MINERALS COUNCIL OF AUSTRALIA
NT DIVISION

TARCOOLA-DARWIN RAILWAY – TEN YEAR REVIEW OF REVENUES

COMPREHENSIVE RESPONSE TO ESCOSA ISSUES PAPER

FEBRUARY 2015

TABLE OF CONTENTS

EXECUTIVE SUMMARY

This submission is provided by the Northern Territory Division of the Minerals Council of Australia (**MCA-NT**). MCA-NT appreciates the opportunity to provide a response to the Essential Services Commission of South Australia (**ESCOSA**) and confirms that this is a public submission.

Under the terms of the *AustralAsia Railway (Third Party Access) Act 1999* (**the Act**), ESCOSA is required to undertake a review of the revenues received from the provision of access to the Tarcoola-Darwin Railway (**TDR**) during the ten-year period ending 30 June 2013. The Threshold Issue states that ESCOSA must resolve which TDR freight infrastructure services are subject to a sustainable competitive price. A resolution of this issue will allow ESCOSA to determine the composition of the Relevant Revenues, and then if these revenues have been excessive.

As noted in the MCA-NT's preliminary submission, the ability for ESCOSA (and stakeholders) to appropriately verify, address and respond to the Threshold Issue relies upon the provision and transparency of relevant information from the Access Provider. Determination of a sustainable competitive price initially relies upon knowing the price of railway services on the TDR as supplied by GWA (North) Pty Ltd (**GWAN**). As this information is not made publicly available, it is difficult for MCA-NT to submit an opinion on its competitiveness or otherwise.

However, despite this lack of transparency, MCA-NT does not support the premise that an alternative form of transport – such as road transport – to the TDR is price competitive. The nature of the bulk mineral and most other freight products transported over long distances in the NT does not support the interpretation that road transport offers a sustainable competitive price to rail transport. We therefore submit that there is no alternative competitive transport solution which by definition means that all below rail services provided on the TDR should be included as Relevant Revenues for the purpose of the ESCOSA review.

As a result ESCOSA must then determine if the revenues earned by GWAN on the TDR over the relevant ten-year period were excessive. MCA-NT believes that the price for access to a declared service should generate revenue that is at least enough to meet the efficient cost of providing access and include a fair return on investment commensurate with the regulatory and commercial risks involved with supplying the service.

MCA-NT believes that it is extremely important in a regulated environment to ensure that the regulated entity, in this case GWAN, is fully and properly recompensed for the risks that it accepts in the regulated environment as well as the reasonable and prudent cost of providing the service altogether. Most importantly, however, MCA-NT believes that this involves a balancing of facts: specifically, a balancing of the risks that the regulated entity accepts against the risks that the regulation passes through to customers of the regulated entity. In this instance, therefore, MCA-NT believes that a strong focus of ESCOSA in undertaking this review should be on identifying and valuing the commercial risks that GWAN bears as opposed to the various commercial risks that GWAN requires users of the TDR to bear.

MCA-NT understands that ESCOSA, in addition to meeting the requirements of the Act, is also seeking comments on other matters that may be of relevance to the review.

MCA-NT submits that the current regulatory regime also needs to be bolstered to appropriately address real concerns regarding; competition for above rail services, appropriate ring-fencing provisions and separation, pricing methodology and certainty, time and capacity certainty, and the frequency of regulatory reviews. The MCA-NT believes that such enhancements to the regime will vastly improve market outcomes in the context of broader competition policy.

From the MCA-NT's perspective, and in the context that such economic regulation ought to provide a proxy for 'true' competition, it is imperative that the regulatory regime results in prudent and efficient outcomes. To this point, the MCA-NT is of the view that the current regime falls short of addressing some fundamental aspects that would otherwise provide some degree of certainty for access seekers going forward – noting that many of the projects in the NT are at a critical stage of securing funding and such certainty is essential in being able to attract investment.

In considering the above matters MCA-NT is of the strong view that it is imperative that a proactive approach to enhancing the regulation is adopted. We submit that simply because particular issues have not manifested themselves through formal dispute processes with the regulator does not mean that the regulatory regime is working effectively, or efficiently. There are many, and varied, legitimate reasons why issues are not brought to bear via the formal processes, for example, the time and cost involved, the asymmetric and incomplete nature of information, and the segregated nature of the markets being serviced. Further, there is overwhelming evidence across regulated assets in Australia, particularly with regard to rail, that such matters will have to inevitably be dealt with through the regulatory regime.

We would welcome the opportunity to discuss any issues raised in our submission.

