Draft Determination

Australian Rail Track Corporation's compliance with the Hunter Valley Coal Network Access Undertaking financial model for the 2013 calendar year

30 October 2015

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Summary

The Australian Competition and Consumer Commission (**ACCC**) has conducted an assessment of the Australian Rail Track Corporation's (**ARTC's**) compliance with the financial model in the Hunter Valley Coal Network Access Undertaking (**HVAU**) for the period 1 January 2013 to 31 December 2013 (**the 2013 calendar year**). The ACCC's Draft Determination is that ARTC has:

- Demonstrated the prudency of its net capital expenditure and has rolled forward the amount into its regulatory value of assets in accordance with the HVAU financial model, subject to correction of an error related to disposals.
- Demonstrated the efficiency of the majority of its operating expenditure that informs its revenue allowance in accordance with the HVAU financial model, with some further information required from ARTC before the ACCC can form a view on the remaining expenditure.
- Not complied with respect to its application of the ceiling limit test in the HVAU financial model because some Access Holders are being asked to pay more than their standalone costs.

The ACCC is now seeking submissions from interested parties on any aspect of this Draft Determination by 27 November 2015. Details on how to make a submission are provided in chapter 1.

ARTC's Hunter Valley rail network is regulated through the HVAU. The HVAU financial model allows ARTC to recover revenue equivalent to its efficient costs in each calendar year for the 'Constrained Network' (currently comprising of rail segments in Pricing Zones 1 and 2), while allowing ARTC to capitalise revenue shortfalls for Pricing Zone 3 into its regulatory value of assets for recovery in future years.[1] ARTC is required to annually submit documentation to the ACCC for an assessment of its compliance with the HVAU financial model.

ARTC submitted documentation for the 2013 calendar year to the ACCC in May 2014. ARTC submitted that its total efficient costs for the Constrained Network to be recovered from 'Constrained Coal Customers' were $297.5 million and that it had a $19.6 million shortfall in the revenue it received for the Constrained Network for the period. ARTC proposed to recover this shortfall from 'Constrained Coal Customers' (currently comprising of Access Holders whose mines are in Pricing Zones 1 and 2).[2] ARTC also submitted that it had a revenue shortfall for Pricing Zone 3 and proposed to capitalise cumulative losses of $8.8 million into its regulatory asset base for future recovery.[3]

The ACCC consulted with stakeholders on the key issues of prudency of capital expenditure, efficiency of operating expenditure and reconciliation of revenues through a Consultation Paper in June 2014 and a Position Paper in November 2014. The ACCC also issued a Discussion Paper in May 2014 to consult with stakeholders specifically on ARTC's approach

[1] 'Constrained Network' is defined in section 14.1 of the HVAU. In general terms, the Constrained Network currently comprises rail segments in Pricing Zones 1 and 2 where there is enough volume to enable ARTC to recover its efficient costs each calendar year. 'Loss capitalisation' applies to Pricing Zone 3 because, during the development of the HVAU, there was relatively lower demand for rail services due to the start-up nature of coal mines in the region and, therefore, ARTC was not expecting to be able to recover its efficient costs in each calendar year. ARTC proposed the loss capitalisation model as a way to encourage investment in new assets where there was limited initial demand.

[2] 'Constrained Coal Customer' is defined in section 14.1 of the HVAU. A Constrained Coal Customer is a coal producer that originates in the Constrained Network, which are currently producers whose mines are in Pricing Zones 1 and 2.

[3] Cumulative losses capitalised as at the end of the 2013 Compliance Period include capitalised losses from 2011, 2012 and 2013.

to revenue allocation and reconciliations with applicable ceiling revenue limits. Taking into account stakeholder's comments, a summary of the ACCC's views on each of the key issues is outlined below.

Prudency of capital expenditure

ARTC sought to roll forward into its regulatory value of assets total net capital expenditure of $155.2 million, comprising of 'major' capital expenditure of $126.9 million plus 'minor' capital expenditure of $29 million plus interest during construction of $5.4 million less loss on disposals of $6.2 million. Of the total net capital expenditure, ARTC attributed $12.95 million to Pricing Zone 3.

The ACCC is satisfied that ARTC has demonstrated the prudency of its major and minor capital expenditure as well as interest during construction. Notably, ARTC provided documentation showing that stakeholders had approved the expenditure and that interest during construction had been calculated in accordance with the methodology provided for in the HVAU financial model.[4] However, the ACCC identified an error in ARTC's submission in relation to the loss on disposals. In particular, ARTC had subtracted from the regulatory value of assets only the net loss on disposals amount of $6.2 million rather than the total value of disposals of $6.98 million.

Accordingly, the ACCC's Draft Determination is that the loss on disposals should be revised to $6.98 million and, therefore, ARTC may roll forward net capital expenditure of $154.4 million into its regulatory value of assets for the 2013 calendar year. The amount attributed to Pricing Zone 3 is also revised to $13.04 million. The ACCC notes that these revisions have some flow on effects to, for example, the calculation of depreciation and return on assets for the 2013 calendar year.

Efficiency of operating expenditure

ARTC sought to recover operating expenditure of $102.7 million for the Constrained Network, consisting of $82.8 million in maintenance and expensed project costs and $20 million in network control costs and corporate overheads. ARTC also sought to recover operating expenditure of $17.3 million for Pricing Zone 3.

The ACCC is satisfied that ARTC has demonstrated the efficiency of the majority of the operating expenditure that it has sought to recover for the Constrained Network. Notably, since the November 2014 Position Paper, ARTC has provided the ACCC with additional information on maintenance costs. This information included historical and forecast costs for maintenance activities, as well as contextual information to explain reasons for variances in expenditures for the 2013 calendar year. The ACCC considers that this additional information was sufficient to demonstrate that ARTC's maintenance costs for the Constrained Network are efficient and, therefore, the ACCC's Draft Determination is that ARTC's may recover the $73.8 million in maintenance costs in the 2013 calendar year.

In the November 2014 Position Paper, the ACCC noted that ARTC had sought to recover $8.97 million of costs associated with the concept assessment of the Port Waratah Coal Services (PWCS) Terminal 4 (T4) expansion in its operating expenditure for the Constrained Network. One stakeholder raised concern, submitting that all Access Holders should pay a proportionate share of the costs and querying whether, in light of ARTC's reconciliations with applicable ceiling revenue limits, this was occurring. The ACCC's views on this particular issue are provided below. As the HVAU allows ARTC to expense costs associated with undertaking a concept assessment in the year incurred, the ACCC's Draft Determination is

[4] The HVAU provides that, if stakeholders have approved capital expenditure, then that capital expenditure is to be treated as prudent and ARTC can roll forward the amount into its regulatory value of assets.

that ARTC's approach in this instance is appropriate and that ARTC may recover the $8.97 million in project costs in the 2013 calendar year.

In relation to network control costs, ARTC incurred unusually higher costs during 2012 and provided no clear explanation as to why network control costs remain at those levels for the 2013 calendar year. The ACCC will seek further information from ARTC as to the reasons for higher network control costs during 2013 before forming a final view on the efficiency of network control costs of $9.3 million. However, based on the information provided by ARTC, the ACCC's Draft Determination is that ARTC's corporate overheads of $10.7 million for the Constrained Network are efficient and that ARTC may recover this amount in the 2013 calendar year.

In relation to Pricing Zone 3, the ACCC is not satisfied that the information provided by ARTC is sufficient to explain the level of ARTC's maintenance costs of $12.9 million for the 2013 calendar year. Similarly, the ACCC is not satisfied that ARTC has demonstrated the efficiency of its network control costs and overheads of $4.4 million for Pricing Zone 3. The ACCC will seek further information from ARTC before forming a view on the efficiency of these costs for the 2013 calendar year.

Reconciliations with applicable ceiling revenue limits

As previously noted, the HVAU financial model allows ARTC to recover revenue equivalent to its efficient costs in each calendar year for the 'Constrained Network' and to capitalise revenue shortfalls for Pricing Zone 3 into its regulatory value of assets for recovery in future years. The total efficient cost incorporates allowances for return on assets, return of assets (depreciation) and efficient operating expenditure.

ARTC provided a detailed calculation of the total efficient costs for the Constrained Network, submitting that $297.5 million was to be recovered from Constrained Coal Customers for the 2013 calendar year. ARTC further submitted that, because there were cumulative losses for Pricing Zone 3, it did not need to provide detailed reconciliations with applicable ceiling revenue limits for Pricing Zone 3.

The ACCC notes that the figure for total efficient costs will need to be revised to take account of the amendments to the net capital expenditure figure noted above as well as any necessary associated adjustments to depreciation and return on assets. However, subject to these revisions, the ACCC's Draft Determination is that ARTC is entitled to recover the total efficient costs of the Constrained Network for the 2013 calendar year in accordance with the HVAU financial model.

In relation to revenue received in the 2013 calendar year, ARTC submitted that it had received $277.9 million from Constrained Coal Customers and $65.1 million from Pricing Zone 3 Access Holders. ARTC submitted that all of the revenue received from Constrained Coal Customers was to be reconciled with the efficient costs incurred within the Constrained Network. Of the amount of revenue received from Pricing Zone 3 Access Holders, ARTC submitted that $2.5 million was to be reconciled with the efficient costs incurred within the Constrained Network and $62.6 million was to be reconciled with the efficient costs incurred in Pricing Zone 3.

In the November 2014 Position Paper, the ACCC noted that ARTC had calculated the proportion of the efficient costs incurred within the Constrained Network to be reconciled with the revenue received from Constrained Coal Customers as the total efficient costs of the Constrained Network less the 'Direct Costs' (i.e. efficient variable maintenance costs)

associated with producers originating in Pricing Zone 3.[5] The ACCC was of the preliminary view that ARTC's approach was inconsistent with the ceiling revenue limits set out in subsection 4.3(a) of the HVAU:

> *In relation to the Segments identified as forming part of Pricing Zone 1 and 2 in Schedule E [of the HVAU], Access revenue from any Access Holder, or group of Access Holders must not exceed the Economic Cost of those Segments which are required on a stand alone basis for the Access Holder or group of Access Holders*

In particular, the ACCC was concerned that, because ARTC subtracted only the Direct Costs associated with Pricing Zone 3 Access Holders' use of Pricing Zone 1, Constrained Coal Customers were proposed to pay more than their 'standalone' costs associated with the Constrained Network (i.e. the total efficient costs of providing the service to Constrained Coal Customers by themselves). The ACCC was of the preliminary view that the proportion of the efficient costs incurred within the Constrained Network to be reconciled with the revenue received from Constrained Coal Customers should be calculated by subtracting the incremental costs associated with Pricing Zone 3 Access Holders' use of Pricing Zone 1 rather than just the Direct Costs (i.e. the avoidable costs from a long-term perspective, of which Direct Costs are a subset).

The ACCC subsequently engaged an independent consultant, WIK-Consult (**WIK**), to review the costs of ARTC's Hunter Valley Coal Network and estimate the incremental costs of Pricing Zone 3 Access Holders' use of Pricing Zone 1. WIK's full report is available on the ACCC's website. In summary, WIK estimated the incremental costs of Pricing Zone 3 Access Holders' use of Pricing Zone 1 as $14.6 million for the 2013 calendar year compared to the $2.5 million Direct Costs calculated by ARTC. WIK noted that the approach it used provides a conservative estimation of the incremental costs because costs were assumed to be unavoidable where there was insufficient data. The difference between WIK's estimate and ARTC's approach and the effect of this on the reconciliation of costs and revenues for Constrained Coal Customers is summarised in the following table.

2013	ARTC ($)	WIK ($)
Total efficient costs of the Constrained Network (including direct costs associated with PZ3 producers)	300 030 434*	300 030 434*
less direct costs associated with PZ3 producers	2 497 914	
less incremental costs associated with PZ3 producers		14 582 884
Costs of the Constrained Network to be recovered from Constrained Coal Customers	297 532 519	285 447 550
Revenue received from Constrained Coal Customers	277 929 657	277 929 657
Shortfall in revenue from Constrained Coal Customers	19 602 862	7 517 892

* As previously noted, this figure is subject to change due to revisions related to prudency of capital expenditure.

The ACCC notes that stakeholders have provided a range of views on the issue of ARTC's application of the ceiling revenue limits in submissions to the May 2014 Discussion Paper, June 2014 Consultation Paper and November 2014 Position Paper as well as during a number of meetings. The ACCC's consideration of these views is outlined in detail later in this Draft Determination as well as in the November 2014 Position Paper. In summary,

[5] 'Direct Cost' is defined in section 14.1 of the HVAU as maintenance expenditure, including major periodic maintenance that varies with usage of the Network, and may include other costs that vary with the usage of the Network but excluding Depreciation, assessed on an Efficient basis.

however, the ACCC generally remains of the preliminary view expressed in its November 2014 Position Paper. The ACCC considers that WIK's assessment provides a thorough, albeit conservative, estimate of the incremental costs of Pricing Zone 3 Access Holders' use of Pricing Zone 1 and is appropriate to accept as a basis for this Draft Determination. This enables stakeholders to provide comment on the methodology applied by WIK and the effect of the results on ARTC's reconciliations.

Accordingly, the ACCC's Draft Determination is that the proportion of the efficient costs incurred within the Constrained Network to be reconciled with revenues received from Constrained Coal Customers should be calculated by subtracting the incremental costs associated with Pricing Zone 3 Access Holders' use of Pricing Zone 1 from the total efficient costs of the Constrained Network. Based on WIK's assessment, the shortfall in revenue to be recovered from Constrained Coal Customers for the 2013 calendar year should therefore be revised from $19.6 million to $7.5 million as per the table above.

