ARTC 2013 ANNUAL COMPLIANCE ASSESSMENT

RESPONSE TO ACCC POSITION PAPER

ARTC

Australian Rail Track Corporation

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1 Executive Summary

This document is provided to the ACCC in response to a Position Paper released on 26 November 2014 (**Position Paper**) in relation to ARTC's compliance with the Hunter Valley Coal Network Access Undertaking (**HVAU**) for the period 1 January 2013 to 31 December 2013 (**2013 Compliance Period**).

The Position Paper raises 4 key issues.

In relation to the three issues raised about prudency of capital expenditure, efficiency of operating expenditure and the true up test, ARTC has provided the additional information sought by the ACCC (see sections 3.1 and 3.2). Subject to further issues being raised by other stakeholders, ARTC considers there are no remaining issues in these areas for the 2013 Compliance Period.

The key outstanding issues relate to ARTC's reconciliation of access revenue with applicable Ceiling Limits required under section 4.9 of the HVAU (which are addressed in section 3.3). The ACCC has raised three issues in its Position Paper in relation to this aspect of the 2013 compliance assessment:

- Compliance with the revenue ceiling test;
- Transparency; and
- Impact on investment decisions.

1.1 Compliance with the revenue ceiling

The ACCC's preliminary view is that ARTC's current revenue allocation approach appears inconsistent with the Ceiling Limits in section 4.3(a) of the HVAU.[1]

ARTC does not agree with the ACCC's preliminary view, which 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.

1.1.1 Misconceptions about the reconciliation process

Before addressing the proper application of the reconciliation of Access Revenue with the applicable Ceiling Limit under section 4.9 (**Ceiling Test**), it is necessary to address some fundamental misunderstandings about the test.

[1] ACCC Position Paper, p 28.

First, the Ceiling Test is a separate process, and is unrelated, to the methodology for charging for access under the HVAU.

It appears that stakeholders are conflating the manner in which charges are levied under the HVAU and access agreements with the reconciliation process under section 4.9. That is, because Pricing Zone 3 producers' charges include an amount referable to capital costs for Pricing Zone 1, it follows that for the purposes of the reconciliation process that such revenue (or a portion of it) should necessarily be included in the access revenue tested against the Ceiling Limit for the Constrained Network. While the confusion is perhaps understandable, this is not the case.

Under the NSWRAU, coal access pricing was based on net tonnes. This method of pricing did not provide a basis for attributing revenue from an individual Access Holder to a particular part of the network that it was using. There was simply an amount of revenue for the whole journey. The move to gtk pricing in the HVAU does not, and was not intended to, alter the fundamental application of the Ceiling Test that applied under the NSWRAU. (For more detail see section 3.3.1.3). While gtk pricing provides a link between revenue collected from an individual Access Holder and Pricing Zones, it does not mean that revenue allocation for the purposes of the reconciliation process is done by Pricing Zone.

Second, the proper application of the Ceiling Test is not done by Pricing Zone but involves a combinatorial ceiling test that involves identifying the Constrained Network by reference to the access revenue obtained from the Constrained Coal Customers (being the customers for the Constrained Group of Mines who are only using the Constrained Network). Revenue allocation is an outcome of the application of the combinatorial ceiling test and not a separate process that is done prior to, or separately from, that test. (For more detail see section 3.3.1.3).

1.1.2 Proper application of the Ceiling Test

Section 4.9 of the HVAU sets out the reconciliation test to ensure compliance with the Ceiling Limits in section 4.3. Section 4.9 requires reconciliation of "Access revenue" with "applicable Ceiling Limits". This requires an understanding of what constitutes the applicable Ceiling Limit and Access revenue for the purposes of the Ceiling Test and related concepts of Economic Cost, Direct Cost and Incremental Cost.

1.1.2.1 Applicable Ceiling Limit and Access revenue

Ceiling Limit is defined in section 4.3(a).

The opening words of section 4.3(a) limit the application of the Ceiling Limit to segments in Pricing Zone 1 and Pricing Zone 2. A number of stakeholders appear to interpret the references to these zones as imposing a test that requires a reconciliation of costs and revenue on a Pricing Zone basis.[2] This is clearly incorrect. The purpose of these opening words is to ensure that the Ceiling Test does not override the operation of loss capitalization applicable in Pricing Zone 3. (The meaning and history of these opening words is explained in section 3.3.2. Stakeholder comments in relation to compliance with the Ceiling Test are addressed in section 3.3.3). Further, it is clear that

[2] ACCC Position Paper, p 24.

the HVAU operates so that the boundaries of the Constrained Network can be smaller or greater than Pricing Zone 1 and Pricing Zone 2.

The Ceiling Limit and the related Access Revenue are determined by reference, and limited, to the Constrained Group of Mines:

- The Ceiling Limit under section 4.3(a) is the "*Economic Cost of those Segments which are required on a stand alone basis for the Access Holder or group of Access Holders*".
- When section 4.3(a) and 4.9 are read together, the Access Holders in section 4.3(a) must be those Access Holders who are Constrained Coal Customers in relation to the Constrained Group of Mines.
- Thus the "applicable Ceiling Limit" in section 4.9 must be the Economic Cost of those Segments forming part of the Constrained Network for those mines.
- The Constrained Group of Mines is defined to mean the "*mines and unloading points that are serviced by Coal Trains where the operation of those Coal Trains is entirely within the Constrained Network...*". Thus, it is clear that other producers may use the Constrained Network but not be a Constrained Coal Customer.
- The "Access revenue" in sections 4.3 and 4.9 must be the access revenue collected from the Constrained Group of Mines (which can include export and domestic coal), noting that since their entire journey is within the Constrained Network, it is all the revenue from that mine with no need to allocate revenue between Segments or Pricing Zones.

Importantly, access revenue collected from Access Holders who are not within the Constrained Group of Mines is not relevant to the reconciliation of the Ceiling Test even if they are using the Constrained Network.

1.1.2.2 Interaction with Floor Limits, Direct Cost and Incremental Cost

The reason that the Access Holder revenue outside of the Constrained Group of Mines is not relevant is because ARTC is also constrained by the Floor Limits in section 4.2. There are two Floor Limits in section 4.2.

Under the first Floor Limit, ARTC must recover Access revenue from all Access Holders at least equal to the Direct Cost imposed by that Access Holder (section 4.2(a)), including the use of the Constrained Network for an Access Holder who is not part of the Constrained Group of Mines.

- Direct Cost is defined to mean maintenance costs that vary with the usage of the network.
- At ARTC's discretion, ARTC may also include other costs that vary with usage of the Network (excluding depreciation).
- The ACCC was concerned that maintenance costs only reflected the short run marginal cost of access, particularly where access agreements may be long term. The discretion to include non-maintenance costs was included after discussions with the ACCC during the HVAU approval process. ARTC did not consider the concept of variable capacity was sufficiently explored or well understood but did not wish to preclude the possibility in the future and so included it in the discretion. The ACCC accepted this position.[3] (For more detail see section 3.3.6).

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[3] ACCC Draft Decision on 2009 HVAU (March 2010), section 12.5.2.7.

Under the second Floor Limit, ARTC has the objective of recovering sufficient Access revenue from Access Holders using a Segment or Segments to meet the "Incremental Cost" of the Segment or Segments. Incremental Cost is defined to mean "*all costs that could be avoided in the medium term if a Segment was removed from the Network*". It was accepted by the ACCC (and as required by the National Competition Council previously) that this should not be a binding limit but an objective. [4]

There are a number of points to be drawn from this.

- First, while ARTC could include capital costs relating to variable capacity in Direct Costs, it has not elected, and nor is it required, to do so. Its views on the practicality of doing so have not changed.
- Second, under the Ceiling Test, the Constrained Group of Mines do not bear the Direct Costs of other Access Holders using the Constrained Network. This removes any meaningful cross-subsidisation concerns.
- Third, the ACCC extensively considered the interaction of Direct Cost and Incremental Cost in the context of stakeholders raising cross subsidy concerns and the ACCC clearly understood that:
    - there could be users of the Constrained Network who are only paying Direct Costs for that network (see section 3.3.1.2);
    - the reconciliation process meant that unconstrained users only "contribute" Direct Costs to the Constrained Network (for more details see section 3.3.1.2); and
    - the binding requirement in relation to the application of the Ceiling Test only required that Direct Cost (rather than Incremental Cost) of the unconstrained users of the Constrained Network be taken into account for the Ceiling Test.

  The ACCC also found (even before the discretion to add non-maintenance costs into Direct Costs was included by ARTC) that the Floor Limits "*are likely to be appropriate as they are unlikely to result in significant cross subsidisation or highly inefficient pricing*". (ACCC 2009 Draft Decision on HVAU, section 12.5.2.7).
- Fourth, given the foregoing, the Position Paper is in error in requiring that capital costs be included in Direct Costs. As ARTC has applied Direct Costs to all traffics using the Constrained Network that are not part of the Constrained Group of Mines, ARTC is therefore in compliance with the Floor Limits and with what constitutes Direct Costs for the purposes of the Ceiling Test.

1.1.2.3 Standalone Economic Cost

As noted above, the Ceiling Limit under section 4.3(a) is the "*Economic Cost of those Segments which are required on a stand alone basis for the Access Holder or group of Access Holders*".

Economic Cost for a Segment is defined in section 4.5 and includes the return and depreciation on the assets in the Segment, an allocation of Non-Segment Specific Assets and direct and indirect operating costs for that Segment. All costs are to be assessed on a standalone basis. Standalone is not defined in the HVAU.

In the Position Paper, ARTC understands the ACCC has formed the preliminary view that "standalone" means the costs of the Segment less "incremental costs" where incremental costs

[4] ACCC Position Paper on 2010 HVAU (Dec 2010), section 5.3.2.

means variable costs (ie Direct Costs) and the fixed costs that could be avoided if the unconstrained users did not use the Constrained Network.[5] The ACCC states "*the relevant timeframe when considering incremental costs is the long term, which will include fixed costs that may change over the long term*".[6]

ARTC does not agree with the ACCC's preliminary view as to the meaning of standalone in the context of the HVAU.

1.1.3 ACCC's interpretation is not consistent with the HVAU

There are a number of interpretation and practical issues with the ACCC's approach.

First, "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. (For more detail see section 3.3.6). The ACCC's approach improperly imports a new definition of incremental cost into the meaning of standalone in the context of:

- the HVAU already having a definition of Incremental Cost;
- the HVAU not using that definition or concept in the Ceiling Limit in section 4.3;
- the issue of incremental cost having already been extensively considered in relation to the approval of the HVAU and its application to the Ceiling Test (by way of the meaning of Direct Cost); and
- the ACCC's imported concept of incremental cost (which is based on the long term) being different to that already used in the HVAU (which is based on the medium term).

