



Australian
Competition &
Consumer
Commission

Discussion Paper

Australian Rail Track Corporation's Hunter Valley Rail
Network Access Undertaking

Revenue allocation review

29 May 2014



Australian Competition and Consumer Commission
23 Marcus Clarke Street, Canberra, Australian Capital Territory, 2601

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Glossary

Capitalised terms used in this paper and not listed in this glossary are terms as defined in subsection 14.1 of the accepted Hunter Valley Access Undertaking (29 June 2011), available on the ACCC's website.

ACCC	Australian Competition & Consumer Commission
Access Holder	Defined under Section 14 of the HVAU as an Applicant who has been granted Access Rights to the Network
the Act	<i>Competition and Consumer Act 2010</i> (Cth)
ARTC	Australian Rail Track Corporation Limited
HVAU	The Hunter Valley Access Undertaking accepted by the ACCC on 29 June 2011 and varied on 17 October 2012
Indicative Access Charge	Charge for use of train paths on the Hunter Valley rail network
IPART	NSW Independent Pricing and Regulatory Tribunal
the network	Hunter Valley rail network covered by the Hunter Valley Access Undertaking
NSWRAU	New South Wales Rail Access Undertaking
PZ1	Pricing Zone 1
PZ2	Pricing Zone 2
PZ3	Pricing Zone 3
RAB	Regulatory Asset Base
Segment	Component of the Hunter Valley rail network
TOP	Take or Pay

1 Introduction

The Australian Rail Track Corporation (**ARTC**) is a Commonwealth Government-owned corporation established in 1998 for the purpose of managing and providing access to its national interstate rail network. ARTC is vertically separated, providing 'below-rail' services (such as the rail track infrastructure) but not 'above-rail' services (such as haulage). ARTC also leases the Hunter Valley rail network from the New South Wales (**NSW**) government under a 60-year lease that was granted on 5 September 2004.

The Hunter Valley rail network (the **network**) is predominantly used to transport coal from mines in the Hunter Valley region to the Port of Newcastle for export and to transport coal to domestic customers, such as power stations. The network is also used by non-coal traffic, including general and bulk freight services (such as grain) and passenger services.

Access to the Hunter Valley rail network is regulated through the Hunter Valley Access Undertaking (**HVAU**) which is administered by the ACCC. The HVAU provides for the negotiation of access to the network operated by ARTC in NSW. The ACCC accepted the HVAU in accordance with subsection 44ZZA(3) of Part IIIA of the *Competition and Consumer Act 2010 (Cth)* (**the Act**) on 29 June 2011. The undertaking applies for an initial five year period and is due to expire in June 2016.

In relation to the transportation of coal, ARTC has determined that there are three pricing zones in the network. All producers traverse Pricing Zone 1 (**PZ1**), the section of track that connects to the port. The network in Pricing Zone 2 (**PZ2**) and Pricing Zone 3 (**PZ3**) connects with the network in PZ1. Only producers originating in PZ2 use the rail network in PZ2. Similarly, only producers originating in PZ3 use the network in PZ3.

As part of the HVAU, ARTC has developed a methodology for determining prices and allocating revenue for the purposes of recovering costs in relation to the use of the network. The ACCC is required to assess ARTC's compliance with the HVAU on an annual basis.

The following sections discuss the context and scope of the ACCC revenue allocation review and the proposed consultation process.

1.1 Context and scope of this review

In the ACCC's determination on ARTC's compliance with the financial model and pricing principles in the HVAU for the 2012 calendar year, the ACCC noted issues relating to ARTC's approach to revenue allocation. The ACCC stated that it intended to undertake a public review of revenue allocation processes under the HVAU, in which stakeholders will be provided with an opportunity to submit their views. This review presents that opportunity.

The purpose of this review is to assess the level and adequacy of, transparency of information provided to stakeholders on ARTC's current revenue allocation practices. This purpose also reflects the objectives of the HVAU. Specifically, subsection 1.2(c) of the HVAU states that "the intent of the Undertaking is to... use transparent and detailed methodologies, principles and processes for determining Access revenue limits, terms and conditions".

