Compliance with the NSW Rail Access Undertaking 2014-15

IPART's Final Decision on RailCorp's compliance with the New South Wales Rail Access Undertaking (Undertaking) for the 2014-15 compliance year for the Sectors owned by RailCorp in the Hunter Valley Coal Network (HVCN) between Newstan Junction and Woodville Junction.

Final Decision

1. In accordance with Schedule 3, clause 5(b)(ii) of the Undertaking,[1] we determine that RailCorp has not complied with the Ceiling Test for 2014-15, having regard to the operation of its Unders and Overs Account.
2. This final determination is based on our conclusion that the Full Economic Costs (FEC) of the 5 sectors owned by RailCorp in the HVCN (HVCN Sectors) are $5,836,155. This is made up of operating costs for coal transport of $3,400,730 (comprising maintenance costs of $2,547,518, network control costs of $568,075 and corporate overheads of $285,137), direct cost for non-coal freight transport of $778,126 plus Depreciation of $520,482 and a real post- tax Rate of Return amount of $894,296 and tax allowance of $242,521.
3. As the Access revenue generated by RailCorp's HVCN Sectors in 2014-15 is $6,321,092, Access revenue exceeds the FEC by $484,937.
4. In accordance with Schedule 3, clause 5(b)(i) of the Undertaking, we determine that RailCorp has complied with the Asset Valuation Roll Forward Principles for 2014-15. Therefore, we accept the closing Regulatory Asset Base (RAB) value of $15,093,975 proposed by RailCorp for 2014-15.

In making this final decision, we undertook a consultative process to ensure that RailCorp and relevant Access Seekers had an opportunity to make submissions to IPART on relevant matters. We received one submission on RailCorp's compliance proposal.

RailCorp's compliance with the Ceiling Test for 2014-15

RailCorp submits that for 2014-15:

- The FEC are $12,660,985 consisting of:
  - maintenance costs, network control, corporate overheads and direct costs of $11,003,686,
  - Depreciation of $520,482, and
  - the Rate of Return amount of $1,136,817 based on 7.5% pre-tax WACC.[2]
- The Access revenue falls short of the FEC by $7,716,290.

1 Terms defined in the Undertaking have the same meaning in this statement of reasons unless otherwise indicated.

2 The Undertaking requires IPART to approve a Rate of Return for 5 years to be applied to the average of the opening and closing RAB of the HVCN. The Rate of Return approved by IPART for the period from 1 July 2014 to 30 June 2019 is 5.9% on a real post-tax basis.

- Due to the recent restructure of RailCorp and devolution of responsibilities from RailCorp to Sydney Trains and NSW Trains the infrastructure cost model (ICM) that calculated the operating costs of the 5-sector HVCN is no longer available. Given this, the operating costs have been calculated by indexing the 2009-10 modelled cost by the determined annual changes in the CPI for the relevant compliance years.
- It has undertaken appropriate calculations involving the Access revenue and the FEC attributable to the operations of the HVCN Sectors utilising the same methodology as used in previous years.
- It has confirmed no capital expenditure has been incurred for the compliance year for the 5-sector HVCN.

Ceiling Test requirements of the Undertaking

We assessed RailCorp's compliance with the Ceiling Test for 2014-15 under the Undertaking. The Ceiling Test requires that for any Access Seeker (or group of Access Seekers), Access revenue must not exceed the FEC of the Sectors required on a standalone basis for the Access Seeker or group of Access Seekers (Schedule 3, clause 1(l)).

Under the Ceiling Test, we must consider various possible groups of Access Seekers and, for each one, compare the Access revenue to the FEC of the standalone system they require. If any one of these comparisons reveals revenue in excess of the FEC, then RailCorp would not have complied with the Ceiling Test. It is therefore important to focus on the groups of Access Seekers that maximise the excess revenue.

In years prior to 2013-14, we conducted the Ceiling Test with a focus on the group of Access Seekers operating freight trains carrying coal. That is because coal trains generate significant access revenue but require relatively inexpensive infrastructure. This group is most likely to cause RailCorp to breach the Ceiling Test.