Further, adopting the ACCC's interpretation of "standalone" would create an inconsistency in the application of the floor and ceiling tests. This is because the ACCC's interpretation of "standalone" for the purposes of the Ceiling Test involves excluding 'incremental costs', rather than Direct Costs, whereas the Floor Limit is determined by reference to Direct Costs. An interpretation that creates an internal inconsistency in the application of the HVAU is inappropriate and should be avoided.

Second, the ACCC's approach is not practical, which further demonstrates that the approach is not consistent with the proper interpretation of the HVAU:

- The ACCC appears to be assuming that the proposed approach need only be applied to the combination of mines forming Pricing Zone 1 and Pricing Zone 2, requiring an assessment of only the incremental impact of Pricing Zone 3. This is not the correct application of the combinatorial ceiling test – the reconciliation process identifies the Constrained Network; the test does not commence with a pre-defined Constrained Network.
- Under a combinatorial ceiling test, the Constrained Network 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.
- There are millions of combinations that apply. While many combinations can be dismissed, there is still a significant number that need to be considered.

[5] ACCC Position Paper, p 27-8.
[6] ACCC Position Paper, p 27.

- The ACCC's approach would require a standalone assessment (effectively an optimization) of the network for each combination of mines considered, ie ARTC would have to determine the capital costs for a network built only to service the traffic from the mines under consideration.
- The impracticality of this assessment was recognized by IPART and stakeholders in the development of the NSWRAU and IPART did not interpret the ceiling test in this manner or require this approach. ARTC was explicit when submitting the HVAU that there was no intention to change the existing approach, nor did the ACCC or stakeholders ever raise the prospect of such an approach during the extended period of consultation prior to the approval of the HVAU.
- This is explained in detail in section 3.3.6.1.

Third, the outcomes of the ACCC's approach are not consistent with the HVAU objectives, HVAU pricing principles or CCA pricing principles.

- Under the HVAU, ARTC is permitted to, and could be required to, provide access to an access seeker at Direct Cost, including the Constrained Network (see section 3.3.6).
- Direct Cost clearly excludes depreciation.
- As discussed in section 3.3.6.2, the ACCC's approach of introducing a new incremental cost concept in the Ceiling Test when combined with the existing concept of Direct Cost (which excludes depreciation) means ARTC could in certain circumstances be unable to recover the full economic cost of the network.
- Such an outcome is not consistent with the HVAU and CCA pricing principles that regulated access prices should be set so as to generate expected revenue for a regulated service or services that is at least sufficient to meet the efficient costs of providing access to the regulated service or services.

Fourth, the ACCC's preliminary view is not reasonable in the circumstances.

- ARTC's interpretation is consistent with that applied under the NSWRAU for over a decade (see section 3.3.1.3).
- ARTC lodged the HVAU on the basis that it was not changing the approach to the Ceiling Test used under the NSWRAU (other than for loss capitalisation which is discussed below).
- The ACCC was clearly advised by ARTC during the approval process of how the reconciliation process operates, including expressly that unconstrained traffic would only contribute Direct Cost to the Constrained Network (see section 3.3.1.2). The ACCC considered the issue in detail and approved the HVAU on the basis of that interpretation. The ACCC formed the view that it did not give rise to material issues of cross subsidisation.
- The ACCC has followed ARTC's interpretation in previous reconciliations under the HVAU.
- The ACCC is in effect reopening the undertaking which is against accepted regulatory practice and the fundamental principle of undertakings providing regulatory certainty during their term.

Finally, the ACCC's preliminary view appears to be predicated on the basis that there is cross subsidisation between Pricing Zone 1 and Pricing Zone 3 producers, which needs to be addressed. 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. The ARTC explained this at some length in sections 7 and 8

of its submission to the Revenue Allocation Review (**RAR**) in August 2014. The ACCC has not addressed these submissions in its Position Paper. It is also surprising that the ACCC now finds issues of cross subsidisation when it considered that very issue at some length in approving the HVAU in circumstances when it clearly understood the historical and proposed operation of the Ceiling Test.

1.1.4 Impact on ARTC

If the ACCC maintains its preliminary view and limits its application to identifying the Pricing Zone 1 projects "*that were commissioned to increase capacity of Pricing Zone 1 solely to accommodate the increase in volumes from Pricing Zone 3*",[7] then on the assumption that the projects under consideration are those undertaken in the 2013 compliance period, ARTC can confirm no projects were solely commissioned for the purposes of Pricing Zone 3 volumes.

Under the Access Agreements, new volumes are conditional on defined projects being undertaken. ARTC can confirm that all projects undertaken in Pricing Zone 1 were a condition precedent to new volumes for Pricing Zone 1 and 2 producers as well as Pricing Zone 3 producers.

However, it is not clear to ARTC if the ACCC is proposing to "split" project capital costs in Pricing Zone 1 between Pricing Zone 1/2 producers (assuming they are all within the Constrained Network) and Pricing Zone 3 producers. At a high level, ARTC's preliminary discussions with the HVCCC in relation to ARTC's capital investment in 2012 and 2013 suggests:

- the Pricing Zone 1 projects would have proceeded in substantially the form undertaken irrespective of additional Pricing Zone 3 volumes;
- there is the potential that Pricing Zone 3 projects have also contributed additional capacity to the entire coal chain to the benefit of all users, including Pricing Zone 1 and 2 producers.

ARTC is uncertain whether the ACCC's approach could significantly lower the applicable Ceiling Limit for the Constrained Network involving segments in Pricing Zone 1 and Pricing Zone 2. If this does occur for a material amount, the ACCC assumes that ARTC will not be adversely affected by its new interpretation.[8] In particular, as loss capitalisation applies to Pricing Zone 3, the ACCC assumes the reduction of revenue allocated to Pricing Zone 3 arising from the greater Pricing Zone 1 allocation is capitalized for Pricing Zone 3 and recovered in the future. However, ARTC will be materially adversely affected if the ACCC maintains its preliminary view and this results in a significant reduction in the Ceiling Limit:

- A lowering of the Ceiling Limit will reduce the revenue earned by ARTC in the 2013, 2014 and 2015 years. ARTC would need to address those reductions in revenue in its accounts (noting that its accounts for 2012/2013 and 2013/14 have already been finalised and capital and funding decisions have been made on the basis of those accounts). This could have a significant impact on ARTC's financial performance in the short term.
- Further, pricing has already been determined for 2015 based on ARTC's approach to the Ceiling Test and as such pricing for 2015 will not be consistent with the new Ceiling Limit leading to large unders and overs. Although an under-recovery in Pricing Zone 3 will lead to an increase in loss capitalisation in Pricing Zone 3, this approach will increase the revenue exposed to stranding risk in relation to Pricing Zone 3 mines (see section 3.3.8).

[7] ACCC Position Paper, p 28
[8] ACCC Position Paper, p 29.

While loss capitalisation is intended to provide a framework for recovery of losses at some point in the future where the market permits, it does not address the risk of that recovery not actually materialising.

1.2 Transparency

The ACCC notes that the majority of stakeholders have submitted they were not aware of ARTC's approach to revenue reconciliation as it was not apparent under the terms of the HVAU and that this highlights the need for greater transparency and provision of information on ARTC's financial model.

While ARTC acknowledges that some producers were of the view that greater transparency was required, it is also noted that the approach to revenue reconciliation had been previously used for over a decade in the Hunter Valley and involved:

- the provision of extensive information over the 3 year consultation period for approval of the HVAU; and
- the use of various consultants and resources by producers over the consultation period for approval of the HVAU.

ARTC clearly explained the approach to the ACCC (see section 3.3.1.2). Presumably, the ACCC did not see the need to more specifically consult on the approach because it formed the view that the approach was acceptable and assumed (like ARTC) that stakeholders understood the approach.

In any case, ARTC is willing to discuss the need for further transparency of the reconciliation process with the ACCC. (For further detail see sections 3.3.1.2 and 3.3.7).

1.3 Impact on investment decisions

A number of issues have been raised in relation to the impact on investment.

First, the issue of cross subsidisation which has been addressed above (see section 1.1.3).

Second, it is claimed ARTC's approach will lead to inefficient capacity expansions as ARTC will be incentivised to fund capacity in Pricing Zone 1 rather than Pricing Zone 3 as it will allow ARTC to recover the revenue earlier. This is not correct – in fact, this will be the effect of the ACCC's approach. If more revenue from Pricing Zone 3 producers is allocated to Pricing Zone 1, this would increase the loss capitalisation in Pricing Zone 3 and the impact of stranding risk so ARTC would have more incentive to invest in Pricing Zone 1 rather than Pricing Zone 3. The reality is that ARTC has invested significant capital in Pricing Zone 3 on the basis of its current approach (see sections 3.3.5 and 3.3.8).

Third, awareness of the revenue allocation approach may have changed investment decisions by the RCG. Stakeholder submissions on the level of knowledge of ARTC's approach is mixed. ARTC's preliminary discussions with the HVCCC suggest that recent investments in Pricing Zone 1 would have had coal chain wide benefits, including for Pricing Zone 1 producers, so this assertion is speculative. ARTC further notes that Pricing Zone 1 capital investment was approved by the RCG with an understanding of the pricing impacts for Pricing Zone 1 producers and in circumstances

where such pricing has not significantly impacted competition in above rail markets or distorted competition in the market for seaborne coal.

Nevertheless, the ACCC has formed a preliminary view that it is likely that ARTC's approach has distorted past investment decisions.[9] The ACCC has not provided the basis of, or any evidence for, this assertion and without further information, ARTC is not in a position to address the ACCC's concerns.

1.4 Conclusion

ARTC intends to resubmit 2013 Compliance Submission to address the further information and matters discussed in relation the prudency of capital expenditure and efficiency of operating expenditure.

ARTC maintains that it has complied with the Ceiling Test requirements of the HVAU and does not agree with the ACCC's preliminary view that its approach to the Ceiling Test is inconsistent with the HVAU. One of the pricing objectives in the HVAU (section 4.13) is to maximize the recovery of efficient capital costs. ARTC is not recovering its full capital costs for the Hunter Valley network and loss capitalisation for Pricing Zone 3 does not fully mitigate this issue. The ACCC's interpretation of what constitutes stand alone cost is inconsistent with the relevant context of the pricing principles under the HVAU, the historical precedent under the NSWRAU, the ACCC's own decision to approve the HVAU and is unworkable in practice.

If, the ACCC maintains its preliminary view, then ARTC's high level analysis based on the recent projects in Pricing Zone 1 is that the ACCC's approach is unlikely to give rise to a substantially different outcome to the Ceiling Test. However, this will depend on how the ACCC intends to implement such an approach. ARTC considers there are substantial practical challenges and complexity involved. The ACCC has given very little guidance and ARTC is unable, at this stage, to meaningfully address the potential implementation of the ACCC's preliminary view to the Ceiling Test. If the ACCC maintains its preliminary view, then ARTC does not believe the ACCC is in a position to unilaterally determine the Ceiling Limit and ARTC therefore requests the ACCC to provide further guidance on implementation and an opportunity to make further submissions.

