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sent by email

Dear Interested Party

### **Re: 2016 Hunter Valley Access Undertaking – preliminary views**

The purpose of this letter is to outline the ACCC's preliminary views on the (now withdrawn) 2016 Hunter Valley Access Undertaking (**2016 HVAU**) submitted by ARTC to the ACCC on 23 December 2015 pursuant to Part IIIA of the *Competition & Consumer Act 2010* (Cth) (**CCA**).

This letter aims to facilitate the ongoing negotiations between ARTC and industry in the development of a revised undertaking for submission to the ACCC, by providing clarity as to the ACCC's position on a number of key issues in ARTC's withdrawn 2016 HVAU.

The ACCC encourages ARTC and industry to continue negotiations and reach agreement on issues where possible. The ACCC is of the view that any narrowing of the matters in dispute will result in all parties' resources being better directed during the formal assessment process.

### **Background**

On 23 December 2015, ARTC submitted an access undertaking to the ACCC in relation to the provision of access to the Hunter Valley Rail Network operated by ARTC in New South Wales. The ACCC previously accepted an access undertaking in relation to the Hunter Valley Rail Network on 29 June 2011. On 22 June 2016, the ACCC approved a six month extension of the term of the 2011 HVAU to 31 December 2016.

On 8 January 2016, the ACCC published an initial consultation paper providing an overview of the 2016 HVAU and seeking submissions from stakeholders. In response to the consultation paper the ACCC received 12 stakeholder submissions.<sup>1</sup> Overall, stakeholder submissions reflected the view that it would not be appropriate to accept the 2016 HVAU in its proposed form.

On 14 June 2016, ARTC withdrew the 2016 HVAU from the ACCC's consideration. ARTC advised the ACCC that it "intends to resubmit a revised access undertaking providing for recent ACCC Compliance period decisions following implementation of the extension period

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<sup>1</sup> Stakeholder submissions were received from: Asciano, Aurizon, Bloomfield, Centennial Coal, Glencore, Hunter Rail Access Task Force, Hunter Valley Coal Chain Coordinator, Hunter Valley Energy Coal, Idemitsu, Independent Pricing and Regulatory Tribunal, Port Waratah Coal Services, and Whitehaven Coal.

and re-engaging with Customers on important aspects reflected in their submissions to the ACCC on the original submission”.

### **Preliminary views**

The ACCC is required to assess access undertakings in accordance with the legislative criteria set out in subsection 44ZZA(3) of the CCA. Based on its assessment against these criteria, the ACCC may either accept or reject the proposed access undertaking.

This letter provides the ACCC’s preliminary views on ARTC’s 2016 HVAU. **Annexure 1** sets out the provisions of the 2016 HVAU. Each section provides a brief summary of the relevant provision of the HVAU, and preliminary views on that provision.

All views expressed by the ACCC in this letter, and in discussions with ARTC and stakeholders, do not represent the ACCC’s final views on the 2016 HVAU or any revised application. Any views expressed will be subject to further consideration taking into account a revised 2016 HVAU application; submissions on a revised undertaking, any other relevant information received in the course of the assessment of a revised 2016 HVAU, and any further consultation undertaken by the ACCC. The ACCC will assess a revised 2016 HVAU in accordance with the matters set out in subsection 44ZZA(3) of the CCA.

### **Next steps**

The ACCC understands that ARTC will shortly be engaging with industry and the ACCC prior to submitting a revised HVAU. The ACCC notes that it is also available to meet with stakeholders to further discuss the preliminary views outlined in this letter, at stakeholders’ request.

The ACCC expects that the assessment of a revised 2016 HVAU application will be finalised in a timely manner and considers the extension of the 2011 HVAU to December 2016 will provide sufficient time to conclude the assessment process. The ACCC recognises however that the speed at which this can be done rests in the hands of ARTC and other stakeholders.

The following table outlines an indicative timeline for the assessment of the revised 2016 HVAU.