In order to ensure that ARTC recovers its total efficient costs for the Constrained Network for the 2013 calendar year, the amount of revenue received from Pricing Zone 3 Access Holders and reconciled with costs incurred within the Constrained Network needs to be revised from $2.5 million to $14.6 million. This means that the amount of revenue received from Pricing Zone 3 Access Holders to be reconciled with costs incurred in Pricing Zone 3 needs to be revised from $62.6 million to $50.5 million. The effect of this is to increase the cumulative losses in Pricing Zone 3 at the end of the 2013 calendar year from $8.8 million to $20.9 million.

Seeking stakeholders' comments on the ACCC's Draft Determination

Parties are welcome to comment on any aspect of this Draft Determination by providing a submission to the ACCC. Parties are encouraged to respond giving consideration to ARTC's compliance with the financial model set out in section 4 of the HVAU.

Submissions are due by 27 November 2015. Details on how to make a submission are outlined in chapter 1 of this Draft Determination.

1. Introduction

The Australian Rail Track Corporation (**ARTC**) is an Australian Government owned corporation that was established in 1998 and provides a single point of contact for parties seeking to run trains on the National Interstate Rail Network across Australia and the Hunter Valley Coal Network in NSW. ARTC is vertically separated, providing 'below rail' services (such as the rail track infrastructure) but not 'above rail' services (such as haulage). The National Interstate Rail Network and the Hunter Valley Coal Network are currently subject to two separate access undertakings that were accepted by the ACCC in 2008 and 2011 respectively.

The Hunter Valley Coal Network is predominantly used to transport coal from mines in the Hunter Valley region in NSW 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.

The Hunter Valley Coal Network was previously subject to the NSW Rail Access Undertaking (**NSWRAU**) administered by the NSW Independent Pricing and Regulatory Tribunal (**IPART**). However, access to the Hunter Valley Coal Network has been regulated through the Hunter Valley Coal Network Access Undertaking (**HVAU**) since the Australian Competition and Consumer Commission (**ACCC**) accepted the access undertaking in June 2011. The HVAU applies for an initial five year period and is due to expire in June 2016.

The following sections provide information on the HVAU financial model that regulates ARTC's revenues, the annual compliance assessment that the ACCC conducts to ensure ARTC's compliance with the HVAU financial model, and an outline of the process for the current assessment (including prior and current consultation).

1.1. HVAU financial model

Section 4 of the HVAU regulates the amount of revenue that ARTC is entitled to recover from Access Holders for the Hunter Valley Coal Network by implementing revenue floor and ceiling limits.

Section 4.2 of the HVAU sets out the floor revenue limits, which links the minimum revenue that ARTC is required to receive to Direct Cost and Incremental Cost:

> *(a) Access revenue from every Access Holder must at least meet the Direct Cost imposed by that Access Holder.*
>
> *(b) For each Segment or group of Segments, Access revenue from Access Holders should, as an objective, meet the Incremental Cost of those Segments ("Floor Limit").*

The term Direct Cost is defined in the HVAU as efficient maintenance expenditure, while the term Incremental Cost is defined as all costs that could be avoided in the medium term if a Segment was removed from the Network.[6]

Section 4.3 of the HVAU sets out the ceiling revenue limits, which caps the maximum amount of revenue that ARTC is entitled to receive at Economic Cost:

> *(a) In relation to Segments identified as forming part of Pricing Zone 1 and 2 in Schedule E, Access revenue from any Access Holder, or group of Access*

[6] All capitalised terms are defined in section 14.1 of the HVAU.

Holders must not exceed the Economic Cost of those Segments which are required on a standalone basis for the Access Holder or group of Access Holders ("Ceiling Limit").

(b) In relation to Segments identified as forming part of Pricing Zone 3 in Schedule E, the Access revenue from any Access Holder, or group of Access Holders must not exceed the Ceiling Limit where the RAB for those Segments is equal to, or falls below, the RAB Floor Limit for those Segments at the end of the calendar year (t-1).

The term Economic Cost is defined in section 4.5 of the HVAU. It is essentially calculated using a 'building block model' and incorporates allowances for return on assets, return of assets (depreciation) and efficient operating expenditure. The calculation of Economic Cost, therefore, also requires a regulatory value of assets. The regulatory value of assets is rolled forward each year to account for depreciation and prudent capital expenditure.

Reconciliation of revenues received with the ceiling revenue limits, which are calculated based on the Economic Cost of providing services, is applied differently for the various parts of the Network while certain circumstances exist:

- For the 'Constrained Network', the HVAU applies an 'unders and overs' accounting framework that enables ARTC to recover the Economic Cost of providing services in each compliance period.[7] If ARTC's revenue for the Constrained Network is less than Economic Cost in a compliance period, then ARTC is entitled to recover the 'under' from Constrained Coal Customers.[8] Conversely, if ARTC's revenue exceeds Economic Cost, then ARTC is required to refund the 'over' to Constrained Coal Customers.
- For Pricing Zone 3 only, the HVAU allows 'loss capitalisation'.[9] Until such time as ARTC is able to recover the Economic Cost of Pricing Zone 3, ARTC is allowed to capitalise revenue shortfalls into the Pricing Zone 3 regulatory value of assets for recovery in future periods. Once ARTC is able to recover the Economic Cost of Pricing Zone 3 (including the losses capitalised from previous years), then Pricing Zone 3 becomes part of the Constrained Network and the 'unders and overs' accounting framework as per the previous point takes effect.

1.2. ACCC annual compliance assessment

Section 4.10 of the HVAU provides for the ACCC to conduct an annual assessment to determine whether ARTC has complied with the HVAU financial model for the calendar year. In particular, the ACCC is required to determine whether:

- ARTC has undertaken prudent capital expenditure and incurred efficient operating expenditure in accordance with the requirements set out in the HVAU.
- ARTC has rolled forward the regulatory value of assets in accordance with the HVAU.

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7 The Constrained Network is defined in section 14.1 of the HVAU as the group of Segments within the Network bounded by the mine loading points and the Newcastle port where access revenue on those Segments is likely to reach or exceed Economic Cost for those Segments on a standalone basis. The Constrained Network currently comprises the Network in Pricing Zones 1 and 2 where ARTC is expected to be able to recover its full Economic Cost.

8 A Constrained Coal Customer is defined in section 14.1 of the HVAU as an Access Holder: (a) who holds Coal Access Rights under a current written access agreement with ARTC; and (b) who paid ARTC for access to the Constrained Network and such payments, other than for Direct Costs, formed part of the annual coal access revenue for the Constrained Group of Mines.

9 Loss capitalisation applies to Pricing Zone 3 because there is currently relatively lower demand for rail services due to the start-up nature of coal mines in the region and, therefore, ARTC is not currently expected to recover its Economic Cost. During the development of the HVAU, ARTC proposed the loss capitalisation model as a way to encourage investment in new assets where there was limited initial demand.

- Pricing Zone 3 forms part of the Constrained Network or whether 'loss capitalisation' continues to apply for that pricing zone as allowed for under the HVAU.
- ARTC has reconciled revenues with the applicable revenue floor and ceiling limits and determined the allocation of any 'unders' or 'overs' to Constrained Coal Customers in accordance with the HVAU.

1.3. Previous consultations

ARTC submitted documentation to the ACCC in May 2014 in order to demonstrate its compliance with the HVAU financial model for the 2013 calendar year. The ACCC has previously issued a Consultation Paper in June 2014 and a Position Paper in November 2014. The ACCC also issued a separate Discussion Paper relating specifically to ARTC's approach to revenue allocation and reconciliation with applicable ceiling revenue limits.

1.3.1. May 2014 Discussion Paper

The ACCC released a Discussion Paper on ARTC's revenue allocation and reconciliation with applicable ceiling revenue limits on 29 May 2014, inviting comments from interested parties on ARTC's approach under the HVAU. The ACCC received submissions from:

- Anglo American Metallurgical Coal Pty Ltd (**Anglo American**)
- ARTC
- Hunter Valley Energy Coal Pty Ltd, a subsidiary of BHP Billiton Limited (**BHP**)
- Rio Tinto Coal Australia Pty Ltd (**Rio Tinto**)
- Glencore Coal Assets Australia Pty Ltd (**Glencore**)
- Idemitsu Australia Resources Pty Ltd (**Idemitsu**)
- Peabody Australia Mining Pty Ltd (**Peabody**)
- Vale Australia Pty Ltd (**Vale**)
- Whitehaven Coal Ltd (**Whitehaven**)

Stakeholders' comments on this issue have been taken into consideration in this Draft Determination in order to reduce the regulatory burden on ARTC and stakeholders by continuing to conduct a separate review. The Discussion Paper and submission are available on the ACCC's website at: http://accc.gov.au/regulated-infrastructure/rail/artc-hunter-valley-access-undertaking/revenue-allocation-review.

1.3.2. June 2014 Consultation Paper

The ACCC published a Consultation Paper on 16 June 2014. In that paper, the ACCC invited comments from interested parties on the documentation that ARTC provided to the ACCC on 21 May 2014 to demonstrate its compliance with the HVAU financial model for the 2013 calendar year. The ACCC received submissions from:

- Asciano Ltd (**Asciano**)
- Glencore
- BHP
- Rio Tinto

The ACCC notes that submissions did not include substantive comments on ARTC's documentation and the issues identified in the ACCC's Consultation Paper. Rather, submissions called for the ACCC to postpone the annual compliance assessment for the

2013 calendar year until the review of ARTC's revenue allocation and reconciliation with applicable ceiling revenue limits had been completed. As noted above, stakeholders' comments on this issue have been taken into consideration in this Draft Determination. The Consultation Paper and submissions are available on the ACCC's website at: http://accc.gov.au/regulated-infrastructure/rail/annual-compliance-assessment-2013.

1.3.3. November 2014 Position Paper

The ACCC published a Position Paper on 26 November 2014. As noted above, the submissions received in response to the June 2014 Consultation Paper did not provide substantive comments on the contents of ARTC's documentation. Accordingly, the ACCC conducted a preliminary assessment of ARTC's compliance for the 2013 calendar year, taking into account the views expressed during the prior consultation and in response to the May 2014 Discussion Paper, and sought submissions from interested parties on these preliminary views. The ACCC received submissions from:

- Whitehaven
- Vale
- BHP
- Glencore
- ARTC
- Idemitsu
- Rio Tinto

A summary of stakeholders' views on the November 2014 Position Paper is included in section 2 of this Draft Determination along with the ACCC's views. The Position Paper and submissions are available on the ACCC's website at: http://accc.gov.au/regulated-infrastructure/rail/annual-compliance-assessment-2013.

1.4. Requests for additional information from ARTC and engagement of independent consultants

During the assessment process, the ACCC has requested additional information from ARTC in order to clarify certain aspects of its documentation and to assist with assessing the prudency and efficiency of expenditure. The ACCC also requested additional information from ARTC that was necessary for the independent consultant's assessment.

1.4.1. Requests for additional information

The ACCC requested additional information from ARTC with regards to its capital expenditure and operating expenditure to assist the ACCC's assessment of the prudency and efficiency of that expenditure. ARTC provided a response to those requests on a confidential basis and the ACCC has taken that information into consideration in this Draft Determination.

1.4.3. Consultant's assessment

The ACCC engaged WIK-Consult (**WIK**) to review and assess the costs of ARTC's Hunter Valley rail network to determine the incremental costs of Pricing Zone 3 Access Holders' use of Pricing Zones 1 and 2 and, therefore the standalone costs of Pricing Zones 1 and 2 producers' use of Pricing Zones 1 and 2. The ACCC specifically asked WIK to:

- Review and assess the extent to which costs in each of the main categories (that is, variable and fixed maintenance costs, other operating costs such as network control costs and overheads, and capital costs) vary with the use by access holders (in particular, those originating in Pricing Zone 3). This assessment is to be performed by adopting a long-run perspective.
- Identify and assess a comprehensive set of cost drivers that can serve as proxies for the amount of service provided to access holders or the corresponding amount of resources attributable to that service (for example, kgtkm, train-km, average and maximum axle load, average and maximum train speed, total gross cycle mass, coal throughput, etc.).
- Provide the incremental cost and stand-alone cost estimates for the 2013 calendar year, as well as an algorithm that would allow the ACCC to repeat the exercise for the subsequent years if needed.

WIK identified information that it needed (in addition that which ARTC had already provided in its compliance submission to the ACCC, including its confidential spreadsheets) in order to complete its assessment. Accordingly, in order to assist WIK with its assessment, the ACCC requested additional information from ARTC as follows:

Date	Action
10 July 2015	Request for information relating to maintenance costs by activity, details of ARTC's split of fixed and variable components for those maintenance activities, details of individual assets included in the regulatory asset base at the end of 2013, axle load of trains, maintenance overhead costs and network control costs.
24 July 2015	ARTC provided a partial response to the request dated 10 July 2015
14 August 2015	ARTC provided a further response to the request dated 10 July 2015
4 September 2015	Request for supporting documentation relating to capital expenditure projects that occurred prior to mid-2011
17 September 2015	ARTC provided a response to the request dated 4 September 2015

The ACCC received WIK's Final Report on 6 October 2015. The findings of WIK's Final Report have been taken into consideration in this Draft Determination. The full report is available on the ACCC's website at http://accc.gov.au/regulated-infrastructure/rail/artc-hunter-valley-access-undertaking.

1.5. Consultation on this Draft Determination

In this paper, the ACCC has presented its draft determination of ARTC's compliance for the 2013 calendar year, taking into account the views expressed through the numerous consultations outlined above and the additional information provided by ARTC. The ACCC is now seeking submissions from interested parties on the draft determination outlined in chapter 2 of this Draft Determination by 27 November 2015.

1.5.1. Making a submission

Submissions should be addressed to:

Mr Matthew Schroder
General Manager
Infrastructure & Transport—Access & Pricing Branch
Australian Competition and Consumer Commission
GPO Box 520
Melbourne VIC 3001
Email: transport@accc.gov.au

Submissions are due by **27 November 2015**.