1. BACKGROUND

This submission is made by MCA-NT in response to ESCOSA's invitation for comments on its Issues Paper (Issues Paper) in respect of the Ten Year Review of Revenues for the TDR. We understand that ESCOSA is required to conduct this review under the terms of the Act and associated Code. The TDR is currently operated by GWAN a subsidiary of Genesee & Wyoming Inc.

MCA-NT submitted a preliminary response to ESCOSA on 19 December 2014, and further appreciates the opportunity to provide this subsequent comprehensive response to ESCOSA expanding on key issues highlighted in our preliminary response. MCA-NT confirms that this submission may be made public.

The focus of this submission is on issues and recommendations as they relate to the minerals industry in the Northern Territory (NT). The Minerals Council of Australia (MCA) is the peak industry association that represents the corporate minerals companies in Australia. The members of the MCA are engaged in mineral processing, mining, exploration, or the provision of services to the industry and account for more than 85 percent of mineral industry output in Australia. The MCA's strategic objective is to advocate public policy and operational practice for a world-class industry that is safe, profitable, innovative, environmentally responsible and attuned to community needs and expectations.

The NT Division of the MCA represents the interests of members operating, exploring and providing services to the industry in the NT. The minerals industry has a large and diverse presence across the NT which comprises of 20% NT's gross state product and employs 4,400 people. The NT has mining operations for a range of mineral commodities including manganese, iron ore, lead, silver, zinc, gold, bauxite and uranium.

Members of MCA-NT are currently engaged in seeking rail transport solutions for their respective projects. As such MCA-NT is well positioned to provide comment on behalf of its members on this review, together with other relevant regulatory issues which we encourage ESCOSA to consider, both in developing its terms of reference for the review and longer term suggestions of improvements to the regulatory framework.

2. RESPONSE TO THE THRESHOLD ISSUE

2.1 SUSTAINABLE PRICE COMPETITION

2.1.1 Information transparency

Under the terms of the Act, ESCOSA is required to undertake a review of the revenues received from the provision of access to the TDR during the ten-year period ending 30 June 2013. The Threshold Issue states that ESCOSA must resolve which TDR freight infrastructure services are subject to a sustainable competitive price. A resolution of this issue will allow ESCOSA to determine the composition of the Relevant Revenues, and thus if these revenues have been excessive.

As noted in MCA-NT's preliminary submission, the ability for ESCOSA (and stakeholders) to appropriately verify, address and respond to the Threshold Issue relies upon the provision and transparency of relevant information from the Access Provider. Determination of a sustainable competitive price initially relies upon knowing the price of railway services on the TDR as supplied by GWAN.

MCA-NT supports a robust and transparent regulatory framework where any potential customer is able to access sustainable rail infrastructure services on cost effective and efficient terms. Currently, no information is published in the public domain in relation to the specific financial, regulatory and operational performance of the TDR. The ability for ESCOSA (and stakeholders) to appropriately verify, address and respond to the Threshold Issue relies upon the provision and transparency of such information.

Section 46 of the Code states that the Access Provider (i.e. GWAN) must in relation to the railway infrastructure services:

- "*keep accounts and records of its business consisting of the provision of railway infrastructure services in relation to the railway so as to give a true and fair view of that business as distinct from other businesses carried on by the Access provider or any related body corporate or associate of the Access Provider*" and
- those records "*be kept in a way that gives a comprehensive view of the Access Provider's legal and equitable rights and liabilities" and*
- *gives "a true and fair view of income and expenditure...and assets and liabilities of the Access Provider's business".*

In this regard, MCA-NT supports ESCOSA to give effect to the provisions of the Code and seeks that the Access Provider make available for stakeholder review, the relevant financial documentation relating to the railway infrastructure services. If this information is not available to be released for stakeholder review in detail, stakeholders will be heavily reliant upon ESCOSA in conducting a prudent revenue and cost assessment. In this respect, it is MCA-NT's strong view that ESCOSA's draft decision should include a sufficient level of detail so stakeholders are able to make informed comment.

MCA-NT understands that the negotiate-arbitrate model of regulation that applies to the TDR does not necessarily lend itself to the publication of specific tariffs on a public website, such as that of ARTC. However, MCA-NT submits that the information provided to access seekers should be sufficient to enable the recipient to determine how the price has been determined in a reasonable level of detail. Historically, MCA-NT members, upon making an access application, have received a single price figure from GWAN (for example, $10/tonne). It is not possible from this information to determine how the price has been determined, and if falls within the floor and ceiling as per the regulatory guidelines.