[9] ACCC Position Paper, p 29.

2 Introduction

2.1 Confidentiality

This document contains no confidential information and is provided for the purpose of assisting the ACCC in its assessment of ARTC's compliance with the HVAU during the 2013 Compliance Period. The ACCC may publish this document should it wish to do so.

3 Issues raised by the ACCC in the Position Paper

3.1 Prudency of Capital Expenditure

3.1.1 Major Capital Expenditure

From the Position Paper, ARTC notes that the ACCC has indicated that it is satisfied that ARTC has shown evidence of Rail Capacity Group (**RCG**) endorsement for $126 860 489 to be rolled into the regulatory value of assets for the 2013 Compliance Period except for one project, being the Aerosol (Murrumbo) Valley Loop for which ARTC has sought to roll $37 750 of post-commissioning costs into the regulatory value of assets.

Subject to evidence in relation to this project being provided, ARTC notes the ACCC's preliminary view is that the major capital expenditure amount of $126 898 239 that ARTC has sought to roll forward into the regulatory value of assets for the 2013 Compliance Period is likely to be prudent.

ARTC has provided this evidence to the ACCC.

3.1.2 Minor Capital Expenditure

Based on the information provided by ARTC in its compliance submission in relation to the 2013 Compliance Period (**2013 Compliance Submission**) and additional documents provided by ARTC, the ACCC has indicated that it has been unable to reconcile the amounts and scope of minor capital expenditure that ARTC has sought to roll forward into the regulatory value of assets with that endorsed by the RCG. The ACCC also indicated that it not provided with a report detailing variations in minor capital projects between January 2013 and June 2014 tabled before RCG members.

ARTC has provided additional information sought by the ACCC to confirm RCG review, including obtaining a copy of the report to RCG members outlining the variations in expenditure.

3.1.3 Interest During Construction

ARTC notes that subject to no concerns being raised by stakeholders in relation to the projects and associated interest during construction, the ACCC's preliminary view is that the interest during construction amount submitted by ARTC is likely to be appropriate.

3.1.4 Disposals

ARTC notes that subject to no concerns being raised by stakeholders in relation to the projects and associated disposals, the ACCC's preliminary view is that the net loss on disposals amount submitted by ARTC is likely to be appropriate. ARTC has provided further clarification sought by the ACCC on how the proceeds from the sale of assets and/or transfer to inventory stockpiles have been incorporated into ARTC's financial model to ensure that the amounts have indeed been appropriately removed from the regulatory value of assets. ARTC has also proposed to correct an error identified in the treatment of disposals in its submission.

3.2 Efficiency of Operating Expenditure

3.2.1 Maintenance Costs

For its annual compliance assessment in relation to the period 1 January 2012 – 31 December 2012, 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 that the additional information submitted by ARTC in response to requests from the ACCC provided useful context to the cyclical nature of rail maintenance programs and would assist in informing future annual compliance assessment.

The report provided to the ACCC involved significant resourcing and cost. As the ACCC had not indicated that it sought this additional level of detail to be provided as part of future submissions, and had indicated that the report would be useful in providing context to the cyclical nature of rail maintenance programs and would assist in informing future annual compliance assessment, ARTC was not under the impression that it would be required to undertake this activity every year going forward.

Each year, ARTC has been asked to provide significant additional information to the ACCC in order to assist the ACCC to carry out its assessment. In some cases, this information has not been sought on a regular basis. In relation to cost efficiency, the ACCC has sought, and ARTC has provided, detailed unit cost comparisons and explanations of trends on a regular basis. In some cases, this information has not been sought on a regular basis.

As the cost associated with regulatory compliance is borne by users (where the network is constrained), ARTC seeks to keep this cost at a minimum.

ARTC is now aware that it is the ACCC's view is that more detailed information is necessary to enable review of ARTC's maintenance expenditure, and has provided the information sought by the ACCC in relation to the 2013 Compliance Period.

3.2.2 Expensed Project Costs

ARTC notes that subject to stakeholders not raising any concerns with ARTC's proposed approach to expensing projects in this instance as provided for under section 8.2 of the HVAU, the ACCC's preliminary view is that including $8.97 million in operating expenditure for the 2013 Compliance Period is likely to be appropriate.

3.2.3 Network Control Costs and Corporate Overheads

ARTC notes the ACCC's preliminary view is that ARTC's network control costs and corporate overheads for the 2013 Compliance Period are likely to be appropriate.

3.2.4 Other matters

ARTC recognises Asciano's concern regarding the lack of incentive scheme for ARTC to efficiently incur all its operating expenditure.

In accordance with Section 13.3 of the HVAU, ARTC submitted an application to vary the HVAU to incorporate a positive performance incentive scheme including several incentive mechanisms as listed below.

<u>Network KPIs focussed on controllable behaviours related to capacity and throughput</u>

Coal Chain Losses – ARTC cause.

Transit Time – impact of temporary speed restrictions.

<u>Network KPIs focussed on other controllable behaviours</u>

Track condition measured by index.

<u>Innovation related performance incentive</u>

Additional Capacity investment innovation incentive.

ARTC's application followed substantial consultation with relevant stakeholders (as required under Section 13.3 of the HVAU) including the release of a draft set of incentives for consultation. The draft set of incentives included, for consultation, a mechanism to incentivise ARTC to improve productivity by enabling ARTC to capture any benefits for delivering services at costs below pre-agreed benchmarks, as presented below:

> *'A positive performance incentive mechanism to improve ARTC productivity, based on encouraging ARTC to continuously seek improvement in productivity and reductions in the cost of service provision to offset the negative asymmetric application of the Ceiling Limit under the 2011 HVAU. Unit costs are set in advance over a multi-year period. Prices are determined in accordance with these costs, taking into account the actual scope of work, inflation and any extenuating circumstances. ARTC is allowed to keep any revenues in excess of actual costs up*

to the pre-determined amount based on the unit rates. ARTC risks under-recovery to the extent its actual unit costs exceed the previously determined rates and ARTC is unable to demonstrate to the regulator that the variation was justifiable and reasonable (efficient). A number of issues were raised in relation to this mechanism including the nature of the Ceiling Limit under the 2011 HVAU requiring costs to be Efficient and any productivity gains to be passed onto users, as well as some complexity regarding measurement.'[10]

In submissions to this consultation, ARTC identified what it considered to be a common theme as follows:

'Productivity based incentives are either not favoured or considered less important.'[11]

Specifically,

'ARTC notes that stakeholders do not favour a productivity incentive (or at least consider it less important than other incentives) and the reasons for these views. Stakeholders would seem to value increased throughput as more important than cost of service. ARTC recognises that the option put forward does raise some concerns (some even raised by ARTC in the consultation document) but is not aware of many other satisfactory mechanisms to achieve an outcome where a revenue ceiling exists. ARTC is concerned that the very nature of the Revenue Limits requiring costs to be Efficient, and rewards require out-performance of 'Efficient', will serve to work against incentives arising from attempting to obtain those rewards.'[12]

To this end, ARTC decided not to propose a productivity related positive incentive mechanism at the time.

ARTC accepts that the industry may change its views in response to prevailing economic and operational circumstances, and 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.

3.3 Revenue reconciliation with applicable ceiling revenue limits

3.3.1 ARTC's Approach to Revenue Reconciliation

ARTC provides the following comments in relation to the ACCC's characterisation of ARTC's approach to revenue reconciliation with applicable revenue ceiling limits (ceiling test) incorporated in the 2013 Compliance Submission and financial modeling, and in compliance submissions for earlier compliance periods under the HVAU.

3.3.1.1 Compliance of the ceiling test used with the HVAU.

In accordance with Section 4.3(a) of the HVAU, ARTC provides documentation in its annual compliance submission (including the 2013 Compliance Submission) and supporting financial modelling to the ACCC, that seeks to reconcile Access revenue collected from an Access Holder (or

[10] ARTC Hunter Valley Access Undertaking – Non TUT Positive Performance Incentives Consultation Document, p7.
[11] Ibid, p 9.
[12] Ibid, p 12.

a number of relevant groups of Access Holders) against the Economic Cost of those Segments which are required on a stand-alone basis for the Access Holder or group of Access Holders. ARTC contends that the test it undertakes is compliant with Section 4.3(a) where the test seeks to ensure that:

> *'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.'*[13]

Where Access revenue collected from an Access Holder (or combination of Access Holders) is closest to if less than, or exceeds by the largest amount, the Economic Cost of the Segments which are required on a stand-alone basis for the Access Holder or group of Access Holders then that Access Holder or Group of Access Holders becomes the Constrained Group of Mines and the Segments that are required on a stand-alone basis for the Constrained Group of Mines becomes the Constrained Network. ARTC contends that this is compliant with the relevant definitions under the HVAU.[14]

Access Holders that pay Access revenue for Coal Access Rights to the Constrained Network in excess of Direct Cost, that forms part of the coal access revenue for the Constrained Group of Mines, become Constrained Coal Customers for which unders and overs amounts are reconciled via an applicable Constrained Coal Customer Account[15]. ARTC contends that this is compliant with Section 4.9 of the HVAU.

3.3.1.2 The outcome of revenue reconciliation for the Constrained Group of Mines and Constrained Network (Pricing Zones 1 and2).

In the Position Paper, the ACCC states:

> *'Accordingly, Access Holders commencing in their journey in Pricing Zone 3 contribute only to the Direct Costs as they traverse the network in Pricing Zone 1, with the remainder of the revenue received from those Access Holders applied to cover the costs of Pricing Zone 3.'*

Together with similar statements made in earlier public documents such as the discussion paper in relation to the RAR and the decision in relation to the 2012 annual HVAU compliance assessment, it seems to ARTC that the ACCC is suggesting that this outcome of the application of the Revenue Limits under the approved HVAU was not known by itself or widely known by stakeholders until recently. The submissions of some stakeholders to the RAR have similarly indicated this.

Under Section 14.1 of the HVAU, the definition of Constrained Coal Customer is:

> *"**Constrained Coal Customer**" means an Access Holder:*
>
> > *(a) who holds Coal Access Rights under a current written access agreement with ARTC; and*

[13] HVAU, Section 4.3(a).
[14] HVAU, Section 14.1, "Constrained Group of Mines", "Constrained Network".
[15] HVAU, Section 14.1, "Constrained Coal Customer Account".

> *(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;'*

It is clear from this definition that there may be Access Holders that pay Access revenue for Coal Access Rights to the Constrained Network that is not in excess of Direct Cost. Indeed the definition explicitly provides for this possibility.

