Submission by Idemitsu Australia Resources Pty Ltd to the Australian Competition & Consumer Commission (ACCC)

ACCC Draft Determination

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

1 Introduction

(a) On 30 October 2015, the Australian Competition & Consumer Commission (ACCC) issued a draft determination regarding ARTC's compliance with the Hunter Valley Coal Network Access Undertaking (HVAU) financial model for the 2013 calendar year (Draft Determination).

(b) This submission will not comment on the ACCC's review of ARTC's operating expenditure or capital expenditure. Due to the significant risk which the Draft Determination regarding ceiling revenue limits poses to the competitiveness of mines in the Gunnedah Basin, this submission will focus on that issue.

(c) The proper application of the HVAU requires that the ceiling revenue limit be calculated as proposed by ARTC. Putting that aside, it is our understanding that the key issue regarding the ceiling revenue limit based on the approach under the Draft Determination is the extent to which PZ3 demand has increased the requirement for major capital expenditure in PZ1, and that the impact of minor capital expenditure and maintenance allocations is less material. Our submission therefore focusses on major capital expenditure projects. In the event that the ACCC considered that minor capital expenditure or maintenance was a material issue (or was minded to further increase the PZ3 incremental estimate of these items) then Idemitsu would seek greater transparency on these estimates and a further opportunity to comment. Our only comment at this stage is that it is clear that the PZ3 trains, which were limited to 25 tonne axle loads (tal) in 2013, would have had less impact in terms of maintenance costs such as rail renewal than trains of 30tal, and that the impact is not fully captured by adopting a 'per gtk' allocation. Similarly, the costs of minor capital expenditure are increased when catering for 30 tal trains from PZ1 (with such costs not required for the benefit of PZ3 producers at that time). We do not consider that the WIK assessment adequately considers these factors.

(d) Idemitsu recognises that the legal, economic and technical issues raised by this issue are complex, and, despite our strong concerns regarding the Draft Determination, we appreciate the ACCC's efforts to undertake a thorough consultation process. Idemitsu has prepared this submission within the limited timeframes set by the ACCC. We would be pleased to provide any further information or explanation which would assist the ACCC in its analysis.

2 Summary of Submission

2.1 Section 3: Regulatory certainty

This section discusses the importance of regulatory certainty. Unexpected changes in approach, even when applied from the commencement date of a new undertaking, undermine regulatory certainty, because long term investment decisions have been made based on the existing regime. However, the Draft Determination goes further, by proposing to overturn the established operation of the HVAU part way through its term.

If the Draft Determination is confirmed, then future investment decisions will need to reflect the increased risk of investing in an environment in which the basis on which access rights are priced is uncertain in the long term, and in which even the terms of the existing undertaking cannot be relied upon. Such an increase in risk perceptions is likely to have a substantial impact on the investment decisions of existing and potential coal producers, particularly those in PZ3.

2.2 Section 4: Perceptions of inequity

This section discusses the claimed inequities and cross-subsidies which a number of Idemitsu's competitors suggest are a basis for altering the operation of the HVAU during its term. These claims are irrelevant during the term of the current HVAU, as the approved terms must be applied. Despite this, we address the claims in order to demonstrate that the established approach is in fact equitable, efficient, and consistent with the criteria which the ACCC must consider when approving an access undertaking.

Also, the existing approach is part of the package of measures within the HVAU which determine pricing outcomes. This package includes a number of features which are inequitable from the perspective of PZ3 producers. These include:

(a) the lack of any distance taper in pricing (which suggests, unrealistically, that all of ARTC's costs are fully variable with distance); and

(b) PZ3 being given a RAB value per km which is significantly greater than that of PZ1 or PZ2.

The overall effect of the current pricing arrangements is that the access charge of Gunnedah Basin mines is around four times that of a typical mine located in the Central Hunter Valley on a per tonne basis or around 20% higher on a per gtk basis. Idemitsu considers that it is not appropriate to modify individual elements of pricing arrangements without undertaking a full review of all related matters. For clarity, we are not suggesting that the elements of the HVAU pricing arrangements which Idemitsu considers unfavourable should be reviewed other than as part of the process of developing the new undertaking. We are raising these issues simply to demonstrate the inappropriateness of altering the application of a single element of the pricing arrangements during the term of the existing undertaking.

2.3 Section 5: Competitive impacts

This section discusses the current coal market environment. Since 2011, benchmark thermal coal prices have reduced from USD136.30/t to USD48.41/t, a reduction of more than 64%. The attempt by certain PZ1 producers to overturn the established operation of the HVAU during its term, if successful, will improve their competitive position, while having a disproportionate impact on the competitiveness of the PZ3 producers. This would further increase the competitive disadvantage of Gunnedah Basin producers in regard to rail freight. The disadvantage is currently more than $6/t for below rail alone, while above rail costs reflect additional distance and the effects of limitations in train length which arise due to the below rail characteristics of this region.