Furthermore, as is discussed below, it is not possible for a user to determine if this price is fair, reasonable, efficient, or predictable. Nor what costs have been included in the revenue base to determine this charge, or the rate of return used by GWAN. MCA-NT submits that this lack of information severely limits the ability for an access seeker to effectively negotiate a fair regulated price in return for the service offered.

2.1.2 Price competition

Despite the current lack of transparency, MCA-NT does not support the general premise that an alternative form of transport – such as road transport – to the TDR is price competitive. The nature of the bulk minerals products transported over long distances in the NT does not, in MCA-NT's view and experience, support the interpretation that road transport offers a sustainable competitive price to rail transport.

It is our view that bulk freight products could be defined as any product which is transported in an unpackaged manner. Rail is inherently most competitive on longer transport tasks of reasonably significant volume. Road transport is generally more competitive on shorter transport tasks of smaller product volumes.

The Australian Government's Department of Infrastructure and Transport[1] also holds the view that "*bulk freight [mineral ores, etc.] generally involves large quantities of homogenous product, typically liquid or crushed solid material, transported en masse, and without packaging. It is easy to load and unload from freight vehicles as it is generally poured or pumped into transport holds.*" Conversely, non-bulk freight (i.e. intermodal) is "*generally placed or lifted into transport holds. It often involves heterogeneous goods being moved between dispersed locations. Non-bulk freight varies in density, perishability and fragility*."

The following simple case study also seeks to illustrate the stark variances between rail and road operations that would underpin the movement of bulk minerals in the NT.

CASE STUDY – NT Exploration Project

This project is location near Alice Springs in the Northern Territory, and is intending to transport approximately 2,000,000 tonnes per annum (2Mtpa) of bulk commodity to the Port of Darwin for shipping to export markets. This project involves a transport task covering over 1100 kilometres, of which cost is vitally important to the overall profitability of the mine project.

MCA-NT has examined, at a very high level, some of the comparable data involved in comparing a truck operation to a train service for the export of 2Mtpa of product from this mine.

	Bulk Rail Freight	Road Freight
Number of machines required	2 train consists	150 trucks
Number of drivers required	12	600
Number of services per week	5	320
Payload per service	9000 tonnes	120 tonnes
Service running time (one way)	22 hours	30 hours

Furthermore, the operating and maintenance costs of running a fleet of 150 trucks (including tyre replacement, diesel, road upgrades etc.) would far outweigh the comparable operating and maintenance costs on rail.

We therefore submit that the transport of minerals in the NT should be considered as 'bulk freight' haulage (as opposed to 'intermodal freight') and that there is no alternative competitive transport solution which by definition means that all below rail freight services provided on the TDR should be included as Relevant Revenues for the purpose of the ESCOSA review.

[1] https://www.bitre.gov.au/publications/2009/files/is_034.pdf

2.2 RELEVANT REVENUE AND COST DETERMINATION

MCA-NT notes the requirements of Section 50, paragraph 5 of the Code, under which ESCOSA is to determine whether revenues are excessive as measured against the costs associated with that required railway infrastructure. In brief, regard must be had to the following:

a) Revenues for the services
b) Costs associated with those services
c) An appropriate commercial return having regard to appropriate risk premiums for the construction, a development and operation of the railway prevailing as at commencement of construction and also the relevant financial market rates at the time of review.

Given the lack of sustainable price competition, MCA-NT is confident that ESCOSA will determine that the definition of Relevant Revenues will include all below rail services on the TDR (see below for further discussion about the inclusion of particular services). On this basis, and with regard to the provisions of the Code, MCA-NT notes the following key issues in the consideration as to whether revenue has been excessive over the past ten year period:

- Typical regulatory pricing principles;
- Allocation of revenue and costs between above and below rail services;
- Appropriate asset value and cost of capital;
- Balancing risk and reward; and
- Cost drivers and influences, and market risk.

2.2.1 Typical regulatory pricing principles

In assessing the revenues at hand, MCA-NT encourages ESCOSA to have regard to regulatory pricing principles in other Australian jurisdictions. These principles centre around and include the following concepts:

- Economic efficiency – are the access charges consistent with achieving economic efficiency?
- Fairness – are access charges consistent with reasonable expectations based on previous transactions and is there proportionality in the treatment of different users?
- Regulatory governance and practice – are the processes for establishing price transparent and are changes in prices predictable?

