

**Submission to the Australian Rail
Track Corporation (ARTC) in
Relation to their Consultation
Paper on the ARTC's Hunter Valley
Access Undertaking Options for
Positive Performance Mechanisms**

February 2012

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1 INTRODUCTION AND BACKGROUND

Asciano welcome the opportunity to comment on the Australian Rail Track Corporation (ARTC) Consultation Paper on the Options for Positive Performance Mechanisms released in December 2011.

In the development of the 2011 Hunter Valley Access Undertaking (HVAU) it became clear that stakeholders had concerns with an incentive regime which only provided penalties for poor performance but did not provide any incentives for positive performance.

In June 2011 the HVAU was approved by the Australian Competition and Consumer Commission (ACCC). The HVAU requires the ARTC to undertake several actions with regard to incentive schemes: In particular section 13.3 requires ARTC to:

- publish options for a proposed performance incentive scheme which encourages ARTC, via financial rewards to improve operating expenditure efficiency, capital expenditure efficiency and safety performance; (these options should be published within six months of the HVAU's approval);
- seek submissions from stakeholders on these proposed options; and
- then prepare a report addressing the options for the proposed performance incentive scheme and lodge an HVAU variation with the ACCC consistent with the report.

Section 13.5 of the HVAU also requires the ARTC to publish options for a proposed performance incentive scheme which encourages ARTC, via financial rewards to improve its performance in relation to making capacity available, but the time frames associated with this process are due after two years of HVAU operation.

The current Consultation Paper focuses on the requirements of HVAU section 13.3 to develop options for improving operating expenditure efficiency, capital expenditure efficiency and safety performance

Asciano has an interest in the proposed performance incentive scheme via its subsidiary Pacific National, which is the largest above rail operator in the Hunter Valley coal chain.

Asciano believes that the major issue facing the Hunter Valley coal chain is lost coal chain capacity due to system congestion. This lost coal chain capacity results in lost revenue for all participants in the coal chain. Any incentive mechanism put in place must address this issue of lost capacity and system congestion.

2 ARTC PROPOSED INCENTIVE MECHANISMS

The ARTC put forward four incentive mechanism options for discussion. These incentive mechanisms are not mutually exclusive and the Consultation Paper indicates that they could be used in combination. They include:

- **a productivity mechanism:** The ARTC propose an incentive mechanism to improve ARTC productivity where unit costs are set in advance over a multi-year period. Prices are determined in accordance with these costs, taking into account the actual scope of work, inflation and any extenuating circumstances. ARTC is allowed to keep any revenues in excess of actual costs up to the pre-determined amount based on the unit rates.
- **a KPI mechanism:** The ARTC propose an incentive mechanism linked to HVAU Network KPIs.
- **a safety target mechanism:** The ARTC propose an incentive mechanism directly linked to achievement of safety targets.
- **an innovation mechanism:** The ARTC propose an incentive mechanism focussed around encouraging the use of innovation to achieve outcomes that could be delivered through infrastructure. The proposed mechanism is based on adding into the regulatory asset base half of the value of the equivalent physical asset that would have been required to produce the same additional capacity. (Currently ARTC earns profits based solely on the value of the asset base. ARTC is not rewarded for solutions derived from innovation).

ARTC is seeking comments from stakeholders in relation to the proposed incentive mechanisms.

3 ASCIANO GENERAL COMMENTS ON ARTC'S PROPOSED INCENTIVE MECHANISMS

Asciano generally supports the principle of incentive mechanisms which will drive improved efficiency and increase capacity within the ARTC's Hunter Valley operations. Asciano believes that in assessing these incentive mechanisms the main criteria that should be used are whether the proposed incentive mechanism:

- encourages efficiency both within ARTC and within the coal supply chain; and
- encourages increased capacity utilisation or an increase in capacity within the coal supply chain.

Asciano believes that the major issue facing the Hunter Valley coal chain is track congestion, resulting in lost coal chain system capacity. Track infrastructure is the constraint in the Hunter Valley coal chain and until the issues of track infrastructure, congestion and system capacity are resolved then system capacity constraints will continue to result in lost coal chain throughput and, consequently, lost revenue for all participants in the coal chain.

In addition, Asciano is concerned that ARTC continues to accept inefficient train lengths in the Hunter valley coal chain. Asciano believes that in a system such as the Hunter Valley which is capacity constrained (i.e. path constrained) then all trains operating should be close to the maximum operating train length (as allowed by existing infrastructure in each zone). This would result in fewer trains, both freeing up paths being consumed by inefficient trains and maximising tonnes hauled per path.