<b>Date</b>	<b>Event</b>
23 December 2015	Lodgement of 2016 HVAU
14 June 2016	Withdrawal of 2016 HVAU by ARTC
July 2016	ACCC consultation with ARTC and stakeholders on revised 2016 HVAU
August 2016	ARTC submits revised HVAU
September 2016	Draft decision on revised 2016 HVAU
October/November 2016	Final decision on revised 2016 HVAU
31 December 2016	Expiry of the 2011 HVAU

If you have any questions in relation to this letter, or the undertaking assessment process, please contact Grant Kari on 03 9290 1807 or [grant.kari@acc.gov.au](mailto:grant.kari@acc.gov.au).

Yours sincerely

A handwritten signature in black ink, appearing to read 'Michael Cosgrave', with a horizontal line underneath.

Michael Cosgrave  
Executive General Manager  
Infrastructure Regulation Division

## Annexure 1: ACCC's preliminary views on ARTC's withdrawn 2016 HVAU application

Matter	ARTC proposal	ACCC's preliminary views
Term	<p>A term of 10.5 years, increasing from 5 years under the 2011 HVAU, with a recurring option of an additional five year extension. The additional half-year aligns the HVAU with the calendar year, making it consistent with the operation of the undertaking and access agreements.</p> <p>Six years before the expiry of the undertaking, there is a mandatory review into depreciation calculation, rate of return, loss capitalisation and term extension (other matters can be considered at the discretion of ARTC).</p> <p>The ACCC's role is limited to accepting or rejecting proposed variations arising from the review. If the ACCC rejects these, ARTC must refer the matter the Australian Competition Tribunal.</p> <p>As the 22 June 2016 application to extend the 2011 HVAU was accepted, the term of the undertaking will likely be 10 years in order to be aligned with the calendar year.</p>	<p>ARTC's proposal on term is likely to be appropriate, subject to amendments to the periodic review process. A number of amendments should be made to the periodic review process before it is considered appropriate. In particular:</p> <ul style="list-style-type: none"> <li>• an amendment of the scope of the periodic review mechanism to include a review of any performance incentive mechanism, and network key result areas; and</li> <li>• in the event ARTC decides not to extend the HVAU for a further term at the time of the periodic review ARTC should be required to outline the relevant transitional steps for any current access holder agreements at the time of expiry of the HVAU.</li> </ul> <p>ARTC have advised the ACCC that the mandatory referral to the Australian Competition Tribunal, if the ACCC decides to reject a variation arising from the periodic review, will be removed in a revised HVAU application.</p>
Minor variation process	<p>ARTC has proposed a new 'minor variation' process to allow amendments to selected administrative provisions without triggering the formal variation process outlined in the CCA (subsection 44ZZA(7)). These administrative provisions include insurance, contact details, the Services Envelope, network Key Result Areas, the Network, Performance Measurements, and Segments. At least 70 per cent of the Rail Capacity Group (based on Train km voting shares) needs to endorse the 'minor variation'.</p>	<p>ARTC's proposal is not likely to be appropriate. The ACCC is of the initial view that the scope of the specific categories of 'minor variation' go beyond what would be considered 'minor'. The specified administrative provisions could affect the ACCC's view of the subsection 44ZZA(3) matters to which it must have regard in deciding whether to accept a variation of the undertaking.</p>
Loss capitalisation	<p>Loss capitalisation is proposed to continue in the 2016 HVAU. It allows ARTC to recover revenue shortfalls sustained in Pricing Zone 3 during earlier periods, at a later period in time from Pricing Zone 3 access holders.</p>	<p>ARTC's proposal is likely to be appropriate.</p>