The disproportionate impact of the Draft Determination on PZ3 producers arises due to the relative tonnages railed from each zone. For example, $12m of costs transferred from PZ1 to PZ3 in 2013, as proposed by WIK, will reduce PZ1 costs by around 8c/t, while impacting the competitiveness of PZ3 producers by 80c/t. We make this point simply to point out that the consequences of an inappropriate decision are not symmetrical in terms of potential impacts on competition in the coal market.

2.4 Section 6: The effects of loss capitalisation

This section discusses the extent to which the loss capitalisation mechanism could mitigate the effect of the Draft Determination on PZ3 producers. In summary:

(a) long term investment decisions are based on expectations of long term future cashflows. Therefore the mechanism will not mitigate the potential damage to future investment in the Gunnedah Basin; however

(b) the loss capitalisation mechanism can be effective in reducing the immediate impact of the Draft Determination on the short term viability of mines in the Gunnedah Basin. Therefore, if the ACCC confirms the position in the Draft Determination, it will be critical that the ACCC seeks ARTC’s commitment to recover the resulting capitalised loss over an extended timeframe. We would suggest that a timeframe aligned with the life applied to ARTC’s fixed assets is appropriate.

2.5 Section 7: The legal position

Regardless of views about the appropriateness or otherwise of the terms of the HVAU, those terms must be applied when assessing compliance with the HVAU ceiling revenue limits for 2013. The key issue to be resolved when applying those terms is the meaning to be given to the undefined term ‘standalone basis’ within Cl. 4.3(a). Idemitsu considers that ‘standalone basis’ must be taken to have the meaning given to that term at the time of approval of the HVAU, which is also the meaning given by ARTC pursuant to its calculation of the Ceiling Limit in its annual compliance submission for the 2013 calendar year. This meaning of ‘standalone basis’:

(a) was sufficiently communicated to, and well-understood by, the ACCC prior to the ACCC’s approval of the HVAU;

(b) formed the basis on which the relevant provisions of the HVAU were approved by the ACCC;

(c) subsequent to the approval of the HVAU, has been approved by the ACCC in each of ARTC's annual compliance assessments during the term of the HVAU; and

(d) does not render the mandatory floor limit (Cl. 4.2(a)) redundant, and is therefore consistent with the notion that all provisions in a document should have a purpose. In contrast, the ACCC's interpretation would effectively create a new floor limit, equivalent to the ACCC's definition of incremental cost (which is not the definition of Incremental Cost which appears in the HVAU) and would render the existing floor test redundant.

2.6 Section 8: Technical assessment

This section responds to the WIK report and identifies material concerns with the conclusions reached by WIK. This information is presented for completeness and without prejudice to Idemitsu's rights.

For the purposes of commenting on the WIK analysis, we ignore the interpretation of 'stand-alone' which our legal advice suggests is required based on the HVAU, and adopt a more traditional definition which ignores the context of the approval of the HVAU and the established practice.

The technical assessment, conducted for Idemitsu by Lunarr Advisory (Lunarr) and The Simulation Group (TSG), concludes that the WIK approach is unlikely to provide a reasonable estimate of the stand-alone costs of PZ1/2. The key concerns are that the WIK approach fails to recognise that:

(a) certain projects which facilitated growth in demand from PZ1, 2 and 3 producers would have been required based solely on the demand of PZ1 and 2 producers. The full value of these projects (rather than a share) falls within the standalone cost of PZ1/2 producers.

(b) other projects were undertaken to reduce congestion or to reduce the impacts of maintenance activities, and these projects would have been undertaken on a standalone basis based only on PZ1/2 demand.

Our understanding is that the major capital projects which WIK identifies as being capacity-related total $777m in value, that WIK calculates a PZ3 allocation of this cost of around $73m, and that the return on and of capital in regard to this $73m makes up most of the proposed incremental PZ3 cost (which is excluded from the PZ1/2 standalone cost). Lunarr and TSG have identified a number of projects within the $777m which are likely to have been required by PZ1/2 users on a standalone basis (i.e. in the absence of PZ3). The exclusion of these projects reduces the capital cost of projects which are allocated between PZ1/2 and PZ3 to $77.8m (plus any projects with a value of under $10m which are not standalone PZ1/2 projects, as these have not been assessed by Lunarr).