1.5.2. 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*'.[10]

1.5.3. Further information

ARTC's submission in relation to the 2013 calendar year and other relevant information, such as the currently accepted HVAU, are available on the ACCC's website at: http://accc.gov.au/regulated-infrastructure/rail/artc-hunter-valley-access-undertaking.

Public submissions received during the current process will also be published at this location.

If you have any queries about any matters raised in this document, please contact:

Renée Coles
Infrastructure & Transport—Access & Pricing Branch
Infrastructure Regulation Division
Phone: +61 3 9290 6921
Email: renee.coles@accc.gov.au

[10] This paper can be accessed here: http://accc.gov.au/publications/accc-aer-information-policy-collection-and-disclosure-of-information.

2. Key issues

This chapter outlines the ACCC's views on the following key issues relating to the 2013 calendar year:

- Prudency of capital expenditure (section 2.1)
- Efficiency of operating expenditure (section 2.2)
- Reconciliation of revenues with applicable ceiling revenue limits (section 2.3)
- True-Up Test audit (section 2.4)

A summary of stakeholders' comments received in response to the ACCC's November 2014 Position Paper is included in each of these sections where applicable. It should be noted that a summary of submissions received in response to earlier consultations and the ACCC's views on the issues raised in those submissions were included in the ACCC's November 2014 Position Paper.

2.1. Prudency of capital expenditure

Subsections 4.4(a) and (b) of the HVAU define net capital expenditure as capital additions, plus interest costs incurred during construction, less the written down value of any disposals.

Importantly, the HVAU requires that, for capital expenditure to be included in the regulatory value of assets, it must be incurred on a 'prudent' basis. Subsection 4.10(d)(iii) of the HVAU explicitly provides that, if capital expenditure has been endorsed by the Rail Capacity Group (**RCG**) in accordance with the consultation obligations set out in section 9 of the HVAU, then the ACCC will accept that capital expenditure as prudent. The RCG is a representative group made up of a range of stakeholders, including access holders and above rail operations and the Hunter Valley Coal Chain Coordinator (**HVCCC**) (in a non-voting capacity).

The HVAU also provides that ARTC can recover interest costs incurred during construction up until 1 July in the calendar year that the asset was commissioned (and determined by reference to the appropriate rate of return) as well as the written down value of disposals all incurred on a prudent basis.[11]

2.1.1. ARTC's May 2014 Compliance Documentation

ARTC sought to roll forward into its regulatory value of assets total net capital expenditure of $155.2 million, comprising of 'major' capital expenditure of $126.9 million plus 'minor' capital expenditure of $29 million plus interest during construction of $5.4 million less loss on disposals of $6.2 million. Of the total net capital expenditure, ARTC attributed $12.95 million to Pricing Zone 3.

ARTC confidentially provided the ACCC with evidence of RCG endorsement of capital expenditure amounts. ARTC's confidential spreadsheets provided details and calculations of interest during construction and disposals.

2.1.2. Stakeholders' comments on the November 2014 Position Paper

Vale stated that it supports the additional transparency that has been achieved with ARTC's release of the bi-annual report on minor capital expenditure. However, Vale noted that it is

[11] See section 4.4 of the HVAU.

concerned about the internal ARTC governance structure in place to monitor and manage the expenditure of the individual minor capital projects:

> *Of concern to Vale is the latest minor capital report included some capital items that had total expenditure of 100% above the budget allocation and there was no indication that any formal internal ARTC process had been completed to transfer funds from another minor project to cover this cost overrun. Vale appreciates that minor capital project priorities will be subject to change, however, Vale believes it is good practice to have a clear governance structure that allows for funds to be transferred between minor projects and does not allow over budget expenditure on minor projects. Vale believes this process will ensure that the combined total of the individual minor projects will not exceed the minor capital allowance approved by the RCG.*[12]

Whitehaven commented that ARTC has followed due process as set out in the HVAU for all major and minor capital approvals, and that transparency of information through the RCG to member companies is acceptable. Whitehaven noted it is comfortable with the interest during construction and disposal amounts as submitted by ARTC:

> *Given the highly competitive global coal market it is expected that ARTC will be investigating all avenues to minimize interest costs (including alternate short term funding sources where available) and maximizing disposal values (through active asset management), with the goal of minimizing total cost of service to the Coal Chain.*[13]

Idemitsu stated that ARTC has undertaken prudent capital expenditure in accordance with the requirements of the HVAU.[14] However, Idemitsu noted that more detail on post-commissioning costs of major capital expenditure is required from ARTC to enable stakeholders to better understand this component of capital expenditure. Idemitsu also suggested that ARTC provide a clearer reconciliation between RCG-endorsed projects and those included in the annual compliance assessment.[15] In regard to minor capital expenditure, Idemitsu suggested that the minor capital endorsement process should be aligned and issued in accordance with the calendar year to more appropriately reflect the HVAU contract year and annual compliance period, and to provide Access Holders with increased transparency and understanding.[16]

Glencore stated that although ARTC is reasonable in its openness at RCG meetings (and in monthly reports), there is no way to reconcile RCG-sanctioned spending to the net capital expenditure additions in ARTC's calculations. Glencore suggested that:

> *There needs to be a transparent reconciliation of project approvals, spending on approved projects, additions to the RAB and the closing 'work in progress'. The monthly reports on project progress supplied by the ARTC to the RCG members should be revamped to ensure there is an easy reconciliation from project spending to the yearly 'Net Capex' number.*[17]

Glencore stated that ARTC's regulatory value of assets appeared to be overvalued by proceeds from disposals, as ARTC has reduced its assets by the net loss on disposals

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[12] Vale, *Submission in response to ACCC Position Paper*, 21 January 2015, p. 1.

[13] Whitehaven, *Submission in response to ACCC Position Paper*, 20 January 2015, p. 2.

[14] Idemitsu, *Submission in response to ACCC Position Paper*, 30 January 2015, p. 1.

[15] Ibid, p. 4.

[16] Ibid, p. 4.

[17] Glencore, *Submission in response to ACCC Position Paper*, 29 January 2015, p. 1.

rather than the total value of disposals. Glencore suggested that this appears to have also occurred in the 2012 calendar year.[18]

2.1.3. ACCC's Draft Determination

The ACCC's assessment of prudency of net capital expenditure is arranged under four key issues: major capital expenditure additions, minor capital expenditure additions, interest during construction and disposals.

Major capital expenditure additions

The HVAU explicitly provides that, if capital expenditure has been endorsed by the RCG, then the ACCC must accept that the capital expenditure is prudent. In its November 2014 Position Paper, the ACCC stated that it was satisfied that ARTC had shown evidence of RCG endorsement for $126 860 489 to be rolled into the regulatory value of assets for the 2013 calendar year. The ACCC noted, however, that additional information was sought from ARTC to confirm RCG endorsement for the Aerosol (Murrumbo) Valley Loop project. ARTC subsequently provided the ACCC with evidence of RCG endorsement of $37 750 of post-commissioning costs for this project.

Accordingly, the ACCC's Draft Determination is that ARTC may roll forward the full major capital expenditure amount of $126 898 239 into the regulatory value of assets for the 2013 calendar year.

Minor capital expenditure additions

The ACCC stated in its November 2014 Position Paper that it was unable to reconcile the amounts and scope of minor capital expenditure that ARTC sought to roll forward into the regulatory value of assets with that endorsed by the RCG. As a result, the ACCC sought additional information from ARTC to confirm RCG endorsement of minor capital expenditure. ARTC has since provided the ACCC with evidence of RCG endorsement of all minor capital expenditure. In addition, ARTC has provided the ACCC with a copy of the report it presented to RCG members in April 2014, which outlined variations in minor capital expenditure between January 2013 and June 2014.

As noted above, Vale supports the release of ARTC's bi-annual reports on variations in minor capital expenditure, but is concerned about ARTC's internal governance structure to monitor and manage the expenditure of individual minor capital projects. Vale noted that the bi-annual report presented to the RCG in November 2014 indicated that many minor capital projects exceeded their original budget cost allocation. Vale stated that the report references funds being transferred between projects to cover cost overruns, but that this does not appear to be consistently applied or at least consistently noted in the report. Vale stated that there needs to be a clear governance structure that allows for funds to be transferred between minor capital projects and does not allow over-budget expenditure on minor capital projects.[19] In addition, Glencore suggested that RCG sanctioned spending should be able to be more easily reconciled with net capital expenditure additions in ARTC's calculations.[20]

The ACCC stated in its Final Determination for the 2012 calendar year that the progress of the RCG consultation processes and how well they are working will inform any future undertaking that may replace the HVAU following its expiry in June 2016.[21] The ACCC

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[18] Ibid, p. 2.

[19] Vale, *Submission in response to ACCC Position Paper*, 21 January 2015, p. 1.

[20] Glencore, *Submission in response to ACCC Position Paper*, 29 January 2015, p. 1.

[21] ACCC, *Determination—Australian Rail Track Corporation's compliance with the financial model and pricing principles in the Hunter Valley Coal Network Access Undertaking for January – December 2012*, 24 March 2014, p. 13.

continues to encourage ARTC to work with stakeholders to refine and improve the consultation process.

On the basis of the information available, the ACCC is satisfied that ARTC has shown evidence of RCG endorsement for the full minor capital expenditure amount of $29 039 480 and the ACCC's Draft Determination is that ARTC may roll forward this amount into the regulatory value of assets for the 2013 calendar year.

Interest during construction

In its November 2014 Position Paper, the ACCC reviewed ARTC's calculations for interest during construction and confirmed that the calculations had been undertaken in accordance with the methodology prescribed under the HVAU.

No stakeholders raised concerns in relation to the projects and associated interest during construction. As such, the ACCC's Draft Determination that ARTC may roll forward the full interest during construction amount of $5 421 587 into the regulatory value of assets for the 2013 calendar year.

Disposals

The majority of ARTC's loss on disposals relates to re-railing or rail replacement activities, as part of ARTC's minor capital expenditure works program. In most of these instances, ARTC has advised that assets were disposed as scrap with some proceeds received, while in some instances assets were transferred to inventory stockpiles.

In relation to the disposals associated with the major capital expenditure program, ARTC advised that some of the amounts were transferred to inventory. It is the ACCC's understanding that ARTC is to reduce the regulatory value of assets by the total value of disposals (i.e. that any amount received from sale or value of an asset is transferred to inventory does not remain in the regulatory value of assets for ARTC to earn a rate of return on). In its November 2014 Position Paper, the ACCC sought clarification on whether the regulatory value of assets had been reduced by the total value of disposals or only the net loss on disposals amount.

ARTC has provided the ACCC with clarification on how proceeds from the sale of assets and/or transfer to inventory stockpiles have been incorporated into ARTC's confidential financial model. ARTC acknowledged that it had erroneously reduced the regulatory value of assets by the net loss on disposals, rather than the total value of disposals. ARTC has proposed to correct this error when it submits revised compliance documentation, which will result in the total value of loss on disposals being revised from $6 171 987 to $6 981 504.

Glencore was the only stakeholder to raise concerns in relation to ARTC's loss on disposals. Glencore stated that ARTC appeared to be reducing net capital expenditure by the net loss on disposals rather than the total value of disposals.[22] The ACCC notes this concern has been addressed above, with ARTC to submit corrected documentation.

Accordingly, the ACCC's Draft Determination is that the loss on disposals should be revised from $6 171 987 to $6 981 504 for the 2013 calendar year.

Assessment of the impact of the ACCC's Draft Determination

Due to the revisions to the loss on disposals, the total net capital expenditure that ARTC may roll forward into its regulatory value of assets for the 2013 calendar year is revised from

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[22] Glencore, *Submission in response to ACCC Position Paper*, 29 January 2015, p. 2.

$155.2 million to $154.4 million and the amount attributed to Pricing Zone 3 is accordingly revised from $12.95 million to $13.04 million. The ACCC notes that these revisions have some flow on effects to, for example, the calculation of depreciation and return on assets for the 2013 calendar year.

2.2. Efficiency of operating expenditure

Subsection 4.10(e) of the HVAU provides for the ACCC to assess the efficiency of ARTC's operating expenditure. Efficient costs and operating expenditure in turn informs the determination of the Economic Cost and the maximum amount of revenue that ARTC is entitled to receive.

Subsection 2(c) of Schedule G of the HVAU requires ARTC to submit a detailed breakdown of the Economic Costs for the review period into standard operating cost line items, return and depreciation, as well as provide comparative values from the previous review period.

2.2.1. ARTC's May 2014 Compliance Documentation

ARTC sought to recover operating expenditure of $102.7 million for the Constrained Network, consisting of $82.8 million in maintenance and expensed project costs and $20 million in network control costs and corporate overheads.[23] ARTC also sought to recover $17.3 million for Pricing Zone 3.[24]

ARTC submitted that the overall cost of maintenance expenditure for the 2013 calendar year was largely in alignment with expenditure in 2012, but that it was significantly lower than the forecasted expenditure advised to Access Holders in late 2012.[25]

In relation to expensed projects, ARTC submitted that:

> *An unexpected cost in fixed maintenance of $8.97M arose through the expensing of projects associated with the PWCS Terminal 4 (T4) expansion. A suite of projects were endorsed by the RCG prior to 2013 to enable the rail track capacity to match the additional capacity provided by T4. For each project, RCG endorsement is required to proceed to the next stage. For the T4 projects, the RCG did not endorse project advancement due to the deferral of the T4 project by PWCS and the capital spent was sought to be expensed in 2013.*
>
> *The expensed projects and the associated costs were discussed with the access holders during quarterly access holder meetings in November 2013 and February 2014. In addition, a consolidated list of expensed projects was provided to the RCG in March 2014 to add further transparency. This information paper did not seek endorsement but provided advice that in accordance with the previously endorsed project phases, projects were being expensed. No objections were raised by the RCG to the expensing of these projects in 2013.*[26]

ARTC submitted that network control costs for the 2013 calendar year were $10.9 million, which was similar to the level of network control costs approved by the ACCC for the 2012 calendar year.[27] In terms of corporate overhead costs, ARTC submitted that these were $1.6 million lower for the Constrained Network in the 2013 calendar year than the costs incurred during 2012. ARTC stated that this decrease was due to:

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23 ARTC, *Initial Compliance Submission*, May 2014, p. 19.

