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2 January 2018

Michael Barnes
Under Treasurer
Department of Treasury
Locked Bag 11 Cloisters Square
PERTH, WESTERN AUSTRALIA, 6850

By email: regulatoryreform@treasury.wa.gov.au

Dear Mr Barnes,

Review of the Western Australian Rail Access Regime

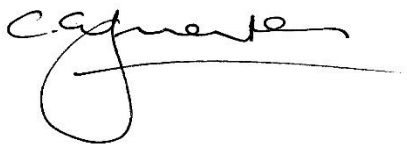
Thank you for the opportunity to make a late submission to the review of the Western Australian rail access regime (WARAR).

The attached document sets out the views of the Australian Competition and Consumer Commission (ACCC) in respect of four issues identified in the July 2017 Issues Paper. These matters are:

- Balance of power in negotiations
- Accountability
- Pricing mechanisms
- Consistency with the National Access Regime.

If you would like to discuss this letter or any issues contained in the attached document, please contact Matthew Schroder, General Manager Infrastructure & Transport – Access & Pricing on (03) 9290 6924 or Kristopher Morey on (03) 9290 1948.

Yours sincerely,



Cristina Cifuentes
Commissioner

ACCC comments on the Review of the Western Australian Rail Access Regime

The ACCC has a role under Part IIIA of the *Competition and Consumer Act 2010* (CCA), previously the *Trade Practices Act 1974* (TPA), to assess and administer access undertakings submitted by the owners or operators of facilities with natural monopoly characteristics. The ACCC has experience with access regimes for below-rail infrastructure, having accepted the Interstate Access Undertaking (IAU) and Hunter Valley Access Undertaking (HVAU) submitted by the Australian Rail Track Corporation (ARTC). In this role, the ACCC seeks to promote the economically efficient operation of, use of and investment in below-rail infrastructure with a view to promoting effective competition in upstream and downstream markets. In light of this experience, the ACCC has an interest in certain issues raised by the Western Australian Government Department of Treasury in the July 2017 Issues Paper.

Balance of power in negotiations

The role of regulatory Access Arrangements

The WARAR allows parties to negotiate agreements entirely outside the regulatory regime. While in principle agreements reached through commercial negotiation are preferable in workably competitive markets, the ACCC considers owners of natural monopoly infrastructure have both the ability and incentive to exercise market power to the detriment of competition in upstream or downstream markets. In the absence of competitive constraints or market disciplines, owners of such infrastructure by virtue of their monopoly position, lack the incentive to price access to services efficiently or to promote efficient use of infrastructure. Thus in monopoly infrastructure circumstances, it may be desirable and necessary for such providers to be subject to some form of regulation so there is a constraint on their ability and incentive to exercise market power. Access regulation is commonly used to replicate the conditions, which would allow access seekers the ability to negotiate outcomes that would be expected in a workably competitive market.

A key objective of such regulatory frameworks is to address the imbalance of bargaining power through elements such as greater transparency, the ex-ante provision of information, a requirement for mandatory non–discrimination clauses, performance measurement, and ideally, dispute resolution/arbitration mechanisms.

The IAU and the HVAU provide an indicative access agreement, which sets out standard terms and operates as a ‘template’ contract. In particular, the HVAU indicative access agreement provides both mandatory and negotiable provisions. The ACCC considers that indicative access agreements provide a clear and transparent starting point for commercial negotiations regarding terms of access. In developing its undertakings, ARTC has engaged in commercial negotiations with access seekers. These are submitted to the ACCC, which can then either accept it or reject it. The ACCC cannot substitute any preferred elements but it can, in rejecting the proposed access undertaking, work with the ARTC and industry to settle areas of concern.

One key mandatory provision in the HVAU indicative access agreement is non-discrimination, where ARTC cannot price discriminate on the basis of the identity of the access seeker, so as to encourage customer confidence, competition and market growth. The ACCC considers that this addresses concerns about preferential or unfair treatment by an access provider. It should be noted that the HVAU does allow ARTC to price discriminate where it aids efficiency.

In the context of the WARAR, the ACCC considers non-discrimination obligations should apply regardless of whether access is negotiated inside or outside the regime. The ACCC also considers that non-discrimination provisions should be supported by active monitoring

and enforcement by the regulator and behavioural requirements—such as capacity allocation and pre-conditions for access (for example, access seekers being solvent and having an acceptable credit rating).

Accountability

Railway owner accountability to comply with the regime

The ACCC considers key performance indicators (KPIs) a useful tool in increasing the accountability of access providers in respect to the standard of service provided to access seekers. An obligation to report on KPIs is a standard component of the below-rail access undertakings accepted by the ACCC under Part IIIA.