For 2013-14 and this compliance year (2014-15), we also considered the group of Access Seekers operating freight trains carrying either coal or general freight (ie, shipping containers). We did not previously consider general freight revenues and costs as it was considered likely to be immaterial and we did not receive Access revenue information for any freight other than coal. The Access revenue for this group is higher than the Access revenue for the coal group by the amount of general freight Access revenue. The FEC of the standalone system required by this group is higher than the coal group's FEC by the direct cost of the general freight trains. The reason that the extra cost is only the direct cost is that the standalone coal system is a double-track freight-only system which has sufficient spare capacity to accommodate the general freight trains as well.

However we do not consider that it is appropriate to include Access Seekers operating passenger trains into the ceiling test. The operational requirements for passenger trains are significantly different than for freight only services. For example, the FEC would need to include electric overhead wiring, CTC bi-directional signalling, and a much higher standard of track inspection.

FEC are defined as "Sector specific costs including a permitted Rate of Return and Depreciation and an allocation of non-Sector specific costs such as train control and overheads including a Rate of Return and Depreciation on non-Sector specific assets. All included items are to be assessed on a stand-alone basis" (Schedule 3, clause 2.1).

The Undertaking states that "the assessment of costs on a standalone basis requires calculation based on the optimal configuration of rail infrastructure in order to serve all Access Seekers operating in a common end market" (Schedule 3, clause 2.2(c)).

Non-coal freight revenue and direct costs

In assessing RailCorp's Ceiling Test for 2014-15, we evaluated both the group of Access Seekers operating coal trains and the group of Access Seekers operating coal and non-coal freight trains. The excess revenue was greater for the second group, because the revenue added by general freight exceeded the cost added by general freight. For this reason, we have included non-coal freight revenue and costs associated with the non-coal freight transport on its HVCN in assessing compliance with the Undertaking. RailCorp submits that Access revenue from non-coal freight transport was $1,376,397 for 2014-15. We estimate that direct costs associated with RailCorp's non-coal freight transport are $778,126. This is based on the benchmark rate we apply to RailCorp's efficient variable maintenance cost for coal transport.

Full Economic Costs

We calculated RailCorp's FEC based on the optimal configuration of rail infrastructure in order to serve all Access Seekers operating in a common end market - the market for the supply and transportation of coal and non-coal freight. The network configuration that underpins the benchmark operating costs for RailCorp's HVCN is consistent with the RAB determined by the Minister for Transport in 2001. The relevant HVCN Sectors comprise a double-track, concrete-sleepered, continuously welded rail system of approximately 52 km of track.

In making our final decision, we:

- considered stakeholder submissions,
- undertook analysis, and
- had regard to the operation of RailCorp's Unders and Overs Account for 2014-15, as set out in its submission.

Stakeholder Submission

We received one submission to our Draft Decision from Pacific National which expressed concern regarding the lack of transparency around RailCorp's actual costs and cost allocation methodologies. It submitted that RailCorp should not continue to escalate previous costs by CPI. Pacific National supported the Draft Decision that RailCorp has not complied with the ceiling test and over-recovered revenue.[3]

We agree with Pacific National that FEC should reflect the efficient costs of providing freight services. We also support the provision of greater information on RailCorp's costs and cost allocation methodology. TfNSW has advised that it is reviewing its costing model to be used for its further compliance proposals.

3 Pacific National, Submission to Draft Decision, 22 December 2016, p 1.

Our final decision for 2014-15

We determine, for this final decision that RailCorp has not complied with the Ceiling Test for 2014-15 as the Access revenue exceeds the FEC which include the direct costs of non-coal freight. In our opinion, RailCorp's claimed operating costs are higher than the efficient costs based on an optimal configuration of a freight network.

For the reasons that follow, we conclude that RailCorp's FEC for 2014-15 are $5,836,155 made up of operating costs for coal transport of $3,400,730 (comprising maintenance costs of $2,547,518, network control costs of $568,075 and corporate overheads of $285,137), direct cost for non-coal freight transport of $778,126 plus Depreciation of $520,482, a return on assets of $894,296 (real post tax) and a tax allowance of $242,521.

Therefore, for 2014-15, we do not accept RailCorp's claimed operating costs (maintenance, network control and corporate overhead costs) and the return on assets but we accept the depreciation proposed by RailCorp (as explained further in the following sections).