24 Ibid, p. 9.

25 Ibid, p. 21.

26 Ibid, p. 21.

27 Ibid, p. 8 & 22.

…the increased share of Interstate non-coal train kms of total ARTC network train kms when compared with the Constrained Coal train kms resulting in a reduction in costs allocated to the Constrained Network. In addition, a restructure within ARTC saw the Technical Services division being absorbed by other business divisions and so relevant associated Technical Services cost could be directly identified with specific corridors rather than being allocated as a system wide cost and allocated to the Hunter Valley corridor on a Train Km basis.[28]

2.2.2. Stakeholders' comments on the November 2014 Position Paper

Vale commented on ARTC's maintenance expenditure, stating that it is unclear whether the reduction in maintenance scope for 2013 means that the network has deteriorated, or that the scope was not required.[29] Further, Vale stated that:

It is not clear to Vale whether the inability to achieve maintenance scope is a result of over contracting network capacity and therefore insufficient allocation of capacity for maintenance, inefficient maintenance planning, or the maintenance scope is not actually required. Vale believes that a more efficient maintenance planning process needs to be established to ensure that the appropriate level of maintenance scope is achieved to ensure the rail network is maintained to a standard that supports the contractual tonnes committed to by ARTC.[30]

Vale also suggested that ARTC should focus on productivity improvements during the coming years to assist the productivity drive being undertaken by coal producers to remain competitive in the global coal market.[31]

Glencore suggested that there should be more transparency on corporate overheads and how these indirect costs are allocated to segments and zones.[32] Glencore also stated that:

There is little detail supplied on Operating Expenditure and yet there is a requirement for such expenditure to be assessed on an Efficient basis. There is a need for further detail with a comparison to forecast to be supplied (again by Zone). Non Segment Specific costs should be detailed with their allocation to Segments/Zones detailed.[33]

Idemitsu made a general comment that ARTC has incurred efficient operating expenditure in accordance with the requirements of the HVAU.[34] Although, Idemitsu suggested that ARTC should begin to provide Access Holders with forecasts of the coming year's operating expenditure prior to the commencement of that year.[35] In addition, Idemitsu suggested that a more consistent reporting methodology would assist Access Holders in understanding the costs incurred by ARTC. Idemitsu provided the example that:

…the forecast operating expenditure for 2013 contained in the 2013 Annual Pricing correspondence issued to Access Holders in November 2012 was extremely inadequate and provides limited opportunity for Access Holders to make any meaningful comparisons against the information provided by ARTC in the 2013 Annual Compliance information.[36]

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[28] Ibid, p. 23.

[29] Vale, *Submission in response to ACCC Position Paper*, 29 January 2015, p. 2.

[30] Ibid, p. 2.

[31] Ibid, p. 2.

[32] Glencore, *Submission in response to ACCC Position Paper*, 29 January 2015, p. 1.

[33] Ibid, p. 1.

[34] Idemitsu, *Submission in response to ACCC Position Paper*, 30 January 2015, p. 1.

[35] Ibid, p. 5.

[36] Ibid, pp. 4-5

In regard to maintenance expenditure, Idemitsu stated that ARTC needs to improve the information provided to stakeholders, such as through information on scope, budgets and actual costs.[37] Whitehaven suggested that a decrease in maintenance costs per tonne has been a positive outcome given 'current market conditions provided that the rail infrastructure is able to operate at a consistent level capacity to efficiently deliver all contracted demand'[38]. Whitehaven also encouraged ARTC to have plans in place to ensure that costs per tonne do not increase in future periods as a result of the deferred maintenance in 2013.

Whitehaven noted that ARTC provided acceptable information for the Constrained Network in its submission.[39] However, Whitehaven suggested that:

> *…the same level of information should be afforded to the Unconstrained Network to allow a similar analysis to be undertaken by all parties. This becomes more relevant in the situation where cost decrease trends differ across networks as is the case in 2013.*[40]

Idemitsu also commented on the information disparities between the Constrained and Unconstrained Networks, stating that:

> *…Idemitsu notes the ACCC's comment regarding limited operating expenditure details for PZ3 [Pricing Zone 3], with all commentary focussed on the expenditure for the Constrained Network and would welcome PZ3 operating expenditure explanations by ARTC, particularly as total operating expense for PZ3 has increased by 39% compared 2012.*[41]

Rio Tinto commented on ARTC's expensed project costs associated with the Port Waratah Coal Services (PWCS) Terminal 4 (T4) expansion. In particular, Rio Tinto was critical of ARTC's revenue allocation approach and how it would apply in this instance:

> *In supporting the expensing of T4 project costs RTCA [Rio Tinto] assumed that all Access Holders who utilise Pricing Zone 1 would be required to contribute. With a more complete understanding of ARTC's revenue recovery model it is now clear that that is not the case. RTCA's view is that a proportionate share of the $8.97 million in T4 project costs must be expensed across all Access Holders, not simply those within the Constrained Network. This is in lieu of expensing the cost across T4 contract holders only, which RTCA believes to be imprudent at this point. Critically, RTCA believes a more adequate expensing mechanism needs to be developed by ARTC, with appropriate amendments to the HVAU, to ensure that Constrained Network customers are not unfairly disadvantaged in this way in the future.*[42]

Whitehaven also commented on ARTC's expensed project costs for the PWCS T4 expansion, and suggested that the process for expensing these project costs was followed by ARTC and that it gained approval through the RCG.[43] Idemitsu noted that it had no comment on the expensed projects, but acknowledged that they had been presented to the RCG.

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[37] Ibid, p. 5.

[38] Whitehaven, *Submission in response to ACCC Position Paper*, 20 January 2015, p. 2.

[39] Ibid, p. 2.

[40] Ibid, p. 2.

[41] Idemitsu, *Submission in response to ACCC Position Paper*, 30 January 2015, p. 5.

[42] Rio Tinto, *Submission in response to ACCC Position Paper*, 6 February 2015, p. 2.

[43] Whitehaven, *Submission in response to ACCC Position Paper*, 20 January 2015, p. 3.

Whitehaven commended ARTC for decreasing its network control costs and corporate overheads in a year where capacity and throughput increased.[44]

2.2.3. ACCC's Draft Determination

ARTC's operating expenditure comprises:

- maintenance costs (such as major periodical maintenance and reactive corrective routine maintenance)
- expensed projects costs
- network control costs (such as labour and materials associated with train control, signalling and operations) and corporate overheads (such as labour and materials associated with head office functions, including human resources, legal, finance etc)
- other matters (such as performance incentives).

Maintenance costs

ARTC submitted that during the 2013 calendar year it incurred $73.8 million in maintenance costs for the Constrained Network and $12.9 million in maintenance costs for Pricing Zone 3.

In the 2012 calendar year, the ACCC assessed the efficiency of ARTC's maintenance costs by conducting a trend analysis of expenditure amounts and by making comparisons against available benchmarks. As part of that assessment, the ACCC requested historical and forecast expenditure amounts for the top six maintenance activities, which accounted for over half of the total maintenance costs. The ACCC noted in its November 2014 Position Paper that ARTC had not provided similar information for the 2013 Compliance Period and that the ACCC would require more detailed information to conduct a robust analysis of ARTC's maintenance expenditure.

ARTC has since provided the ACCC with historical and forecast expenditure amounts for the top six maintenance activities during the 2013 calendar year, as well as contextual information to explain reasons for variances in expenditures from prior forecasts. The ACCC is of the view that this detailed supporting information for ARTC's maintenance costs has enabled a more robust analysis of ARTC's maintenance costs and provided useful context to the cyclical nature of maintenance programs. As such, the ACCC will continue to seek this information from ARTC for future annual compliance assessments.

ARTC's six major maintenance activities accounted for more than half of total maintenance costs and consisted of:

- ballast cleaning
- rail grinding
- tamping (resurfacing)
- full track reconditioning (mudhole rectification)
- wayside detection systems
- rail defect removal.

As noted in the November 2014 Position Paper, ARTC's maintenance costs for the Constrained Network in 2013 made up approximately 78.7 per cent of total operating expenditure (excluding unexpected expensed project costs), which was largely in line with the maintenance costs incurred in 2012. The ACCC reviewed ARTC's maintenance costs for

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44 Ibid, p. 3.

the Constrained Network over time and found that the costs during 2013 for most maintenance activities were around the historical average and ARTC's forecasted 2013 expenditure levels (as provided by ARTC for the 2012 calendar year). The ACCC considers that the overall level of expenditure for the Constrained Network is reasonable.

For Pricing Zone 3, maintenance costs have increased from $8.4 million in 2012 to $12.9 million in 2013, which accounted for approximately 67.4 per cent and 74.4 per cent of total operating expenditure for Pricing Zone 3 in 2012 and 2013 respectively. The ACCC assessed ARTC's maintenance expenditure across Pricing Zone 3 and found that the costs during 2013 for most maintenance activities were around the historical average and ARTC's forecasted 2013 expenditure levels. However, full track reconditioning expenditure in 2013 was considerably higher in Pricing Zone 3 than in any past year and was substantially larger than ARTC's forecast expenditure for 2013. The explanatory information provided by ARTC to date has not sufficiently explained the reasons for the increased maintenance costs in Pricing Zone 3 for 2013. The ACCC considers that more information is required from ARTC on the increased maintenance costs in Pricing Zone 3 before it can be concluded that this level of expenditure is reasonable.

The ACCC considers that ARTC's maintenance costs in the Constrained Network of $73.8 million for the 2013 calendar year are efficient. The ACCC will seek further information from ARTC on the increased maintenance costs in Pricing Zone 3 before forming a view on the efficiency of maintenance costs in Pricing Zone 3 of $12.9 million for the 2013 calendar year.

Expensed project costs

ARTC submitted that an unexpected cost of $8.97 million arose in the 2013 calendar year as a result of the expensing of projects associated with the Port Waratah Coal Services (PWCS) Terminal 4 (T4) expansion. ARTC sought to include these expenses as part of the operating expenditure for the Constrained Network for the 2013 calendar year.

ARTC stated that it had received RCG endorsement to conduct 'Concept Assessment' for a suite of projects that were intended to increase track capacity to match the additional capacity provided by PWCS's T4 expansion. However, the RCG did not endorse advancement of the projects beyond the initial phase as a result of the decision by PWCS to defer the T4 expansion project.

Ordinarily, capital expenditure endorsed by the RCG would be rolled into the regulatory value of assets following completion and commissioning of the asset, allowing ARTC to earn an ongoing return on capital. However, in this instance the projects are not proceeding and ARTC has sought to include the associated capital expenditure to date as an expense item for the Constrained Network for the 2013 calendar year. This would enable ARTC to recover the associated costs in the current period, but not receive an ongoing return on the capital.

ARTC stated that it discussed its approach with Access Holders, who were provided with a list of expensed projects via the RCG consultation process. ARTC noted that no objections were raised by Access Holders in relation to the expensing of projects in the 2013 calendar year, although it did not seek RCG endorsement for the expenses. The ACCC stated in its November 2014 Position Paper that the proposed approach to expensing projects in this instance was likely to be appropriate, subject to any stakeholder concerns.

In response to the November 2014 Position Paper, only one stakeholder raised concerns with the expensing of the costs associated with the T4 expansion project. Rio Tinto's concerns related to ARTC's revenue allocation approach, with Rio Tinto considering that all

Access Holders should pay a proportionate share of the project.[45] The ACCC's views on ARTC's revenue allocation approach, which also addresses Rio Tinto's concerns related to expensed project costs, is outlined in section 2.3 of this paper.

As such, the ACCC considers that it is appropriate for ARTC to include expensed project costs of $8.97 million for the 2013 calendar year.

Network control costs and corporate overheads

ARTC submitted that during the 2013 calendar year it incurred network control costs of $9.3 million and corporate overheads of $10.7 million for the Constrained Network. In Pricing Zone 3, ARTC submitted that it incurred network control costs of $1.7 million, corporate overheads of $1.3 million and asset management overheads of $1.4 million for the 2013 calendar year.

The ACCC is not aware of any circumstances that would have significantly impacted on the overall level of network control costs and corporate overheads for the 2013 calendar year when compared to the level of costs deemed efficient in prior periods. With this in mind, the ACCC has considered what changes have occurred compared to the previous year(s).

ARTC submitted that network control costs in the Constrained Network remained approximately the same for the 2013 calendar year as those approved by the ACCC for the 2012 calendar year. However, the ACCC notes that, in its 2012 compliance documentation, ARTC submitted that network control costs during that year were increased due to higher than normal transitioning costs for new staff as a result of unusually high staff turnover.[46] ARTC's compliance documentation for the 2013 calendar year did not outline why network control costs in the Constrained Network remained at the unusually higher costs level incurred during the 2012 calendar year. In addition, the ACCC is not satisfied that the information provided by ARTC is sufficient to demonstrate the efficiency of its network control costs in Pricing Zone 3 for the 2013 calendar year. Accordingly, the ACCC will seek further information from ARTC on the reasons for higher costs during 2013 before forming a view on the efficiency of the overall network control costs of $12.4 million.

ARTC submitted that corporate overheads in the Constrained Network decreased by approximately 11 per cent for the 2013 calendar year compared to those approved by the ACCC for the 2012 calendar year. ARTC submitted that this reduction in corporate overheads was due to an increased share in interstate non-coal train kilometres compared to Constrained Coal train kilometres, resulting in less corporate overheads being allocated to the Constrained Network. In addition, ARTC advised that a restructure resulted in the Technical Services division being absorbed by other business divisions and so relevant associated Technical Services cost could be directly identified with specific corridors rather than being allocated as a system wide cost and allocated to the Hunter Valley corridor on a train km basis.