Lunarr and TSG have based their conclusions on a range of alternative approaches to the identification of incremental and stand-alone costs, as follows:

Method	Test of PZ1/2 standalone
Qualitative Assessment	Expert view of the drivers for the project, based on a review of project documentation, indicates that the project was not predominantly driven by demand. This indicates that the project would have proceeded in the absence of PZ3.
Trigger project basis	Forecast PZ1/2 demand for the year of project completion, as forecast at the time of project commitment, exceeds forecast capacity in the absence of the project.
Actual Use	Actual PZ1/2 volumes at time of ceiling test exceeds capacity in the absence of the project
Expected Use	Forecast PZ1/2 demand for the year of assessment (in this case, 2013), as forecast at the time of project commitment, exceeds capacity in the absence of the project.

None of the alternative methodologies are perfect. In some cases, the facts surrounding a particular project will lead to a clear conclusion, based on one or more of the analysis methods, as to the standalone or incremental nature of the project. In other cases, judgement must be applied based on assessment of a range of approaches. The limitations of each of the approaches is described in the Lunarr Advisory report.

It is possible that further refinement of the alternative approaches could result in the development of an equitable and repeatable methodology for future application, however, it is likely that a qualitative analysis would always be required in order to test the outcomes of the mechanistic approaches. If such a methodology was developed for future undertakings, then we would expect that the project approval process would involve discussion and resolution of cost allocation issues. This has not occurred in regard to past projects, because the HVAU does not contemplate a need for such judgements and allocations.

For the purposes of the current undertaking, Idemitsu reiterates its view that the ACCC has already considered the appropriate method for the measurement of standalone costs, that this method is reflected in the undertaking, and that the method requires no more than the deduction of Direct Costs of PZ3 mines from the Economic Cost of the relevant segments.

2.7 Section 9: Conclusion

The Draft Determination is not based on an appropriate interpretation of the ceiling revenue limit of the HVAU. The appropriate interpretation is that which has been proposed by ARTC and approved by the ACCC for 2011 and 2012. Despite this view and without prejudice to Idemitsu’s rights, we provide a review of the technical assessment conducted by WIK. This review shows that many of the projects which contributed to WIK's estimate of incremental PZ3 costs were likely to have been required on a standalone basis for PZ1/2.

It is critical that in reaching its final decision, and in making any future decisions on this matter (including in regard to the new undertaking), that the ACCC considers how these decisions will impact regulatory certainty and competition in coal markets. Idemitsu considers that the contribution by PZ3 of Direct Costs to PZ1 is sufficient in the short term and is appropriate taking into account the Objects of the Act. In the long term, the approach is in the interests of NSW coal producers as a whole. Any review of approaches to pricing needs to consider the package of measures which make up pricing arrangements under the HVAU. Idemitsu considers that a number of the existing measures are inequitable to PZ3 producers.

3 Regulatory Certainty

This section discusses the importance of regulatory certainty. Unexpected changes in approach, even when applied from the commencement date of a new undertaking, undermine regulatory certainty, because long term investment decisions have been made based on the existing regime. However, the Draft Determination goes further, by proposing to overturn the established operation of the HVAU during its term. If the Draft Determination is confirmed, then future investment decisions will need to reflect the increased risk of investing in an environment in which the basis on which access rights are priced is uncertain in the long term, and in which even the terms of the existing undertaking cannot be relied upon.

Undermining regulatory uncertainty will impact on:

(a) Future investment decisions of ARTC; and

(b) Future investment decisions of existing miners regarding expansion opportunities; and

(c) Investment decisions of potential new coal producers (not limited to those operating in the Gunnedah Basin).

ARTC has stated its concern that the ACCC intends to, in effect, reopen the HVAU and that any such reopening would be against accepted regulatory practice and the fundamental principle of undertakings providing regulatory certainty during their term.[1] ARTC also expressed its extreme concern, in terms of regulatory and investment certainty in the Hunter Valley, that the ACCC, despite having approved ARTC's Floor Limit and relevant cost definitions in the HVAU, intends to import an additional definition of 'incremental cost' into the HVAU. Idemitsu agrees with ARTC's concerns regarding the potential loss of regulatory certainty if the ACCC implements these significant changes to the application of Ceiling Limit under the HVAU.

Despite the concerns expressed by ARTC in relation to regulatory uncertainty, the ACCC does not consider that regulatory certainty provides a sufficient basis to support the continued use of Direct Costs in ARTC's application of the Ceiling Limit. The ACCC states that its position in this regard is based on information available to the ACCC, which appears to include the WIK report, that estimates

[1] ARTC, *2013 Annual Compliance Assessment – Response to ACCC Position Paper*, page 9.

the incremental costs of PZ3 Access Holders' use of PZ1 as $14.6 million for the 2013 calendar year compared to the $2.5 million Direct Costs calculated by ARTC.[2]

The significant difference in these values arises from the ACCC adopting (and instructing WIK to adopt) a definition of incremental costs which:

(a) Does not appear in the HVAU.

(b) Is not consistent with past practice.