<u>Economic Efficiency</u>
The Queensland Competition Authority (**QCA**), in its Statement of Pricing Principles[2], describes the key characteristics of competitive markets as "*including large numbers of buyers and sellers, costless entry and exit for firms, perfect information, homogeneous goods and services, no transaction costs, and the ability to manage risk effectively*. *Competitive markets can be expected to achieve efficient results with minimum government intervention – or at least perform well that government intervention in pricing and investment decisions is not required*."

By this definition, the TDR is not subject to effective competition. It is operated by an integrated monopoly service provider providing both below and above rail services, with regulation required to improve economic performance.

In respect of economic efficiency, the QCA also states its observations of monopolies[3]:

"Monopolies often exhibit poor economic performance. Poor economic performance means some combination of prices that exceed costs, costs that exceed efficient levels, quality of service levels that deviate from the optimum, inappropriate levels of investment, or slow rates of technological change."

[2] QCA – Statement of Regulatory Pricing Principles, August 2013 – p. iv, 9.
[3] QCA – Statement of Regulatory Pricing Principles, August 2013 – p1.

The QCA goes on to discuss that regulators have a range of tools at their disposal to achieve their objectives on these principles including to:

- set the level and structure of prices;
- monitor and approve operating expenses;
- monitor and approve capital expenditure;
- set profits or rates of return on allowed asset values; and/or
- approve the terms and conditions of sale.

The MCA-NT advocates that ESCOSA needs to fully consider all of the above aspects and not discard or ignore any particular item in undertaking its assessment.

<u>Fairness</u>
One of the single most important considerations in regulating an asset is to ensure fairness between access seekers and users of the regulated asset. It is critical that users can be confident that the revenue earned by the asset owner is fair, and therefore is generating fair access charges for each and every user on a consistent basis.

Whilst it is reasonable to accept that users will all pay an access charge that reflects their individual transport requirement, users must have confidence that the methodology in generating these charges is fair and consistent, and is proportional to all users of the asset.

MCA-NT submits that without additional information transparency requirements enforced by ESCOSA on GWAN, MCA-NT members will continue to lack confidence that fairness is being achieved in the regulatory regime.

<u>Regulatory practice and governance</u>
There are a number of regulatory governance and practice principles that are important for ensuring that the objectives of economic efficiency and fairness can be achieved in the design and application of pricing principles. The QCA also notes that at an operational level, the following is also relevant[4]:

- *transparency – the methodology for determining prices needs to be as transparent as practicable to ensure participants have confidence that outcomes are consistent with relevant public policy and regulatory objectives.*
- *predictability – the regulatory arrangements should be as stable and predictable as possible given other objectives. Stability and predictability are likely to promote confidence in the regulatory arrangements and also economic efficiency by reducing uncertainty associated with long term decisions.*

This supports MCA-NT's argument that while the negotiate-arbitrate model is a sound underlying philosophy, a level of transparency and predictability is required in ensuring that the revenues and costs (and ultimately the prices being charged for access to the TDR) concur with these principles.

2.2.2 Clear allocation between Above and Below Rail services

As highlighted in our preliminary response, MCA-NT notes that in determining the relevant revenues to be assessed, it is critical for ESCOSA to review an appropriate allocation of assets, revenues and costs between above and below rail services provided by GWAN. Further, we encourage ESCOSA to seek appropriate evidence of the process and procedures used to either identify, allocate or attribute these items as relevant below rail infrastructure items. Our preliminary submission contained a brief comparison of key railway infrastructure services in comparable jurisdictions across Australia, and noted the typical services which are regulated under these arrangements. These services needs to be considered in the context of the assets, revenues and costs associated with those services.

Aurizon Network's Costing Manual[5] provides a suitable basis upon which we encourage ESCOSA to determine the types of allocations required for assets, revenues and expenses. By way of summary, MCA-NT provides the following list of typical items that need to be included in the review:

[4] QCA – Statement of Regulatory Pricing Principles, August 2013 – p34.
[5] http://www.aurizon.com.au/Downloads/Costing%20Manual%20%20June%202013%20Final.pdf

Assets	Revenues	Expenses
Fixed Assets • Land • Buildings • Rollingstock • Plant and equipment • Motor vehicles • Computers and miscellaneous equipment • Permanent way • Facilities • Signals – control systems and field signals • Telecommunications – backbone network and customer premises equipment • Assets under construction **Intangible Assets** • Receivables • Inventories • Prepayments • Investments • Cash, net deferred income tax assets	**Sales Revenues** • Access charges • Contributions from developers **Other Revenue** • Property revenue • Telecommunications revenue • Construction works revenue • Insurance claims revenue • Other	**Train Operations Management** • Signalling and safeworking • Train Control and scheduling • Operations management **Infrastructure Maintenance** • Track & Bridge • Building and facilities • Signals • Telecommunications • Inventory adjustments • Other maintenance **Derailment / Flood Repairs** **Insurance and Accreditations** **Corporate Overhead** **Depreciation and Amortisation** **Other** • Business support costs • Infrastructure management • Regulatory levy • Land tax • Gain/Loss on disposed assets • Professional fees • Bad/doubtful debts