In response to the November 2014 Position Paper, Glencore stated that there is no transparency on corporate overheads and the way these costs are allocated to each segment of the network. Glencore stated that ARTC provides this detail to the ACCC, but suggested that this should also be disclosed to access holders.[47] The ACCC notes that WIK assessed ARTC's allocation of overheads in its report to the ACCC, which is available on the ACCC's website. WIK noted that:

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[45] Rio Tinto, *Submission in response to ACCC Position Paper*, 6 February 2015, pp.1-2.

[46] ARTC, *Revised 2012 Compliance Submission*, February 2014, p. 22.

[47] Glencore, *Submission to the ACCC's Position Paper*, 29 January 2015, p.1.

> *…ARTC distributes overhead costs to the line segments according to the volume of traffic (GTK or Tkm) in each Line Segment. In doing so, ARTC first distinguishes between overhead of the constrained and the unconstrained network and allocates them according to the constrained and unconstrained volume of traffic. This approach shifts allocated overhead between Line Segments and Pricing Zones in comparison to a direct allocation of total overhead according to total traffic volume.*[48]

WIK illustrated the difference in allocated overhead costs between ARTC's approach and an approach without a distinction between constrained and unconstrained traffic. WIK did not identify any systematic distortion in ARTC's approach that gives an advantage or disadvantage to any pricing zone.[49]

Given the reduction in costs compared to the previous year, ARTC's explanation and WIK's assessment, the ACCC's Draft Determination is that ARTC's corporate overheads in the Constrained Network of $10.7 million for the 2013 calendar year are efficient. However, the ACCC is not satisfied that the information provided by ARTC is sufficient to demonstrate the efficiency of its overheads in Pricing Zone 3 in 2013. Accordingly, the ACCC will seek further information from ARTC before forming a view on the efficiency of the overhead costs in Pricing Zone 3 for the 2013 calendar year.

Other matters

In its November 2014 Position Paper, the ACCC noted that ARTC intended to develop a performance incentive scheme now that it has concluded its True-Up Test review (see section 2.4 of this Draft Determination). ARTC stated in its response to the ACCC's Position Paper that it undertook consultation with relevant stakeholders on a performance incentive scheme, including through the release of a draft set of incentives. ARTC noted that a common theme in the submissions it received from its consultation was that 'productivity based incentives are either not favoured or considered less important'[50]. As such, ARTC has decided not to propose a productivity related positive incentive mechanism at this time. However, ARTC noted that it:

> *…remains open to consideration of a reasonable productivity based positive performance incentive in the future, subject to certain threshold issues being resolved such as the application of such an incentive alongside the existing Ceiling Limit under the HVAU.*[51]

2.3. Reconciliation of revenues with applicable ceiling revenue limits

The financial model set out in section 4 of the HVAU caps the maximum amount of revenue that ARTC is entitled to receive at Economic Cost. The term Economic Cost is defined in section 4.5 of the HVAU. It is essentially calculated using a 'building block model' and incorporates allowances for return on assets, return of assets (depreciation) and efficient operating expenditure.

Section 4.3 of the HVAU sets out the ceiling revenue limit for the different parts of the Hunter Valley rail network as follows:

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48 WIK-Consult, *Assessment of the Incremental Costs of Pricing Zone 3 Access Holders' Use of Pricing Zone 1 and 2 of the Australian Rail Track Corporation's Hunter Valley Rail Network*, 30 September 2015, p. 13.

49 Ibid, p. 14.

50 ARTC, *Submission to the ACCC's Position Paper*, 3 February 2015, p.16.

51 Ibid, p. 16.

(a) *In relation to Segments identified as forming part of Pricing Zone 1 and 2 in Schedule E, Access revenue from any Access Holder, or group of Access Holders must not exceed the Economic Cost of those Segments which are required on a standalone basis for the Access Holder or group of Access Holders ("Ceiling Limit").*

(b) *In relation to Segments identified as forming part of Pricing Zone 3 in Schedule E, the Access revenue from any Access Holder, or group of Access Holders must not exceed the Ceiling Limit where the RAB for those Segments is equal to, or falls below, the RAB Floor Limit for those Segments at the end of the calendar year (t-1).*

Further, as set out in chapter 1, reconciliation of revenues with the ceiling revenue limits is applied differently for the various parts of the Network while certain circumstances exist:

- For the Constrained Network, the HVAU applies an 'unders and overs' accounting framework that enables ARTC to recover the Economic Cost of providing services in each compliance period. If ARTC's revenue for the Constrained Network is less than Economic Cost in a compliance period, then ARTC is entitled to recover the 'under' from Constrained Coal Customers. Conversely, if ARTC's revenue exceeds Economic Cost, then ARTC is required to refund the 'over' to Constrained Coal Customers.
- For Pricing Zone 3 only, the HVAU allows 'loss capitalisation'. Until such time as ARTC is able to recover the Economic Cost of Pricing Zone 3, ARTC is allowed to capitalise revenue shortfalls into the Pricing Zone 3 regulatory value of assets for recovery in future periods. Once ARTC is able to recover the Economic Cost of Pricing Zone 3 (including the losses capitalised from previous years), then Pricing Zone 3 becomes part of the Constrained Network and the 'unders and overs' accounting framework as per the previous point takes effect.

2.3.1. ARTC's May 2014 Compliance Documentation

ARTC provided a detailed calculation of the total efficient costs for the Constrained Network, submitting that $297.5 million was to be recovered from Constrained Coal Customers for the 2013 calendar year.[52] ARTC further submitted that, because there remained cumulative losses for Pricing Zone 3, it did not need to provide detailed reconciliations with the ceiling revenue limit for Pricing Zone 3.[53]

In relation to revenue received in the 2013 calendar year, ARTC submitted that it had received $277.9 million from Constrained Coal Customers and $65.1 million from Pricing Zone 3 Access Holders. ARTC submitted that all of the revenue received from Constrained Coal Customers was to be reconciled with the costs incurred within the Constrained Network. Of the amount of revenue received from Pricing Zone 3 Access Holders, ARTC submitted that $2.5 million was to be reconciled with the costs incurred within the Constrained Network and $62.6 million was to be reconciled with the costs incurred in Pricing Zone 3.

The above is summarised in the following tables.

[52] ARTC, Initial Compliance Submission, p. 19.

[53] ARTC, Initial Compliance Submission, p. 13.

Table: Reconciliation of revenues received from Constrained Coal Customers with costs incurred within the Constrained Network

2013	ARTC ($)
Total efficient costs of the Constrained Network (including direct costs associated with PZ3 producers)	300 030 433
less direct costs associated with Pricing Zone 3 producers	2 497 914
Costs of the Constrained Network to be recovered from Constrained Coal Customers	297 532 519
less revenue received from Constrained Coal Customers	277 929 657
Shortfall in revenue from Constrained Coal Customers	19 602 862

Table: Reconciliation of revenues received from Pricing Zone 3 Access Holders with costs incurred within Pricing Zone 3

2013	ARTC ($)
Total cumulative losses for Pricing Zone 3 at the beginning of the year	10 438 669
add total efficient costs of Pricing Zone 3 for the period	60 951 405*
less revenue received from Pricing Zone 3 producers that is to be reconciled with costs incurred within Pricing Zone 3	62 588 568
Total cumulative losses for Pricing Zone 3 at the end of the year	8 801 506

* Note that in the absence of detailed reconciliations from ARTC, this figure has been calculated as the difference between the opening and closing cumulative losses less revenue received.

2.3.2. ACCC's November 2014 Position Paper

The ACCC's preliminary assessment of ARTC's reconciliations focused on the compliance with the ceiling revenue tests in the HVAU. The ACCC also responded to stakeholder comments on the transparency and the implications for efficient investment. The ACCC's views expressed in its November 2014 Position Paper are outlined below.

Transparency

The ACCC noted that, although ARTC had provided some information to stakeholders on the intended application of the HVAU financial model during the development of the HVAU, the majority of stakeholders submitted that they were not aware of ARTC's approach and that it was not apparent under the terms and conditions of the HVAU.

Impact on investment decisions

The ACCC noted that one of the key considerations in accepting the HVAU was to promote efficient use of and investment in infrastructure and promote competitive outcomes within the Hunter Valley coal supply chain.

The ACCC considered that efficient use of and investment in infrastructure occurs where ARTC is able to recover its efficient costs of providing access to its network (including receiving a rate of return commensurate to its risk). The ACCC considered that the existing mechanisms in the HVAU, such as take-or-pay contracts, accelerated depreciation, the rate

of return, the unders and overs accounting framework and loss capitalisation in Pricing Zone 3 adequately compensate ARTC for the risks associated with its investments on the Hunter Valley Coal Network and in particular in Pricing Zone 3. Therefore, although ARTC argued that a change to its current approach would stifle investment and increase risk, the ACCC was of the view that existing mechanisms in the HVAU should mitigate this risk.

The ACCC further noted that, to the extent that ARTC's current application leads to cross-subsidies between Access Holders, then ARTC's approach would likely have distorted past investment decisions and, if not rectified, will continue to send inefficient investment signals to the Hunter Valley supply chain.

Compliance with the ceiling revenue limits in the HVAU

The ACCC's preliminary view was that ARTC's application appears inconsistent with the ceiling revenue limits set out in subsection 4.3(a) of the HVAU. In particular, the ACCC was concerned that, because ARTC subtracted only the direct costs (i.e. variable maintenance costs) associated with Pricing Zone 3 Access Holders' use of Pricing Zone 1 from the costs of the Constrained Network to be recovered from Constrained Coal Customers, Constrained Coal Customers were proposed to pay more than their standalone costs.

The ACCC was of the preliminary view that the proportion of the efficient costs incurred within the Constrained Network to be reconciled with the revenue received from Constrained Coal Customers should be calculated by subtracting the incremental costs (i.e. avoidable costs, of which direct costs are a subset) associated with Pricing Zone 3 Access Holders' use of Pricing Zone 1 rather than just the direct costs.

The ACCC noted that the incremental cost of Pricing Zone 3 Access Holders' use of Pricing Zone 1 was unclear at that point. The ACCC therefore sought input from stakeholders on this issue.

2.3.3. Stakeholders' comments on the November 2014 Position Paper

Stakeholders provided comments on ARTC's revenue allocation approach in response to the ACCC's November 2014 Position Paper. Submissions have been arranged into the following categories:

- transparency
- regulatory certainty and impact on investment decisions
- cross-subsidies
- interpretation of the ceiling revenue test in the HVAU
- approaches to assessing incremental costs

Transparency

Glencore raised concern with ARTC's disclosure of its revenue allocation process and expressed disappointment that the level of detail in its annual compliance report was such that Access Holders were not aware of this process.[54]Vale stated that it:

> *…supports the ACCC's views that further transparency would be gained by the introduction of examples to demonstrate the likely outcomes of any proposed changes, to allow stakeholders to make a better informed decision. Vale believes*

[54] Glencore, *Submission in response to ACCC Position Paper*, 29 January 2015, p. 2.

that examples would assist understanding and reduce asymmetric nature of information and knowledge between ARTC and coal producers.[55]

BHP stated that ARTC's historical approach to pricing was not sufficiently transparent so as to make ARTC's cost allocation evident. BHP also noted that it assumed that the existence of pricing zones meant that all revenue in a given pricing zone would be applied towards the full recovery of the economic cost of the pricing zone. BHP attributed the failure to appreciate how costs were being allocated to a lack of transparency, which it suggested should be addressed in the design and application of a compliant financial model.[56]

Idemitsu suggested that stakeholders should have been aware of ARTC's revenue allocation approach as it had previously applied within Pricing Zone 2.[57] Idemitsu also raised concerns with stakeholders' comments regarding transparency of revenue allocation and how this would impact their approach to endorsing projects in the RCG. Idemitsu suggested that the need for transparency should not be traded off against endorsing justified future rail infrastructure projects with wider coal chain benefits.[58]

Whitehaven also noted that ARTC's revenue allocation approach was a widely known and accepted practice and argued that it would seem inconsistent for the coal chain to argue for a change to this practice midterm of the HVAU.[59]

Regulatory certainty and impact on investment decisions

Idemitsu suggested that the complexity of applying the ACCC's proposed approach suggests that it should be deferred and reflected in the next undertaking.[60] Idemitsu stated that 'the need for regulatory stability is essential for the development, competitiveness and sustainability of the NSW coal market'[61]. Idemitsu contended that the current revenue allocation approach encourages the entry of new coal producers and ensures the development and growth of the NSW coal market, which is in the broader public interest.[62]

Whitehaven stated that it has no specific issue with the ACCC's application of a standalone cost test. However, it is concerned that there will be investment uncertainty resulting from any retrospective ARTC revenue adjustments, as well as reduced ability to accurately and objectively identify and cost Pricing Zone 1 investments that are related to other Pricing Zones.[63]

Whitehaven acknowledged that in the HVAU, the incremental cost rather than the direct cost should be used to determine the ceiling limit and floor price in each pricing zone, but past practice has been that direct cost has been used in Unconstrained Networks (as in Pricing Zone 2 when it was unconstrained).[64] In particular, Whitehaven argued that:

> *A fundamental change in the interpretation of 'standalone costs' in the middle of the term of the current HVAU contradicts the principles that the HVAU provides and has been operating under. The HVAU was requested by the Coal Chain to provide clarity and certainty for long term investment decisions to be made in a multiuser,*

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55 Vale, *Submission in response to ACCC Position Paper*, 21 January 2015, p.3.