Maintenance costs

RailCorp submits that:

- its maintenance costs amount to $6,914,045 for 2014-15, and
- these costs have been adjusted upward for the CPI movement as used by the RAB roll forward over the period.

We have reviewed RailCorp's claimed maintenance costs and conclude that we are not satisfied that the maintenance costs claimed by RailCorp are based on an optimal configuration of a freight-only network.

As part of our review, we:

- used the efficient benchmark costs determined for the 2013-14 compliance year for RailCorp's HVCN of $33,607 per track km for fixed maintenance costs and $3.38/'000 gtk for variable and shared maintenance costs combined; and
- updated those benchmark costs by using a maintenance cost index (MCI) for 2014-15.

The MCI comprises components of labour, consumables, assets, fuel, and accommodation with the weights of each cost component based on weights used by QR National for its Central Queensland Coal access arrangement. The MCI uses relevant inflators based on ABS data for NSW and Sydney. We considered these indexed maintenance benchmark costs were reasonable and reflect efficient costs of providing rail networks on an optimal configuration for a freight-only network.[4] We are of the view that the 2013-14 benchmark rates as set out in Table 1 and indexed by the MCI are appropriate for establishing the efficient maintenance costs for RailCorp's HVCN.

The indexed benchmark rates for setting the efficient maintenance costs for 2013-14 and 2014-15 are presented in Table 1.

4 Sapere Research Group, *RailCorp Compliance with the NSW Rail Access Undertaking for 2010-11 year*, 20 November 2012.

Table 1 Maintenance benchmark unit rates for 2013-14 and 2014-15

	2013-14 unit rate	NSW escalating factor	2014-15 unit rate
Fixed maintenance costs (unit rate in $/track km)	33,607	1.0244	34,427
Variable maintenance costs (unit rate in $/'000 gtk[a])	1.69	1.0244	1.73
Maintenance overheads (unit rate in $/'000 gtk[a])	1.69	1.0244	1.73

a gtk means gross tonne per km.

Source: IPART analysis.

As mentioned above, we conclude that we are not satisfied that the maintenance costs claimed by RailCorp are based on an optimal configuration of a rail freight network.

We consider that RailCorp's claimed fixed maintenance costs include the costs of maintaining passenger and other non-coal freight operations. In our view, there are various reasons why the fixed costs of a freight network are much lower than the fixed costs of rail infrastructure for passenger operations. The key reasons include that a rail freight network requires:

- A lower standard of track than passenger operations, which have higher train operating speeds and pose greater risk of catastrophic accidents.
- A less complex and costly signalling and communication system than would be required for passenger operations because of lower freight train frequencies and speeds.
- Less frequent and detailed manual track inspections than would be required for a passenger network because of less severe consequences of freight train incidents.
- Slower maximum response times for infrastructure failures and track incidents than would be required for a passenger network because of lower train frequencies and more flexible train scheduling for freight, and smaller track maintenance gangs per kilometre of track than would be required for a passenger network because of the reduced frequency of track inspections and lower track standard for freight.

We conclude that the efficient maintenance unit rates for 2014-15 are as shown in Table 1. Applying the 2014-15 unit rates to RailCorp's 2014-15 Ceiling Test, the benchmark maintenance costs are $2,547,518 as shown in Table 2.

Table 2 RailCorp maintenance costs for 2014-15 compared to IPART benchmarks

	RailCorp proposed 2014-15	2014-15 benchmark cost
Fixed maintenance costs	np	1,774,884
Variable maintenance costs	np	386,317
Maintenance overheads	np	386,317
Total	**6,914,045**	**2,547,518**

Note: columns may not add due to rounding; np = not provided.

We consider these costs represent efficient costs for an optimal freight rail network as required by the Undertaking for the purposes of RailCorp's Ceiling Test compliance for 2014-15.

Network control costs

As defined in the Undertaking, the FEC of a Sector include an allocation of non-Sector specific costs such as train control and overheads. RailCorp claimed network control costs of $1,683,708 for the purposes of the Ceiling Test for 2014-15. As RailCorp submitted, the claimed network control costs are modelled costs, not actual costs, and these costs are allocated on a sector level. In RailCorp's view, the network control costs are largely fixed. This is due to the integration of the Hunter Valley network control functions with RailCorp's entire network.