Given the lack of transparency with the TDR regulatory arrangement, it is not possible for MCA-NT to determine the allocation methodology between the regulated TDR and GWAN's non-regulated above rail business or to what services and assets this methodology has been applied. Any items which are not clearly identified as below rail services and to which an allocation methodology needs to be applied, has the potential for revenues and costs to be shifted between above and below rail areas to satisfy a particular criteria.

In its determination, ESCOSA is required to have regard to "*the relevant revenues are to be measured against the costs associated with the required railway infrastructure…including an appropriate commercial return…*". As part of this review, it is in GWAN's interest to allocate any expenses to the greatest extent possible to the below rail aspect of the business in order to justify the revenues received and to mitigate the likelihood of revenues being deemed excessive. Clearly, this raises concerns about cross-subsidisation and cost shifting between the regulated and un-regulated parts of GWAN's business.

MCA-NT strongly encourages ESCOSA to ensure that appropriate allocations have been made between above and below rail services to ensure that both revenues and expenses reflect a true representation of those which are incurred by each section of the business.

2.2.3 Appropriate asset valuation

Appropriate pricing, efficient network usage and future investment are all hinged on appropriate asset valuations and return on the invested capital. If this is inappropriate, it can lead to distortion in prices that end users pay and undermine the competitiveness of local producers, distortion of competition between different transport modes and alter development of other elements of the supply chain.

MCA-NT's preliminary response outlined the discrepancy between the TDR construction cost of $1.2B and GWAN's purchase price of $334M some seven years later. Since this time, GWAN has also depreciated the asset down from $334M, resulting in an even lower 'real' asset value. Clearly, using the higher asset value of $1.2B will drive up access pricing, and allow GWAN to earn greater revenues well in excess of that which is reasonable based on the lower and realistic asset value, representing a 'windfall' gain for GWAN.

While we agree that it is appropriate for GWAN to earn a reasonable commercial return on its investment for providing the services, MCA-NT does not support the principle that this should guarantee a return on an overinflated valuation (representing the original construction cost) of the pre-existing assets, particularly where those assets have been effectively written down by approximately 75%. There is a legitimate case for a valuation to be based on the actual capital GWAN invested in the railway from 2010 onwards.

A parallel can be drawn in this instance to Queensland Rail's Western System, where existing assets were written down to scrap value in 1995. Since that time additional capital has been added to the network to support coal and other traffics, however Queensland Rail continues to push for a DORC methodology to apply to those written off assets, thereby generating tariffs that are unsustainably high and providing an inherent disconnect between true asset book value and the asset base upon which returns are generated. Stakeholders on this system such as New Hope Group have proposed that a reasonable and efficient tariff requires a combination of:

a) Revising/correcting certain elements which lead to high ceiling prices e.g. comparison with road
b) Recognition that access charges must support a sustainable capacity to pay on the part of producers through:
    - Recognising the value of the asset base must be reduced from the theoretical DORC value (i.e. to what GWA paid); and
    - If required to ensure a reasonable tariff, charging access that are below a ceiling price perhaps in conjunction with a 'loss capitalisation' approach (as adopted by ARTC for particular rail lines).[6]

We note in ESOCSA's Issues Paper that the Federal and NT Government contributions made at the time of construction of the TDR are not required to attract a financial return during the concession period. Therefore regardless of the method chosen to value the assets, ESCOSA should ensure that the value of these government contributions are not included in the asset base. It is MCA-NT's view that this is also supported by sufficient flexibility in the Code which permit adjustments to the valuation of capital assets.

2.2.4 Weighted Average Cost of Capital

In conducting the review, ESCOSA is required to have regard to "*an appropriate risk premium associated with construction, development and operation of the railway infrastructure facilities…*" and the relevant financial market rates prevailing at the time of the regulator's review.

