ARTC Submission

Productivity Commission Issues Paper

Economic Regulation of Airports

September 2018

ARTC

1 Introduction

Australian Rail Track Corporation (ARTC) welcomes the opportunity to comment on the Productivity Commission's (PC's) Issues Paper on the Economic Regulation of Airports.

As ARTC is not a direct user of airport services this submission has limited comments on the PC's information request with respect to alternatives to monitoring. The Issues Paper notes commentary by market participants regarding the use of negotiate arbitrate frameworks as an alternative to the current monitoring arrangements. ARTC has drawn on its own experiences and other party observations on the efficacy of both ex-ante regulation and negotiate-arbitrate within the rail industry.

The submission will argue that there are considerable parallels between the market structures of airports and rail networks, and that the experience of regulation of rail networks supports an approach that prefers negotiated outcomes within a light-handed regulatory framework.

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 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; and
- 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; and
- 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); and
- 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.

ARTC's experience of regulation is that while it can provide significant benefit to society in managing market failure, it is an inherently imperfect solution that imposes substantial costs via:

- Resources to develop the proposed undertakings and supporting documentation;
- Resources to respond to extensive data requests to support analysis of the proposed undertakings;
- Resources to provide annual compliance reviews;
- Independent experts to support positions proposed in the proposed undertakings;
- Legal, drafting expertise to draft undertaking documents.

In addition, ARTC's HVAU model of ex post compliance creates a significant risk of time lag between costs incurred and approval, where the ACCC is currently still reviewing the 2015 Compliance submission.

Any consideration of regulation should therefore start from a presumption against regulation unless there is a demonstrable case for each element of regulation that there is a material net benefit from imposing it.

3 Rail Market Structure

ARTC operates in highly concentrated markets, particularly the Interstate Freight Network where the Intermodal market comprises 3 players with market shares of 69%, 25% and 6%.

The two undertakings defined above operate with different models; where the HVAU is a revenue cap model (such that the undertaking caps ARTC's revenue at a level), whilst the IAU is a negotiate arbitrate model within a defined floor and ceiling.

The approval process of the HVAU allows for negotiated outcomes on specific elements of the Undertaking; although in the absence of such outcomes the ACCC provides decisions on acceptable parameters.

In respect of the IAU, the ACCC provides decisions on the proposed ceiling to apply and, for the 2008 IAU, on the proposed Indicative Tariff which set the maximum tariff that ARTC could charge for the 10 year term of the IAU.

Both Undertakings provide for open access on a non-discriminatory and transparent basis.

The structures of ARTC's two undertakings mirror those that apply in Queensland where the QCA has declared the networks of QR and Aurizon as open access. The coal networks (QR's West

Moreton Line and Aurizon's Central Queensland Coal Network) are regulated in a similar fashion to the HVAU; whilst QR's freight network is subject to open access provisions but not to any tariff or revenue cap, similar to, but less constraining than, the IAU.

The concentrated nature of the rail market shares strong similarities with the concentrated nature of airport access. The lessons from rail can therefore be applied to the development of an appropriate regulatory structure for airports.

3.1 QCA Declaration Review

The QCA is currently undertaking a review of the merits of its declaration of, inter alia, the rail networks in Queensland. The public submissions made to this review provide critical insights into the values of regulatory mechanisms.

The submissions lodged largely reflect the position of the parties in respect of access negotiations – with the owners of access infrastructure recommending that the declaration should cease for their relevant asset and the users of that asset insisting that the declaration should continue.

Many of these submissions are accompanied by extensive independent expert reports which support the various positions. This QCA submission process therefore reflects the submission process for approval of Undertakings with "experts at 50 paces" and the extensive costs which are incurred in these efforts by all parties involved. Further critical issues raised are:

- The submissions of Glencore and Pacific National (PN) have praised the benefits of the declaration on QR's Mt Isa and North Coast Lines. They see the critical aspect of the declaration as underpinning open access and NOT the determination of an Indicative Tariff
    - This is consistent with an economic framework reflecting the New Institutional Economics of Ronald Coase, Oliver Williamson and Elinor Ostrom (all whom won Nobel prizes) that efficiency is driven by the contractual allocation of property rights through negotiated (and court enforceable) agreements;
- QR's and DBCT's proposals define enforceable arbitration principles to resolve disputes which allow the parties to make conscious decisions in respect of the merits of such arbitration;
    - This, too, is consistent with the NIE outcomes whereby the transaction costs are key to negotiated outcomes and efficiency of industries as parties will act to minimize transaction costs which include the risk of outcomes that are addressed in the contractual agreements;
- The submission by Aurizon Network has a primary emphasis on whether prescriptive ex-ante regulation is contrary to the objectives of the Competition Principles Agreement that access regulation should promote negotiation

4 Regulatory Process

The costs and risks of the regulatory process are incurred to provide certainty on whether the price paid by customers is efficient – but efficient based on a theoretical assessment of a so called efficient return and benchmarked cost. This creates an academic exercise contributing significantly to the costs of regulation, all designed to find the so called "efficient" price of access.