Asciano supports a capacity linked mechanism that both acts to strongly encourage ARTC investment in both track infrastructure and other non-capital forms of capacity enhancement, and acts to strongly discourage actions that reduce capacity, and in particular act to discourage ARTC's acceptance of inefficient trains.

Asciano recognises that section 13.5 of the HVAU requires a capacity driven incentive mechanism to be implemented, but the timing around section 13.5 means

that such a mechanism will only be implemented in two years time at the earliest. The urgency surrounding track congestion and the lack of capacity requires a capacity linked mechanism to be developed and implemented in the short term.

Asciano notes that to some extent the positive performance incentive schemes put forward by ARTC are required to encourage desired performance from ARTC as this performance is not achieved through the primary regulatory model. Given this Asciano believes that the design of the regulatory model could be reconsidered at the next HVAU review in order to improve the model and incorporate positive incentives more fully into the model.

While Asciano generally supports the concept of positive performance incentives Asciano has concerns with the potential for poorly designed incentive programs to encourage inappropriate trade-offs or provides perverse incentives for ARTC to engage in activity which provides short term benefits to ARTC but which disadvantages the broader coal supply chain. In particular Asciano is concerned that capacity will be reduced by an incentive scheme which rewards reductions in maintenance costs or operating costs. Such inappropriate trade-offs are often not apparent until the detailed design of the incentive program is known. ARTC acknowledges the potential for inappropriate trade-offs (for example ARTC Consultation Paper page 20) and Asciano seeks that ARTC consider the potential for inappropriate trade-offs when detailed design of the incentive program is being considered.

4 ASCIANO COMMENTS ON THE ARTC'S SPECIFIC INCENTIVE MECHANISM PROPOSALS

Asciano's comments and concerns with each of the ARTC's specific proposed mechanisms are outlined below.

Productivity Mechanism

ARTC argues that due to the Hunter Valley regulatory framework ARTC is not necessarily driven by commercial incentives to improve productive efficiency in relation to operations and maintenance. For example, elements of the current Hunter Valley regulatory framework, such as the annual assessment of whether operating costs are efficient, act as a disincentive to ARTC to seek ongoing productivity improvements.

The mechanism proposed by ARTC is one where a level of costs for an activity for a period of time (3 to 5 years) are determined *ex ante* and ARTC can then retain any cost savings against this cost level for this period of time.

While Asciano supports improving the efficiency and productivity of ARTC's operating and maintenance activities, Asciano has concerns with the ARTC proposal. These concerns include:

- the mechanism may provide incentives to defer or simply not undertake necessary operations and maintenance activities, which will in turn impact on future Hunter Valley operations, efficiency and capacity;
- the mechanism may provide incentives to reallocate expenditure such that costs subject to *ex ante* benchmarking (such as operating and maintenance costs are reduced) but other costs not subject to *ex ante* benchmarking (such as capital) are increased. Thus the mechanism may encourage an inefficient combination of operating and capital expenditure;
- the mechanism may provide incentives to increase possession time, which will improve maintenance productivity but negatively impact on Hunter Valley capacity;
- the detail of the mechanism is currently not well specified. In particular the appropriateness of the mechanism would be heavily reliant on:
 - which ARTC costs for an activity for a period of time are determined by reference to an *ex ante* benchmark cost;
 - whether the benchmark *ex ante* costs are set at the efficient cost level or whether there is some margin built into the costs;
 - how the appropriate level of benchmark *ex ante* costs are determined and allocated. In particular Asciano is concerned that ARTC appear to be seeking to define *ex ante* benchmark costs as stand alone costs. Asciano believes that the issue of the appropriate level of benchmark costs should allocate joint costs such that these costs are only

recovered once. As such, any determination of the appropriate level of benchmark *ex ante* costs should at the very least include an allowance for the economies of scale and scope that the ARTC receives by operating more than one rail system. Such an approach should ensure that there is no double counting or double recovery of joint costs which are also recovered via other regulated networks; and

- the length of time for which cost savings are retained and how these savings are ultimately transferred back to users.

Asciano believes that the first three concerns outlined above could be addressed by a strong ACCC and ARTC focus on service quality measurement, capital expenditure and capacity performance. However such an approach may require additional regulatory monitoring with its attendant costs.