ARTC notes that the ACCC appears to also acknowledge this possibility in expressing an issue relating to how the unders and overs amount should be allocated to Constrained Coal Customers (which was prescribed in Section 4.8 of the proposed undertaking at the time) in its draft decision in relation to ARTC proposed Hunter Valley Coal Network Access Undertaking in March 2010 as follows:

> *'It is noted that the definition of Constrained Coal Customer does not include those customers who pay only the direct cost of services. However, as these customers are only paying for the direct cost of their services, the ACCC's preliminary view is that they should not be eligible for any refund as their contribution to ARTC's revenue is merely the direct cost they imposed upon ARTC. The ACCC considers that the proposed unders and overs principle appears to be in accordance with normal regulatory practice. However, the ACCC considers that several modifications need to be made before the ACCC would be likely to find it appropriate. The modifications likely to be needed to make the clause appropriate are:*
>
> - *Firstly, to avoid potential claims of economic cross subsidisation, the ACCC considers that any rebate should not be applicable in relation to the "direct cost" an access seeker imposes on ARTC. To resolve this concern, the ACCC considers the methodology should calculate the rebate on the basis of revenue from access seekers excluding revenue related to the direct costs of providing access; and*
> - *Secondly, clause 4.8(b)(iii) is generally unclear on how ARTC will calculate and allocate any rebate. This clause leaves ARTC with a large discretion that could result in disputes and associated costs. Therefore, the ACCC considers that ARTC should specify with more certainty how any rebate (over) or charge (under) is to be calculated for each Constrained Coal Customer.'*[16]

From this it would seem clear that the ACCC accepted the likelihood that there may be Access Holders that pay Access revenue for Coal Access Rights to the Constrained Network that is not in excess of Direct Cost, and that the unders and overs amount should not be allocated to such Access Holders.

The ACCC's understanding in this regard was expected by ARTC given that ARTC had explicitly provided detail has to how revenue was allocated under the relevant revenue tests incorporated in the HVAU in supporting documentation to its April 2009 application in relation to the Hunter Valley Coal Network Access Undertaking.[17]

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[16] ACCC Draft Decision, March 2010, p 596.
[17] ARTC Hunter Valley Access Undertaking Explanatory Guide 13 May 2009, p 100.

This detail has also been provided earlier to coal producers, other industry stakeholders and the ACCC in July 2008 in consultation documents provided during early industry consultation on the HVAU.[18]

The ACCC's March 2010 draft decision was also published for stakeholder consultation.

In its subsequent application of the Hunter Valley Coal Network Access Undertaking, submitted in September 2010, ARTC incorporated in the unders and overs accounting provisions at Section 4.8, clarifying provisions that addressed the ACCC's issue, as noted in the ACCC's position paper in December 2010, as follows:

> '*In the March 2010 Draft Decision, the ACCC considered that:*
>
> - *any rebate resulting from unders and overs should not provide any rebate of Direct Costs; and*
> - *the methodology for calculating any unders and overs amount should be specified.*[19]
>
> *The ACCC notes that ARTC has included a new section 4.8(c) to provide clarity that an overs rebate will not provide any rebate of Direct Costs to Access Holders, and the ACCC considers that this addresses the concern in the Draft Decision.*
>
> *The ACCC also notes that ARTC has amended section 4.8(b)(iii) to specify a methodology to determine unders and overs amounts, and likewise the ACCC considers that this addresses the concerns in the Draft Decision.'*[20]

The ACCC's December 2010 position paper was also published for stakeholder consultation.

In the Position Paper and earlier documentation published by the ACCC in relation to its RAR, the ACCC seems to characterise the potential existence of Access Holders that pay Access revenue for Coal Access Rights to the Constrained Network that is not in excess of Direct Cost, as something that may not be widely known by stakeholders, nor possibly the ACCC, until fairly recently during the annual compliance assessment for the 2013 Compliance Period.

ARTC finds this very concerning given the above extent of relevant disclosure and discussion provided by ARTC both with industry and the ACCC prior to and during development and consultation on the HVAU, as well as by the ACCC on more than one occasion during consultation on the HVAU, as included in formal ACCC documents expressly published for stakeholder consultation.

In undertaking consultation with the industry and the ACCC throughout the early development of, and formal ACCC consultation on, the HVAU, ARTC sought to make available what it considered at the time to be reasonably sufficient information to the ACCC and publicly in relation to the Pricing Principles incorporated in the HVAU, and the application of the Revenue Limits under the HVAU. ARTC's consideration of what was reasonable at the time was guided by its understanding that the application of the Revenue Limits under the HVAU had not changed significantly from that which

[18] In July 2008 a preliminary consultation draft of the HVAU was provided to coal producers, industry stakeholders and the ACCC including an explanatory guide. The relevant detail was provided at Appendix 3 (p 42).
[19] '*Ibid, p 597.'*
[20] ACCC Position Paper, p 89.

applied for many years in the Hunter Valley under earlier regulation, including times where Pricing Zone 2 mines were not constrained, as is the case for Pricing Zone 3 mines more recently.

Furthermore, ARTC comprehensively responded to any request for further information received from stakeholders or the ACCC during this period.

Specific examples of relevant information provided by ARTC during consultation on the HVAU include:

- An Explanatory Guide supporting the 2008 HVAU Preliminary Discussion Draft, which was provided to the ACCC and 32 industry stakeholders (including all coal producers) and an Explanatory Guide supporting the 2009 HVAU Application, which was provided to the ACCC for public consultation. Both of these Guides included an explanation of the combinatorial pricing approach.[21]
- Email sent from ARTC to the ACCC in September 2009 explaining the relationship between Direct Cost, Incremental Cost and the Floor, which expressly states that '*only revenue equivalent to Direct Cost is applied to the Constrained network for Unconstrained traffics*' and that '[r]*emaining revenue for Unconstrained traffics is allocated to that part of their journeys for those Unconstrained traffics outside of the Constrained Network*'.
- Email attachments sent from ARTC to the ACCC in October 2010 in direct response to ACCC information request regarding revenue allocation and application of the Ceiling Limit, which expressly state that "*revenue from all traffics operating on the constrained network will recover Direct Cost…*" and that "*where traffics…also operate on unconstrained parts of the HVAU network (these are termed unconstrained traffics), revenue for these traffics remaining after allocation [for Direct Costs] will be allocated to the unconstrained parts of the network"*. ARTC also clearly stated in these attachments that *"the result of this allocation is that unconstrained traffics make no contribution towards fixed costs for the constrained network, and constrained traffics pay the entire fixed cost for the constrained network (because they can as the network is constrained). In this way, ARTC can maximise recovery of total revenue from the constrained and unconstrained parts of the network."* Further, the spreadsheet explaining the revenue allocation model states "*for any combination of constrained and unconstrained traffic, allocate only sufficient revenue to cover variable cost from unconstrained traffics to constrained segments. This permits total revenue to be maximised in a particular year.*"

Full extracts of the above, together with other examples, have been provided separately to the ACCC.

ARTC contends that these examples demonstrate that ARTC provided detailed advice (including financial modelling and spreadsheet examples) to the ACCC on more than one occasion over the period in relation to:

- how the financial modelling relating to the application of the Revenue Limits in the HVAU would operate;

[21] ARTC Explanatory Guide supporting 2008 HVAU Preliminary Discussion Draft, p 42; ARTC Explanatory Guide supporting 2009 HVAU Application, p 100.

- how constrained and unconstrained traffics would be treated on the constrained network; and
- how revenue would be allocated across the journeys of unconstrained traffics (including unconstrained coal traffics).

ARTC further contends that it would be reasonable to assume, in light of all of the information provided to the ACCC, that the ACCC must have had a sufficient understanding of the financial modelling provided by the ARTC, the practical application of the Revenue Limits under the HVAU, the treatment of constrained and unconstrained traffics in relation to these Revenue Limits, and how revenue would be allocated for the purpose of assessing compliance with the Pricing Principles under the HVAU.

ARTC believes that resolution of concerns held by the regulator or stakeholders during consultation prior to acceptance of a regulatory instrument is far more efficient and provides for more certain future outcomes for all parties compared to raising such concerns during the term of that regulatory instrument.

ARTC therefore finds it difficult to understand why the ACCC, in light of all of the information provided to it:

- did not seek any further information from ARTC at various times over the period;
- did not raise any substantive issues with ARTC in relation to these aspects of the HVAU at various times over the period as it seems to have done more recently in the RAR;
- apart from discussion around the appropriateness of the Floor Limit as described at Section 3.3.8.1 below, did not express any relevant and substantive preliminary views in relation to these aspects of the HVAU in public documents;
- did not further increase stakeholder transparency in relation to these aspects of the HVAU over the period as it seems to have done more recently in the RAR; and
- accepted ARTC's compliance with the HVAU following compliance assessments since the commencement of the HVAU.

Over the period, it would therefore have been reasonable for ARTC to assume that the ACCC was comfortable with these aspects of the HVAU and the extent of public disclosure by ARTC at the time. Since commencement of the HVAU, ARTC has, not unreasonably, relied on this assumption in making decisions around access pricing and substantial capacity investments in the Hunter Valley coal network.

3.3.1.3 Revenue allocation in the 2013 Compliance Submission

In the Position Paper, the ACCC appears to characterise the financial modelling provided by ARTC in support of the 2013 Compliance Submission as carrying out 2 allocations of revenue, one being an allocation of revenue to Segments and Pricing Zones in accordance with the its approach to pricing and then a further allocation of this revenue between Pricing Zones, as follows:

> '*As set out above, ARTC levies charges for Access Holders based on the number of gtkm used as they traverse each Segment that forms part of their journey. ARTC* ***first allocates the***

> ***revenue*** *[ARTC emphasis] received from each Access Holder to the Segments and Pricing Zones as per its approach to pricing.*
>
> *Where revenue has been received and allocated to Segments in Pricing Zone 1 from Access Holders that commenced their journey in Pricing Zone 3, ARTC* ***subsequently deducts the revenue*** *[ARTC emphasis] received from their TOP charges from the amount allocated to the Segments in Pricing Zone 1 and applies it to Segments in Pricing Zone 3.*
>
> *Accordingly, Access Holders commencing in their journey in Pricing Zone 3 contribute only to the Direct Costs as they traverse the network in Pricing Zone 1, with the remainder of the revenue received from those Access Holders applied to cover the costs of Pricing Zone 3.*
>
> *It is* ***after this allocation that ARTC then reconciles its revenues*** *[ARTC emphasis] received with the applicable floor and ceiling limits to determine whether there is any revenue shortfall or surplus in the Constrained Network (which currently excludes Pricing Zone 3*).'[22]

ARTC has never represented that it treats revenue in the manner characterised by the ACCC (as set out above).

The ACCC and stakeholders would be aware that the structure of coal access pricing prior to the commencement of the HVAU was based on net tonnes from origin (mine) to destination (terminal). Due to this pricing structure, coal access revenue could not be identified with a particular part of coal network, only a mine. The NSWRAU therefore provided for a test of revenue collected by ARTC for the whole journey from a mine (or group of mines) to a port or power station against economic cost of that part of the network required for that journey (or group of journeys).