It is MCA-NT's view that the appropriate commercial return to which ESCOSA is to have regard to, as stated in Section 50, paragraph (5)(c) of the Code, is that the TDR was constructed on the assumption that there would be a single constructor, developer and operator of the TDR for the initial period over which the revenues are to be assessed. This does not consider the unique voluntary administration circumstances under which the TDR was sold to GWAN in June 2010 at a heavily discounted price to the 'as constructed' cost.

When considering the historical revenue, a position must also be taken as to the historical WACC. In the absence of demonstrable risks having been borne by GWAN (with the onus being on GWAN to demonstrate), it could be argued that the allowable return could be limited to the 'risk free rate' for each respective period in time. Arguably, the risks associated with the purchase by GWAN in June 2010 are significantly different to those to which FreightLink was exposed to in 2003. For example, GWAN did not have to take on construction and development risk of the TDR as it was already operational.

MCA-NT submits that in this circumstance, it is appropriate for ESCOSA to determine an appropriate cost of capital for the prevailing risks during each of the following periods should be reflected in the beta elements of the WACC:

- From construction and operation of the railway in from 1 July 2003 up until 30 June 2010.
- Operation of the railway from 1 July 2010 onwards until 30 June 2013.

The Code also provides ESCOSA have regard to relevant financial market rates prevailing at the time of review. MCA-NT does not consider that using current rates is relevant to a review of historical revenues. It is however relevant to any future revenues earned by GWAN and subject to a future regulatory review.

[6] http://www.qca.org.au/getattachment/53ff293e-ee15-4cbc-90e3-34d14e65a29a/New-Hope-Coal-Corporation.aspx

2.2.5 Balancing risk and reward

MCA-NT believes that the price for access to a declared service should generate revenue that is at least enough to meet the efficient cost of providing access and include a fair return on investment commensurate with the regulatory and commercial risks involved with supplying the service.

MCA-NT believes that it is extremely important in a regulated environment to ensure that the regulated entity, in this case GWAN, is fully and properly recompensed for the risks that it accepts in the regulated environment as well as the reasonable and prudent cost of providing the service altogether. Most importantly, however, MCA-NT believes that this involves a balancing of facts: specifically, a balancing of the risks that the regulated entity accepts against the risks that the regulation passes through to customers of the regulated entity.

This argument is also supported by the QCA's position that in establishing economic efficiency[7]:

"The efficient allocation of risk in a regulatory setting also needs to recognise that the various affected parties are not likely to have incentives to reveal their true preferences. As a result, consideration needs to be given to the ability to mitigate risk and causal responsibility for risk. Optimal risk allocation also needs to take account of the impact on efficient operation and investment, including the incentives to reduce costs."

In this instance, therefore, MCA-NT believes that a strong focus of ESCOSA in undertaking this review should be on identifying and valuing the commercial risks that GWAN bears as opposed to the various commercial risks that GWAN requires users of the TDR to bear.

In order to properly determine if the revenues received were excessive, ESCOSA will need to review the level of revenue risk borne by GWAN to determine if the risk pass-through to infrastructure users is commensurate with the margin earned by GWAN. MCA-NT believes that GWAN's revenue risk is low, as it is shielded from demand shocks through mechanisms such as the revenue ceiling form of regulation and strong take-or-pay obligations on customers, but also eligible for potential "windfall" upside if above contracted tonnages are hauled. On this basis, MCA-NT does not believe GWAN bears substantial commercial risk that would justify a high rate of return.

2.2.6 Cost drivers, influences and market risks

Members of MCA-NT seeking a rail solution for their projects and therefore directly affected by the outcomes of this review are, without exception, junior exploration companies in the planning and feasibility stages of development of their mines. These companies are therefore highly dependent on favourable market conditions to ensure private and/or public investment flows to support development activity and to reach investment decisions that allow construction and production to commence.

In this context, MCA-NT reflects upon the current status of the resources market in Australia, and the downward pressure on commodity prices in the face on ongoing upward pressure on cost inputs such as labour and materials. Given the nature of the contracting arrangements between GWAN and its customers, GWAN remains unaffected by unfavourable market conditions due to the protected nature of its revenues. This outcome is a feature of the regulatory regime and is generally accepted by producers who access infrastructure across the country. However, this situation does highlight that GWAN's cost of capital should not reflect any exposure to resource markets and that the situation and relative competitiveness of producers or of other entities which face an exposure to resource markets are not relevant to the assessment of GWAN's cost base.

Further, rather than the strict application of economic theory, regard also has to be given to the competitiveness of customers and the reasonableness of the access costs given the quality of the service provided. MCA-NT notes that two minerals producers in the NT have recently gone into administration as a result of pricing impacts compared to unsustainable inputs costs, of which transport is a key component.