The ACCC notes that this review is not required by the HVAU or the Act. Nonetheless, the ACCC considers that this review is important and will be of interest to stakeholders. In particular, it may allow stakeholders to make better informed investment decisions.

1.1.1 Past regulation

The Hunter Valley rail network was previously subject to the New South Wales Rail Access Undertaking (NSWRAU) administered by the NSW Independent Pricing and Regulatory Authority (IPART).

The ACCC understands that ARTC's revenue allocation practices have been historically practiced by ARTC under the NSWRAU, which was accepted by IPART since the early 2000s. The ACCC notes, however, that there have now been a number of changes in the industry which may necessitate a revision in approach. These changes are outlined below.

1.1.2 Increase in coal volumes and investment

Coal volumes have increased significantly since the early 2000s which means that capacity in PZ1 is now constrained, and PZ3 producer originating volumes are forecast to increase significantly in coming years. ARTC notes that while the heaviest coal volumes are currently at the lower end of the Hunter Valley (PZ1), the expected growth in coal mining is along the Gunnedah Basin which is producing high rates of growth in percentage terms.¹

The increase in coal volumes has necessitated investment in the network, in part to accommodate the expanding volumes in PZ3. In its 2013 Hunter Valley Corridor Capacity Strategy ARTC noted that 'coal demand on the (Gunnedah Basin) line has already increased significantly and is forecast to continue to increase very rapidly. Considerable increases in capacity continue to be needed to accommodate this growth'.²

In the 2012 calendar year several major projects to create additional capacity in PZ1 were undertaken. These capital projects are likely to become more significant given that traffic traversing the network in PZ1 is forecast to increase significantly in coming years and significant investments in PZ1 are required to accommodate the increased traffic from PZ3 producers.

In this regard, ARTC has noted that congestion over the network remains a concern.³ ARTC has also stated that additional infrastructure is one option to mitigate congestion and enable the full capacity of network to be realised.⁴

For new investments, the HVAU sets out a process by which the Rail Capacity Group (**RCG**) – a body comprised of industry representatives – can endorse capital projects proposed by ARTC. If a project is endorsed by the RCG then the ACCC must assume that the expenditure is prudent⁵ and can be included in the RAB (which in turn determines the Floor and Ceiling limits).⁶

1.1.3 Loss capitalisation under the HVAU

The ACCC understands that it was not anticipated that ARTC would recover economic cost in PZ3 during the time it was being regulated by IPART, and as such IPART considered it appropriate that revenue from PZ3 producers (aside from covering their Direct Costs in PZ1) would go towards minimising losses incurred by ARTC in PZ3. This was considered to be an efficient outcome which maximised utilisation of the network.

In contrast, however, under the HVAU loss capitalisation now applies in PZ3 which ensures that ARTC is able to recover its Economic Cost (and any capitalised losses) over the long term once volumes in PZ3 increase sufficiently. The loss capitalisation mechanism therefore minimises the risk of truncated returns to ARTC, as it is able to earn a return on the capitalised losses when they enter the PZ3 Regulated Asset Base (**RAB**). Loss capitalisation is discussed in more detail in section 2.3 of this discussion paper.

¹ ARTC, *2013-2022 Hunter Valley Corridor Capacity Strategy*, p. 5.

² *ibid.*, p. 15.

³ *ibid.* p. 27.

⁴ *ibid.*, p. 26.

⁵ In determining whether ARTC has complied with the HVAU provisions in rolling forward the RAB or the RAB Floor Limit, subsection 4.10(d)(iii) of the HVAU provides that where capital expenditure has been endorsed by the RCG, the ACCC will not consider whether that capital expenditure is prudent.

⁶ The Floor and Ceiling Limits are discussed further in section 2 of this discussion paper.