(c) Is not consistent with the basis on which the ACCC approved the HVAU.

We would suggest that the materiality of this difference only increases the extent to which regulatory certainty would be undermined by this decision, rather than providing a justification for abandoning the established application of the undertaking.

If the WIK report does in fact represent an appropriate measure of PZ3 incremental costs (which Idemitsu does not accept) then this may suggest that the HVAU ought to contain a different definition of stand-alone costs and direct costs. However, this is not a relevant consideration for the ACCC's review of ARTC's compliance with the HVAU financial model for the 2013 calendar year.

The ACCC has previously recognised that regulatory uncertainty may be 'harmful to efficient investment'[3] and has stated that 'regulatory certainty will generally be in the interests of the access provider as well as access seekers and is also likely to support conditions that promote competition'.[4]

Others commentators and entities, including the Australian Productivity Commission, have also recognised the importance of regulatory certainty. The Productivity Commission is of the view that 'uncertainty regarding future access conditions compounds the inherent risk of investment in infrastructure services, increasing the hurdle rate for investment above the expected rate of return – deterring or delaying investment'[5] and considered that 'uncertainty regarding future access obligations could compound the inherent risk associated with making infrastructure investments'.[6] Similarly, New Zealand's competition agency, the Commerce Commission, has expressed a view that 'increased regulatory certainty is important for fostering efficient investment'[7] while the Queensland Competition Authority has noted, "an undertaking that delivers regulatory certainty provides a major stimulus to the Queensland economy and local employment which is an important public interest consideration. The development of new, or replacement, upstream producers may be at risk if there is material pricing uncertainty for rail access. This can have flow on impacts on regional economic development". [8]

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[2] Draft Determination, page 38.

[3] ACCC, *ACCC submission to the Independent Cost Benefit Analysis Review of Regulation Telecommunications Regulatory Arrangements Paper (s.152EOA Review)*, 14 April 2014, Executive Summary.

[4] ACCC, *Assessment of FANOC's Special Access Undertaking in relation to the Broadband Access Service - Draft Determination*, December 2007, page 138.

[5] Australian Government Productivity Commission, *National Access Regime – Productivity Commission Inquiry Report,* page 228.

[6] Australian Government Productivity Commission, *National Access Regime – Productivity Commission Inquiry Report,* page 101.

[7] Commerce Commission of New Zealand, *Commerce Commission releases draft capital expenditure input methodology for Transpower,* 4 July 2011.

[8] Queensland Competition Authority, *Draft Determination, Queensland Rail's 2015 Draft Access Undertaking, October 2015*, page 254.

Significant changes to the application of revenue tests under an access undertaking by the regulator during the term of the undertaking would undermine the regulatory certainty sought to be achieved by the undertaking. Given the magnitude of the change to the calculation and application of the Ceiling Limit proposed by the ACCC in the Draft Determination, giving effect to the change would be inconsistent with principles of good regulatory policy and practice and undermine regulatory certainty. Good regulatory policy and practice means that the ACCC should not impose any significant change to the calculation and application of the Ceiling Limit under the HVAU, as approved by the ACCC, during the term of the HVAU.

Idemitsu and Whitehaven have invested substantial sums to grow the Gunnedah basin from 6.2mt in 2010 to 24.2mt in 2015. Idemitsu alone has invested over $500m to expand production in the Boggabri mine, while producers in the Gunnedah basin have underwritten (through take or pay contracts and in some cases through direct funding) $338m of investment in PZ3 ‘major project’ rail infrastructure, $68m in minor projects, and $82m in the former CRIA section of the infrastructure. This has created a substantial new coal producing region which:

(a) is now making efficient use of previously underutilised rail infrastructure; and

(b) is likely to extend the life of the Hunter Valley coal industry and therefore extend the useful life of rail infrastructure (including PZ1 infrastructure).

Gunnedah Basin producers continue to assess a range of new mines and expansion options including:

(a) Shenhua Watermark project.

(b) BHP Caroona project.

(c) Further expansions of existing mines.

Investment decisions are clearly challenging in the current coal market. The consequences of introducing substantial regulatory uncertainty into this environment should not be underestimated. We do not consider that the Draft Determination reflects an appropriate consideration by the ACCC of the issue of regulatory certainty, particularly the impacts on the investment decisions of existing and potential Gunnedah Basin coal producers. A proper consideration of the importance of regulatory certainty would lead to a conclusion that:

(a) the established application of the HVAU should not be changed during the term of the undertaking; and

(b) When considering the new undertaking, the ACCC should exercise extreme caution in seeking to amend (or approving any proposal to amend) the pricing approaches on which long term investment decision have been based.