56 BHP Billiton, *Submission in response to ACCC Position Paper*, 29 January 2015, p. 2.

57 Idemitsu, *Submission in response to ACCC Position Paper*, 30 January 2015, pp. 6-7.

58 Ibid, p. 7.

59 Whitehaven, *Submission in response to ACCC Position Paper*, 20 January 2015, p. 3

60 Idemitsu, *Submission in response to ACCC Position Paper*, 30 January 2015, p. 9.

61 Ibid, p. 8.

62 Ibid, p. 7.

63 Whitehaven, *Submission in response to ACCC Position Paper*, 20 January 2015, p. 3

64 Ibid, p. 3.

competitive network. The principle of allowing any retrospective changes to agreed methodologies undermines previous investment decisions but more importantly creates uncertainty for any investment approvals for ARTC's infrastructure into the future. [65]

Cross-subsidies

Vale stated that it supported the application of the standalone cost approach, which includes at least the direct costs plus any capital expenditure projects that were commissioned to increase capacity in Pricing Zone 1 for Pricing Zone 3 Access Holders. Vale noted that this would lead to a cost reflective approach to pricing that would assist in matching revenues and costs and avoid any cross-subsidies between producers that currently occur.[66] Vale suggested that the current methodology is inefficient and that:

> *….this inefficiency will lead to a long term pricing advantage to Pricing Zone 3 producers and provides a reduction in revenue risk for ARTC which is likely to have not been considered in the ACCC's determination of ARTC's WACC.* [67]

BHP stated that ARTC's current approach overestimates the ceiling revenue limits for Pricing Zones 1 and 2 and results in Pricing Zone 3 Access Holders effectively being cross-subsidised by Access Holders in Pricing Zones 1 and 2. BHP considered that ARTC needs to reformulate its approach to the application of the financial model and its basis for allocating costs between Pricing Zones. BHP suggested that this should be done in a manner that removes cross-subsidies between Pricing Zones 1 and 2 and Pricing Zone 3. [68]

Rio Tinto stated that if there were no changes to ARTC's current approach, Constrained Network Access Holders would continue to be significantly disadvantaged in terms of access pricing, while the benefits received by Pricing Zone 3 Access Holders would likely increase.[69]

Whitehaven stated that it does not agree that the current revenue allocation approach distorts competition as the additional cost to Pricing Zone 1 Access Holders is immaterial and amounts to approximately $0.05/tonne.[70]

Interpretation of the ceiling revenue test in the HVAU

Glencore stated that it does not agree with the ACCC that the incremental costs of Pricing Zone 3 Access Holders use of the segments in Pricing Zone 1 need to be quantified.[71] Glencore suggested that nothing in the HVAU dictates this need and that if it were to be carried out, it would be difficult as it would mean allocating already existing infrastructure to each Access Holder and likewise with every incremental project.[72] However, Glencore stated that:

> *…the 2012 and 2013 ceiling limit calculations must be redone with this reallocation of Zone 1 revenue to Zone 3 removed. This process was not in accordance with the HVAU and as such Glencore is seeking the ACCC to intervene and ensure the*

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65 Ibid, p. 4.

66 Vale, *Submission in response to ACCC Position Paper*, 21 January 2015, p.2.

67 Ibid, pp. 2-3.

68 BHP Billiton, *Submission in response to ACCC Position Paper*, 29 January 2015, p. 1

69 Rio Tinto, *Submission in response to ACCC Position Paper*, 6 February 2015, p.4.

70 Whitehaven, *Submission in response to ACCC Position Paper*, 20 January 2015, p. 3

71 Glencore, *Submission in response to ACCC Position Paper*, 29 January 2015, p. 2.

72 Ibid, p.2.

ARTC reissues the 2012 annual compliance assessment/unders and overs account and also reworks the 2013 assessment to remove the cross subsidisation. [73]

Idemitsu contended that the current revenue allocation approach is consistent with the HVAU and is aligned with the objects of Part IIIA of the CCA by promoting economically efficient use of, and investment in, infrastructure.[74] Idemitsu also suggested that it would be inappropriate to force ARTC to amend the HVAU during its approved term, or to implement changes with retrospective effect.[75]

Idemitsu also stated that the ACCC's proposed approach to standalone and incremental costs is:

…inconsistent with historical methods applied to PZ2 and with the method previously approved by the ACCC in the past two Annual Compliance Assessments under the current HVAU. Idemitsu considers the approach proposed by ARTC is consistent with the undertaking and that there is no basis under the undertaking on which the ACCC should reject ARTC's proposal. [76]

Approaches to assessing incremental costs

Rio Tinto supported the ACCC's position that access pricing must, at a minimum, reflect Access Holders paying the full incremental cost of being provided capacity in a given pricing zone.[77] Rio Tinto stated that that ARTC is best placed to make the most accurate assessment of the capital investments in Pricing Zone 1 that should be itemised to determine the incremental cost of Pricing Zone 3 Access Holders, because ARTC has complete information with regard to project costs and historical contracted coal volumes.[78] However, Rio Tinto noted that the HVCCC could confirm the stated capacity requirements and benefits of past track investment.[79]

Rio Tinto attempted to analyse the investment that has occurred in Pricing Zone 1 in recent years to deliver growth in coal volumes from the Constrained Network and Pricing Zone 3 Access Holders. Rio Tinto utilised available data and concluded that over the past three years Pricing Zone 3 users have directly benefited from at least $150 million in Pricing Zone 1 track investment that was necessary to support Pricing Zone 3 coal volumes.[80] Rio Tinto suggested that this result is likely to be conservative and that given the limitations on available data the results are likely to be only indicative.

BHP stated that the first step in reformulating ARTC's approach would require ARTC to quantify the incremental cost of Pricing Zone 3 Access Holders using Pricing Zone 1. This would include the direct costs of Pricing Zone 3 Access Holders using Pricing Zone 1 plus any capital expenditure projects that were commissioned to increase capacity of Pricing Zone 1 so as to accommodate the increase in volumes from Pricing Zone 3.[81]

BHP also stated that it is not in a position to provide the necessary capital expenditure data to enable the ACCC to analyse the capital expenditure projects that have occurred in Pricing

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[73] Ibid, p.2

[74] Idemitsu, *Submission in response to ACCC Position Paper*, 30 January 2015, p. 6.

[75] Ibid, p. 6.

[76] Ibid, p. 2.

[77] Rio Tinto, *Submission in response to ACCC Position Paper*, 6 February 2015, p.2.

[78] Ibid, p.2

[79] Ibid, p.2

[80] Ibid, pp.3-4.

[81] BHP Billiton, *Submission in response to ACCC Position Paper*, 29 January 2015, p. 2.

Zone 1 solely for Pricing Zone 3 users.[82] BHP suggested that this information should be available from ARTC. BHP also noted that:

> *…while the correct conceptual approach to calculating incremental cost is relatively straightforward, there are a number of methodologies that could ultimately be adopted to achieve such an outcome. As such, HVEC [BHP] submits that prior to such an exercise being conducted, the ACCC should consult with the ARTC and industry regarding the appropriate methodology that is to be adopted in calculating incremental capital costs.* [83]

Vale suggested an approach to determine the allocation of capital costs to Pricing Zone 3, noting that it would:

> *…establish a standalone network baseline including items such as the asset value, rail network infrastructure, and contracted train paths, for Pricing Zone 1, before the commencement of any railings from Pricing Zone 3. Vale would argue that at this point the standalone network baseline represents that costs and infrastructure that are required to operate Pricing Zone 1 on a standalone basis. Therefore, any capital investment constructed within Pricing Zone 1 after this period should be allocated between the pricing zones based on the additional asset value and contracted train paths added above the standalone network baseline. Vale believes that allocating capital costs across pricing zones based on contracted train paths is a fair and reasonable approach as it represents the mechanism used by ARTC to determine when an expansion of the rail network is required.* [84]

Whitehaven submitted that it is too simplistic to just identify investment in Pricing Zone 1 that relates to other pricing zones in determining the incremental costs for Pricing Zone 3 Access Holders. Whitehaven outlined what it believes would be required from a true incremental cost calculation, stating that:

> *1. Identification of % of projects in PZ1 relating to additional pathing requirements for PZ3, (or identifying projects relating solely to additional pathing requirements for PZ3)*
>
> *2. Calculation of the % of PZ1 project investment for PZ3 additional pathing requirements, on a marginal cost basis (given these shared projects would have been completed without PZ3 requirements therefore fixed costs should be excluded from the calculation)*
>
> *3. Identification of projects in PZ3 that releases additional pathing for other access holders in PZ1 or PZ2. Analysis of avoidable investment costs for PZ1 due to PZ3 investment.*
>
> *4. Calculation of cost of PZ1 projects based on PZ3 infrastructure requirements (noting PZ3 infrastructure requirements are less than PZ1 & PZ2).*[85]

Whitehaven stated that this is a difficult calculation with a number of subjective components that will require agreement on methodology. Whitehaven suggested that given the short time available for consultation, the existing process should be held for the current HVAU and be discussed and agreed during consultation on the 2016 HVAU.[86]

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[82] Ibid, p. 2.

[83] Ibid, p.2

[84] Vale, *Submission in response to ACCC Position Paper*, 21 January 2015, p.2.

[85] Whitehaven, *Submission in response to ACCC Position Paper*, 20 January 2015, pp. 4-5

[86] Ibid, p.5

2.3.4. ARTC's comments on the November 2014 Position Paper

ARTC re-iterated earlier comments that revenue allocation is an outcome of the application of the combinatorial ceiling test and is not a separate process that is done prior to, or separately from, the ceiling test.[87] ARTC stated that it does not agree with the ACCC's preliminary assessment of ARTC's compliance with the ceiling test, as it is:

> *…not consistent with the wording of the HVAU and its objectives or the historical operation of the HVAU (and its predecessor, the NSW Rail Access Undertaking or NSWRAU) or the ACCC's own decision to approve the HVAU. It represents a fundamental and unreasonable change of regulatory approach by the ACCC during the term of the HVAU that will potentially have significant adverse impacts on ARTC and the basis for existing and future investment in the Hunter Valley.*[88]

ARTC raised five specific interpretation and practical issues with the ACCC's preliminary assessment of ARTC's compliance with the revenue ceiling test, as below.

1. Interpretation of 'standalone costs'

ARTC stated that 'standalone' in the HVAU must 'be interpreted in the context of the provisions and operation of the HVAU and not as an independent concept to be purely defined by reference to economic theory'.[89] ARTC submitted that the ACCC's approach imports a new definition of incremental cost into the meaning of standalone costs, which differs to the definition of the term in the HVAU. ARTC suggested that adopting the ACCC's interpretation of 'standalone' would create internal inconsistencies in the application of the HVAU.[90]

2. Practicality of the ACCC's approach

ARTC stated that the current ceiling test does not commence with a pre-defined Constrained Network and is identified by comparing Access Revenue from a combination of mines against the Economic Costs of the part of the network used by those mines. ARTC suggested that the ACCC's approach would require a standalone assessment of the network for each combination of mines considered. ARTC noted that the impracticality of this approach was previously recognised by IPART and stakeholders during the development of the NSWRAU.[91]

3. Consistency of the ACCC's approach with the HVAU objectives

ARTC suggested that the outcomes of the ACCC's approach would not be consistent with the HVAU objectives, HVAU pricing principles or the CCA pricing principles. ARTC stated its view that the ACCC's introduction of a new incremental cost concept into the ceiling test could result in ARTC being unable to recover the full economic cost of the network in certain circumstances.[92]

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87 ARTC, *Submission in response to ACCC Position Paper*, 3 February 2015, p. 5.

88 Ibid, p. 4.

89 Ibid, p. 8.

90 Ibid, p. 8.

91 Ibid, pp. 8-9.

92 Ibid, p. 9.

4. Reasonableness of the ACCC's approach

ARTC argued that its interpretation is consistent with that applied under the NSWRAU and that the ACCC was advised by ARTC how it intended to allocate revenue. ARTC suggested that the ACCC's approach would raise concerns with regulatory certainty.[93]

5. Transparency and cross-subsidies

ARTC stated that:

> *ARTC rejects the proposition that there is cross subsidisation or inefficient pricing under its approach when evaluated over the longer term and from a whole of network perspective—both of which are appropriate given the long life of rail investment and the fact that the Hunter Valley network forms part of one coal chain.*[94]

ARTC also directly responded to key issues raised by stakeholders in response to the ACCC's Discussion Paper on Revenue Allocation. In particular, ARTC stated that it provided coal producers with a significant amount of detail on its proposed revenue allocation approach during the ARTC and ACCC's consultation on the 2011 HVAU. ARTC noted that:

> *Coal producers would have had an opportunity to provide views at the time in relation to these matters, and ARTC would have thought that the ACCC would have had regard to any stakeholder comments in coming to a view to accept the current Floor Limit and Direct Cost prescription in the HVAU as appropriate.*[95]

ARTC also disagreed with Glencore's suggestion that the HVAU requires a reconciliation of revenues and costs on a Pricing Zone basis.[96]

2.3.5. WIK's Assessment

As outlined in section 1.4.3, the ACCC engaged WIK to review and assess the costs of ARTC's Hunter Valley rail network to determine the incremental costs of Pricing Zone 3 Access Holders' use of Pricing Zone 1 and 2. WIK considered the concept of incremental costs based on economic literature and regulatory practice, assessed a comprehensive set of ARTC's cost drivers, and developed a cost model to estimate the incremental costs for all mine-port combinations included in ARTC's ceiling test model.

Definition of incremental costs

WIK noted that incremental costs are 'costs that a firm incurs in providing a service relative to not providing that service at all'[97]. WIK noted that the considered time horizon is crucial in determining whether costs are incremental or not. Specifically, WIK observed that incremental costs are often assessed over the long term in economic literature and regulatory practice, whereas ARTC approximates incremental costs by short term direct costs. WIK's stated approach estimates 'incremental costs understood as costs that are avoidable in the long term'[98]. When assessing ARTC's approach to incremental costs, WIK concluded that:

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[93] Ibid, p. 9.