1.2 Related processes

Separate to this review, the ACCC notes two other upcoming processes which relate to both ARTC's obligations to comply with current HVAU, and regulation of the network more broadly:

- The ACCC determination of whether ARTC has complied with the financial model and pricing principles specified in the HVAU for the 2013 calendar year (and subsequent years until the expiry of the current HVAU). Under the HVAU, ARTC has to submit its compliance documentation by 30 April each year but the HVAU does not specify a timeframe within which the ACCC must assess compliance.
- The ACCC's assessment of any new replacement undertaking (the current HVAU expires in June 2016). The ACCC's assessment of any new undertaking is likely to commence around mid to late 2015.

While this review is separate to these processes, information gathered from stakeholders during this review may inform both of the above processes.

1.3 Consultation

As noted in section 1.1 of this discussion paper, the primary purpose of this review is to provide transparency to stakeholders about how ARTC applies the pricing principles contained in section 4 of the HVAU when complying with its annual compliance obligations under section 4.10 of the HVAU.

Questions of particular interest to the ACCC relating to this review are contained in section 2.3 of this discussion paper. However, stakeholders are welcome to comment on any aspect of revenue allocation under the HVAU.

1.3.1 Invitation to make a submission

The ACCC invites public submissions on this review. Submissions should be addressed to:

Mr Matthew Schroder
General Manager
Fuel, Transport and Prices Oversight Branch
Australian Competition and Consumer Commission
GPO Box 520
Melbourne VIC 3001

Email: transport@acc.gov.au

1.3.2 Due date for submission

Submissions on this review are due by **29 August 2014**.

The ACCC will consider submissions and, if necessary, engage in further consultation with stakeholders in September and October 2014 in order to clarify and obtain further details on any issues raised.

The ACCC anticipates that it will release a Review Outcomes Paper by early November 2014. The Review Outcomes Paper will summarise any discussions that arise from the public consultation process.

1.3.3 Confidentiality

The ACCC strongly encourages public submissions. Unless a submission, or part of a submission, is marked confidential, it will be published on the ACCC's website and may be made available to any person or organisation upon request.

Sections of submissions that are claimed to be confidential should be clearly identified. The ACCC will consider each claim of confidentiality on a case by case basis. If the ACCC refuses a request for confidentiality, the submitting party will be given the opportunity to withdraw the submission in whole or in part.

For further information about the collection, use and disclosure of information provided to the ACCC, please refer to the ACCC publication '*Australian Competition and Consumer Commission / Australian Energy Regulator Information Policy – the collection, use and disclosure of information*' available on the ACCC website.⁷

1.4 Further information

The currently accepted HVAU is available on the ACCC's website at the following link.

<http://registers.accc.gov.au/content/index.phtml/itemId/1095003>

If you have any queries about this review, please contact:

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⁷ *Australian Competition and Consumer Commission / Australian Energy Regulator Information Policy – the collection, use and disclosure of information* available at: <http://www.accc.gov.au/publications/accc-aer-information-policy-collection-and-disclosure-of-information>.

2 Pricing principles

In this section of the paper, the ACCC provides an overview of the relevant pricing principles in the HVAU and then discusses ARTC's approach to revenue allocation and revenue reconciliation.

2.1 Overview of pricing principles

Section 4 of the HVAU contains the pricing principles that apply to the network.

Section 4.1 of the HVAU specifies that the charge to an Access Holder will include a price negotiated in accordance with the pricing principles in the HVAU. Section 4.2 regulates the amount of revenue that ARTC is entitled to receive for the network by implementing revenue floor and ceiling limits:

- Access Revenue from every Access Holder must at least meet the Direct Cost⁸ imposed by that Access Holder (the **Floor Limit**)
- The HVAU caps the maximum amount of revenue that ARTC is entitled to receive at the Economic Cost of providing services (the **Ceiling Limit**).

The Economic Cost is calculated using a Building Block Model⁹ and includes a return on assets, return of assets (straight line depreciation method, based on remaining mine life) and efficient operating expenditure. Determination of Economic Cost also requires a regulatory value of the assets, which is rolled forward each year to account for depreciation and prudent capital expenditure and forms the RAB Floor Limit.