4 Perceptions of Inequity

Idemitsu understands the view of some stakeholders that ARTC’s current approach to pricing will lead to inequitable outcomes to the extent that the costs recovered from PZ1/2 producers include any costs which could have been avoided in the absence of PZ3 mines. Idemitsu:

(a) does not agree that such an outcome would breach the ceiling revenue limit (see Section 7, "Legal Position"), and therefore

(b) does not agree that the perceived inequity is a relevant consideration for the ACCC's assessment.

However, regardless of the legal position, we wish to comment on the perceived inequities and 'subsidies', as these claims are likely to be put forward by certain stakeholders during the development of the replacement undertaking.

We consider that the perceived inequity arises from taking a short term and selective view of the pricing arrangements. A longer term view suggests that any perceived short term 'subsidy' is in fact an efficient arrangement and is in the long term interests of both ARTC and of PZ1/2 producers, while consideration of the full package of pricing arrangements under the HVAU points to PZ3 producers paying a share of system costs which is more than would be expected if developed on a cost-reflective basis.

4.1 Long term efficiency

ARTC's approach is efficient and aligned with the objects of Part IIIA of the Competition and Consumer Act 2010 (the Act). The approach promotes the economically efficient use of and investment in infrastructure and promotes competition in coal markets. The approach is also appropriate taking into account the legitimate business interests of ARTC, ARTC's investments in the facility (particularly PZ3 infrastructure), and the public interest, including the public interest in having competition in markets. The current arrangements have seen PZ3 production grow from 6.2mtpa in 2010 to 24.2mt in 2015. In the future, it is expected that further growth in this region will see PZ3 producers making an increasing contribution to PZ1 costs, such that the contribution ultimately exceeds the full incremental costs of PZ3 use of this segment. The growth of Gunnedah Basin mines will also support the ongoing utilisation of PZ1 assets as the reserves of the more mature PZ1 mines decline, allowing for longer below rail asset lives than would be the case in the absence of PZ3 mines. Therefore, the view that the recovery of only Direct Costs of PZ3 producers within PZ1 is inequitable is based on a very short term view, while a longer term perspective demonstrates the benefits, for all stakeholders, of the current approach.

4.2 Package of pricing arrangements

The existing approach is part of the package of measures within the HVAU which includes a number of features which are inequitable from the perspective of PZ3 producers. These include:

(a) the lack of any distance taper in pricing, which suggests, unrealistically, that all of ARTC's costs are fully variable with distance. By contrast, around 50% of Aurizon Network's Central Queensland below rail revenue is recovered via reference tariff components which do not vary with distance[9]; and

(b) PZ3 being given a RAB value per km which is significantly greater than that of PZ1 or PZ2, despite the inferior service capability of the asset (shorter maximum train length).

[9] Excludes charges related to electrification, for comparability with HV network. Tariff components which do not vary with distance are AT2 (per path), and AT4 (per tonne)

The overall effect of the current pricing arrangements is that the access charge of Gunnedah Basin mines is:

(a) More than <u>four times</u> that of a typical mine located in the Central Hunter Valley on a per tonne basis

(b) Around 20% higher on a per gtk basis.

(c) $2.70 per tonne higher than a typical Central Queensland mine located at a similar distance from the port.

(d) $1.50 per tonne higher than a PZ2 mine located at the same distance from the port.

(e) Based on a 'reverse distance taper', where the average cost per gtk increases with distance.

These comparisons are based on the current tariff being paid by PZ3. However, while paying this tariff, PZ3 producers are also accumulating a capitalised loss, which must be repaid through future access charges.

In the context of the above data, it is difficult to conclude that PZ1/2 producers are being disadvantaged by the current package of pricing arrangements, such that the established operation of the HVAU needs to be overturned.

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Idemitsu understands that claims of pricing inequities are not a relevant consideration when assessing compliance with the terms of an approved undertaking, which must be applied based on its terms. When the time comes to review the terms of the undertaking:

(a) The impacts of creating regulatory uncertainty by implementing material unexpected changes to pricing arrangements must be considered (see section 3);

