ARTC Submission on Heavy Vehicle Road Reform Regulatory Impact Statement

RIS Consultation Paper response

August 2018

1 Key Issues

Australian Rail Track Corporation (ARTC) welcomes the opportunity to comment on the Regulatory Impact Statement (RIS) in respect of Heavy Vehicle Road Reform (HVRR). ARTC is the owner or lessor of (inter alia) the interstate freight rail network which is regulated by the Australian Competition and Consumer Commission (ACCC) and competes in the intermodal freight market of which road is a major participant. ARTC, including through its involvement with industry groups such as the Freight on Rail Group (FORG), the Australian Railway Association (ARA) and the Australian Logistics Council (ALC), has a deep history of involvement in the Heavy Vehicle Road Reform (HVRR) debate. The last submission made by FORG was in respect of the Discussion Paper *Land Transport Market Reform: Independent price regulation of heavy vehicle charge*.

That Independent Pricing submission concluded support for HVRR by moving to independent economic regulation. However it noted that this raised a number of scheme design issues which were understood to be the subject of further consultation and comment. Whilst this RIS provides an opportunity to comment on the preferred pathway, there is still a requirement for further detail on the specific scheme details to be reviewed and discussed (i.e. how is the Forward Looking Cost Base designed). ARTC looks forward to further engagement on such detail.

One element of detail that requires specific definition is the definition of a "Heavy Vehicle" and also what roads will this reform apply to. ARTC has undertaken this response on the assumption that a Heavy Vehicle is a vehicle over 4.5 tones and that the reform applies to the main highways within states and territories.

ARTC is a strong advocate for HVRR and firmly supports:

- Reform Option B - Price regulation by an independent price regulator with increased powers for the regulator but where the FLCB is based on a floor and ceiling approach; and
- Scenario 2 - Further reform is undertaken consistent with phases 3 and 4 of the HVRR program.

The application of full economic regulation within a floor and ceiling approach has delivered considerable benefits to the rail industry over the last 20 years for the reasons outlined in this paper. ARTC therefore recommends an approach to HVRR that delivers the same framework which allows the benefits of HVRR to be achieved as quickly as possible.

2 Australian Rail Track Corporation Ltd (ARTC)

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

- Improve performance and efficiency of interstate rail infrastructure

- Increase capacity utilization
- Listen, understand and respond to the market
- Operate on sound commercial principles
- Provide shareholders with a sustainable return on capital invested

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

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

2.1 ARTC Undertakings

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

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

In addition, some small sections of the network in NSW continue to be regulated by IPART under the NSW Rail Access Undertaking.

These undertakings, and ARTC itself, reflect the substantial economic reform of the rail industry which arose from the recommendations of the Hilmer Report in 1993. These reforms delivered substantial benefits through the introduction of new, private entrants into that market which compete strongly. The regulatory framework which arose, with its oversight of investment and operations, in combination with the benefits of competition, has delivered a world class freight rail network. In particular, the regulatory framework and its focus on prudency has provided the mechanism for better targeted investment decisions by stakeholders across the industry chain (including government) ensuring the alignment of demand for and supply of capacity across the rail freight network.

The benefits that have arisen within the rail industry from the development of a regulatory framework have therefore:

- Delivered an increase in competition across the industry;
- Provided a framework for prudent investment by ARTC, Government and stakeholders;
- Ensured better investment decisions through the alignment of supply of and demand for capacity in the rail network.

The focus of the RIS is to provide a pathway to full economic regulation of roads. Given the benefits of economic regulation that have arisen in the rail industry, ARTC encourages the adoption of the necessary steps within the road industry which accelerates the achievement of those benefits.

3 Road Funding Model

The current PAYGO model funds the maintenance of the Australian road network via a combination of fuel excise and registration fees. Although the National Transport Commission can make recommendations, there is no requirement for a state government to follow that recommendation, resulting in a process where there is some inconsistency between states. Further, as registration is paid only by in-state residents whilst roads are used by any vehicle that travels on them, regardless of residency, there is a break in the linkage between payment for roads and the costs of the roads; creating a free rider problem.

This issue is managed in Europe through the vignette system such that the cost differences which are conferred by varying registration and road charging systems in different countries are removed. Such a system would be difficult to impose in Australia; therefore a shift to a user based charging system would eliminate this inefficiency.

Fuel excise as a method of raising revenue to fund the upkeep of roads was originally developed in the USA. Given the technology of the time, fuel excise was as close to a user based system as could be created in the absence of toll booths on every road. It was therefore an approximation of an efficient charging mechanism based on existing technology. Current technology allows both a far more accurate determination of the costs incurred by user groups, as well as the means of recovering those costs.

In addition, the long term trend for increased fuel efficiency of internal combustion engines as well as the increased market penetration of electric vehicles results in a further breakage in the link between road usage and road funding. A further impact of this is that the funding base for roads is declining, with electric vehicles making no fuel based contribution (despite causing costs on those roads).