Importantly, section 4 of the HVAU only relates to the total amount of revenue that is recoverable by ARTC through Access Charges. The HVAU does not specify how revenue from the charges is to be allocated to particular Pricing Zones or Segments for the purposes of compliance with the combinatorial matrix in sections 4.2 and 4.3 of the HVAU.

2.2 Revenue allocation

ARTC collects revenue from producers by applying various Access Charges as they traverse each part of the network.

For each Pricing Zone, ARTC levies Access Charges that include a variable charge to cover Direct Costs (a non-take-or-pay (**non-TOP**) charge) and a fixed charge (**TOP** charge) to cover remaining operating and capital costs. For example, the Access Charges applying in PZ1 are intended to cover both variable and fixed operating and capital costs attributed to PZ1, PZ2 and PZ3 producers through their combined use of the Segments in PZ1.

Additionally, both the TOP and non-TOP Access charges that ARTC levies are based on a one thousand gross tonne kilometre basis (**\$kgtkm**).

Based on confidential financial modelling provided by ARTC, the ACCC understands that ARTC implements the following process in allocating revenues it receives from Access Charges:

⁸ The HVAU defines 'Direct Costs' as efficient maintenance expenditure and other costs that vary with the usage of the network but excluding depreciation. The HVAU also includes an objective to recover 'Incremental Costs'. Incremental costs are defined as all costs that could be avoided in the medium term if a Segment was removed from the network.

⁹ See section 4.5 of the HVAU.

- Firstly, ARTC charges producers based on the number of gross tonne kilometres (**gtk**m) used by each producer as they traverse each Segment which forms part of their journey. As indicated above, under the HVAU, the receipt of non-TOP revenue is based on the Direct Cost (variable component of costs) that the producer imposes on particular Segment(s). The receipt of TOP revenue is based on indirect or 'common costs' (fixed component of costs and new capital component of costs) that producers impose on particular Segment(s) within a particular pricing zone.¹⁰
- ARTC then allocates revenue to each Segment based on the Direct Cost and share of common costs imposed by producers on that Segment. Common costs are allocated in accordance with the cost allocation factors in section 4.6 of the HVAU. In particular, the common costs are allocated using either train kilometres or gtkm as the cost driver.¹¹
- However, in the case of revenue received by ARTC to cover the common costs of PZ3 producers as they traverse the Segments in PZ1, this revenue is distributed to the Segments in PZ3 even though the revenue was originally allocated to the PZ1 Segments.
- It is after this distribution that ARTC then conducts revenue reconciliation to determine whether there has been a revenue shortfall or surplus in PZ1 and PZ2 (the 'constrained' part of the network).¹²

The ACCC understands that the effect of ARTC's approach to revenue distribution is that producers originating in PZ3 pay only for the Direct Costs as they traverse the network in PZ1. The remainder of revenue received from PZ3 producers as they traverse PZ1 is instead allocated to reduce the capitalised losses in PZ3. As such, all of the remaining operating and capital costs of the rail network in PZ1 are incurred by producers originating in PZ1 and PZ2.¹³ This revenue distribution is illustrated in the diagram in **Appendix A**.

2.3 Revenue reconciliation

After revenue is distributed as above, revenue is reconciled as specified in subsection 4.10(d) of the HVAU. Reconciliation of revenue received that is within the Ceiling Limit is applied differently for various parts of the network as follows:

- For the 'constrained' part of the network¹⁴ an 'unders and overs' accounting framework applies.¹⁵ If ARTC's revenue is less than Economic Cost in a compliance period, then the HVAU provides that ARTC is entitled to recover this revenue 'shortfall' from Constrained Coal Customers in PZ1 and PZ2.¹⁶ If ARTC's revenue exceeds Economic Cost, then ARTC is required to refund this over-recovery to Constrained Coal Customers.¹⁷
- 'Loss capitalisation' applies in PZ3 only,¹⁸ which currently forms part of the 'unconstrained' network.¹⁹ ARTC is allowed to capitalise revenue shortfalls into the PZ3 RAB for recovery

¹⁰ See section 4.13 of the HVAU.