We reviewed RailCorp's network control costs and in our view, RailCorp has not demonstrated that its claimed network control costs are based on an optimal configuration of a freight rail network.

For 2014-15, we have indexed the 2013-14 network control costs by the increase in CPI of 2.58%.[5] We also consider that there is no new evidence that suggests the network control costs have increased by more than the rate of inflation. The efficient costs for network control for an optimal freight rail network for the purposes of the Ceiling Test for 2014-15 are $568,075 for this final decision.

Corporate overheads

RailCorp proposes an amount of $911,794 for corporate overheads for the purposes of the Ceiling Test for 2014-15. This represents 10.6% of the fixed maintenance and network control costs that RailCorp allocated to its HVCN Sectors.

We reviewed RailCorp's claimed corporate overheads and conclude that a 'mark-up' rate of 9.2% on the benchmark maintenance costs and network control costs is reasonable.

In our view, in determining the benchmark 'mark-up' rate for corporate overheads, the 'mark-up' approach is a generally accepted industry practice and is appropriate for RailCorp's freight rail network. We note that RailCorp uses the same approach albeit using a slightly higher rate (10.6%) and applied to a much higher cost base.

For the purpose of the final decision on the Ceiling Test for 2014-15, we determine RailCorp's corporate overheads for an optimal freight rail network to be $285,137 representing 9.2% of the benchmark maintenance and network control costs.

Rate of Return and Depreciation

In its submission on its compliance with the Ceiling Test, RailCorp included Depreciation of $520,482 and a Rate of Return amount of $1,136,817 for 2014-15. We reviewed the claimed Depreciation and Rate of Return. The Depreciation amount is calculated consistently with the requirements of clause 3.2(c) of Schedule 3 to the Undertaking, using a Depreciation rate of 3.33% calculated using a straight-line methodology. RailCorp confirmed that there was no capital expenditure incurred in 2014-15 that could be characterised as "standalone".

5 The CPI increases are the same as those we use for the indexation of RailCorp's 5-sector HVCN RAB.

However, we found that RailCorp's Rate of Return calculation is incorrectly based on the rate of 7.5% (pre-tax real). We decided in 2014 that the rate of return under the Undertaking is a real post-tax return of 5.9% plus tax allowance from 1 July 2014.[6]

For the purpose of the final decision on the Ceiling Test for 2014-15, we are therefore satisfied that the Depreciation amount complies with the Undertaking. However, RailCorp's Rate of Return is not in accordance with our 2014 decision on the rate of return.

Unders and Overs Account

We have had regard to the operation of the Unders and Overs Account in assessing RailCorp's compliance with the ceiling test under the Undertaking. RailCorp has proposed that:

- the balance of the Unders and Overs Account for 2014-15 is an under-recovery of $7,716,290 (being the claimed amount by which Access revenue has fallen short of the claimed FEC), and
- the running balance of the Unders and Overs Account is an under-recovery of $32,381,475 as at 30 June 2014 (such amount includes balances from the 2004-05 to 2013-14 compliance years).

We note, however, that, as stated in its submission, RailCorp established its Unders and Overs Account in light of our 2009-10 decision. RailCorp did not establish or operate an Unders and Overs Account for the compliance years from 2004-05 to 2008-09.

For the reasons stated above, we determine, for this final decision, that the Access revenue exceeds the FEC by $484,937 for 2014-15.

On this basis, the balance in the Unders and Overs Account as at 30 June 2014 is an over-recovery of $6,345,868. The over-recovery from this final decision would result in an overall over-recovery of $6,830,805 as at 30 June 2015 (Table 3).

Table3 Overs and unders account - RailCorp over recovery (nominal $)

	Over-recovery
2009-10 – IPART 2009-10 final decision	78,656
2010-11 – IPART 2010-11 final decision	1,132,108
Balance at 30 June 2011	1,210,764
2011-12 - IPART 2011-12 final decision	1,660,341
Balance at 30 June 2012	2,871,105
2012-13 IPART 2012-13 final decision	2,125,465
Balance at 30 June 2013	4,996,570
2013-14 – IPART final decision	1,349,298
Balance at 30 June 2014	6,345,868
2014-15 - IPART final decision	484,937
Balance at 30 June 2015	6,830,805

Source: IPART determinations of RailCorp's compliance for 2009-10 to 2013-14.