The IAU commits ARTC to periodically report on unit costs and the service quality performance indicators of reliability, network availability, transit time, temporary speed restrictions and track condition. The HVAU commits ARTC to periodically report on transit time, maintenance requirements and coal chain capacity losses. KPIs can provide transparency regarding the level of service provided, for example, by enabling access seekers and regulators to identify instances of discrimination against access seekers.

Another example where the ACCC and access seekers have sought to improve ARTC's accountability in the HVAU has been through the development of an operating expenditure (opex) efficiency mechanism (also reliant on appropriate KPIs). However, the development of an appropriate opex efficiency mechanism has proved difficult and is yet to be incorporated.

In terms of the WARAR, the ACCC considers that the use of KPIs to require railway owners to report on service quality matters can provide greater transparency and assurance to stakeholders on these matters, and ameliorate concerns about information asymmetry in negotiations.

Regulator accountability

A justification for merits review of regulator decisions is that it is an essential mechanism for holding the regulator to account for its decisions and affording the parties to the decision an opportunity for an independent review of the merits of the decision. The ACCC supports the principles of transparency and accountability of regulatory decisions. However, in the ACCC's experience (both directly and as an observer of the outcomes of the Australian Energy Regulator's (AER's) experience with the Limited Merits Review regime which was recently abolished), access to merits review has not necessarily achieved these objectives. Rather it has provided an incentive for monopoly access providers to game the regulatory process.

Regulatory decisions involving access determinations are by their nature complex and involve a considerable exercise of regulatory judgement. They typically involve extensive inquiry and analytical processes. The primary decision-maker brings significant legal, economic and technical expertise to its decisions. Under a merits review process, the review body is the second and ultimate decision-maker for these complex decisions but without the benefit of the time, resources and expertise available to the original decision-maker. These shortcomings have been recognised in a number of access regimes.

In 1997, a telecommunications-specific access regime (Part XIC) was incorporated into the TPA.[1] Most decisions that were part of this regime were subject to full merits review,

[1] *Trade Practices Amendment (Telecommunications) Act 1997* (Cth).

including decisions on access undertakings and arbitration of access disputes, but not declarations (although exemptions from the access obligations were). In 2001, the Productivity Commission undertook a review into the telecommunication competition regulation, which examined the role of merits review.[2] In 2002, in response to the Productivity Commission's review, the Australian Government amended Part XIC to reduce the availability of merits review and reduce the cost and delay associated with such a review.[3] In 2010, further amendments to Part XIC removed merits review from the telecommunications-specific access regime.[4] The ACCC notes that repeated challenges to arbitrations and undertakings were highly resource-intensive and time-consuming. For example, six ACCC undertaking decisions were appealed to the Australian Competition Tribunal, all of which were unsuccessful.

Further, until 2017, energy network service providers had access to limited merits review of the AER's decisions. Prior to this, network service providers would routinely seek review, as there was a widely held perception that the regime had no downside risk.

In 2016, the Council of Australian Governments Energy Council (COAG EC) reviewed the limited merits review regime and found it imposed significant costs to all participants, presented barriers to meaningful consumer participation and led to significant regulatory and price uncertainty.[5] On 16 October 2017, the Australian Government abolished limited merits review in energy related decisions.

The availability of judicial review, together with elements such as Statements of Expectations, Statements of Intent, extensive consultation processes, the issuance of statements of approach and guidelines, detailed decision documents and explanatory statements to decisions, annual reports, performance measurement reporting, are important in promoting and ensuring regulator commitment to transparent, robust decision-making and accountability.

Pricing mechanisms

Indicative tariffs

The WARAR provides for the railway owner and access seeker to negotiate an access price within the price floor and ceiling for the relevant route. While there are no benchmark or reference tariffs approved by the regulator, if the regulator considers an access proposal is likely to be made for a particular route, it may determine the relevant price floor and ceiling.

Although the WARAR requires that access charges fall between the relevant price floor and ceiling, this captures a broad range of access charges. As the railway owner will have greater market power than the access seeker, as a result of owning infrastructure with natural monopoly characteristics, parties will not start negotiations from an equal position. Further, the railway owner will benefit from information asymmetries, as it will always know more about the actual costs of providing access than the access seeker. Consequently, the railway owner will be in a superior bargaining position during negotiations and access charges will typically be higher than they otherwise would be under competitive conditions.

In contrast, the IAU and HVAU include indicative access charges, which the ACCC assesses and may accept as part of its assessment process. ARTC is required to publish the relevant

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2 Productivity Commission, *Telecommunications Competition Regulation Inquiry report*, December 2001, http://www.pc.gov.au/inquiries/completed/telecommunications-competition/report.