¹¹ For example, corporate overheads and network control centre costs are allocated using train kilometres as the cost driver, whereas maintenance overheads are allocated using gtkm as the cost driver.

¹² The 'constrained' part of the network comprises the majority of Hunter Valley Rail Network in PZ1 and PZ2, where ARTC is expected to recover its full Economic Cost.

¹³ This occurs while PZ3 is part of the 'unconstrained' network and therefore 'loss capitalisation' (rather than 'unders and overs' accounting) applies.

¹⁴ See footnote 12 above.

¹⁵ See section 4.9 of the HVAU.

¹⁶ See subsection 4.9(b)(iii) of the HVAU.

¹⁷ *ibid.*

¹⁸ See subsection 4.3(b) of the HVAU.

¹⁹ The 'unconstrained' part of the network comprises all of the rail segments in PZ3 (as well as a small number of segments in PZ1) where there is currently not enough volume to enable ARTC to fully recover Economic Cost. There is currently relatively lower demand for rail services in the Gunnedah Basin due to

in future periods. Once ARTC is able to recover the Economic Cost of PZ3 (including the losses capitalised from previous years), then the 'unders and overs' accounting framework (as in PZ1 and PZ2) applies. This is because the whole network becomes 'constrained'.

In its 2012 Annual Compliance submission to the ACCC, ARTC identified that it had under-recovered \$4.82 million in revenue in the constrained part of the network and sought to recover this amount from PZ1 and PZ2 producers via the 'unders and overs' accounting framework. ARTC also capitalised cumulative losses of \$10.44 million in PZ3.

The ACCC notes that absent the revenue distribution noted in section 2.2 above, ARTC would have over-recovered revenue in the constrained part of the network and would be required to refund this over-recovery to PZ1 and PZ2 producers, while the 'loss' to be capitalised in PZ3 would have been higher.