The net result of this is that the current PAYGO model creates a substantial variance between different classifications of users of the roads and their contribution to costs, establishing significant cross subsidies which, by their very nature, imply that the funding model is not only declining but inefficient.

A change to the funding model is therefore required – especially one which will ensure the revenue pool matches the economic cost of the provision and maintenance of capacity in the road network and eliminates any cross subsidies between users.

ARTC therefore strongly supports the reform objective of the RIS to deliver an economically efficient road pricing model based on the principle of user pays.

4 RAB

The RIS maps a framework to full economic regulation of road pricing, a goal which is critical to the efficient funding and operation of the road market itself, as well as ensuring regulatory consistency across the intermodal freight transport market.

The RIS highlights the benefits that will arise from prudent capital investment and efficient provision of maintenance; in particular based upon the ability to focus on a whole of asset life cycle approach. ARTC supports this approach, and its conclusions, however would highlight that such an approach is dependent upon the whole of the capital's life being incorporated into the analysis.

Therefore, it cannot be only capital incurred from the start of the HVRR that is recovered through this process; but rather that historic capital must be included to ensure that whole of life cycle approach is possible. The RIS makes reference to the calculation of a starting asset base, so this process is clearly contemplated and ARTC would highlight the critical nature of its inclusion to deliver the optimal efficient outcomes sought by the process.

RABS should be defined by specific asset or segment to ensure that the past and future investment and operational needs of each asset can be addressed. The floor and ceiling model proposed in this paper allows for that flexibility whilst ensuring that the regulatory and economic principles underpinning all assets are consistent.

Further, based on its own experience and that of other regulated infrastructure owners, ARTC believes that it is more efficient to calculate the starting RAB based upon a Depreciated Optimized Replacement Cost (DORC) of the roads to be covered by the RIS. This is the same approach used in Rail regulation. ARTC's experience in defining DORC's for inclusion in its regulatory models is this process is readily achievable in a timely fashion via the engagement of expert engineering consultants at reasonable cost; particularly in the context of the other costs included in the RIS.

There is an argument that some capital has already been paid for through the operation of the PAYGO system, so any DORC assessment process should account for that capital which has already been recovered, whilst ensuring that a return is possible on capital which has not. The recent changes to the National Gas Law in respect of the arbitration of access charges for gas transmission pipelines (as developed by the Gas Market Reform Working Group) provides a framework for assessing the Recovered Value of capital investments over time. Introduction of such a valuation methodology should be considered to ensure there is no double recovery of capital.

5 Revenue Neutrality

The RIS, as well as discussion in the webinar, suggests that the initial stage of HVRR will be predicated on the principle of revenue neutrality. ARTC interprets these references to reflect revenue neutrality at the aggregate, total revenue level and not the revenue paid by one particular segment.

This is essential to the value of the process, as a primary goal of HVRR should be the efficient pricing of road access to ensure User segments pay the share of costs they impose on the roads. This must mean there will be some redistribution of costs from the current shares paid by user groups, which will result in variance from their current amounts. Therefore, revenue neutrality cannot apply at the user segment level, or the benefits of reform would be lost.

The RIS comments that an initial Asset Base can be used to ensure the achievement of the revenue neutrality outcome. ARTC believes that this goal can be achieved in a more objective and economically consistent fashion through the calculation of the starting RAB based on a DORC calculation as above.

6 Building Block Framework

The RIS refers to a building block framework as the optimal approach. ARTC supports this approach as the most efficient method of calculating efficient prices as it ensures the recovery of

prudent investment and efficient operating costs. The development of a starting RAB is critical to this process to allow the calculation of the appropriate return of and on capital.

ARTC does not believe it is appropriate to define a starting RAB to solve a revenue outcome. This is not consistent with efficient regulatory practice.

Rather, it is common regulatory practice to define an economic ceiling as the maximum allowable revenue calculated using the building block approach and incorporating the return on and of capital of the RAB value and of efficient operating costs. This is a maximum rate.

In most regulatory models, the ceiling is accompanied by a floor; which is effectively the direct variable costs associated with a user group.

The efficient regulatory model therefore becomes that all User groups should pay the floor such that they cover their direct costs but overall pricing is constrained by the ceiling which reflects the recovery of full economic cost; where the return on and of capital especially is priced in a way that links to causation of the capital and operating costs. Where pricing sits relative to the floor and ceiling is a function of pricing negotiations between network owners and users, including the pricing impact of substitutes on those pricing outcomes. These negotiations occur within a regulatory framework which provides oversight of the process and/or a mechanism for regulatory dispute resolution.