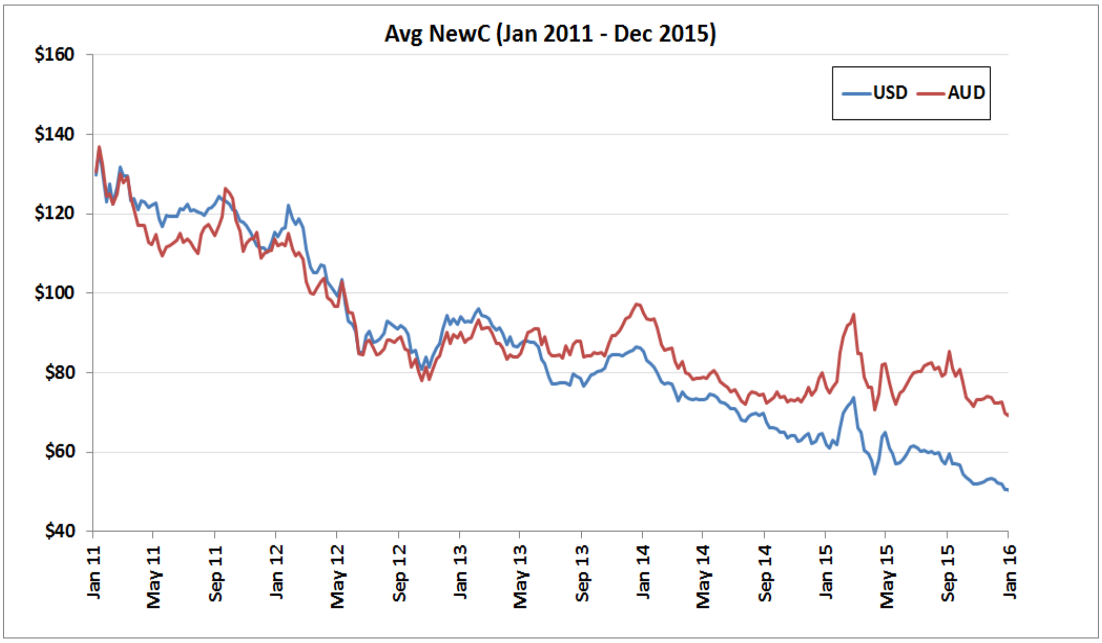
(b) It will not be appropriate to modify individual elements of the pricing arrangements without undertaking a full review of all related matters;

(c) A full review of all matters which affect pricing should include a review of the lack of any distance taper and the inequitable asset values given to the existing zones. Idemitsu looks forward to this review and to the development of a HVAU which includes equitable and cost-reflective pricing.

5 Competitive Impacts

This section discusses the current coal market environment and the efforts which all coal producers are making to reduce costs and remain competitive.

Since 2011, benchmark thermal coal prices have reduced from USD136.30/t to USD48.41/t, a reduction of more than 64%. PZ3 producers face a competitive disadvantage of more than $6/t for below rail alone, while above rail costs reflect additional distance and the effects of limitations in train length which arise due to the below rail characteristics of this region. Survival of existing mines in this environment is clearly challenging.



The potential consequences on competition in the coal market of transferring substantial additional costs to PZ3 producers must therefore be considered by the ACCC.

The attempt by certain PZ1 producers to overturn the established operation of the HVAU during its term, if successful, will improve their competitive position, while having a disproportionate impact on the competitiveness of the PZ3 producers. This would further increase the competitive disadvantage of Gunnedah Basin producers in regard to rail freight.

The disproportional impact of the Draft Determination on PZ3 producers arises due to the relative tonnages railed from each zone. For example, $12m of costs transferred from PZ1 to PZ3, as proposed by WIK, will reduce PZ1 costs by around 8c/t, while impacting the competitiveness of PZ3 producers by 80c/t. We make this point simply to point out that the consequences of an inappropriate decision are not symmetrical in terms of potential impacts on competition in the coal market.

6 Loss Capitalisation

Idemitsu wishes to comment on two aspects of the principle of loss capitalisation as it relates to this Draft Determination.

First, we wish to address any possible misconception that the existence of loss capitalisation itself will protect Gunnedah Basin coal producers from the impact of the Draft Determination, such that long term investment decisions of coal producers will not be adversely affected. Long term investment decisions are based on expectations of long term future cashflows. The capitalised loss, which would be substantially increased under the Draft Determination, will result in higher access charges at some point in time compared to those which Idemitsu previously expected (having based its expectation on the established operation of the HVAU). Idemitsu had previously forecast that access charges would reduce in the medium term due to the reset of the WACC and the benefits of increasing volumes within PZ3. The Draft Determination has caused Idemitsu to revise its long term plan to reflect the risk that access charges may now continue to increase, rather than decrease. Long term investment decisions must therefore now be made in this context unless the final decision provides an improved outlook.

Second, it is important to note that loss capitalisation does have an important role to play in reducing the immediate impact of the Draft Determination on the short term viability of mines in the Gunnedah Basin. If the ACCC confirms the Draft Determination, it will be critical that the ACCC seeks ARTC's commitment to recover the resulting capitalised loss over an extended timeframe in order to prevent an immediate and substantial impact on the viability of existing mines. We would suggest that a timeframe aligned with the life applied to ARTC's PZ3 fixed assets (which should be aligned to the PZ3 mine lives) is appropriate.