Matter	ARTC proposal	ACCC's preliminary views
Regulatory asset base (RAB)	This section outlines the initial values for the RAB and RAB floor limit (covering the direct cost), the roll over mechanism from one year to the next, and any new segments incorporated after the start of the undertaking would be valued using the Depreciating Optimised Replacement Cost (DORC) method.	ARTC's proposal is likely to be appropriate. No comments were made on this issue in any submission.
Remaining mine life	Remaining mine life (RML) determines the level of asset depreciation for ARTC. ARTC proposes that mine life remain 22 years from 1 July 2010, with depreciation calculated using the straight-line method. Further, this means new assets would have an expected mine life of 16 years if the undertaking commences 1 July 2016. The 2011 HVAU and proposed 2016 HVAU uses Weighted Average Mine Life (WAML) based on mine reserves to calculate remaining mine life.	<p>ARTC's proposal is not likely to be appropriate. Broadly, the ACCC views the proposed RML as too short.</p> <p>The ACCC accepts the use of WAML to calculate RML as it is advocated by both ARTC and industry. However, the ACCC agrees with industry that prospective mines should be included in this calculation.</p> <p>The ACCC's view is that a future undertaking should clearly specify a transparent process and data sources for calculating WAML, including the process for including prospective mines.</p>
Costing manual	A Costing Manual is proposed by ARTC which identifies the mechanism by which assets and costs shared across segments are attributed or allocated. This is partly due to the allocation mechanism (GTK and Train km) for indirect costs in the 2011 HVAU being broadly defined and poorly recognising costs associated with the network. In the case of the latter, for example, ARTC calculates that the new method would result in an additional \$5.5 million being allocated to the network.	<p>ARTC's proposal is not likely to be appropriate.</p> <p>The ACCC considers that ARTC needs to:</p> <ul style="list-style-type: none"> <li>• provide more justification (both quantitatively and qualitatively) of allocators used to address potential incentives to inappropriately allocate costs to the Hunter Valley network</li> <li>• potentially change the choice of allocator for some costs.</li> </ul>

Matter	ARTC proposal	ACCC's preliminary views
Weighted average cost of capital	<p>A pre-tax real weighted average cost of capital of 6.74 per cent. This includes a discount of 0.09 per cent on the calculated weighted average cost of capital (6.83 per cent) to 'demonstrate its commitment to a workable solution'.</p> <p>The values of key parameters in the calculated weighted average cost of capital are:</p> <ul style="list-style-type: none"> <li>• 1.5 per cent for inflation</li> <li>• 6.5 per cent for market risk premium</li> <li>• 0.40 for gamma</li> <li>• 0.47 for asset beta.</li> </ul>	<p>ARTC's proposal is not likely to be appropriate.</p> <p>The ACCC considers a pre-tax real weighted average cost of capital of 6.74 per cent as too high, with the values of several key parameters needing revision.</p> <p>The ACCC recognises that the risk free rate and the debt risk premium will need recalculating prior to finalising the next undertaking. However, the ACCC believes an agreed transparent process for calculating these should be adopted.</p>
Path based pricing	<p>The 2011 HVAU specifies access prices using the concept of 'indicative service', which vary according to train characteristics. The 2016 HVAU proposed to adopt 'path based pricing' where access pricing for each pricing zone is largely independent of train characteristics, if the train specification fits into the 'Services Envelope'. Services Envelope characteristics include maximum length, axle load, speed empty and speed loaded.</p> <p>Access prices are comprised of a Take or Pay (<b>TOP</b>) component (measured in \$ per Train km) and a non-TOP component (measured in \$ per GTK). The TOP component recovers fixed operating and capital cost while the non-TOP component covers variable maintenance costs. It should be noted that the non-TOP component in the 2011 HVAU was levied on a \$ per GTK basis.</p>	<p>The ACCC engaged Frontier Economics to assess the proposed move to path based pricing. The ACCC has published the report by Frontier Economics. The report is available on the ACCC's website at: <a href="http://www.accc.gov.au/regulated-infrastructure/rail/hunter-valley-access-undertaking-2016/path-based-pricing-proposal-report">http://www.accc.gov.au/regulated-infrastructure/rail/hunter-valley-access-undertaking-2016/path-based-pricing-proposal-report</a>.</p> <p>The ACCC is still considering the report and submissions provided, and is yet to reach a view on this issue.</p>