[94] Ibid, p. 9.

[95] Ibid, p. 28.

[96] Ibid, p. 28.

[97] WIK-Consult, *Assessment of the Incremental Costs of Pricing Zone 3 Access Holders' Use of Pricing Zone 1 and 2 of the Australian Rail Track Corporation's Hunter Valley Rail Network*, 30 September 2015, p. 18.

[98] Ibid, p. 18.

> *From our perspective, direct costs can only be an adequate approximation of short-run incremental costs. In the longer run, direct costs are only a subset of incremental costs. More costs could be avoided if a service or a segment was no longer provided. In particular, incremental costs include depreciation and costs of capital for assets if the specific assets are related to the provision of additional capacity, or are otherwise required because of network usage.*
>
> *In our understanding, the ARTC substantially underestimates incremental costs by equating them with short-run variable maintenance costs.*[99]

WIK's approach to estimating incremental costs builds on ARTC's data and methodology to the maximum possible extent. WIK suggested that because some cost elements that could be seen as incremental in the long term were not considered, its approach provides a conservative estimation of the incremental costs of Pricing Zone 3 Access Holders' use of Pricing Zone 1 and 2.[100] In particular, WIK did not consider:[101]

- corporate overhead costs—if Pricing Zone 3 was removed from the network, there may be effects on corporate overheads and on their allocation to the network. However, WIK considered corporate overheads as common costs that are unavoidable.
- investment projects and related additions to the regulatory asset base before mid-2008—ARTC did not have data on investment projects and related additions prior to mid-2008, which resulted in WIK considering all costs related to existing assets before mid-2008 as unavoidable. WIK also did not consider capital expenditure projects commissioned prior to mid-2008 due to unavailable data.

WIK's technical assessment of cost variability

To determine the incremental costs of Pricing Zone 3 Access Holders' use of Pricing Zone 1 and 2, WIK reviewed and assessed the split between fixed and variable costs for ARTC's maintenance activities, as well as evaluating ARTC's minor and major capital expenditure projects.[102] For each of the cost categories, WIK allocated a relatively small share of capital costs to Pricing Zone 3 Access Holders, based on their small share of total traffic volumes on the network.[103]

WIK also sought further information on maintenance overhead costs and network control costs from ARTC on the origin and allocation of these costs, but the additional information was not sufficient for WIK's purpose.[104] As a result, WIK could not estimate a breakdown of these costs into incremental and fixed proportions and so did not alter ARTC's cost estimations in the model.

Assessment of maintenance costs

WIK reviewed 117 maintenance activities to identify the cause and then allocate the corresponding cost drivers of each particular activity. WIK considered there were 80 relevant maintenance activities, which were carried out in line segments in Pricing Zone 1 and 2 that were used by Pricing Zone 3 Access Holders. WIK estimated the relative cost share of each activity caused by the different cost drivers and defined the variable percentage.

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[99] Ibid, p. 20.
[100] Ibid, pp. 20-22.
[101] Ibid, pp. 21-22.
[102] Ibid, pp. 23-24.
[103] Ibid, p. 44.
[104] Ibid, pp. 28-29.

WIK's assessment determined that ARTC's allocation of maintenance costs into fixed and variable costs was generally plausible.[105] WIK regarded ARTC's approach to apportion variability in 25 per cent steps as a good and practicable approach. However, WIK did make adjustments to some of ARTC's cost allocations, as WIK notes:

> *…where the cost positions reach higher amounts and where the main cost drivers are GTK [gross tonne kilometres] or Tkm [train kilometres] (indicating for incremental cost) and where "minor fixed component", "small fixed component" or alike wordings describe that just a small part of the costs are driven by time and are hence fixed, even the smallest step (25%) leads in our opinion to a too big distortion.*
>
> *Therefore the cost allocations were slightly adjusted in smaller steps and towards more realistic portions for incremental (GTK / Tkm depending) or fixed (time) related costs.*[106]

Assessment of major and minor capital expenditures

WIK reviewed 65 major capital expenditure projects (that is, projects related to investment into capacity). WIK assessed these projects questioning their sole necessity to facilitate capacity growth and found 27 relevant projects.[107]

WIK reviewed 427 minor capital expenditure projects (that is, projects deemed to be more reinvestments into infrastructure). WIK assessed these projects as per its assessment of the maintenance activities. For each of the 227 relevant projects, WIK identified the cause for the project and assigned the main cost drivers to define the incremental cost.[108]

WIK agreed with ARTC's approach to apportion variability in 25 per cent steps. However, as per the assessment of maintenance costs, WIK found that smaller steps were favoured when reaching the limits (for example, for very small fixed/variable share; a 90/10 split was favoured over a 75/25 split).[109]

WIK's incremental cost model and results

WIK created an incremental cost model that uses matrix multiplication techniques to estimate the incremental costs for all mine-port combinations included in ARTC's ceiling test model, including those with Pricing Zone 3 Access Holders' use of Pricing Zone 1 and 2. The details of the incremental cost model and its calculation methodology can be found in WIK's full report.

WIK estimated that the incremental cost of Pricing Zone 3 Access Holders' use of Pricing Zone 1 and 2 for the 2013 calendar year was $14.6 million and the standalone costs of Pricing Zone 1 and 2 Access Holders as $282.1 million.[110] As noted, WIK considers that ARTC substantially underestimates incremental costs by equating them with short run variable maintenance costs. WIK considers that its estimation of incremental costs is conservative as it did not consider cost elements to be incremental if there was any doubt.[111]

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[105] Ibid, p. 26.
[106] Ibid, p. 26.
[107] Ibid, pp. 23-25.
[108] Ibid, pp. 23-25.
[109] Ibid, p. 29.
[110] Ibid, p. 44.
[111] Ibid, p. 44.

2.3.6. ACCC's Draft Determination

The ACCC notes that the figure for total efficient costs will need to be revised to take account of the amendments to the net capital expenditure figure noted in previous sections as well as any necessary associated adjustments to depreciation and return on assets. However, subject to these revisions, the ACCC's Draft Determination is that ARTC is entitled to recover the total efficient costs of the Constrained Network for the 2013 calendar year in accordance with the HVAU financial model.

The remainder of this section provides the ACCC's views on the application of the ceiling revenue limits in the HVAU as well as relevant issues such as cross-subsidies, transparency, and impact on investment decisions. Finally, the ACCC summarises the effect of its views.

Transparency

The ACCC acknowledges, as ARTC has re-iterated, that ARTC provided a significant amount of information to the ACCC and coal producers during the development of the HVAU. In particular, ARTC outlined in confidential communications to the ACCC in 2009 its intended approach to applying the ceiling limit test in the undertaking that was proposed at that time, which is consistent with its current approach. However, ARTC requested that its communications be kept in confidence. Accordingly, this information was never consulted on with stakeholders either in relation to the proposed undertaking in 2009 or in relation to any of the later versions of the undertaking that were proposed by ARTC before the HVAU was ultimately accepted in 2011. So, while Whitehaven and Idemitsu contend that ARTC's application should have been widely known, the majority of stakeholders did not appear to have sufficient transparency and clarity surrounding ARTC's intention.

The ACCC remains of the view that transparency and clarity in ARTC's reconciliations is paramount for enabling all parties to make informed decisions and to encourage efficient use of and investment in the Hunter Valley Coal Network. This is consistent with the HVAU objectives such as to 'use transparent and detailed methodologies, principles and processes for determining access revenue limits, terms and conditions'.

To assist with providing greater transparency to stakeholders on this particular issue, the ACCC has outlined additional detail surrounding ARTC's approach to reconciliation of revenues throughout section 2.3 of this Draft Determination and the ACCC has also made public the full report from WIK regarding its assessment. The ACCC also expects that transparency and clarity will be an important consideration during the development of any future undertaking.

With all that said, the ACCC emphasises that the purpose of the annual compliance assessment is to determine whether ARTC has reconciled revenues with the applicable floor and ceiling limits and determined the allocation of any under or over recovery to Constrained Coal Customers in accordance with the requirements set out in section 4 of the HVAU. That is, while comments made by ARTC about its intended approach during the development of the HVAU (whether clear or not) assisted the assessment of whether or not the HVAU was appropriate to accept, in conducting the annual compliance assessment the ACCC is required to apply the provisions of the HVAU as it was ultimately accepted.

Impact on investment decisions

ARTC has submitted throughout previous consultations that its current application of the ceiling revenue test would encourage greater investment in Pricing Zone 3 than might otherwise be the case. Similar concerns were raised by Whitehaven and Idemitsu, which

contended that the current revenue allocation approach encourages the entry of new coal producers and ensures the development and growth of the NSW coal market.

As the ACCC has previously noted, ARTC sought to allow for loss capitalisation in Pricing Zone 3 as a way to encourage investment in new assets where there was limited initial demand. As set out under compliance with the revenue ceiling test below, the ACCC considers that ARTC should utilise this mechanism for this purpose.

Further, the ACCC considers that the array of existing mechanisms in the HVAU, such as take-or-pay contracts, accelerated depreciation, the rate of return, the unders and overs accounting framework in addition to loss capitalisation adequately compensate ARTC for the risks associated with its investments on the Hunter Valley Coal Network and in particular in Pricing Zone 3.

Accordingly, the ACCC remains of the view that, to the extent that ARTC's approach leads to cross-subsidies between access holders, then ARTC's approach would likely have distorted past investment decisions and, if not rectified, will continue to send inefficient investment signals to the Hunter Valley supply chain. The ACCC considers this is consistent with the HVAU objectives such as 'the promotion of economically efficient investment, use and operation of the Network'.

Regulatory certainty

The ACCC acknowledges that ARTC's current approach is consistent with how it applied the ceiling test under the NSWRAU. As the ACCC noted in its November 2014 Position Paper, ARTC's approach was considered appropriate by IPART under the NSWRAU in the circumstances that existed at the time. For example, the ACCC understands that previously there may not have been significant congestion in Pricing Zone 1 so that increased volumes from Pricing Zone 3 would not have significantly impacted on the need for capacity enhancing investments in Pricing Zone 1.

However, the ACCC notes that the HVAU incorporates some differences from the NSWRAU, such as the application of loss capitalisation in Pricing Zone 3 and the different reconciliations for Pricing Zone 3 compared to the Constrained Network. Further, the ACCC understands that by the 2013 calendar year there was congestion in Pricing Zone 1 such that increased volumes from any Access Holder, including those originating in Pricing Zone 3, will have had an impact on the need for investments in Pricing Zone 1. Accordingly, the ACCC does not consider, as ARTC has submitted, that the fact that ARTC applied its approach under the NSWRAU is a good enough reason for no change when the information currently before the ACCC indicates that ARTC's approach does not comply with the ceiling revenue limits set out in section 4.3 of the HVAU.

As some stakeholders, including ARTC, Glencore and Idemitsu, have noted, the ACCC accepted ARTC's reconciliations with the ceiling revenue limits for the 2012 calendar year in which ARTC applied its current approach. The ACCC accepted ARTC's reconciliations on the basis of the information that was before it at that time. The ACCC does not intend to revise its position in relation to the 2012 calendar year as Glencore has requested because doing so after having made a Final Determination based on the information then before the ACCC would reduce regulatory certainty.

For the 2013 calendar year, however, the ACCC has undertaken a more detailed examination of ARTC's costs that has included consideration of the appropriateness of using Direct Costs rather than incremental costs in the reconciliations with the ceiling revenue limits. The ACCC has consulted extensively with stakeholders on the issue and has also received the report from WIK. Notably, WIK noted that incremental costs are 'costs that a firm incurs in providing a service relative to not providing that service at all'. WIK observed

that incremental costs are often assessed over the long term in economic literature and regulatory practice, whereas ARTC approximates incremental costs by short term Direct Costs. WIK concluded that ARTC substantially underestimates incremental costs by equating them with short-run variable maintenance costs. WIK estimated the incremental costs of Pricing Zone 3 Access Holders' use of Pricing Zone 1 as $14.6 million for the 2013 calendar year compared to the $2.5 million Direct Costs calculated by ARTC. WIK noted that the approach it used provides a conservative estimation of the incremental costs because costs were assumed to be unavoidable where there was insufficient data.

The ACCC does not consider that regulatory certainty, as ARTC has submitted, provides a sufficient basis for using Direct Costs as a proxy for incremental costs when the information now before the ACCC indicates that this is not appropriate for the 2013 calendar year.

Cross-subsidies

The ACCC is of the view that, in order to avoid a cross-subsidy, a firm that offers a set of services should receive revenue for each service or a group of services that is no more than the standalone cost of providing that service or group of services.[112]

As outlined above, ARTC considers that it is not clear that cross-subsidies arise under its current application of the ceiling revenue test particularly when considered over the longer-term. Whitehaven considers that any cross-subsidy would likely be immaterial, while stakeholders such as Rio Tinto, BHP, Vale and Glencore are concerned that material cross-subsidies do arise. The ACCC understands that ARTC's view in particular is founded on the assertion that direct costs can be an approximation for incremental costs in certain circumstances, as was contemplated by the ACCC during the development of the HVAU. The ACCC agrees with ARTC's view only to the extent that it can be demonstrated that there is no difference between direct costs and incremental costs. The ACCC notes that WIK considered this specific point in its assessment:

> *From our perspective, direct costs can only be an adequate approximation of short-run incremental costs. In the longer run, direct costs are only a subset of incremental costs ... In our understanding, the ARTC substantially underestimates incremental costs by equating them with short-run variable maintenance costs.*[113]

The ACCC acknowledges that some statements made in its Draft Decision in March 2010 in relation to the undertaking that ARTC had proposed in 2009 could potentially be read to discount the possibility of cross-subsidies arising in the context of the HVAU where services pay only for their Direct Costs.[114] Nevertheless, the ACCC notes that, while ARTC calculated the Direct Costs of Pricing Zone 3 Access Holders' use of Pricing Zone 1 as $2.5 million for the 2013 calendar year, WIK's assessment, performed by adopting a long-run perspective, estimated their incremental costs as $14.6 million. As noted by ARTC, the appropriate timeframe for determining potential cross-subsidies is the longer term, particularly given the long life of rail investment.

