, which is to include a commercial rate of return that reflects the risks the pipeline operator faces in providing the service. When determining the value of any assets used in the provision of the service, the arbitrator can have regard to any asset valuation techniques it considers are consistent with the workably competitive market objective, including those that take into account past recoveries of capital*

[16] The regulations conform to the European Council Directive 2001/14/EC on the allocation of railway infrastructure capacity and the levying of charges for the use of railway infrastructure.

- the charges for the minimum access package [of track rights] must be set at the cost that is directly incurred as a result of operating the train service;
- the charge imposed for track access must not exceed the cost of providing the service, plus a reasonable profit;
- the charges may be averaged over a reasonable spread of train services and times, but the relative magnitudes of the railway infrastructure charges must be related to the costs attributable to the services; and
- the charging system must respect the productivity increases achieved by the applicants.

The important construct of these principles is that they relate to observable and reported costs in the railway infrastructure accounts and not conceptual values of replacement costs.

Effective regulation of marginal freight routes

Aurizon acknowledges the financial challenges facing the grain industry, government and the railway owner in the continuation of rail services on marginal freight routes.

The Issues Paper states:

> *The infrastructure manager has assessed that continuing to provide access to and use of these marginal routes is uneconomic, however the regime is silent on whether they should remain within the scope of the regime. It is questionable whether the marginal routes would continue to meet the requirements for a route to be regulated under the Code.*

It is important to recognise that a marginal route may be uncommercial to the infrastructure manager but remain economic if the services are able to recover the avoidable forward looking costs. The assessment of whether rail is competitive or economic against competing modes is also distorted by the failure of the road infrastructure charging regime to reflect the economic costs of road services and their relevant externalities. Therefore, an assessment of the full economic costs of the competing modes may lead to a conclusion that many marginal routes are in fact not economic to duplicate, either by a competing rail facility or the cost reflective use of local road infrastructure.

Aurizon recognises that it may be in the public interest to apply the WARAR to marginal freight routes which may not satisfy the declaration criteria where the continued operation of those routes is contingent on government contribution.

The continuation of the access regime to these routes should be considered in the context of efficient resource allocation. Where the provision of rail services on these routes is dependent on ongoing government support then the government should provide for the appropriate directions to be made on the pricing of access to ensure the policy objectives of the government will be satisfied. The application of the WARAR to these routes may represent a more effective oversight mechanism than the development of an alternative contractually based policy framework underpinning government funding.

Aurizon supports the retention of marginal freight routes within the scope of WARAR where this supports the continuation of the most economically efficient transportation of freight.

Interactions with the National Access Regime

Aurizon does not consider that bringing the interstate services offered by Arc Infrastructure on the interstate route under regulations consistent with the ARTC undertaking will necessarily provide material advantages relative to improving the WARAR as identified within this submission.

In practice, the revenue earned by ARTC from the East West interstate rail freight services would be unlikely to meet or exceed a revenue ceiling test whether that ceiling was determined with reference to a DORC or a GRV based valuation. Both the WARAR and the ARTC undertaking will retain the broad range of feasible price outcomes between floor and ceiling costs.

Aurizon notes CBH comments in its submission to the National Freight and Supply Chain Priorities that the ARTC model be introduced into Western Australia[17]:

> *On the basis that ACCC's oversight of the Australian Rail Track Corporation ("ARTC") rail network [has] been well regarded generally by industry participants throughout southern and eastern Australia, CBH considers that a similar ARTC rail access regime should be introduced into Western Australia.*

It is important to recognise that the ARTC access undertaking is strictly voluntary and is relatively light handed while ARTC management incentives are subject to government ownership objectives. Similarly, the ACCC has not yet been required to arbitrate an access dispute which is largely attributable to the application of indicative charges and an indicative access agreement. It remains to be seen whether ARTC will continue to offer standing terms and conditions in the next interstate access undertaking or whether it would be prepared to maintain a voluntary access undertaking if the ACCC rejected the proposed indicative access charges. Therefore, it is not apparent that the ARTC access undertaking represents an effective model that would address the issues that have been identified in the Issues Paper or the problems associated with the arbitrating prices between the floor and ceiling limits.

Aurizon strongly prefers that issues regarding consistency with the national access regime for interstate freight services are addressed through changes to the overall WARAR framework rather than incorporating bespoke arrangements within the WARAR which could result in divergent arrangements applying to the same rail corridor. The costs, risks and complexity of this approach outweigh the benefits of reforming the WARAR to more closely align to the national access regime.

Aurizon does not believe the wholesale access agreement between ARTC and Arc Infrastructure operates as originally intended and does not provide '*for a single process for persons to seek access to the service, a single body to resolve disputes about any aspect of access and a single forum for enforcement of access arrangements*' as per the CPA.

As discussed earlier in this submission the WARAR should provide for the determination of indicative reference tariffs for interstate intermodal services concurrently with approval of the interstate access undertaking. However, in the absence of indicative reference tariffs the regime should provide for:

- the ACCC to be appointed the arbitrator; and
- joint arbitration with interested access seekers for interstate services.

Inclusion of these arrangements would allow for consistency in outcomes with the access arrangements for service operating over infrastructure subject to multiple access regimes.

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[17] CBH Group (2017) Inquiry into National Freight and Supply Chain Priorities: Submission from the CBH Group, July, p.