

The Hunter Valley Access Undertaking: elements of a negotiated settlement

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I. Industry Background

Australian Rail Track Corporation (ARTC) is an Australian Government-owned corporation, established in 1998 for the purpose of managing and providing access to the Australian Interstate Rail Network. ARTC provides 'below-rail' track access services but not 'above rail' haulage services. It manages the Hunter Valley rail network under a lease with the State Government of New South Wales. The lease was entered on 4 September 2004 and is for 60 years, and includes a requirement that ARTC submit an access undertaking to the ACCC.

The ACCC's assessment of the Hunter Valley Access Undertaking (HVAU) occurred in the context of attempts by coal industry participants to implement a 'long term solution' to capacity constraints that had adversely impacted the performance of the Hunter Valley coal chain over a number of years. Inefficiencies in supply chain coordination had contributed to significant ship queues and demurrage costs for coal producers seeking to satisfy the increased international demand for coal associated with the mining boom.

II. The Hunter Valley Access Undertaking

The HVAU is a detailed and complex document, running to 270 pages.

It includes:

a process for parties to apply to ARTC for access, negotiate an access agreement and, in the event of a dispute, have recourse to binding ACCC arbitration;
an indicative access contract, which the parties may either take up without modification or use as the basis for negotiation;

a revenue cap and pricing methodologies to regulate ARTC's access prices;
liability and performance incentive measures with implications for both ARTC and access seekers;

protocols regulating management of capacity on the rail network, including provisions designed to facilitate alignment of capacity management across the Hunter Valley coal chain; and

processes for the investment in and creation of additional network capacity.

The HVAU has a term of five years.

III. The substantive issues and the agreed solutions

The appropriate cost of capital to include in the 'building block' calculation of allowed revenues, the duration of the initial agreement, and the nature of the transitional arrangements, were important issues that are discussed in this paper. In order to indicate the commonality of the situation to that of other network infrastructure situations, including electricity, natural gas, airports, etc., it may be helpful to note three of the other major substantive issues that the parties had to address.

1. How to ensure that the management of existing capacity and the investment in new capacity would be conducive to 'supply chain alignment', that is, end-to-end efficiency of the whole coal supply chain comprising coal mines, below-rail, above-rail and ports?

As regards new investment, the HVAU provides that ARTC may propose and fund capital projects, but there is a customer engagement process, the 'Rail Capacity Group', by which capital projects must be endorsed by users in order to proceed. If users do not endorse a particular project, ARTC may seek the ACCC's assessment of whether it is 'prudent' and appropriate to proceed with. On the other hand, if users seek a particular project but ARTC is unwilling to fund it, the HVAU sets out a 'user-funding' process by which users may pay for the project, and where ARTC is

effectively obliged to undertake construction, subject to the project meeting certain safety and technical requirements.

2. How to set prices to ensure that ARTC made efficient use of its network, and how much flexibility to provide for the recovery of the costs of new investment?

Pricing under the HVAU is by reference to 'Indicative Services', which at the time of acceptance reflected the most common train configurations used on the Hunter Valley network. In order to promote efficient use of the network, stakeholders sought to have the Indicative Services defined (and hence prices set) by reference to the most efficient train configuration that could conceivably be run on the network.

The model also allows ARTC to under-recover its costs in relation to certain parts of the network for a preliminary period, and then to recover the relevant shortfall at a later date, a mechanism referred to as 'loss capitalisation.' The intent of this approach is to facilitate new investment in assets where there is limited initial demand, by recoupment of full revenues when demand has increased. (The ACCC cautiously accepted this device, noting its novelty and limiting its application to only part of ARTC's network where new investment was likely to occur and where demand was initially likely to be low.)

3. How to ensure that ARTC would meet its obligations under the agreement?

The HVAU incorporates a complex set of arrangements governing ARTC's liability for performing its obligations. These include contractual provisions in the access agreements, provision for ARTC to report against key performance indicators and to develop incentives to improve performance, as well as a mechanism known as the 'true-up test' by which ARTC would pay a rebate in the event that capacity on the network was not made available. The HVAU also includes detailed processes and binding timelines for ARTC to develop and implement performance incentives.