7 The Legal Position

7.1 Cross-subsidies

In the Draft Determination, the ACCC reiterated its concern that ARTC's approach to calculating the Ceiling Limit results in cross-subsidisation. In particular, the ACCC considered that 'because ARTC subtracted only the Direct Costs associated with Pricing Zone 3 Access Holders' use of Pricing Zone 1, Constrained Coal Customers were proposed to pay more than their 'standalone' costs associated with the Constrained Network (i.e. the total efficient costs of providing the service to Constrained Coal Customers by themselves)'.[10] The ACCC considered that the $12.1 million difference between the Direct Costs assessed by ARTC (i.e. $2.5 million) and the incremental costs assessed by WIK (ie. $14.6 million) indicates that, if Constrained Coal Customers pay that difference, then a cross-subsidy does arise.[11]

However, the position taken by the ACCC on the issue of cross-subsidisation in the Draft Determination is inconsistent with the position taken by the ACCC in its Draft Determination dated March 2010[12] in relation to the 2009 HVAU. In that Draft Determination, the ACCC concluded that the existing provisions under the 2009 HVAU would ensure that there would be no cross subsidy between users. In particular, 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' and, in coming to this view, the ACCC considered it 'seems unlikely that longer term marginal costs will be significantly higher [than direct costs]'.[13] ARTC notes that this view was maintained in the ACCC's position paper on the 2010 HVAU where the ACCC was of the view that

[10] Draft Determination, page 6.

[11] Draft Determination, page 39.

[12] ARTC, *Hunter Valley Coal Network Access Undertaking – Draft Determination,* 5 March 2010, pages 489, 519-520, 621 and 668.

[13] ACCC Draft Determination on 2009 HVAU (March 2010), section 12.5.2.7, referred to in ARTC, *2013 Annual Compliance Assessment – Response to ACCC Position Paper*, page 32.

the Direct Cost standard in section 4.2(a) of the HVAU would require ARTC to cover at least the short term marginal cost of access, and that this was likely to be appropriate.[14]

ARTC has rejected the ACCC's 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.[15] ARTC explained its position with respect to cross-subsidisation at some length in sections 7 and 8 of its submission dated August 2014 in response to the ACCC's Revenue Allocation Review and expressed concern that the ACCC did not address these submissions in its Position Paper dated 26 November 2014.[16] Idemitsu agrees with the views expressed by ARTC in relation to cross-subsidisation.

Despite ARTC's explanations, Idemitsu understands that the ACCC now holds a view that marginal costs are in fact significantly higher than Direct Costs and that therefore a subsidy exists. If this view is correct, it does not change the fact that the HVAU has been approved on the basis of the ACCC's previous analysis and must operate based on its terms until expiry. The correct application of those terms is discussed in the following sections.

7.2 Interpretation of ceiling revenue test in HVAU

(a) Meaning of 'standalone basis'

(1) (**'standalone basis' not defined**) The calculation of the Ceiling Limit under the HVAU requires an assessment of the Economic Cost of the relevant Segments which are required on a standalone basis for an Access Holder or group of Access Holders.[17] In calculating the Ceiling Limit, the assessment of the 'Economic Cost of a Segment' must be undertaken on a standalone basis.[18] However, the term 'standalone basis' is not defined in the HVAU. Given that the undefined term 'standalone basis' is used in the calculation of the Ceiling Limit, this provides flexibility as to how the Ceiling Limit must be calculated. This flexibility has given rise to a difference of opinion as between the ACCC and ARTC as to the correct approach to calculating the Ceiling Limit (despite ARTC's approach being documented and explained to the ACCC prior to approval of the HVAU by the ACCC).

(2) (**ACCC's approach**) The ACCC proposes to rely on a definition of 'standalone' put forward by Professor Gerard Faulhaber, which is set out below:

…the stand-alone cost of any service or group of services of an enterprise is the cost of providing that service (at the existing or "test" demand level) or group of services by themselves, without any other service that is provided by the enterprise. A closely related concept is that of "incremental cost". The incremental

[14] ARTC, *2013 Annual Compliance Assessment – Response to ACCC Position Paper*, page 33.

[15] ARTC, *2013 Annual Compliance Assessment – Response to ACCC Position Paper*, pages 9 – 10.

[16] Ibid.

[17] HVAU, section 4.3(a).

[18] HVAU, section 4.5(a) and 4.5(c).

cost of a service or group of services is the additional cost of providing that service or group of service over and above the cost of providing all the remaining services.[19]

(ARTC's approach) In contrast to the ACCC's approach, ARTC considers that 'standalone' in the HVAU must be interpreted in the context of the provisions and operation of the HVAU and not as an independent concept to be purely defined by reference to economic theory.[20]

ARTC's interpretation of 'standalone' for the purpose of calculating the Ceiling Limit is demonstrated by the revenue allocation method used by ARTC in the 2013 calendar year (and in previous years). ARTC's revenue allocation method excludes the Direct Cost of traffics that do not serve the Constrained Group of Mines and operate within the Constrained Network from the full Economic Cost of the relevant Segment.[21] ARTC's revenue allocation methodology is described in further detail immediately below.