The ACCC also notes that ARTC submits that the assessment should be done from a whole of network perspective as the Hunter Valley network forms part of one coal chain. However, in the context of the HVAU, the ACCC notes that ceiling revenue test in the HVAU (discussed in more detail below) explicitly provides for different applications between Pricing Zone 3 and the current Constrained Network. As previously outlined, the ACCC is required

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112 G. R. Faulhaber, *Cross-subsidization: pricing in public enterprises, American Economic Review 65(5)*, December 1975, pp. 966-977.

113 WIK-Consult, *Assessment of the Incremental Costs of Pricing Zone 3 Access Holders' Use of Pricing Zone 1 and 2 of the Australian Rail Track Corporation's Hunter Valley Rail Network*, 30 September 2015, p. 20.

114 ACCC, *2010 Draft Decision on the HVAU*, pp. 518-519.

to determine whether ARTC has reconciled revenues with the applicable floor and ceiling limits in accordance with the requirements set out in section 4 of the HVAU.

The ACCC is of the view that the $12.1 million difference between the direct costs assessed by ARTC and the incremental costs assessed by WIK indicates that, if Constrained Coal Customers pay the difference, then a cross-subsidy does arise. As stated above, the ACCC considers that the existence of cross-subsidies in the context of the HVAU is inconsistent with the financial model as well as the HVAU objectives such as 'increasing competition and ensuring efficient use of resources', 'providing access in a transparent, efficient and non-discriminatory manner'.

Interpretation of the ceiling revenue test in the HVAU

The ceiling revenue test is set out in subsection 4.3(a) of the HVAU:

> *In relation to the Segments identified as forming part of Pricing Zone 1 and 2 in Schedule E [of the HVAU], Access revenue from any Access Holder, or group of Access Holders must not exceed the Economic Cost of those Segments which are required on a stand alone basis for the Access Holder or group of Access Holders*

In its submission to the May 2014 Discussion Paper, ARTC described its application as follows:

(a) First, mines and relevant combinations of mines are identified for testing access revenue against the relevant ceiling limit.

(b) Second, for each mine or combination of mines, total access revenue is determined.

(c) Third, the result of that determination is tested against the standalone economic cost, which consists of the total of the Direct Costs for all the segments utilised by that mine or combination of mines, plus the total of fixed costs (including allocated overheads, depreciation and return on capital) for all the segments utilised by that mine or combination of mines.

(d) The test described at (c) above identifies the combination of mines that is the Constrained Group of Mines and the Constrained Network (currently the Constrained Network consists of Pricing Zones 1 and 2).

(e) Unders and overs accounting in accordance with section 4.9 of the HVAU then seeks to ensure that access revenue for the Coal Trains serving the Constrained Group of Mines and operated entirely within the Constrained Network recovers that standalone Economic Cost of the Constrained Network.

(f) The standalone Economic Cost applicable to the combination of mines that is the Constrained Group of Mines excludes Direct Costs associated with traffics that do not serve the Constrained Group of Mines and operate outside the Constrained Network (referred to by ARTC as "unconstrained traffics").

(g) Any access revenue associated with unconstrained traffics utilising part of the Constrained Network (other than the Direct Cost associated with the operation of unconstrained traffics on the Constrained Network) is allocated to parts of the journey of such traffics outside the Constrained Network.[115]

As previously outlined, the ACCC's preliminary view was that ARTC's current application of the ceiling revenue test is inconsistent with subsection 4.3(a) of the HVAU. In particular, the ACCC's preliminary view was that the ceiling revenue limit is the Economic Cost determined 'on a standalone basis'. That is, the ceiling revenue limit for Constrained Coal Customers is

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[115] ARTC, *Submission to the May 2014 Discussion Paper*, pp. 23-25.

equal to the full Economic Cost for the Segments in Pricing Zones 1 and 2 minus the incremental costs (rather than the Direct Costs) for the use of those segments by Access Holders originating outside those Segments (i.e. Pricing Zone 3 Access Holders).

In forming this view, the ACCC notes that the HVAU provides definitions for Economic Cost (see section 4.5 of the HVAU). The Economic Cost of a Segment is essentially the prudent and efficient cost determined using the sum of the underlying components or 'building blocks' consisting of a return on assets, depreciation and efficient operating expenditure. That is, the HVAU entitles ARTC to receive revenue equal to the sum of its efficient costs. The ACCC notes that the definition of Economic Cost also requires that 'all costs are to be assessed on a stand alone basis'.

The HVAU does not provide a definition for what is meant by 'on a stand alone basis'. The concept of standalone costs has a well-accepted meaning in economics. From Faulhaber's paper (also cited in the ACCC's November 2014 Position Paper):

> *… the stand-alone cost of any service or group of services of an enterprise is the cost of providing that service (at the existing or "test" demand level) or group of services by themselves, without any other service that is provided by the enterprise. A closely related concept is that of "incremental cost". The incremental cost of a service or group of services is the additional cost of providing that service or group of services over and above the cost of providing all the remaining services.*[116]

The ACCC does not consider, as ARTC submits, that this application of standalone cost would create an inconsistency in the application of the floor revenue limits and the ceiling revenue limits in section 4.2 and 4.3 of the HVAU respectively. The ACCC is of the view that, while the two limits form the boundaries of the range of permissible ARTC revenue, this does not indicate that they must be determined on the same basis. The ACCC considers that this is particularly the case where the floor revenue limit applies to all Access Holders and Segments, whereas the ceiling revenue limit is calculated differentially depending on the Access Holders and the location of the Segment. The ACCC also considers that the application of standalone cost as outlined above is consistent with the HVAU objectives, HVAU pricing principles and CCA pricing principles

The ACCC notes that the majority of stakeholders provided in principle support for this view, although some stakeholders, such as Whitehaven and Idemitsu, contend that any change to ARTC's application should be considered in detail for any future undertaking. In contrast, Glencore argues that the ACCC's application does not go far enough. Nevertheless, as previously noted, the HVAU requires the ACCC to undertake an assessment of ARTC's compliance with the provisions of the HVAU as it is currently accepted.

Accordingly, the ACCC's Draft Determination is that ARTC's current application does not comply with the ceiling revenue limit in subsection 4.3(a) of the HVAU and that, in order to comply, ARTC needs to amend its compliance documentation to reflect the ACCC's application as outlined above.

Assessment of the impact of the ACCC's Draft Determination

As previously noted, the ACCC engaged WIK to independently review the costs of ARTC's Hunter Valley rail network and estimate the incremental costs of Pricing Zone 3 Access Holders' use of Pricing Zone 1. In summary, WIK estimated the incremental costs of Pricing Zone 3 Access Holders' use of Pricing Zone 1 as $14.6 million for the 2013 calendar year compared to the $2.5 million Direct Costs calculated by ARTC. WIK noted that the approach

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116 Faulhaber G, *Cross-subsidy analysis with more than two services*, August 2002, p. 1. Accessible at: http://assets.wharton.upenn.edu/~faulhabe/cross%20subsidy%20analysis.pdf.

it used provides a conservative estimation of the incremental costs because costs were assumed to be unavoidable where there was insufficient data. The difference between the effect of WIK's estimate on the reconciliation of costs and revenues for Constrained Coal Customers compared to ARTC's current application of the ceiling revenue limit is summarised in the following table.

Table: Reconciliation of revenues received from Constrained Coal Customers with costs incurred within the Constrained Network

2013	ARTC ($)	WIK ($)
Total efficient costs of the Constrained Network (including direct costs associated with PZ3 producers)	300 030 433*	300 030 433*
less direct costs associated with Pricing Zone 3 producers	2 497 914	
less incremental costs associated with Pricing Zone 3 producers		14 582 884
Costs of the Constrained Network to be recovered from Constrained Coal Customers	297 532 519	285 447 549
Revenue received from Constrained Coal Customers	277 929 657	277 929 657
Shortfall in revenue from Constrained Coal Customers	19 602 862	7 517 892

* As previously noted, this figure is subject to change due to revisions related to prudency of capital expenditure

In order to ensure that ARTC recovers its total efficient costs for the Constrained Network, the amount of revenue received from Pricing Zone 3 Access Holders and reconciled with costs incurred within the Constrained Network needs to be revised from $2.5 million to $14.6 million. Further, the amount of revenue received from Pricing Zone 3 Access Holders to be reconciled with costs incurred in Pricing Zone 3 needs to be revised from $62.6 million to $50.5 million. The effect of this is summarised in the following table.

Table: Reconciliation of revenues received from Pricing Zone 3 Access Holders with costs incurred within Pricing Zone 3

2013	ARTC ($)	WIK ($)
Total cumulative losses for Pricing Zone 3 at the beginning of the year	10 438 669	10 438 669
add total efficient costs of Pricing Zone 3 for the period	60 951 405*	60 951 405**
less revenue received from Pricing Zone 3 Access Holders to be reconciled with Pricing Zone 3 costs	62 588 568	50 503 598
Total cumulative losses for Pricing Zone 3 at the end of the year	8 801 506	20 886 476

* Note that in the absence of detailed reconciliations from ARTC, this figure is indicative only and has been calculated as the difference between the opening and closing cumulative losses less revenue.

** Note that this unchanged for comparative purposes.

The ACCC notes that WIK's definition in relation to incremental and standalone costs is consistent with the ACCC's views and that this definition appears not to be in dispute amongst stakeholders. The point of contention, however, is the timing of application (as discussed previously) and the methodology to be applied in estimating incremental costs. In

Whitehaven's view, this is a difficult calculation with a number of subjective components that will require agreement on methodology. In response to the November 2014 Position Paper, stakeholders provided a range of views on how the incremental costs of Pricing Zone 3 Access Holders' use of Pricing Zone 1 should be estimated and the practicalities of such approaches. For example, BHP suggested as a first step to identify the Direct Costs of Pricing Zone 3 Access Holders using Pricing Zone 1 plus any capital expenditure projects that were commissioned to increase capacity of Pricing Zone 1 so as to accommodate the increase in volumes from Pricing Zone 3. This approach was similar to those expressed by Rio Tinto and Vale.

The ACCC considers that WIK's assessment provides a thorough, albeit conservative, estimate of the incremental costs of Pricing Zone 3 Access Holders' use of Pricing Zone 1. WIK's assessment considers both operating and capital expenditure and the extent to which these costs are variable (i.e. driven by usage). Also, WIK's assessment considered only those Segments in Pricing Zone 1 that are traversed by Pricing Zone 3 traffic. The ACCC notes Whitehaven's submission that investments have occurred in Pricing Zone 3 that have freed up train paths in Pricing Zone 1. However, WIK has not considered those investments in its assessment. The ACCC considers that this is appropriate in this context as those investments would have been avoidable had there not been Pricing Zone 3 traffic on the network.

For these reasons, the ACCC is of the view that WIK's estimates and the associated effects as summarised in the above tables are appropriate for forming the basis of this Draft Determination. This enables stakeholders to provide comment on the methodology applied by WIK and the ACCC welcomes stakeholders' views on this aspect of the assessment.

2.4. True-Up Test audit

The HVAU incorporates liability arrangements in the Indicative Access Holder Agreement that provides for the payment of rebates to users for ARTC's failure to deliver contracted path usages. The payment of these rebates occurs following the completion of an annual reconciliation process, which is informed by the True-Up Test.

The True-Up Test determines whether there was sufficient capacity available on ARTC's 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.

Subsection 4.10(f) of the HVAU requires an independent audit of ARTC's compliance with the True-Up Test, to ensure the integrity of the test and avoid perceptions of conflicts of interest on the part of ARTC. ARTC engaged BDO (SA) Pty Ltd (BDO) as auditor for the True-Up Test, which the ACCC approved in accordance with subsection 4.10(f)(ii).

2.4.1. ARTC's May 2014 Compliance Documentation

ARTC submitted that a 'True-Up Test was conducted for each month and quarter (as applicable) during the [2013] Compliance Period'.[117] BDO prepared a final audit report regarding ARTC's True-Up Test for 2013, which was provided to the ACCC on 21 May 2014 as part of ARTC's compliance submission. ARTC submitted that BDO's final audit report concluded that it was not liable for any rebates for the 2013 calendar year.

2.4.2. ARTC's True-Up Test Review

ARTC conducted, in consultation with stakeholders, a review of the operation and effectiveness of the system-wide True-Up Test, as required under section 13.4 of the

117 ARTC, *Initial Compliance Submission*, May 2014, p. 27.

HVAU.[118] On 5 September 2014, ARTC notified the ACCC that had decided not to propose a variation to the HVAU in response to the matters raised by stakeholders.

2.4.3. ACCC's Draft Determination

The True-Up Test is subject to audit by an independent party with the appropriate qualifications in order to ensure the integrity of the test. The ACCC notes that BDO's final audit report concludes that:

> *In our opinion, ARTC has complied, in all material respects, with Schedule 2 of the Access Holder Agreements under the HVAU for the year ended 31 December 2013.*[119]

The ACCC specifically notes BDO's comments that:

> *No system availability shortfall was recorded for any period during the year meaning no accruals were required to be paid.*

On the basis of BDO's report, the ACCC considers that it is appropriate to accept the outcome of the True-Up Test, being that ARTC is not liable for any rebates for the 2013 calendar year.

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[118] ARTC's True Up Test review report can be accessed at: http://www.accc.gov.au/regulated-infrastructure/rail/artc-advices-on-reviews/true-up-test-review

[119] BDO, Independent compliance audit report to Australian Rail Track Corporation Ltd, 28 March 2014, p. 1.