ARTC stated in earlier submissions to the RAR, and on many occasions during stakeholder and ACCC consultation prior to acceptance of the HVAU, that it was not proposing to alter the fundamental application of the ceiling test from that which applied under the NSWRAU. As an example, a statement to this effect was made at the outset of the ACCC consultation in ARTC's Explanatory Guide supporting ARTC initial application in April 2009 (p 63).

Indeed there was no intent on ARTC's part for the proposed approach to pricing to impact on the application of the ceiling test under the NSWRAU. ARTC considers that any approach to pricing merely prescribes a way for revenue to be identified against an Access Holder for use in the ceiling test. Both the net tonne origin-destination based pricing utilised under the NSWRAU and the gtkm based pricing approach under the HVAU essentially achieve this same end. The NSWRAU is non-prescriptive in relation to pricing approach, to the extent that a gtkm based pricing approach similar to that used under the HVAU could have been adopted under the NSWRAU. Such an approach would merely have been used to determine revenue for a mine (or group of mines) to align to the required ceiling test application under the NSWRAU. ARTC considers it most unlikely that, had this approach been adopted, it would have altered the very application of the ceiling test under the NSWRAU.

Under the NSWRAU, access pricing for many non-coal traffics on the NSW rail network (including the Hunter Valley network) has historically been applied in a variety of ways (including on a GTK basis). For the purpose of determining compliance with relevant revenue limits the basis of pricing is not relevant where only total revenue determined over a traffic's journey (calculated through

[22] ACCC Position Paper, p 21.

application of relevant pricing) is tested against the relevant revenue limits in accordance with the NSWRAU.

ARTC has sought to do nothing different in its financial modelling provided to support its 2013 Compliance Submission. Access revenue for a mine is built up as an accumulation of revenue for each Segment used by that mine's journey to the port, based on the application of GTK for that Segment to the price for that Segment.

It is only the Access revenue accumulated over the mine's journey that is then used (by itself or in combinations with other mines) for testing against the relevant Ceiling Limit.

In financial models provided in earlier periods to IPART, the corresponding build-up is based on net tonnes and price for each mine, where, again, the revenue accumulated over the mine's journey that is then used (by itself or in combinations with other mines) for testing against the relevant Ceiling Limit.

Importantly, ARTC does not seek to allocate revenue to parts of a journey based on pricing and then re-allocate revenue to other parts of a journey prior to testing against the Ceiling Limit, as seems to have been characterised in the Position Paper.

3.3.2 Effect on the ceiling revenue limit calculation

In the Position Paper, the ACCC states the following:

> '*Importantly, the ACCC notes that the above approach is equivalent to saying that ARTC has calculated the ceiling revenue limits for Segments forming part of Pricing Zone 1 and 2 by excluding only the Direct Costs of Access Holders originating in Pricing Zone 3 as opposed to the incremental costs.*'[23]

The ACCC seems to have characterised the application of the ceiling revenue limits to Segments or Pricing Zones (in this case Pricing Zones 1 and 2) rather than to revenue for an Access Holder (or group of Access Holders).

Notwithstanding the reference to Direct Costs and incremental costs which will be considered later in this response, ARTC believes that the application of the ceiling revenue limits under the approved HVAU must be considered in light of the relevant development of, and consultation on, the HVAU that occurred during the ACCC consultation leading to that approval.

During ACCC consultation on the HVAU, ARTC incorporated additional clarification of the previous Section 4.2 to create a two new Sections 4.3(a) and 4.3(b) in the April 2011 application of its proposed Hunter Valley Coal Network Access Undertaking, as follows (shown in mark-up back to the previous version):

> ***'4.3 ~~For~~ Ceiling Revenue Limits***
>
> *(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~~, Access revenue~~ must not*

[23] ACCC Position Paper, p 21.

*exceed the Economic Cost of ~~the~~those Segments which are required on a stand alone basis for the Access Holder or group of Access Holders ("**Ceiling Limit**") ").*

~~(c)~~(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 ~~relevant~~ calendar year (t -1).'[24]

A review of published ACCC and ARTC documents at the time reveal that the above amendments made by ARTC were to constrain the application of loss capitalisation to Pricing Zone 3 which was sought in the ACCC's December 2010 position paper as noted below:

'Ceiling limit

Section 4.2(c) places a limit on the amount of Access revenue ARTC may recover. Under this section, Access revenues must not exceed the Economic Cost of the Segments which are required on a stand alone basis to provide services to any Access Holder or group of Access Holders, where the RAB for those Segments is equal to, or falls below, the relevant RAB Floor Limit.

The qualification to the Ceiling Limit — that is, that the limit applies where the relevant RAB is equal to or falls below the relevant RAB Floor Limit — enables the implementation of loss capitalisation. Provided that the Access Revenue earned is consistent with the recovery calculated under the RAB and RAB Floor Limits in sections 4.3(a) and 4.3(b) respectively, ARTC will be constrained to charge during the term of the HVAU no more than Access Revenue that would be allowed under a more typical BBM; that is, ARTC will recover up to Economic Cost, as provided for under section 4.2(c). Where, however, Access Revenue earned is not consistent with the recovery calculated under the RAB and RAB Floor Limits, the shortfall may be capitalised for recovery in later periods.

The use of loss capitalisation is discussed further below.'[25]

'*The underlying assumption of a Loss Capitalisation Model is that the regulated firm's projects will expect to make full recovery of economic cost over their life, notwithstanding that the firm may not be able to recover the appropriate quantum of economic cost during an earlier period or periods. The model intends though that the regulated firm will only have a temporary period to earn a return on a shortfall or loss, and that the period will end once full economic cost recovery begins.*

The ACCC considers that it is appropriate for ARTC to be able to expect to achieve a full economic return on its assets, and that the financial model proposed by ARTC, combining a BBM with an appropriate loss capitalisation component, should, in general, facilitate this outcome.

[24] Hunter Valley Coal Network Access Undertaking, Revised application, 7 April 2011.
[25] ACCC Position Paper in relation to the Australian Rail Track Corporation's proposed Hunter Valley Rail Network Access Undertaking, December 2010, p 76.

Use of loss capitalisation in relation to Pricing Zone 3

ARTC has submitted that loss capitalisation is only likely to occur in relation to Pricing Zone 3. Pricing Zone 3 is referred to as the 'unconstrained' part of the Hunter Valley Rail Network, as the Economic Cost of its Segments is greater than the Revenue received from Access Holders that utilise the zone. ARTC has stated:

> *… the proposed [access charges] in Pricing Zone 3 do not generate sufficient revenue to recover the Economic Cost of that part of the Network. As such the proposed [access charges] should be taken as being subject to the endorsement by the ACCC of the Loss Capitalisation approach proposed by ARTC as described at section 4.3 of the HVAU.*[26]

In the March 2010 Draft Decision, the ACCC recognised that, for this reason, loss capitalisation could be limited to operating in Pricing Zone 3.[27] *The ACCC considered, however, that there were advantages in using a single pricing regime across the entire Network in terms of 'regulatory burden,' and in recognition of 'common regulatory practice.'* [28] *The ACCC acknowledges though that the effect of the view expressed in the Draft Decision is to provide ARTC with the ability to use loss capitalisation across the entire Hunter Valley rail network, including in relation to existing assets.*

The ACCC has reconsidered the preliminary view expressed in the Draft Decision in relation to loss capitalisation, and considers that in order for the undertaking to be appropriate, it should clearly state that ARTC may only utilise loss capitalisation in relation to new investment in Pricing Zone 3. The ACCC has revised its view for the following reasons.

The intent of loss capitalisation is to allow under-recovery of economic cost for a period and then recovery of the relevant shortfall at a later date. In appropriate circumstances loss capitalisation may therefore operate to facilitate investment in new assets where there is limited initial demand, by allowing initial under-recovery of relevant costs in the expectation of 'making up' the shortfall when demand reaches an appropriate level. Loss capitalisation may not, of course, be the only method of encouraging investment in these circumstances, and the particular form of its implementation may require scrutiny.

As ARTC has indicated, it does not expect to recover the economic cost of the network in Pricing Zone 3 in the immediate term. However, the ACCC understands that Pricing Zone 3 serves mines in the Gunnedah Basin, which include new mines by companies such as Whitehaven and Idemitsu, as well as potential new entrant Shenhua Coal.[29] *The use of loss capitalisation in relation to Pricing Zone 3 may, therefore, facilitate ARTC investing in track infrastructure to service those mines, and therefore facilitate increased coal exports via the Port of Newcastle. This is consistent with a conservative application of the above understanding of loss capitalisation.*

Further, the ACCC considers that using loss capitalisation in relation to new investment in Pricing Zone 3 is consistent with the ACCC's general views in the Additional Capacity and

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[26] '*ARTC, 2009 HVAU Explanatory Guide (Supplementary Information), 13 October 2009, p. 29.*'
[27] '*ACCC, Draft Decision on HVAU, 5 March 2010, p. 490.*'
[28] '*ACCC, Draft Decision on HVAU, 5 March 2010, p. 490*'
[29] '*Gunnedah Shire Council, Submission to the Standing Committee on Infrastructure, Transport, Regional Development and Local Government - Inquiry into the Impact of the Global Financial Crisis on Regional Australia, 3 April 2009, p. 2.*'

Investment chapter regarding investment in the Hunter Valley rail network, and should be seen in that light.

Pricing Zones 1 and 2, unlike Pricing Zone 3, are essentially existing assets, and are 'constrained,' that is, access revenues are sufficient or likely to be sufficient to recover economic cost. As such, there is no justification for using loss capitalisation in relation to these Zones.

Ultimately, the ACCC considers that loss capitalisation is a relatively new concept in the regulation of access pricing, and consequently a conservative approach should be taken at these early stages to mitigate the risk of regulatory uncertainty in later decisions. These considerations outweigh the concerns in the Draft Decision regarding regulatory burden and common regulatory practice.'[30]

The reasoning for the inclusion of the clarifications to new Section 4.3(a) and 4.3(b) is reinforced in ARTC's supporting documents to its April 2011 application as described below[31]:

Issue	*Doc ref.*	*ARTC understanding of ACCC recommendation*	*ARTC response*
5	*PP Ch 5.6, p80*	***Loss capitalisation in Pricing Zone 3 only*** *Revisions to ensure that loss capitalisation is confined to Pricing Zone 3 only.*	*Refer Item 6 of this table.* *In light of the ACCC's conservative approach to this innovation, ARTC has amended new sections 4.2 and 4.3 (which are now sections 4.3 and 4.4) of 2010 HVAU to limit application of loss capitalisation to Pricing Zone 3 only.*
6		*Loss Capitalisation to apply to new investments only in Pricing Zone 3* *Revisions to ensure that loss capitalisation is confined to new investment assets in Pricing Zone 3 only.* *Conservative approach required with loss capitalisation to avoid regulatory uncertainty.*	*ARTC proposes to maintain the approach proposed in the 2010 HVAU.* *ARTC advises that PZ3 producers are supportive of the PZ3 loss capitalisation as proposed by ARTC in the 2010 HVAU.*

The above clarifications to Section 4.3(a) and 4.3(b) were also reflected in ARTC final June 2011 application in relation to the Hunter Valley Coal Network Access Undertaking, which was accepted by the ACCC.