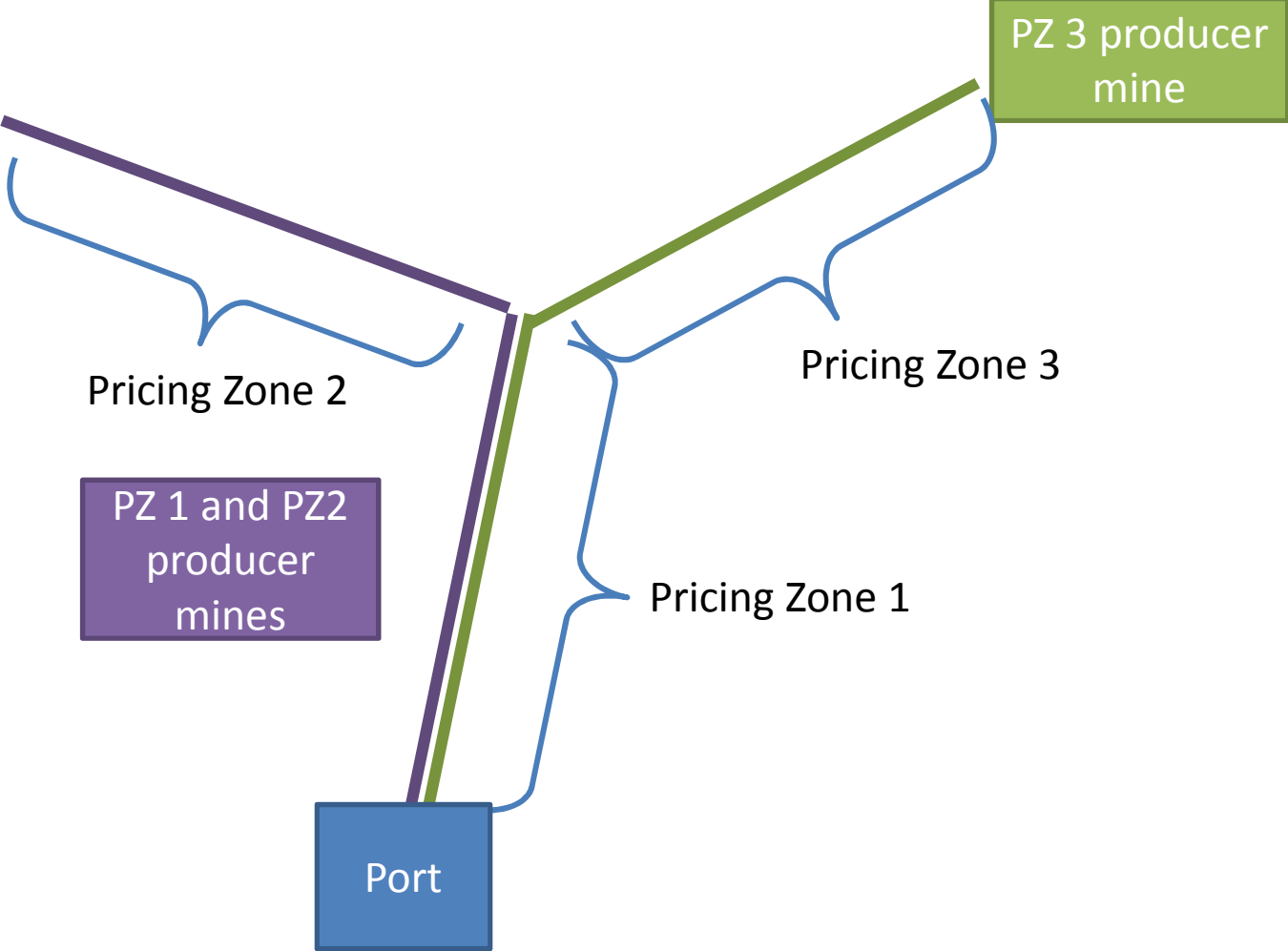
Questions for stakeholders

1. What information has ARTC provided to stakeholders about its revenue allocation practices?
2. To the extent that ARTC has provided information on revenue allocation, has it been sufficient to understand how ARTC allocates revenue across Segments of the network?
3. Do stakeholders consider they have sufficient information about ARTC's revenue allocation/reconciliation processes to make informed business and investment decisions? If not, please provide reasons why.
4. Please identify and explain any other matters relevant to this revenue allocation review.

the start-up nature of coal mines in the region, and ARTC is not expected to recover its full Economic Cost in the short term. As such, during the assessment process for acceptance of the HVAU by the ACCC under Part IIIA of the Act, the ACCC considered that the loss capitalisation model was appropriate to encourage investment in new assets where there was limited initial demand.