4. Negotiations and the final settlement

Initially, the parties submitted evidence to the ACCC's consultation process. Later, as the issues clarified, the parties began to discuss the issues between themselves. Negotiations between the parties then reduced the outstanding differences to four critical issues. In simple terms, these were as follows:

- i) Term of undertaking: ARTC was proposing a 10 year term, to give it and the industry a longer period of certainty. The NSWMC was initially comfortable with a 10 year term, but became unsure how the arrangements would work and more concerned about lock-in, and later argued for 5 years.
- ii) Transition plan: Proposed arrangements were quite different from what had happened before. For example, previous arrangements had not involved coal producers contracting directly with the railroad. ARTC was to set out a transition plan in a letter, but views differed as to what that plan should contain.
- iii) System Assumptions: The coal producers wanted calculations of rail capacities to be based on common assumptions applicable across the whole supply chain, and which would match rail capacity with recently agreed port capacities. ARTC was not prepared to have System Assumptions imposed upon it by another party, when ARTC's performance would be measured, and financial penalties applied, based on those System Assumptions.
- iv) Rate of return: ARTC was seeking a higher rate of return (originally over 10% real pre-tax WACC, later 9.16% and by this time 9.10%) than the return that the ACCC had set out (originally 7%, then 8.57% in its second Position Paper).

On 13 June 2011, the NSWMC advised the ACCC that, although ARTC had not yet addressed all its concerns, if appropriate changes were made to address the first three points then it would not object to the rate of return for ARTC that the company was seeking.

5. ACCC acceptance

The first three of these terms were acceptable to the ACCC. However, the ACCC had already "arrived at a view on an appropriate rate of return", using "a standard regulatory approach". How could it now justify allowing a higher return? It argued that the negotiated settlement made all the difference. The ACCC nonetheless noted that agreement of the parties would not necessarily have been sufficient on its own, and that issues of market power and the interests of consumers were also relevant.

6. Factors conducive – or not - to negotiated settlement

What factors were or were not conducive to the eventual emergence of this negotiated settlement?

Importantly, there was a common interest, shared by all parties and government, in reforming the supply chain performance at the Port of Newcastle. The expectation (or at least possibility) that coal producers would negotiate access directly with ARTC also facilitated the parties coming together. At the same time, however, this broader focus also created a need to address relatively new and unique regulatory issues, such as how to reflect supply chain alignment within the terms of the HVAU. These factors perhaps extended the complexity and duration of the process beyond that which an economic regulator might normally consider.

The main users (the coal producers) were well-informed, with relatively homogeneous interests. In other contexts they had long experience of negotiating to achieve mutually satisfactory outcomes, and already had a representative trade body (NSWMC). This is not to say, however, that the coal producers always spoke with one voice. They were competing with one another and might have different, even contradictory, perspectives, so that the views expressed by the industry representative body might not always be fully representative of the industry.

The sheer complexity of the undertaking and its implications may initially have deterred cost-effective negotiation. After the ACCC's draft decision reduced the challenge to more manageable proportions (7-10 issues), ARTC and NSWMC began to engage more constructively with each other. Further negotiations between the parties reduced the remaining differences to the four critical issues. At this point a deal was proposed and agreed.

ARTC was concerned that the issues seemed to change throughout the process. An alternative view from among the coal producers was that the underlying principles that they sought to achieve remained consistent throughout the negotiations.

The negotiating styles of the parties were also relevant, and not surprisingly the parties had different views of the styles of their counterparts. Each felt that the other was not sufficiently flexible. Despite this, agreement was reached. What enabled the final

successful negotiations? How did the parties come to perceive that negotiation could result in a win for both sides?

The main factors seem to have been a) the coal producers settling upon a clearer and fixed specification of the central remaining issues; b) their willingness to accept, in return, a higher return for ARTC to reflect the risks involved; c) a new flexibility on the part of ARTC in relation to the key remaining issues, motivated in important part by the prospect of achieving the higher return it sought; d) an indication from the ACCC that it might consider a negotiated outcome including the higher return; and e) a mutual desire to end the regulatory uncertainty within a defined time frame, and thereby bring to an end a process that one participant described as “excruciating in the extreme”.