3 *Telecommunications Competition Act 2002* (Cth).

4 *Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Act 2010* (Cth).

5 *Competition and Consumer Amendment (Abolition of Limited Merits Review) Bill 2017* (Cth).

indicative access charges on its website. ARTC and access seekers have the option to commercially negotiate away from these indicative charges, but the indicative access charges provide a starting point, which have been subject to ACCC oversight. The ACCC considers this approach promotes balanced and transparent negotiations between ARTC and access seekers. Further, this approach reduces the impact of information asymmetry between ARTC and access seekers.

A similar result could be achieved by amending the WARAR to require the railway owner to publish the access charges that it negotiates with access seekers. Railway owners and access seekers could continue to negotiate access charges, however by publishing existing access charges, the negotiations will have a starting point and will be contained to a much narrower range than the price floor and ceiling. This will result in more transparent and balanced negotiations. Additionally, as this would limit the range of the dispute, parties should be able to reach an agreement more quickly than is currently the case.

Assessing the capital charge using GRV

There are a number of methodologies that can be used for calculating asset values. For example, the HVAU uses a depreciated optimised replacement cost (DORC) method for calculating asset values. Regardless of the particular valuation methodology used, the ACCC considers the following principles should be taken into account in establishing the asset value and subsequently calculating the price ceiling:

- calculate the initial asset base including depreciating the current value to account for the age and condition of the asset
- use a building block model to calculate the maximum allowable revenue (equal to the price ceiling) that the access provider can earn each regulatory year including:
    - a return on capital determined by the calculated asset base, commensurate with the regulatory and commercial risks faced by the rail owner
    - an amount equal to the operating expenditure in the relevant regulatory year
    - an amount equal to the depreciation in the relevant regulatory year
- each regulatory period, roll forward the value of the asset base taking into account capital expenditure, depreciation and disposals.

Additionally, the calculation of the initial asset base, and roll forward calculations, should be subject to assessment by the regulator and subsequently made publically available. This will increase the transparency of the actual costs faced by the railway owner, consequently reducing information asymmetries and improving the balance of power in negotiations between the railway owner and access seeker.

The July 2017 Issues Paper states that the gross replacement value (GRV) approach should result in an even capital charge over the life of the asset, whereas the DORC approach should result in a higher capital charge early in the life of the asset and lower capital charge later in the asset's life. The ACCC notes however that the cash profile over the life of the asset is determined by the depreciation profile, rather than the valuation methodology.

It is of interest to note the recent review by Dr Michael Vertigan for the COAG EC on the ability of certain gas pipelines to exercise market power.[6] This report examined appropriate information disclosure and asset valuation methodologies in the context of a commercial

[6] M Vertigan, *Examination of the current test for the regulation of gas pipelines*, Report to Council of Australian Government Energy Council, 14 December 2016, http://www.coagenergycouncil.gov.au/publications/examination-current-test-regulation-gas-pipelines-consultation-paper.

negotiate–arbitrate model. Following this review, Part 23 of the National Gas Rules was amended to include new information disclosures and a new asset valuation framework so:

> *… to facilitate access to pipeline services on non-scheme pipelines on reasonable terms, which … is taken to mean at prices and on other terms and conditions that, so far as practical, reflect the outcomes of a workably competitive market.*

A key aspect of this is the ex-ante publication of key financial information to enable prospective users to negotiate with pipeline owners in a way, which addresses the relative imbalance of bargaining power.[7] The new framework also requires that pipeline assets be valued according to the recovered cost methodology rather than a depreciated actual cost model.[8]

Consistency with the National Access Regime

The ACCC is of the view that there should be a consistent approach to the regulation of third party access for the interstate rail network. One of the objectives of the National Access Regime is to provide a framework and guiding principles to encourage a consistent approach to access regulation in each industry. This is in line with the 2006 Competition and Infrastructure Reform Agreement requirement to implement a simpler and consistent national system of rail access regulation for nationally significant routes.

The benefits of consistent regulation with the National Access Regime include improved efficiency and regulatory certainty for access providers and access seekers who would operate under below-rail access regimes that provide similar rights and obligations for the interstate route. Additionally, consistent regulation may help reduce the administrative and compliance cost for access seekers operating under multiple regulatory regimes.

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7 Gas Market Reform Group, *Gas pipeline information disclosure and arbitration framework – final design recommendation*, Report to Council of Australian Governments Energy Council, 5 June 2017, http://gmrg.coagenergycouncil.gov.au/publications/gas-pipeline-information-disclosure-and-arbitration-framework-final-design.

8 Australian Energy Regulator, *Non-scheme pipeline financial reporting guideline,* 19 December 2017, https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/non-scheme-pipeline-financial-reporting-guidelines.