A Illustration of revenue distribution

The Network

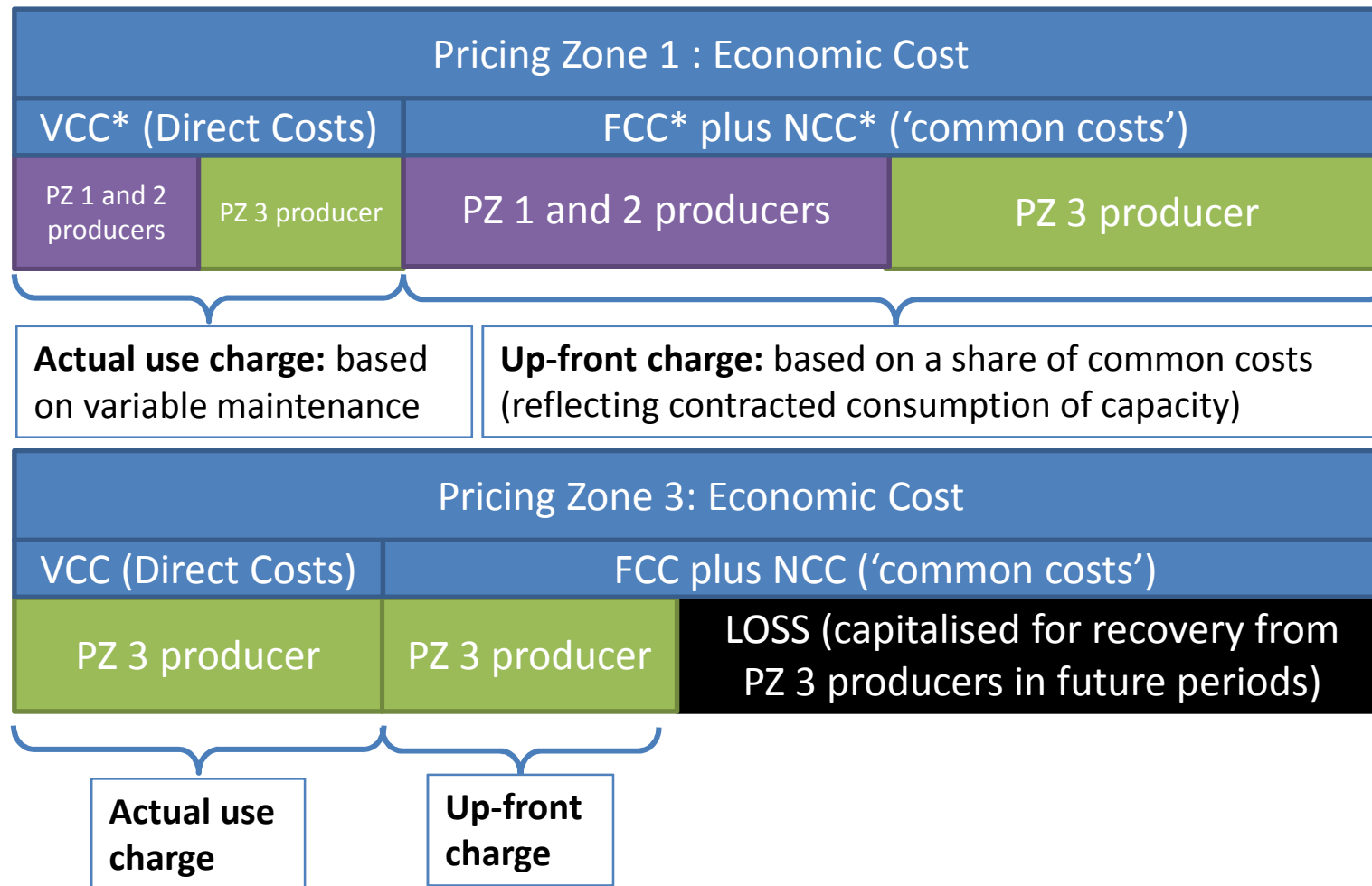


Maximum allowable revenue = Economic Cost

Pricing Zone 1 : Economic Cost	
VCC (Direct Costs)	FCC plus NCC ('common costs')
maximum allowable revenue	