NT explorers and producers continue to reduce costs in all areas within their control. Rail access charges are a significant element of the cost structure, in some circumstances representing up to 30% of total project costs. The rate of these charges will without doubt determine if a project is feasible or otherwise, which in turn affects the entire resources sector in the NT and Australia wide.

[7] QCA – Statement of Regulatory Pricing Principles, August 2013 – p33.

As such, MCA-NT relies upon GWAN to diligently pursue efficient cost reductions, and on ESCOSA to ensure that tariffs reflect only efficient costs. In the current environment, cost reductions, including those expected to arise from efficiency improvements during the term of the regulatory period, must be reflected in the revenue base. The industry's efforts to remain competitive will be impeded if GWAN can secure the approval of current costs (or costs based on prior periods), then retain the benefits of efficiency improvements achieved since that time or during the term. This is particularly important in GWAN's case with the TDR network, as we understand that the business remains on a path of growth since the purchase of the assets in 2010.

We therefore rely on a combination of voluntary cooperation from GWAN, and effective regulation. In this context, we welcome ESCOSA's efforts to diligently review and assess the revenue and cost base applicable to the TDR.

3. OTHER RELEVANT REGULATORY ISSUES

MCA-NT understands that ESCOSA, in addition to meeting the requirements of the Act, is also seeking comments on other matters that may be of relevance to the review. MCA-NT submits the following key issues for ESCOSA's consideration both in developing the terms of reference for its current review and also a broader review of the regulatory regime to which improvements could be made.

MCA-NT does not suggest a complete change in the current "soft handed" regulatory philosophy towards a "heavy handed" regulatory approach, but rather refinements which seek to improve the competitive outcome for the markets which it services. It is imperative that a proactive approach to improving regulation is taken. Simply because a particular issue has not manifested itself through a formal dispute process with a regulator does not necessarily mean that a regulatory regime is working well. There could be many reasons why these issues are not brought to bear including the parties involved, the dispute process and the costs and time involved.

In this regard, MCA-NT notes the recent review of National Competition Policy. The draft recommendations of the review asked 6 simple questions:

1. Does it focus on making markets work in the long term interests of consumers?
2. Does it foster diversity, choice and response in government services?
3. Does it encourage innovation, entrepreneurship and the entry of new players?
4. Does it promote efficient use of infrastructure and natural resources?
5. Does it establish laws and regulations that are clear, predictable and reliable?
6. Does it secure necessary standards of access and equity?

Similarly, MCA-NT is of the view that these questions should also be asked of the current regulatory regime applying to the TDR as they apply to the key areas below.

3.1 COMPETITION FOR ABOVE RAIL SERVICES

The NT economy relies on movements smaller volumes of a diverse, but valuable range of products and minerals. The transport of these products is often over significant distances. While MCA-NT appreciates that the current regulatory framework for the TDR is designed to facilitate an open market for above rail services, it is questionable whether this framework openly supports this approach. MCA-NT understands that GWAN remains the only above rail operator providing freight services on the TDR, 10 years after being opened.

Declared access to below rail networks has led to above rail competition prevailing in most Australian states over the last 10-15 years. However, there is strong evidence, from other rail systems in Australia that the foothold of incumbent operators has tended to be a difficult nexus to break and often been a long and arduous process for new entrants. MCA-NT appreciates the role that market dynamics of the products and services and alternative modes of transport also play in facilitating competition.

In this respect, the regulatory regime needs to cater for the particular market dynamics which it services and appropriately lower the barriers to entry – i.e. promote efficient use of infrastructure and also satisfy the objective of making markets work in the long term interests of consumers. The TDR is a unique situation in the Australian regulated rail industry in that it is, to the best of our understanding, the only mainland railway that is not part of an integrated supply chain where both above and below rail operations are performed by the same company with minimal regulatory oversight.

MCA-NT believes that the following would facilitate a more open and sustainable competitive above rail services market in the NT:

- access to provisioning facilities through a "service station" type approach, to reduce significant investment for new entrants;
- declaration of and facilitating third party access to key pieces of rail infrastructure e.g. access roads and any necessary land into and around the Port of Darwin;
- ensuring there are no other significant "blockers" to providing a rail service e.g. yards, provisioning, land ownership
- appropriate ring-fencing and separation of above and below rail services (discussed further below); and
- providing greater certainty over time, cost and capacity for access seekers (discussed further below).