It is ARTC's view that the above evidence strongly supports ARTC's assertion that these clarifications were made to constrain the application of loss capitalisation to Pricing Zone 3, as sought by the ACCC at the time. ARTC asserts that the interpretation now seemingly placed by the ACCC on these clarifications in the context of this assessment (where ceiling revenue limits might be determined for particular Segments or Pricing Zones) is not supported by ARTC's and the ACCC's published intentions at the time.

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[30] ACCC Position Paper in relation to the Australian Rail Track Corporation's proposed Hunter Valley Rail Network Access Undertaking, December 2010, p 80.

[31] ARTC Revised Application – 2010 HVAU – Supporting Document - ACCC Issues Review (13 April 2011)

In the 2013 Compliance Submission and supporting financial modelling, ceiling revenue limits are only determined in relation to the use of the Network by an Access Holder (or group of Access Holders).

3.3.3 Stakeholder Comments in relation to compliance with the revenue ceiling test in the HVAU and attribution of costs

The ACCC's characterisation of ARTC's comments is reflective of those made in its submission to the RAR and consistent with ARTC's comments provided earlier in this submission. Given the comprehensiveness of ARTC's submission to the RAR, ARTC is disappointed however that the ACCC has elected not to recognise or respond to key arguments put forward by ARTC in relation to the efficiency and equity considerations surrounding revenue allocation sought to be examined by the RAR.

Whilst ARTC acknowledges that the ACCC may still be minded to publish its views in relation to the RAR at some point in the future (responding to ARTC's arguments), the Position Paper appears to put forward the ACCC's position in relation to the RAR and its implications for the 2013 Compliance Submission.

ARTC notes comments made by coal producers highlighted in the Position Paper. ARTC considers that comments made by stakeholders were largely expected and aligned to their respective business interests.

ARTC notes that the ACCC appears to have drawn two key themes from stakeholder (coal producer) submissions being:

1. Producers have expressed broad agreement that Pricing Zone 3 producers should be paying access charges that reflect their use of Pricing Zone 1.[32]
2. Producers note that to avoid a cross subsidy, producers should at least be paying their incremental costs of traversing Pricing Zone 1.[33]

With respect to some stakeholder comments incorporated by the ACCC in the Position Paper, ARTC provides the following comments:

Anglo American

> *'Anglo American agrees and submitted that each pricing zone should be responsible, at least, for their variable costs and share of capital works on the common corridor (PZ1).'*[34]

BHP (Frontier Economics)

> *'… access charges appear to be set for users in Zone 3, in a way that does not cover all of the incremental costs that these users are likely to impose on the Hunter Valley rail network, in the long run. This is because Zone 3 users impose additional costs on Zone 1 of the network other than simply the direct operating and maintenance costs they generate in that zone. This is*

[32] ACCC Position Paper, p 23.
[33] Ibid.
[34] Anglo American, *Submission to the ACCC's Discussion Paper on ARTC's revenue reconciliation*, 29 August 2014, p. 3.

principally due to additional investments needed in the network in Zone 1, to expand capacity in response to growing demand in Zone 3.'[35]

Peabody

'Peabody recommends that in order to undertake a robust debate it is prudent to examine the incremental Pricing Zone 1 investment required for Pricing Zone 3 expansion, the contribution to common costs of congestion mitigation projects in Pricing Zone 1, the long term payback scenarios of investment associated with Pricing Zone 3 and the expectation of contribution to the existing Coal Network.'[36]

ARTC provided a significant amount of detail in relation to revenue allocation proposed under the HVAU that was provided to coal producers during the three and a half-year period of ARTC and ACCC consultation on the HVAU. In addition there was significant discussion incorporated in the ACCC's March 2010 draft decision and December 2010 position paper in relation to the Floor Revenue Limit and Direct Costs, which are relevant to the minimum that should be paid for utilisation of a Segment. This will be discussed later in this submission.

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.

Glencore

In addition, Glencore has questioned the legality of ARTCs revenue allocation stating that

"in our view it is artificial, wrong and improper to undertake 'revenue allocation' in the way that ARTC has done".[37]

Glencore considered that as the HVAU is clear that costs and revenue should be reconciled on a Pricing Zone basis:

'The pricing framework mandated by the Access Undertaking relies on the attribution of costs to Pricing Zones in order to compare against actual revenue from that Pricing Zone. Costs must be allocated to Pricing Zones particularly common costs such as corporate overheads and network control costs that are not closely related to the provision of services in respect of a particular Segment or Pricing Zone in accordance with the methodology prescribed in the Access Undertaking to arrive at the Economic Cost of a Segment'.[38]

ARTC does not agree that the pricing approach in the HVAU 'mandates' a comparison of Access revenue in a Pricing Zone against cost associated with a Pricing Zone. This is at odds with the test prescribed at Section 4.2(a) of the HVAU and is addressed at section 3.3.2 of this submission.

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[35] BHP, *Submission to the ACCC's Discussion Paper on ARTC's revenue reconciliation*, 4 September 2014, p. 1.
[36] Peabody, *Submission to the ACCC's Discussion Paper on ARTC's revenue reconciliation*, 29 August 2014, p. 2.
[37] Glencore, *Submission to the ACCC's Discussion Paper on ARTC's revenue reconciliation*, 29 May 2014, p. 1.
[38] Glencore, *Submission to the ACCC's Discussion Paper on ARTC's revenue reconciliation*, 29 May 2014, p. 1.

3.3.4 Stakeholder Comments in relation to transparency

ARTC provided significant evidence in relation to the information that was provided to the ACCC and producers during the early stages of the HVAU development and during ACCC consultation ahead of approval of the HVAU in 2011. ARTC has provided further evidence of information available to producers and the ACCC during this period earlier in the submission (section 3.3.1.2). ARTC considers that this evidence strongly supports ARTC's submission.

ARTC also notes that submissions made to the RAR in relation to the transparency and understanding held by producers was mixed. It remains unclear to ARTC, given the evidence provided, as to the reasons why some producers are not aware of the application of the ceiling test and resulting application of revenue in the Constrained Network that has been applied under the NSWRAU and HVAU for many years, including when mines in Pricing Zone 2 were unconstrained.

In relation to stakeholder comments relating to the level of disclosure to coal producers during annual compliance assessment (in particular the availability of financial modelling), ARTC will respond to this issue at section 3.3.7 of this submission.

3.3.5 Stakeholder Comments in relation to impact on investment decisions

ARTC notes stakeholder comments highlighted by the ACCC in the Position Paper.

ARTC notes that the ACCC appears to have drawn key themes from stakeholder (coal producer) submissions being:

1. retaining ARTC's current approach to revenue allocation and the cross subsidy between producers will lead to inefficient investment outcomes in the Hunter Valley coal supply chain;
2. the revenue allocation approach being adopted by ARTC is likely to lead to inefficient capital expansion decisions by ARTC, as ARTC will be incentivised to fund a capacity expansion in Pricing Zone 1 rather than Pricing Zone 3 as the revenue reallocation will allow them to recover the revenue earlier;
3. responses in relation to the impact of revenue allocation on investment certainty was mixed; and
4. awareness of revenue allocation may have resulted in different investment decisions by the RCG.

With respect to the asserted cross subsidy referred to by producers, it is not clear that there is any cross-subsidy under the HVAU. Indeed, the ACCC in its March 2010 draft decision and December 2010 position paper in relation to the Hunter Valley Coal Network Access Undertaking concluded that the existing provisions under the HVAU would ensure that there would be no cross subsidy between users.

The HVAU prevents a user paying less than Floor Limit or more than the Ceiling Revenue Limit in relation to its use of the Network.

With respect to ARTC's incentives to invest in the Network, ARTC would argue that revenue allocation would not encourage investment in Pricing Zone 1 rather than Pricing Zone 3. Indeed, if the application of the ceiling test under the HVAU resulted in more revenue from Pricing Zone 3 producers being allocated to Pricing Zone 1, this would increase Pricing Zone 3 losses to be

capitalised, increase the revenue subject to long term risk, and so create greater incentives to invest in Pricing Zone 1. The current application of the ceiling test (in 2013), in fact, reduces losses to be capitalised in Pricing Zone 3, reducing revenue subject to long term risk and so encourages ARTC to invest more in Pricing Zone 3 than might otherwise be the case.

This is evidenced by the significant investment recently made in Pricing Zone 3 by ARTC.

In relation to the awareness of RCG members of revenue allocation, stakeholder submissions would suggest that the extent of awareness of RCG is mixed. As ARTC indicated earlier, it remains unclear to ARTC, given the evidence provided, as to the reasons why some producers are not aware of the application of the ceiling test and resulting application of revenue in the Constrained Network that has been applied under the NSWRAU and HVAU for many years, including when mines in Pricing Zone 2 were unconstrained.

3.3.6 ACCC's preliminary assessment in relation to compliance with the revenue ceiling test in the HVAU and the attribution of costs

ARTC notes that the ACCC has adopted a preliminary view that applies a certain interpretation of costs, specifically 'incremental' cost and 'stand-alone' cost. In the Position Paper, the ACCC has asserted that:

> '*a firm that offers a set of services should receive revenue at least equal to the incremental cost of providing that service or group of services.*'[39]

The Position Paper also prescribes that:

> '*the relevant timeframe when considering incremental costs is the long-term, which will include fixed costs that may change over the long term*'[40].

The ACCC also asserts that:

> '*the firm 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.*'[41]

The ACCC also asserts that:

> *'In the context of the Hunter Valley Coal Network, the incremental cost associated with Pricing Zone 3 Access Holders in Pricing Zone 1 would include the variable cost associated with the actual usage of the network by Pricing Zone 3 Access Holders plus the fixed costs that could be avoided if the Pricing Zone 3 Access Holders did not use Pricing Zone 1.'*[42]

The reference provided by the ACCC (Faulhaber 2002) is used to support the ACCC assertions and also recognises the close relationship between stand-alone cost and incremental cost.

Whilst not explicitly stated in the Position Paper, it would be ARTC's understanding from the above that where the minimum revenue that a firm should receive is the incremental cost of providing a service or group of services (measured over the long term), say the floor revenue limit, then the

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[39] ACCC Position Paper, p 27.
[40] Ibid., Footnote 73.
[41] Ibid., p 27.
[42] Ibid.,

maximum revenue that a firm should receive for a service or group of services stand-alone (say the ceiling limit) should not include incremental cost (measured over the long term) for services not forming part of that service or group of services.

This would seem to be consistent with the ACCC assertion in relation to the Hunter Valley coal network context and its use by Pricing Zone 3 Access Holders above.