This process creates an adversarial environment that ensures parties will not negotiate an outcome because they are constantly second-guessing what the regulator would find to be the academic theoretical price – ensuring that despite a stated intent to see negotiated outcomes, the regulatory presence actually militates against a negotiated outcome. As it currently stands, the role of an Economic Regulator is designed to impose efficient pricing on what is deemed a natural monopoly; by virtue of the fact that the economic theory associated with National Competition Policy in Australia suggests that efficiency can only be achieved in workably competitive markets. Therefore, the role of economic regulation is to impose pricing outcomes on "natural monopolies" that would otherwise be attained in "workably competitive" markets.

This creates a significant theoretical exercise to determine what such an outcome would be – through the development of a building block model, the estimation of an efficient rate of return and the assessment of what efficient operating and maintenance costs should be. Each and every step involves substantial theoretical exercises and the use of judgement in determining every parameter. The recent approach by the Australian Energy Regulator in conducting a transparent expert forum on WACC parameters demonstrates the variance in expert opinions and the use of judgement by the Regulator in reaching a conclusion.

The use of regulatory judgement in WACC calculations and the lack of appropriate investment comparators therefore create the potential for return calculations that distort investment decisions and are substantially different than the outcomes which would be reached by commercial negotiation.

The reality of these outcomes, and their impact on the negotiation process, entrenches the adversarial process outlined above and imposes substantial costs on the industries that are subject to regulation. It is increasingly observed that pursuing preferred outcomes through the economic regulator has displaced the role of commercial negotiation and reduced the scope of mutually beneficial and welfare enhancing customer specific arrangements.

4.1 Investment Efficiency and Regulatory Model

The structure of the industry being regulated is relevant to the regulatory decisions made. In essential industries, such as electricity and water, where the regulator is implicitly negotiating on behalf of the consumer, such decisions are potentially reasonable; especially where the cost decisions have a direct impact on economic activity. Even then, however, the regulatory process can have potential impacts on efficiency.

To demonstrate this, consider the examples of two industries natural gas and electricity.

4.1.1 Natural Gas Transmission Investment

In natural gas transmission, where pipelines were largely unregulated following the EAPL decision and then the revocation of coverage of the Moomba to Adelaide Pipeline System in 2007, access seekers and pipeline owners were able to negotiate access contracts and capacity expansions to ensure that capacity demand and supply were met. Whilst the ACCC (notably not participant companies) expressed some concern at the rates charged by pipeline companies, the investments were made, capacity expanded and a large interconnected system covering an area (soon to be) from Darwin to Adelaide and Gladstone to Tasmania has been created.

4.1.2 Electricity Network Investment

In respect of the fully regulated electricity network system, however, there have been examples of significant over investment in the system. As was highlighted by the Consumer Challenge Panel Number 16's submission in May 2018 to the AER's Rate of Return Guideline Review (p32) growth in capital expenditure ballooned between 2004 and 2014 in what has come to be referred to colloquially as the "gold plating of the system": There is an argument that the over investment of the networks correlates significantly with the forecasting errors of the market operator; so it could be said that over investment is a function of the regulatory process that relied on forecasts and independent efficiency assessments to determine ex ante capital profiles for the future term of Access Undertakings.

This allows the two industry outcomes of gas and electricity to be juxtaposed – where the capacity expansions and access negotiations that have been underpinned by contracts in gas have created the efficient outcome to meet capacity requirements; whilst the independently assessed and regulated capacity expansions in electricity transmission resulted in over investment and inefficient expansion. This demonstrates that negotiation between parties is what drives investment efficiency. This conclusion, that negotiation not regulation drives efficient capacity outcomes, is further affirmed by the AEMC's decision that the concept of capacity rights is required to be introduced in the Victorian Gas Transmission system to deliver efficient capacity investment.

4.2 Regulatory Process - Conclusion

This discussion on regulatory process highlights that industries that freely negotiate for access on terms that meet the needs of both sides of the negotiation, unencumbered by the exercise of specific regulatory discretion, deliver efficient investment in capacity in the network.