3.2 ADEQUATE RING-FENCING PROVISIONS AND SEPARATION

MCA-NT is concerned that adequate and transparent ring-fencing provisions do not currently exist in the regulatory framework which offers sufficient protection to third parties seeking rail access. As explained above, the TDR is a unique situation whereby GWAN operates integrated above and below rail services with minimal regulatory oversight.

The viability of a regulatory regime which permits open access is only valid where the Access Provider deals with all parties (including its own related parties) on equal terms. Further, any dealings between these parties must be at arm's length and on conditions which are no more favourable than those offered to unrelated parties. The Aurizon Network current 2010 access undertaking provides an example of ring-fencing provisions which may be adopted and modified as necessary to apply to a vertically integrated rail provider for the TDR.

Appropriate ring-fencing provisions, in the MCA-NT's view, should include at least the following key principles:

- establishment of an appropriate organisational structure to facilitate the separation of the management of the below rail infrastructure from the operation of above rail train services. It is acknowledged that some corporate services and support functions may be provided to both business group areas, so long there are appropriate measures in place to manage any confidential information flows (discussed further below);
- line of reporting of the management of the below rail services directly to the chief executive officer (or equivalent);
- an annual audit of financial statements of the below rail services by a qualified auditor with appropriate expertise and experience in the area of costing railway activities;
- management, and internal and external flows, of confidential information. Information sought by GWAN in its capacity as a below rail services provider, needs to be limited to that which is reasonably required to enable it to assess the train operations being proposed. The below rail business group should keep confidential from other GWAN business groups any information provided by the access seeker in its access request, negotiations on an access agreement or the terms and conditions of any executed access agreement.
- a straight forward complaint handling and enforcement process whereby an access seeker is able to apply to an appropriate regulatory authority to assess a case of any potential breach or misuse of confidential information.

MCA-NT supports a truly open and competitive above rail services market through effective separation of above rail services and regulated below rail operations based on the above principles.

3.3 PRICING METHODOLOGY AND CERTAINTY

The current regulatory regime initially focusses on parties achieving a negotiated commercial price rather than price determination by regulators. The floor and ceiling methodology, together with the above transparency issues, in the context of the TDR provides very little certainty for industry during the feasibility phase of project development. It is strongly preferable for the regulatory framework to provide greater certainty over pricing where a vertically integrated entity provides both above and below rail services.

The key concern of the current approach of a commercially negotiated pricing outcome is that it significantly favours the Access Provider. Access seekers are at a significant disadvantage in negotiating access prices with the Access Provider in that only the Access Provider has detailed knowledge of their costs.

In this regard, MCA-NT views that transparent pricing and commercial terms of access for the TDR should be more aligned to those which operate in Queensland, New South Wales and on the interstate freight network. While a published reference tariff would provide ultimate certainty for potential access seekers this lends itself to a more rigorous regulatory framework and regulatory oversight requirement. To balance this against access seeker price certainty, MCA-NT submits that ESCOSA consider amendments to the regime to allow a more definitive pricing range to be provided to access seekers, together with greater transparency of cost build up to allow pricing that is clear, predictable and reliable.

3.4 TIME AND CAPACITY CERTAINTY

In addition to pricing certainty as discussed above, access seekers require a regulatory framework which provides greater certainty of availability and timeliness of capacity. Currently, very little transparency is available on the TDR itself and the value and timeframes of any proposed expansions.

MCA-NT believes that a prudent and transparent methodology for current capacity availability and future capacity potential would be a valuable addition to the current framework. Both Aurizon Network and ARTC provide information which supports this via the following:

- the Network Development Plan [8]
- the Hunter Valley Capacity Strategy [9]
- interstate Network Committed Capacity. [10]

Provision of this information allows access seekers to make an informed judgment as to whether capacity may be available and the potential lead times and costs associated with expansion options.

3.5 FREQUENCY OF REGULATORY REVIEWS

MCA-NT is supportive of a regulatory regime which is fit for purpose and promotes balance between industry and the Access Provider. To achieve greater consistency across other Australian jurisdictions, MCA-NT supports a review at least every 5 years of the regulatory framework as put forward in the preliminary submission.

Other access regimes also provide a requirement for the Access Provider to submit for regulatory approval an annual capital and maintenance budget for the coming year. MCA-NT would support a more frequent review of these items to ensure that expended amounts are prudent and efficient and are relevant to the transport tasks at the time.

[8] http://www.aurizon.com.au/Downloads/Aurizon%20Network%20Development%20Plan%202013.pdf

[9] http://www.artc.com.au/Content.aspx?p=236

[10] http://www.artc.com.au/Content.aspx?p=209