6 IPART, *NSW Rail Access Undertaking – Review of the rate of return and remaining mine life from 1 July 2014,* July 2014.

The Undertaking provides that the Rail Infrastructure Owners shall manage its Unders and Overs Account in accordance with any determination made by IPART under clause 5(b) of Schedule 3 (Schedule 3, clause 5(e)). The Undertaking also sets out certain requirements in clause 4 of Schedule 3 for the management of the Unders and Overs Account.

One of those requirements is that the Unders and Overs Account balance should not exceed five percent of forecast Access revenue (Schedule 3, clause 4(e)). Our view is that RailCorp has not managed the Unders and Overs Account balance in accordance with that requirement.

RailCorp's compliance with the Asset Valuation Roll Forward Principles

RailCorp proposes a closing RAB of $15,093,975 as at 30 June 2015 for the HVCN Sectors (Table 4).

Table 4 Regulatory asset base roll forward (nominal $)

	2014-15
Opening value	15,221,143
CPI increase	393,314
Capex	--
Depreciation	520,482
Disposal	--
Closing RAB	15,093,975
Average RAB	15,157,559

Note: Column may not add due to rounding.
Source: RailCorp submission, 2014-15.

Determination on compliance with the Asset Valuation Roll Forward Principles for 2014-15

We are satisfied that RailCorp has complied with the Asset Valuation Roll Forward Principles for 2014-15 for the purposes of Schedule 3, clause 5(b)(i) of the Undertaking and accept that RailCorp's proposed closing RAB of $15,093,975 as at 30 June 2015 for the HVCN Sectors is consistent with the Asset Valuation Roll Forward Principles.

Determination on compliance with the ceiling test for 2014-15

In determining whether RailCorp has complied with the Ceiling Test, we have, consistent with the terms of the Undertaking:

- had regard to RailCorp's Unders and Overs Account,
- then estimated what we consider to be the appropriate costs of an optimally-configured freight rail network, and
- then assessed those costs against RailCorp's claimed costs.

We conclude, for this final decision, that RailCorp's FEC is $5,836,155 for 2014-15. We also consider that these costs represent the efficient costs for an optimal freight rail network on a standalone basis. We found RailCorp's claimed costs are significantly greater than its FEC. On this basis, we determine that RailCorp has not complied with the Ceiling Test for 2014-15. We note that as the Access revenue generated by its HVCN Sectors in 2014-15 is $6,321,092 it exceeds the FEC by $484,937 for the 2014-15 compliance year.

Our final decision on RailCorp's compliance with the Ceiling Test for 2014-15 is summarised in Table 5.

Table 5 RailCorp's proposed Ceiling Test 2014-15 and IPART Final Decision (nominal$)

	RailCorp proposed	IPART final decision
Access revenue (coal transport)		
- coal transport	4,944,695	4,944,695
- non-coal freight transport	np	1,376,397
	4,944,695	6,321,092
Operating costs (coal):		
-Maintenance (indexed by MCI)	6,914,045	2,547,518
-Network control	1,683,708	568,075
-Corporate overheads[a]	911,794	285,137
Coal direct cost (modelled)	1,494,139	na
Total operating costs (coal)	11,003,686	3,400,730
Non-coal freight direct costs	np-	778,126
Depreciation	520,482	520,482
Return on assets	1,136,817[b]	894,296[c]
Tax allowance	na	242,521
Full Economic Costs (FEC)	12,660,985	5,836,155
Access revenue exceeds/(under-recovers) Full Economic Cost	(7,716,290)	484,937

Note: Columns may not add due to rounding. **np** - not provided. **na** – not applicable.

a:Corporate overheads are calculated at 9.2% of the maintenance and network control costs.

b:Based on 7.5% on a real pre-tax basis.

c:Based on 5.9% on a real post-tax basis.

Source: RailCorp submissions for 2014-15 and IPART analysis.

CONCLUSION

Based on the requirements of the Undertaking and our consideration of stakeholder submissions, our final determination is that for 2014-15, RailCorp:

- has complied with the Asset Valuation Roll Forward Principles; and
- has not complied with the Ceiling Test, having regard to the operation of the Unders and Overs Account.

February 2017