Matter	ARTC proposal	ACCC's preliminary views
Capacity management	<p>There are several mechanisms in the HVAU and Indicative Access Holder Agreement (<b>AHA</b>) designed to facilitate coordination and cooperation between parties in the Hunter Valley coal chain. The provisions relating to capacity management are important to achieving overall supply chain alignment.</p> <p>These include the tripartite contracting structure, the requirement for consultation with the HVCCC, network exit capability, consistent protocols ('system assumptions') for capacity management, a mechanism for the relinquishment of capacity, and the capacity investment framework.</p> <p>The key change proposed by ARTC in the 2016 HVAU is a strengthening of the engagement obligations in Schedule G, which set out the principles that guide ARTC / HVCCC consultation. ARTC is required to follow this process wherever the HVAU obliges it to consider the views of the HVCCC (for example, in determining whether there is sufficient capacity on the network to accommodate a request for access). ARTC included these provisions as a result of discussions with HRATF during 2015.</p>	<p>The ACCC notes that the capacity management provisions in the HVAU are considered by HRATF to have 'generally worked well'. This view is reflected in the minimal changes that ARTC proposed for the 2016 HVAU.</p> <p>Regarding ARTC's consultation obligations with the HVCCC, the ACCC maintains the view from the 2011 Final Decision that the 2016 HVAU should not impose strict rules which oblige ARTC to comply with the HVCCC's views.</p> <p>In light of this, ARTC's proposed amendments to Schedule G are likely to be appropriate as they provide additional clarity around the HVCCC consultation process when compared to that accepted in the 2011 HVAU.</p> <p>In its submission to the ACCC's consultation paper, HRATF proposed a number of additional amendments to Schedule G to 'improve' and clarify the operation of certain elements in relation to capacity management.</p> <p>The ACCC agrees with HRATF's suggested amendments where they provide further certainty to the obligations without unduly restricting ARTC's ability to manage its network (for example, by seeking to impose timeframes within which ARTC is to comply with specific obligations).</p>

Matter	ARTC proposal	ACCC's preliminary views
<p>Capacity Investment Framework and Rail Capacity Group (RCG)</p>	<p>The Capacity Investment Framework in the 2016 HVAU comprises three steps:</p> <ul style="list-style-type: none"> <li>• project initiation—new project providing additional capacity are identified for endorsement by RCG</li> <li>• industry consultation—where industry is represented by the RCG.</li> <li>• user funding—users have an option to fund a project if ARTC elects not to fund.</li> </ul> <p>ARTC propose to expand the role of the RCG to include a greater level of consultation in the decision making process. As a result, ARTC consider it appropriate to extend membership to all coal Access Holders so that they are directly involved in decision making. In keeping with the move to path based pricing, the weighting for voting has been adjusted from GTK to Train km.</p> <p>ARTC also propose to remove the requirement for monthly meetings, this would avoid requiring meetings over the Christmas period.</p>	<p>ARTC's proposal is likely to be appropriate.</p> <p>The ACCC's initial view is that extending membership of the RCG to all coal access holders will provide a greater level of consultation.</p> <p>Whilst the ACCC considers the removal of the requirement for monthly meetings may increase efficiencies, it considers that a minimum number of meetings should be set in order to provide certainty for members of the RCG.</p> <p>The ACCC has not yet reached a view on the change to voting based on Train km.</p>
<p>User funding</p>	<p>The objective of the 'user funding' option is to provide a flexible mechanism whereby industry can fund projects where ARTC elects not to do so. If ARTC ceases or refuses development of a project, a user-funding agreement may be negotiated between ARTC and a 'Contributor'. The dispute resolution mechanism set out in section 3.15 of the 2016 HVAU provides a path through to ACCC arbitration in the event of a dispute as to the terms of a user funding agreement.</p> <p>For the 2016 HVAU, ARTC does not propose any substantive changes to the user funding provisions from the 2011 HVAU.</p>	<p>ARTC's proposal is likely to be appropriate</p> <p>The ACCC considers the user funding provisions in the 2016 HVAU will continue to act as an incentive for ARTC to pursue projects that provide additional capacity, noting that ARTC will not earn a return on user funded contributions.</p> <p>The Hunter Valley rail network is now entering a phase targeting efficiency and maintenance rather than expansion. Given it is unlikely that there will be substantial demand for expansion over the next five years, the ACCC supports HRATF's view that the time and expense associated with developing a fit for purpose user funding framework for the 2016 HVAU is likely not justified in the current environment.</p>