Asciano believes that its concerns with the detail of the mechanism may be addressed by ARTC providing further information on these details. In relation to this Asciano notes that the mechanism proposed by ARTC seems quite similar to various CPI-X price and revenue caps which have been applied to utilities under various regulated price and revenue setting frameworks. These caps essentially set the price or revenue path for a service in advance and the provider of the service bears the cost risk (and in the case of a price path the volume risk). In order to avoid price shocks at regulatory resets there is typically a “glide path mechanism” which requires the costs savings to be returned to users at a rolling interval. Asciano believes that ARTC should consider these regulatory approaches to determine if the benefits and disadvantages of the proposal have already been identified and addressed in other regulated industries. For example issues such as cost allocation and allowances for one-off events are built into regulatory processes which apply to other regulated industries.

If, in the longer term, such a productivity mechanism is adopted by ARTC and ACCC then this may require a review of the primary regulatory model used in the Hunter Valley, and in particular such a review should consider if the type of regulatory mechanism outlined above is more appropriate than the current regulatory approach.

Overall Asciano does not oppose the principle of the productivity mechanism if it is well-designed; but Asciano currently has strong concerns about how the mechanism

will operate and the lack of detail relating to the implementation and operation of the mechanism. Asciano is seeking that these concerns be addressed before the mechanism is progressed. In addition, there should be an assessment as to whether the benefits of the proposed productivity mechanism will offset the additional costs in implementing the proposed approach.

In addition Asciano is concerned that even a well designed productivity mechanism will do little to address the system capacity issue facing the Hunter Valley coal chain. As such, while Asciano does not oppose a well designed productivity mechanism Asciano believes that the ARTC's focus should be on increasing system capacity rather than cost reduction.

KPI Mechanism

ARTC argues that ARTC could receive some benefit from exceeding agreed standards against the Hunter Valley network KPIs already reported by ARTC. These KPIs are in Schedule D of the HVAU and relate to network and system performance and include measures related to transit time and paths availability.

ARTC (Consultation Paper pages 43-44) recognises that such an approach based on KPIs presents issues in identifying the relevant KPIs, determining KPI benchmarks and quantifying ARTC benefits. However the Consultation Paper does not provide any firm proposals as to how these issues may be addressed.

Asciano believes that, given the KPIs focus on issues such as transit times and path availability, these KPIs may act as a proxy for measures of congestion and system capacity. As noted throughout this submission the issue of congestion and system capacity is the major issue facing the Hunter valley coal chain.

Asciano strongly supports ARTC further developing this concept of a KPI mechanism with firm proposals which link the KPIs to system capacity, which could then be assessed.

Asciano believes that as these KPIs are already recorded and reported the implementation of a KPI mechanism may be relatively straightforward when compared to other incentive mechanisms proposed by ARTC, and believes the ARTC should focus on a KPI system capacity mechanism in preference to the other mechanisms put forward.

Safety Mechanism

ARTC proposes that there should be a specific safety incentive operating in conjunction with other commercial and efficiency driven incentives.

Asciano recognises that ARTC is a safety focussed organisation; however Asciano has some concerns with the ARTC proposal for safety based incentives.

The Hunter Valley regulatory model is an economic model designed to produce efficient economic outcomes, and the incentive mechanisms being developed to enhance this model are economic and commercially based. Asciano has concerns that incorporating safety performance into a commercial incentive process may not be ideal. .

Asciano believes that safety and safety performance should be addressed separately as absolutes, rather than via an ACCC process where commercial, access and pricing issues are all, rightly, the focus of the process.

Asciano believes that the only appropriate means to incorporate safety may be to use safety performance as a “gateway trigger” whereby if safety performance was not exemplary then any gains from the productivity mechanism, KPI mechanism or innovation mechanism would not be forthcoming.

Innovation Mechanism

The proposed innovation mechanism will allow ARTC to keep 50 per cent of the benefit of any additional capacity ARTC can create via the use of improved systems and management, as opposed to hard infrastructure assets, (where the capacity created is beyond the capacity expected to be achieved from the network). The 50 per cent would be retained via a mechanism that increases the regulatory asset base by 50 per cent of the net hard capital expenditure that would be required to produce a similar capacity outcome.

The assessment of the capacity increase will involve users and operators via the Rail Capacity Group (RCG).