Arguably, in an environment where there were no legacy assets (i.e. all investment was subject to commercial negotiation with no risk other than a failure to proceed), the customers had reasonable levels of expertise and market power, and there was vertical separation (i.e., there was no incentive for the asset owner to constrain access to the detriment of the economy as a whole) there would be no need for regulation.

The negotiation process benefits from transparency and a binding dispute resolution process; but that process should support commercial outcomes rather than imposing academic positions relying heavily on discretion and judgement with little accountability for poor performance.

5 Negotiated Outcomes

The comparison between the capacity investment in gas and electricity infrastructure appears consistent with the view that efficiency in investment is driven by negotiated outcomes and not by regulatory imposition. This is supported by a strong suite of examples of infrastructure access reaching efficient negotiated outcomes in the absence of regulatory pricing outcomes:

- The statements to the QCA Declaration Review from PN and Glencore that their business profitability relies on declared access; but notably in the absence of a regulated price so prices must be negotiated;
- Natural gas pipelines expanded and connected the transmission network between Darwin, Adelaide, Gladstone and Tasmania based on negotiated outcomes in the absence of regulated tariffs (and offers a stark comparison to the efficiency of regulated electricity development); and
- WA rail access has been based on negotiated not regulated pricing outcomes.

ARTC therefore strongly supports any movement towards a structure which promotes negotiated outcomes rather than adversarial regulatory processes that are based on abstract, subjective, and theoretical positions, divorced from the commercial positions of the participating companies.

In the rail industry, be it in either the coal or the freight transport sectors, there are a small number of highly informed, well-resourced and large counterparties (including many of the largest mining companies in the world) who exercise significant counter-vailing bargaining power against the infrastructure owners. In addition, in the freight sector, rail faces a significant competitive constraint via competition from road. The statements by PN and Glencore highlight that these constraints ensure that competitive tariffs can be negotiated for rail access in both resource and freight environments and economic benefits achieved via negotiation rather than regulation.

The attributes associated with the negotiate-arbitrate model can be contrasted with those associated with industry regulation as summarised in the table below.

Attributes	**Negotiate-Arbitrate**	**Industry Regulation**
Service Model	Few, large corporate entities who directly contract the service (Direct Users)	Large, diverse stakeholders who indirectly use services through retail prices (Indirect Users)
Industry Types	Access to export logistics infrastructure (port, airports, freight rail, gas)	Monopoly infrastructure as an input to an essential service (water, electricity, gas, passenger rail)
Regulatory Objectives	Promote timely and efficient expansion and utilisation of infrastructure	Promote the long term interests of consumers with respect to price, quality, reliability and security
Constructive Engagement	The engagement is intended to reach binding agreement.	The engagement is consultative intended to inform regulator proposal considers consumer preferences
Scope for Negotiation	Wide scope to negotiate on services, performance, cost and price	Narrow scope with engagement typically related to business plans

Regulatory Framework	Discretionary based with regulator arbitrating areas of dispute	Prescription based with regulator approving all aspects of regulatory proposal.

In summary, effective access regulation should promote commercial negotiation and limit regulatory involvement to circumstances where parties have made genuine attempts to reach a negotiated settlement or agreement.

6 Airport Regulation

The balance of negotiating power between large, well informed access seekers and infrastructure owners in the market for airport access would appear similar to that for access to rail networks. The analysis above is therefore relevant for consideration in determining the relevant structure of regulation (if any) of airports. ARTC believes that an efficient regulatory regime for access to concentrated infrastructure markets is one which:

- Does not intrude into the negotiation between counterparties;
- Does not impose inefficient costs on the counterparties by engaging in extensive regulatory processes;
- Does provide timely, strong and binding dispute resolution procedures that give both sides confidence that the requisite decisions will be based on reasonable commercial (not theoretical) principles;
- Allows access seekers to hold infrastructure owners to account for the delivery of the promised services and at a reasonable (commercial) price; but not in a manner that exposes the owner to significant, retrospective, operational risks; and
- Ensures transparency of negotiated outcomes to ensure that entrants have certainty on their competitive access position vis a vis their competitors and giving credence to the principle of non-discriminatory access;

7 Conclusion

The Coasian economic framework that efficiency is driven by access negotiation rather than regulation is shown to apply in the rail industry and, given the similarities, should be applied to the airport industry. ARTC therefore suggests the development of a system which promotes negotiated outcomes whilst providing the critical protections of binding commercial dispute resolution, transparency and national consistency would be appropriate for airport regulation.