Matter	ARTC proposal	ACCC's preliminary views
Performance measurement and incentives	<p>ARTC has proposed a performance incentive scheme to improve operating, maintenance and capital expenditure efficiency.</p> <p>The 2016 HVAU specifies that:</p> <ul style="list-style-type: none"> <li>• within 18 months of the start of the 2016 HVAU, ARTC will be required to prepare an incentive mechanism to reduce operating expenditure (Efficiency Incentive Proposal).</li> </ul> <p>An Innovation Incentive Mechanism is also proposed, which provides ARTC with incentives to identify, promote and implements projects, change practices or technologies that are innovative and not in the ordinary course of business.</p>	<p>ARTC's proposal is not likely to be appropriate. The ACCC is particularly concerned about the delay in implementing the mechanism and the lack of detail of what a mechanism will look like. Specifically, ARTC only provides a <i>process</i> in the 2016 HVAU to develop an opex efficiency incentive mechanism. The ACCC also has concerns about the potential overlap and interaction between the Innovation Incentive mechanism and the potential opex efficiency incentive mechanism.</p> <p>On 29 April 2016, ACCC staff and ARTC held a workshop in Newcastle discussing options for the opex efficiency incentive mechanism. Following this workshop ARTC has committed to amending the opex efficiency incentive mechanism in the 2016 HVAU to address ACCC concerns. ARTC has advised that they will be discussing the amendments with industry before providing them to the ACCC. ARTC intend a greater level of involvement of the RCG in the consideration of opex.</p>
True Up Test (TUT)	<p>The TUT determines whether there was sufficient capacity available on the rail network in a given period to meet all contracted entitlements, taking into account reductions in capacity caused by maintenance, usage by non-coal trains and other factors. If the TUT test finds ARTC has not provided sufficient capacity, then ARTC must rebate charges to affected users. No rebates have been paid by ARTC.</p> <p>The annual TUT audit is proposed to be retained.</p>	<p>ARTC's proposal is likely to be appropriate.</p> <p>Although a number of concerns were raised in submissions about the efficacy of the TUT, the ACCC has not been provided with evidence of instances where contracted entitlements were not provided by ARTC and the TUT has resulted in rebates not being paid in circumstances where it is considered they should have been.</p> <p>The ACCC is also of the view that an obligation for ARTC to rotate the TUT auditor used for the annual TUT audit process should be included in a revised 2016 HVAU.</p>

<b>Matter</b>	<b>ARTC proposal</b>	<b>ACCC's preliminary views</b>
<p>Indicative Access Holder Agreement (<b>AHA</b>) and Operator Sub-Agreement (<b>OSA</b>)</p>	<p>The AHA sets out the terms and conditions that ARTC grants access to the network for coal transport for access holders. The OSA is an agreement between ARTC and an accredited operator (that is, a rail operator).</p> <p>There are no substantive changes to either the AHA or OSA.</p> <p>ARTC proposes some minor changes necessary to the AHA for the transition to path based pricing. The AHA is also proposed to be amended to require Access Holders to nominate a port terminal exit point (NCIG or PWCS) for their coal export volumes.</p>	<p>The ACCC is yet to form a view on the appropriateness of the changes to the AHA and OSA, in particular the requirement for binding terminal exit capacity for coal export volumes.</p> <p>The ACCC considers that further information is required in order to assess this issue. We will shortly be seeking this information from ARTC and stakeholders.</p>
<p>Privatisation</p>	<p>ARTC has included section 2.2(c) at the requests of its shareholder. The section requires that in the event that ARTC is privatised, ARTC will use its 'best endeavours' that the new owners develop an undertaking on the same terms as the 2016 HVAU.</p>	<p>The ACCC's view is that some form of external compulsion by government mandating the appropriate regulatory arrangements must be implemented. There is no form of drafting that can be included in the HVAU alone that will provide sufficient regulatory certainty for users of the Hunter Valley rail network.</p>
<p>Information gathering provision</p>	<p>The inclusion of an information gathering provision does not form part of ARTC's proposal.</p>	<p>The ACCC's initial view is that any future HVAU needs to include provisions setting out information gathering powers by the ACCC. The inclusion of a formal information gathering provision is necessary to increase the ACCC's current ability to obtain relevant information, in a timely manner.</p> <p>The ACCC currently has similar powers in relation to annual compliance under the 2011 HVAU. The ACCC considers this would provide a consistent approach under the HVAU.</p> <p>Information gathering provisions have been included in previous Part IIIA undertakings accepted by the ACCC, for example the wheat port access undertakings.</p>