7. The role of regulation and the ACCC

What about the regulatory framework and the regulatory stance? As the matter progressed, ACCC staff encouraged the parties to negotiate, as a more effective way to resolve some of the differing views of the parties in this case. At the request of the parties, the ACCC was willing to extend its timetable on at least two occasions, in order to facilitate discussion. ACCC staff also played a pro-active role, acting where necessary as mediator and seeking to build consensus.

The ACCC was able to encourage negotiation, rather than simply take its own decisions, because the majority of the issues it assessed (such as supply chain alignment, and provision for investment in the network) were those raised by stakeholders and identified by them as being critical. In contrast, a much smaller group of issues were identified and addressed on the ACCC’s own initiative, such as the term of the HVAU. The rate of return was also of concern to the ACCC (for its precedential value and implications for customers) and to the parties themselves.

The legal regime under Part IIIA gives the ACCC a broad discretion in assessing an access undertaking. Amongst ACCC project staff there was a view that this broad discretion gave the flexibility to pursue innovative and responsive approaches to issues, one of which was the agreed position on the rate of return.

In the event, the negotiation process did not turn out as ACCC initially envisaged. In the early stages of the process there was little negotiation between the parties to resolve different views, and the ACCC rather than the parties themselves had to filter out and resolve

the majority of the issues. In contrast, when all this groundwork had been done, and the few main outstanding issues were identified, the parties themselves resolved them and proposed an agreed outcome rather than left this to the ACCC. It seems that the earlier work in clearing the ground and clarifying the options served to facilitate – indeed, make possible - the later and successful negotiation between the parties. It is also arguable that such negotiation was more effective once there was a credible regulatory alternative. That is, a negotiated outcome became more achievable once the parties realised that the ACCC had reached its own view on all the issues, and was likely to accept ARTC's next iteration of its undertaking. The parties then realised that they could achieve a variation of that outcome that would be mutually beneficial to them.

8. Effects of the settlement

The settlement led to different terms and to a higher rate of return than would otherwise have been allowed. Experience here is thus consistent with experience elsewhere, that customers are often willing to pay a little more than the regulator deems appropriate, in order to secure a service better tailored to their needs than the regulator would otherwise specify. In short, both sets of parties secured a better outcome than they would have done with a regulatory decision.

9. Lessons from this experience

What lessons might be drawn from this experience?

- i) A negotiation process can be effective in a wide range of contexts, resulting in a win-win outcome for the parties involved.
- ii) Although previously state-owned monopoly networks may feel that they are engaged in innovative and risky commercial negotiation, customers and users negotiating with them tend to see them as conservative and risk averse. Greater flexibility seems helpful (i.e. conducive to securing a successful outcome).
- iii) Customers and users of a network can have diverse and possibly inconsistent demands and priorities that hinder negotiations. Greater and earlier agreement on the critical issues seems helpful (in the above sense).

- iv) A willingness by customers and users to accept a slightly higher rate of return for desired services seems to work wonders in facilitating negotiations. An early recognition of this seems helpful.
- v) A pro-active role for the regulatory body can be helpful. This is not simply to allow or encourage negotiations but also can include structuring the discussions, clarifying the issues, taking initial decisions on the less critical ones, insisting that the parties get round the negotiating table, giving a lead on what is or is not likely to be acceptable, taking a firm line where necessary with the regulated entity, and not allowing discussions and negotiations to drag on. Of course, during this process the regulatory body needs to be mindful of its statutory duties, not least to protect customers and other parties not at the negotiating table.
- vi) It seems helpful to allow the parties to focus on the particular circumstances of that industry at that time rather than to tie down the outcome too closely to previous decisions in that or other industries; to allow the parties to agree a mutually acceptable rate of return to reflect the services provided and the risks incurred; and not to leave doubt in the minds of the parties as to whether the regulator will accept an agreed outcome.
- vii) Finally, personalities matter. Leadership is required on all sides, including at the regulatory body, to see the scope for mutually beneficial negotiations, to coordinate the parties, and to drive forward the process of negotiation to a successful conclusion.

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