Finally, ARTC also notes that the ACCC has expressed a preliminary view that 'ARTC's current approach to revenue allocation appears to be inconsistent with the ceiling revenue limits set out in subsection 4.3(a) of the HVAU.'[43]

This interpretation and ARTC's response are discussed in the sub-sections below.

3.3.6.1 Floor and Ceiling Revenue Limits under the HVAU

The Floor and Ceiling Revenue Limits approved by the ACCC in the HVAU are prescribed at sections 4.2 and 4.3 of the HVAU and are reproduced below.

'4.2 ***Floor Revenue Limits***

(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**").*

4.3 ***Ceiling Revenue Limits***

*(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 stand alone 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).

(c) Access revenue for the purposes of this ***section 4.3*** *does not include Access revenue returned to a Contributor as a result of the operation of a user funding agreement between the Contributor and ARTC. '*

As ARTC has explained earlier in Section 3.3.2, the separation of the application of the Ceiling Limit to Pricing Zones 1 and 2, and Pricing Zone 3 was intended to address an issue raised by the ACCC during HVAU consultation seeking clarification that the Ceiling Limit did not apply in Pricing Zone 3 when the RAB was higher than the RAB Floor Limit (this is, where loss capitalisation applied). The separation was not intended to introduce a perception (as now seems to have been taken by the ACCC and some stakeholders) that the Ceiling Limit applies to Pricing Zones rather than Access Holders (or groups of Access Holders) for the purpose of the RAR.

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[43] Ibid., p 28.

ARTC contends that the Floor and Ceiling Revenue Limits should not be viewed separately. The ACCC (and Faulhaber) seems to recognise this by drawing a strong linkage between incremental cost and stand-alone cost.

The definition of Direct Cost and Incremental Cost approved by the ACCC in the HVAU is prescribed at section 14.1 of the HVAU and is reproduced below.

> *"**Direct Cost**" means 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*;
>
> "***Incremental Cost**" means all costs that could be avoided in the medium term if a Segment was removed from the Network*;

These definitions clearly relate Direct Cost to the usage of the Network by an Access Holder, and Incremental Cost to a part of the Network (Segment). There is no definition approved by the ACCC in relation to the incremental cost of usage of the Network by an Access Holder. It is also clear that the use of the term 'incremental cost' by the ACCC in its Position Paper is a substantially different concept to the defined term contained within the HVAU.

The usage related Floor Limit under the HVAU clearly allows ARTC (and ARTC could even be required) to permit an Access Holder to utilise the Hunter Valley coal network where that Access Holder could only pay revenue equivalent to Direct Cost (but no less). Whilst Direct Cost under the HVAU provides for ARTC to include costs other than maintenance expenditure that varies with usage, it is not mandated.

The extent of consultation between ARTC and the ACCC during the HVAU development and approval process, and the extent of consideration provided in public documents by the ACCC would indicate that the ACCC carefully considered ARTC's proposals (and amended proposals) prior to expressing public views and approving these definitions.

Examples of relevant information provided by ARTC in direct response to ACCC requests and the ACCC's public consideration of ARTC's proposals are set out in section 3.3.1.2 above.

It would seem from these examples that the ACCC would have fully understood ARTC's proposals in relation to these cost definitions, as well as their implications in terms of a range of different aspects also considered in this Position Paper (such as the appropriate time frame) in coming to the its views on these definitions expressed publicly at the time.

Indeed a review of the ACCC's position put forward in its draft decision on the 2009 HVAU, would seem to indicate that in coming to a preliminary view in relation to ARTC's proposal in relation to the Floor Limit and Direct Cost, the ACCC had fully recognised and considered the implications of respective time frames in relation to ARTC's proposal. The ACCC considered that ARTC's proposal (to require prices to be at or in excess of Direct Cost) was "*unlikely to result in significant cross subsidisation or highly inefficient pricing.*"[44] In coming to this preliminary view, the ACCC considered that it "*seems unlikely that longer term marginal costs will be significantly higher [than Direct Costs]".*[45]

[44] ACCC Draft Decision on 2009 HVAU (March 2010, section 12.5.2.7.
[45] ACCC Draft Decision on 2009 HVAU (March 2010, section 12.5.2.7.

This view was maintained in the ACCC's position paper on the 2010 HVAU where the ACCC was of the view that the Direct Cost standard in section 4.2(a) of the HVAU would require ARTC to recover at least the short term marginal cost of access, and that this was likely to be appropriate.

The ACCC also noted that ARTC had amended the definition of Direct Cost where it 'may include other costs that vary with the usage of the Network'. The ACCC considered that this is likely to promote the economically efficient operation and use of infrastructure, as it reflects Access Holders essentially paying for the costs they impose upon ARTC and other Access Holders in using the Network.

In proposing this amendment, ARTC indicated to the ACCC:

> '*ARTC has amended the definition of Direct Costs to provide for inclusion of costs other than maintenance that vary with the usage of the Network in response to the ACCC's views that the definition of Direct Cost should be an inclusive definition, which allows the inclusion of costs other than maintenance that are relevant over longer periods*.'[46]

The amendment provided for, but did not mandate, the inclusion of other costs. This was done to specifically address a concern expressed by ARTC earlier in the consultation that it did not consider that the concept of variable capacity is sufficiently well explored and defined as yet for rail and chose not to incorporate this in Direct Cost. ARTC did not wish, however, to preclude the possibility of recognising variable capacity cost in Direct Costs at some stage in the future. To this end, ARTC revised the relevant wording in the HVAU in order to recognise this possibility.

It is extremely concerning to ARTC in terms of regulatory and investment certainty in the Hunter Valley that the ACCC, despite having approved ARTC's proposed Floor Limit and relevant cost definitions in the HVAU, now seems to have imported an additional definition called 'incremental cost' that is related to an Access Holder's (or group of Access Holders), specifically Pricing Zone 3 Access Holders, usage of a part of the Network (Pricing Zone 1). This additional definition seems to take on a longer time frame than that required by the ACCC for the Direct Cost concept incorporated in the approved Floor Limit and conflicts with the term 'Incremental Cost' defined in the HVAU.

After having recognised the implication of selecting an appropriate time frame, it is unclear to ARTC why the ACCC did not raise this as an issue during HVAU development and consultation. This would likely have led to consideration and consultation in relation to the level of cost that should be excluded from the Ceiling Limit as has been raised in this Position Paper.

ARTC did not detect any other discussion in the ACCC's public consultation documents in relation to how 'stand-alone' should be interpreted as has been presented in the Position Paper. In the absence of such guidance, ARTC does not consider it unreasonable to adopt the approach that had been used in the Hunter Valley for many years, and had been subject to extensive earlier industry consultation by IPART.

The NSWRAU or the HVAU do not prescribe any particular part of the network as being the Constrained Network or the Constrained Group of Mines. This is because the Constrained Network (and Constrained Group of Mines) only becomes known following the application of the Revenue

[46] ARTC Application 2010 HVAU Explanatory Guide – Appendix 1. p 39.

Limits to Access revenue for a range of mines or combination of mines in a particular compliance year.

Since the commencement of the HVAU, the Constrained Network is that part of the Network between Ulan (via Muswellbrook) and the coal terminals at Newcastle, and the Constrained Group of Mines are those mines which operate trains that haul coal entirely within that part of the Network.

As the utilisation of the Hunter Valley coal network changes over time, the application of the Revenue Limits may result in changes to the Constrained Network and Constrained Group of Mines.

For example for a period of 2-3 years under the NSWRAU, a mine at Dartbrook (5 kilometres north of Muswellbrook) operated. At the time, the application of revenue limits under the NSWRAU resulted in the network to Dartbrook forming part of the Constrained Network (and Dartbrook mine forming part of the Constrained Group of Mines) during that period. Since then, closure of the Dartbrook mine has seen the Constrained Network shrink to Muswellbrook.

As another example, traffic on the line from Bengalla to Ulan was initially unconstrained, but volumes increased to the extent that the Constrained Network grew to include these additional Segments.

Similarly, the growth in volume and revenue for Gunnedah Basin mines is likely to be such that the application of the relevant Revenue Limits may see that part of the Network extending to the Gunnedah Basin forming part of the Constrained Network, and the Gunnedah Basin mines forming part of the Constrained Group of Mines.

In the Position Paper, the ACCC seems to be limiting the scope of its proposed change to the determination of Revenue Limits to just the combination of mines forming Pricing Zones 1 and 2, requiring an assessment of the incremental impact of Pricing Zone 3 mines. ARTC believes that this is inconsistent with the combinatorial approach which is the basis for the Revenue Limits. ARTC is unable to find an interpretation of the HVAU that would support limiting the scope of the Revenue Limits in this way.

ARTC considers that the change in how the Revenue Limits are determined as contemplated by the ACCC in the Position Paper may have significant implications for the outcome of the application of the Revenue Limits. It will become uncertain as to whether the application of revised Ceiling Limits as contemplated may change the extent of the current Constrained Network and Constrained Group of Mines.

As an example, it may be that a change to the determination of Revenue Limits as contemplated (resulting in a reduction in relevant Ceiling Limits) may result in some or all of the Ulan Line no longer forming part of the Constrained Network (as was the case several years ago).

Any change to the extent of the Constrained Network cannot be properly ascertained without a similar change to the determination of the Revenue Limits being carried out for a range of different mine combinations particularly around those parts of the Network further away from the ports. This would allow Access revenue for those mine combinations to be tested against revised Revenue Limits.

This would require an assessment of the incremental impacts of a range of mines (and combinations of mines) other than just the Gunnedah Basin mines within the scope of the ACCCs proposal.

ARTC would suggest that undertaking a potentially unlimited number of 'stand-alone' assessments (and 'incremental impact' assessments) of mine combinations will render the application of the Pricing Principles under the HVAU unworkable. This was recognised by IPART and stakeholders during the early development and assessment of the NSWRAU (circa 1999) and in part resulted in the existing, more pragmatic approach adopted by IPART to dealing with both the floor and revenue ceiling limits under the NSWRAU and earlier arrangements.

3.3.6.2 Revenue Allocation under the HVAU

As it now stands, under the HVAU it is possible (and explicitly recognised – refer Section 3.3.1.2 above) that Access Holders that pay Access revenue for Coal Access Rights to the Constrained Network that is not in excess of Direct Cost may exist. Such Access Holders may operate under longer term Access Holder Agreements.

Where this occurs and ARTC is required to remove, from the relevant Ceiling Limit, what is now considered to be a higher incremental cost determined over the longer term in relation to such traffics, it is difficult to imagine how ARTC can recover the Full Economic Cost of the relevant part of the Network and how any part of the Network can become constrained.

Imposing regulatory pricing and revenue limits in a regulatory instrument that may prevent the owner from recovering revenue for a regulated service that is at least sufficient to meet the efficient costs of providing access to the service would not be consistent with the prescribed objectives of the HVAU or the pricing principles at Clause 44ZZCA of the Competition and Consumer Act 2010.