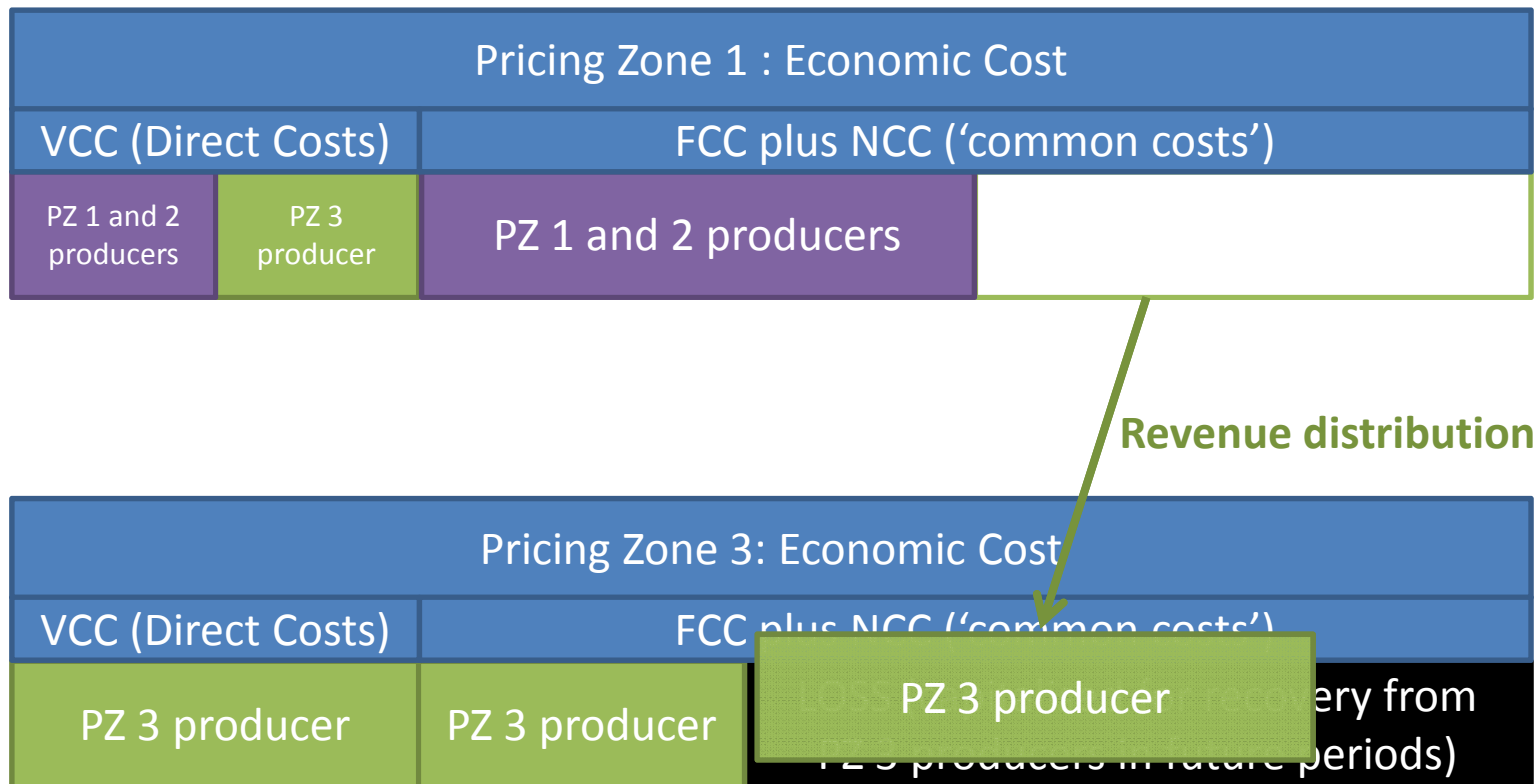
Pricing Zone 3: Economic Cost	
VCC (Direct Costs)	FCC plus NCC ('common costs')
maximum allowable revenue	

Revenue is received, based on use of the network...



* VCC is variable component of costs, FCC is fixed component of costs and NCC is new capital component of costs

...some revenue from PZ3 producer is distributed...



...then total revenue is “reconciled” to Economic Cost.

Pricing Zone 1 : Economic Cost			
VCC (Direct Costs)		FCC plus NCC ('common costs')	
PZ 1 and 2 producers	PZ 3 producer	PZ 1 and 2 producers	“under recovery” paid by PZ 1 and 2 producers

↑
PZ1 and 2 producers to pay extra due to ‘unders and overs’

Pricing Zone 3: Economic Cost			
VCC (Direct Costs)		FCC plus NCC ('common costs')	
PZ 3 producer	PZ 3 producer	PZ 3 producer	LOSS

↑
Smaller loss to be recovered from PZ3 producer in future periods through ‘loss capitalisation’