As noted above, Asciano ‘s major concern is the urgent need to address congestion in the Hunter Valley, and as such Asciano supports in principle any incentive to

increase Hunter Valley capacity. However Asciano has some concerns regarding the innovation mechanism proposed, namely;

- if ARTC are currently aware of any actions they could take which would increase Hunter Valley capacity without capital expenditure, then Asciano strongly queries why these actions have not been taken by ARTC given the level of congestion in the Hunter Valley.
- actions to increase capacity may involve inappropriate trade-offs. For example removing maintenance possessions would increase network capacity but at a detriment to longer term track condition and efficiency. As such Asciano believes that the RCG should be involved in approving any actions to increase capacity prior to their incorporation into the incentive mechanism to ensure that there are no trade-offs or that the cost of trade-offs are incorporated into the process.
- the innovation mechanism proposal of incorporating 50 percent of the capacity benefits into the regulated Hunter Valley capital base creates substantial concerns including:
 - the net hard capital expenditure figure used as the basis for the increase in the capital base may be very large, and this may result in a very large and permanent increase in the capital base, which will then provide regulated returns to the ARTC for a long period of time. Such returns may not be commensurate with the actual innovation activity undertaken. For example removing inefficient trains from the network may result in substantial capacity gains but such an action should not be rewarded by a substantial long term return on a substantially increased capital base;
 - actions to increase capacity may be temporary, but locking 50 per cent of the gain into the capital base is permanent.

Asciano believes that rather than incorporate the benefit of any additional capacity into the capital base ARTC should be permitted to retain the revenue from the increased throughput volumes for a period of time, (for example three to five years as suggested in the ARTC proposal related to the

productivity mechanism) . If the increase in capacity is greater than forecast then revenue would increase as volumes increased, similarly if the increase in capacity is less than forecast then revenue would only increase in line with actual volume increases. The retention of this revenue would in addition to the revenue allowed under the revenue cap. This process has the benefit that it can be managed through a framework similar to the current “unders” and “overs” process, and the process is incremental and reversible.

If such a proposal is not adopted then, as a minimum, Asciano believes that the RCG should be approve any actions to increase capacity prior to their incorporation into the capital base to ensure that the increase is acceptable to users and operators and that that the increase is permanent, (or in the event that the increase is not permanent, that the gain will be removed from the capital base.

Asciano believes that actions taken by ARTC to reduce capacity, such as the encouragement of inefficient trains, should result in either

- a commensurate reduction in revenue regardless of the revenue cap; or
- a commensurate reduction in the capital base;

depending on which incentive option is included in the innovation mechanism.

Overall Asciano believes that the innovation mechanism has potential to increase capacity if the capacity benefit is incorporated into the ARTC Hunter Valley revenue (in addition to the revenue cap) rather than the ARTC Hunter Valley capital base. Asciano believes that the implementation of the innovation mechanism will require substantial RCG involvement to ensure that the increases in capacity arise from innovations rather than inappropriate trade-offs.

In implementing the innovation mechanism Asciano has a broad concern that if capacity can currently be increased by use of improved systems and management then such systems should be implemented now to address current congestion.

5 CONCLUSION

Asciano generally supports the principle of incentive mechanisms which will drive improved efficiency and increase capacity within the ARTC's Hunter Valley operations, and in particular incentive mechanisms which encourage increases in capacity and reductions in system congestion by both encouraging investment in track infrastructure and other non-capital forms of capacity enhancement and discouraging actions that reduce capacity, such as the acceptance of inefficient trains. Such incentive mechanisms will encourage efficiency within ARTC and should encourage increased capacity utilisation and / or an increase in capacity within the coal supply chain.

Asciano has concerns with several of the incentive mechanisms proposed by ARTC. In particular:

- the productivity mechanism has the potential to encourage inappropriate trade-offs and the details of the mechanism raise the potential for regulatory gaming;
- the KPI mechanism has the most potential to increase capacity and reduce congestion but appears to be the least developed of the ARTC incentive mechanism proposals. Asciano strongly believes that given the KPIs focus on issues such as transit times and path availability the KPI proposal should be further developed with a view to the KPI mechanism promoting increased capacity and reduced congestion;
- the safety mechanism as proposed creates a concern that safety is being addressed via an ACCC process where commercial, access and pricing issues are all, rightly, the focus of the process ; and
- the innovation mechanism has potential if the capacity benefits are returned via increased revenue rather than an increased capital base and if RCG are involved in implementation, however Asciano strongly believes that if capacity can currently be increased by use of improved systems and management then such systems should be implemented now to address current congestion.

Asciano believes that both the KPI mechanism and / or the innovation mechanism they have potential to become positive performance incentive mechanisms following further refinement (and the development of more concrete proposals in relation to the KPI mechanism). Any positive performance incentive mechanism must address the current system capacity issues and congestion issues facing the Hunter Valley.