It is ARTC's strong view that the ACCC's assessment of the 2013 Compliance Submission is required to be carried out as an assessment of compliance with the HVAU as it applied during the 2013 calendar year.

Whilst ARTC accepts that the ACCC (and/or stakeholders) may develop a new position (or change an earlier position) in relation to the definition and determination of the Floor Limit (and corresponding impact on the Ceiling Limit), it is not clear as to whether the imposition of that new or revised position in relation to an annual assessment of compliance as prescribed under the approved HVAU is relevant or appropriate.

Subsection 4.2(a) of the HVAU, in conjunction with the definition of Direct Cost clearly defines the minimum amount of revenue paid by an Access Holder that should be applied to the Segments of the Network over which the Access Holder's train traverses (noting that 4.3(a) does not specifically mention Segments, but this is a necessary implication from the context). Regardless of the desirability (or otherwise) that a greater level of Access revenue from a particular train movement could be allocated to a particular Segment, so long as the Direct Cost – which is defined as including as a minimum, the relevant variable maintenance costs – then ARTC has complied with the HVAU Floor Limit obligation with respect to that movement.

Therefore, despite the ACCC's arguments in the Position Paper, and those views held by some stakeholders, ARTC cannot agree with the preliminary view expressed by the ACCC that ARTC's current approach to revenue allocation appears to be inconsistent with the ceiling revenue limits set out in subsection 4.3(a) of the HVAU. ARTC contends that its approach is compliant with the HVAU

(refer Section 3.3.1.1 above). It is ARTC's view that the ACCC's proposed introduction of a new and revised interpretation of the Ceiling Limit under the HVAU is inconsistent with the approved 'operative' Floor Limit set out at subsection 4.2(a) of the HVAU.

3.3.7 ACCC's preliminary assessment in relation to transparency

ARTC notes that based on submissions to the RAR, the ACCC considered:

> 'that greater transparency on revenue allocation and reconciliation, as well as the interaction of ARTC's financial model with access charges would be beneficial.'[47]

ARTC presumes from the Position Paper that this view was based on the views expressed by the majority of stakeholders that they were not aware of ARTC's approach to revenue allocation as it was not apparent under the terms and conditions of the HVAU.

ARTC does not contest the views held by these stakeholders but notes the following:

- Reasons for the lack of awareness were varied, including the possibility of lack of retention of corporate knowledge. ARTC maintains, as referred to above in section 3.3.1.2, that its approach to revenue allocation was made public on several occasions during development of, and consultation on, the HVAU. Stakeholders were free to seek further information on its approach and application at those times.
- The examples referred to in section 3.3.1.2, together with the other evidence provided to the ACCC, strongly suggests that the ACCC was aware of ARTC's approach to revenue allocation and its application in financial modelling. The ACCC was free to seek greater transparency at the time.
- The approach to revenue allocation was not apparent under the terms and conditions of any earlier regulatory instrument in the Hunter Valley, despite its application having similar implications for Pricing Zone 2 mines in the mid-2000's as it does for Pricing Zone 3 mines now. The only prescription in relation to revenue allocation in other rail regimes in Australia that ARTC is aware of occurs in Western Australia, where approved 'Overpayment Rules' incorporate words almost identical to those publicly disclosed by ARTC and the ACCC on several occasions during development and consultation on the HVAU. ARTC would therefore argue that the level of detail that is currently transparent is similar to that applicable in other jurisdictions.

ARTC has consistently maintained an approach in its interaction with regulators and stakeholders on regulatory matters over a number of years and in several jurisdictions that it would be completely transparent in relation to the detail of financial modelling used to assess undertakings and in compliance assessments with the regulator to enable the regulator to make fully informed assessments and decisions, in order to provide a basis for Access Holders to have confidence in the regulator's decisions in relation to access undertakings and compliance. The regulator's role in this case is not dissimilar to that of an external auditor of company accounts reporting to company shareholders.

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[47] ACCC Position Paper, p 29.

This approach is similar to that practiced in the Hunter Valley prior to commencement of the HVAU.

In this regard it is noted that the basis of revenue allocation has remained fundamentally consistent from the commencement of the HVAU consultation process and that the ACCC has had complete visibility of the financial models both prior to the commencement of the HVAU and in subsequent compliance assessments.

3.3.8 ACCC's preliminary assessment in relation to impact on investment decisions

ARTC notes that the ACCC considers:

> '*that the existing mechanisms in the HVAU, such as TOP contracts, accelerated depreciation, the rate of return, the 'unders and overs' 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 argues that a change to its current revenue allocation practices will stifle investment and increase ARTC's risk, the ACCC considers that existing mechanisms in the HVAU should mitigate this risk.*'[48]

Apart from the application of loss capitalisation, these features of the HVAU apply to all parts of the Hunter Valley coal network, not just Pricing Zone 3. As such, it is difficult for ARTC to understand how these other features may impact on investment incentives in relation to a particular Pricing Zone such as Pricing Zone 3.

ARTC maintains the view that a change to revenue allocation permitted under the Pricing Principles in the HVAU will increase the time frame for recovery of cost in Pricing Zone 3 and so the risk of asset stranding in Pricing Zone 3. All else being equal, this will incentivise investment in other more heavily utilised parts of the network where the risk of stranding is lower, such as Pricing Zone 1.

In relation to the ACCC's assertion that there is a cross subsidy between Pricing Zone 1 and 2 Access Holders and Pricing Zone 3 Access Holders, ARTC has addressed this in earlier sections of this response. This current view would seem to be at odds with the views expressed by the ACCC in public documents during consultation on the HVAU. Given the level of detail provided to the ACCC during consultation on the HVAU (see section 3.3.1.2 above) as well as the financial model (which is not substantially different to that provided in subsequent compliance assessments) it is difficult for ARTC to understand how the ACCC has now taken a seemingly different view.

3.3.9 Response to ACCC Questions for Comment

ARTC notes that the ACCC has sought stakeholder comments in relation to the following questions.

> '*Does industry have any comments about the ACCC's application of the standalone cost test contained in subsection 4.3(a) of the HVAU that requires the incremental costs (as opposed to Direct Costs) of the use of Pricing Zone 1 by Pricing Zone 3 Access Holders to be taken into account in determining the ceiling revenue limits?*

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[48] ACCC Position Paper, p 29.

Does industry have any comments on how the capital investments in Pricing Zone 1 should be itemised to determine the incremental cost of Pricing Zone 3 Access Holders? If yes, please explain the approach and rationale.

Does industry have any further comments on revenue allocation and reconciliation?'[49]

Following on from ARTC's comments in the above section, it is ARTC's view that the ACCC's proposed introduction of a new and revised interpretation of the Ceiling Limit under the HVAU does not seem to be consistent with the approved 'operative' Floor Limit set out at subsection 4.2(a) of the HVAU. For the HVAU to remain commercially viable there would need to be a commensurate adjustment to the Floor Limit in the HVAU that also recognised this revised interpretation, and introduction of another cost definition.

ARTC is also concerned with the apparent selectiveness of the application of the revised interpretation to only Pricing Zone 1 and Pricing Zone 3 Access Holders.

ARTC notes that the ACCC was previously concerned with the use of incremental cost and a long term time frame in relation to a Floor Limit under the HVAU.[50]

ARTC has stated earlier that it does not consider that the concept of variable (or incremental) capacity is sufficiently well explored and defined as yet for rail in order for it to be appropriately used in relation to cost allocation for regulatory purposes. ARTC believes that getting it wrong will almost certainly result in adverse outcomes in terms of equity and incentives. Such outcomes may be worse than the adverse impacts claimed in the Position Paper from having a more limited Floor Limit.

ARTC's recent dialogue to date with the HVCCC on this matter has done little to change ARTC's views in this regard.

ARTC notes that the ACCC has sought advice from stakeholders in relation to approaches for determining the incremental impact of Pricing Zone 3 Access Holders on Pricing Zone 1 capital investments. ARTC would be interested in reviewing any responses in this regard. Of particular interest is the way in which stakeholders expect the ACCC to separate out, with any certainty, particular investments for particular traffics in an environment where the interrelatedness of the different traffics (including anticipated future traffics at the time the decision was made) is a specific feature of the Hunter Valley coal chain.

In its submission to the RAR, ARTC raised a number of issues and concerns in relation to the equity and incentive aspects of identifying and allocating incremental capacity. ARTC is yet to receive any feedback from the ACCC in relation to these issues and concerns. Specifically, in its submission, ARTC proposed that a longer term, network focussed perspective should be taken, which is aligned to the characteristics of investment planning and delivery in the Hunter Valley, compared to a short term (annual) Pricing Zone perspective.

To this end, ARTC would be interested in seeing how any stakeholder responses address such issues as:

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[49] ACCC Position Paper, p 30.
[50] ACCC Draft Decision on 2009 HVAU (March 2010), section 12.5.2.7.

- In what circumstances and to what extent should the cost of capacity investment be socialised or quarantined to particular users?
- How are incremental capacity costs apportioned over the life of a capacity investment and aligned to relative utilisation of that capacity?
- It is said that a stand-alone consideration in relation to a service or group of services operating within a broader network fails to recognise and correctly apportion the benefits that accrue to that stand alone group from operating in a broader network. In the Hunter Valley, an example might be the benefits that may accrue to Prizing Zone 1 Access Holders from capacity investments that occur in Pricing Zone 3 that are only paid for by Pricing Zone 3 Access Holders under current regulation. How would such benefits be identified and apportioned under an incremental assessment?

The development of the Hunter Valley corridor capacity strategy is necessarily undertaken from the perspective of the whole of the Hunter Valley coal chain and the network that it uses. This is supported by the involvement of the HVCCC in its development as required under the HVAU. ARTC also believes that the industry's investment decision making process (via the RCG) operates from a clear perspective of delivering efficient long term outcomes for the Hunter Valley coal chain generally and the Hunter Valley coal network in an holistic way.

Whilst ARTC hopes that development from this perspective will continue, it is likely that ongoing contemplation of the beneficiaries and relativity of benefits derived from each investment in incremental capacity may become a focus in future decision making under the ACCC's proposal. This may draw the planning focus away from holistic coal chain and network considerations and towards maximising outcomes with respect to different parts of the rail network only.

ARTC considers that this would be contrary to the general principles supported by the industry during the Greiner Review[51] that recognised and supported the inter-relationships that existed across the Hunter Valley coal chain and rail network, and need for alignment across these elements.

3.4 True-Up Test Audit

ARTC notes the ACCC's preliminary view that it is appropriate to accept the outcome of the True-Up Test for the 2013 Compliance Period.

[51] A broad review of the operation of the Hunter Valley Coal Chain to address a perceived lack of coordination between investments and operations in various parts of the coal chain which manifested in these inefficient outcomes and additional costs to the industry was carried out by the NSW Government circa 2008-2009.