Therefore a better approach would be to define the RAB to reflect the unrecovered historic capital base, and calculate the floor of the direct costs of access. If revenue neutrality is a requirement, once the floor has been recovered from all users, the extent of any capital return can be established and priced at the required level to deliver the target revenue.

Assuming this is below the ceiling, setting a price between floor and ceiling is efficient regulatory practice and consistent with pricing of intermodal rail access.

A further argument to support this approach is that it entails efficient use of expert engineering services; where any starting RAB calculation will involve a cost which is unlikely to be much different (in either time or total cost) than establishing the full RAB. Therefore, creation of the historic RAB to apply the building block model is both an efficient upfront investment whilst also ensuring regulatory consistency across the freight market.

7 Regulatory Structure

The structure of a market, and especially the number of participants in that market, impacts on the optimal regulatory model in respect of both the type of pricing regulation and also in respect of the assessment process.

Where there are few participants (such as in natural gas transmission or rail), the ability to achieve negotiated outcomes is readily achievable and the regulator can take a more light handed approach and act more as an arbitrator of access disputes. In such markets, the regulator has a preference for negotiated outcomes, as it is the counterparties that understand their issues most readily and can achieve the most efficient negotiated outcome.

Where the number of participants is too numerous to achieve a negotiated outcome, it is incumbent on the regulator to set the efficient price as a negotiated outcome with all participants is not possible to achieve when they number in the tens and hundreds of thousands (or millions in the case of

electricity). Such a regulatory determination process, based upon a proposal by the network owner which can be anywhere between floor and ceiling, must also incorporate an ability for the individual operators to indicate their support; most likely through industry associations – electricity provides some examples of how this can be more readily achieved.

A key benefit of the regulatory model, as identified above, is the alignment of supply and demand of capacity through an increased focus on the investment plans of network owners. This focus makes the network owner accountable to the regulator, the industry and other stakeholders to comment on the prioritization and benefits of investments. The regulatory prudency assessment of capital therefore allows a focus on the investment plans of network owners contributing to the supply and demand alignment highlighted above. These capital plans can be approved on an ex ante basis or rolled into the RAB based on ex post assessment. Each model has its own risks and whilst ARTC notes this discussion was not incorporated into the discussion paper, a brief discussion on those risks is warranted.

7.1 Ex-post Capital Approval

The ex-post system carries risk for network owners who invest capital but with some uncertainty as to whether that cost is ultimately recoverable as it is subject to an ex post assessment; and if deemed imprudent is unrecoverable.

This risk is manageable to an extent by agreeing with customers projects which can be deemed prudent (so a variation on contractual agreement); however where the numbers of customers are too great, such an option is impracticable.

7.2 Ex-ante Capital Approval

The main risk of ex-ante capital approvals is that it can deliver a misalignment of supply and demand if forecasts of capacity demand underpinning the investments plans are incorrect. This risk can be mitigated through the regulatory process where customers have the ability to comment on the proposed investments.

A Forward Looking Cost Base model presupposes an ex ante approach. A floor and ceiling model where the price is below the ceiling, allows some flexibility in determining an approach that delivers both efficient current pricing and promotes prudent investment without demand forecasting risk.

ARTC has experience with both models and is happy to discuss the risks and benefits of such an approach further as required.

8 Conclusion

ARTC is supportive of the HVRR framework and the approach in the RIS as evidenced by Option B. However, ARTC believes that the goals of HVRR with an end point of full economic regulation can be more readily achieved through the imposition of a floor and ceiling model based on an initial calculation of the RAB to apply to the relevant roads.

Such an approach has the following critical characteristics:

- It ensures regulatory consistency across the market for intermodal freight haulage;
- It ensures full flexibility in delivering revenue neutrality;

- It allows for the recovery of investment in roads but without a risk of double recovery of already recovered investments;
- It is consistent with the recovery of forward looking costs initially as per Option B, but requires minimal further investment to reach the desired end point of full economic regulation;
- It therefore accelerates the time frame for the imposition of fully efficient HVRR;
- It allows for efficient pricing to ensure cross subsidies between segments are removed (so all groups meet the costs they impose);
- It provides flexibility in mitigating the effect of volume forecasting risk on prudent capital investment; and
- It provides a transparent model to determine the process for customer involvement.

These principles are critical to achieving efficient regulation which is consistent across the intermodal freight market. ARTC therefore recommends:

- Reform Option B - Price regulation by an independent price regulator with increased powers for the regulator but where the FLCB is based on a floor and ceiling approach; and
- Scenario 2 - Further reform is undertaken consistent with phases 3 and 4 of the HVRR program but at an accelerated pace.

The application of full economic regulation within a floor and ceiling approach has delivered considerable benefits to the rail industry over the last 20 years for the reasons outlined in this paper. ARTC therefore recommends an approach to HVRR that provides the same framework which allows the benefits of HVRR to be achieved as quickly as possible.