(3) (**ARTC's revenue allocation method**) ARTC's revenue allocation method is described in the Draft Determination as follows:

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

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

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

(D) The test described above identifies the combination of mines that is the constrained group of mines and the constrained network.

(E) Unders and overs accounting in accordance with section 4.9 of the HVAU then seeks to ensure that access revenue for the coal trains serving the constrained group of mines and operated entirely within the constrained network recovers that standalone economic cost of the constrained network.

(F) The standalone economic cost applicable to the combination of mines that is the constrained group of mines excludes direct costs associated with traffics

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[19] ACCC, *Position Paper – Australian Rail Track Corporation's compliance with the financial model in the Hunter Valley Coal Network Access Undertaking for January – December 2013,* page 27.

[20] ARTC, *2013 Annual Compliance Assessment – Response to ACCC Position Paper*, page 8.

[21] ARTC, ARTC *submission to ACCC Discussion Paper*, August 2014, pages 24-25.

that do not serve the constrained group of mines and operate outside the constrained network.

(G) Any access revenue associated with unconstrained traffics utilising part of the constrained network (other than the direct cost associated with the operation of unconstrained traffics on the constrained network) is allocated to parts of the journey of such traffics outside the constrained network.

(4) (**ARTC's combinatorial ceiling test**) ARTC's revenue allocation method is an outcome of the application of the 'combinatorial ceiling test' and not a process that is done prior to, or separately from, the ceiling test. The combinatorial ceiling test involves identifying the constrained network by comparing to access revenue obtained from a combination of constrained coal customers against the economic costs of the part of the network used by those customers. In ARTC's view, there is no pre-defined constrained network for the purposes of applying the ceiling test. In particular, ARTC considers that the opening words of section 4.3(a) do not limit the application of the ceiling test to segments in Pricing Zone 1 and Pricing Zone 2. Instead, the purpose of the opening words is to ensure that the ceiling test does not override the operation of loss capitalisation in Pricing Zone 3.

(5) (**ACCC's proposal**) In the Draft Determination, the ACCC considered that ARTC's calculation of the Ceiling Limit (as described above) was inconsistent with section 4.3(a) and, on that basis, proposed an alternative method for calculating the Ceiling Limit. The ACCC expressed a concern that because ARTC subtracted only the Direct Cost associated with Pricing Zone 3 Access Holders' use of Pricing Zone 1 from the costs of the Constrained Network to be recovered from Constrained Coal Customers, Constrained Coal Customers were proposed to pay more than their standalone costs.[22] The ACCC proposed that the Ceiling Limit is 'equal to the Economic Cost for the Segments in Pricing Zones 1 and 2 minus the **incremental costs** for the use of those segments by Access Holders originating outside those Segments (i.e. Pricing Zone 3 Access Holders)' [emphasis added].[23]

(6) (**Idemitsu's response to ACCC's proposal**) Idemitsu does not agree with the ACCC's view that ARTC's approach to the Ceiling Limit is inconsistent with the HVAU. Nor does Idemitsu agree with the ACCC's proposal regarding the deduction of incremental costs (rather than Direct Costs) for the purpose of calculating the Ceiling Limit. Idemitsu considers that 'standalone basis' must be taken to have the meaning given to that term by ARTC pursuant to its calculation of the Ceiling Limit in its annual compliance submission for the 2013 calendar year because this meaning of 'standalone basis':

[22] Draft Determination, page 27.

[23] Draft Determination, pages 39-40.

(A) was sufficiently communicated to, and well-understood by, the ACCC prior to the ACCC's approval of the HVAU (as discussed in further detail below);

(B) formed the basis on which the relevant provisions of the HVAU were approved by the ACCC; and

(C) subsequent to the approval of the HVAU, has been approved by the ACCC in each of ARTC's annual compliance assessments during the term of the HVAU (as discussed in further detail below).

The methodology adopted by ARTC to calculate and apply the Ceiling Limit for the 2013 calendar year (and in previous years) is the basis on which the ACCC approved the relevant provisions of the HVAU. The ACCC approved the HVAU in the context of material, advice and information provided by ARTC to the ACCC which documented and explained the meaning and operation of 'standalone basis' in ARTC's calculation and application of the Ceiling Limit. By approving the HVAU in this context, the ACCC is taken to have intended that 'standalone basis' would, for the term of the HVAU, be interpreted in accordance with the meaning given to that term, as documented and explained by ARTC, when it approved the HVAU. It is not reasonable to expect that the meaning of 'standalone' could change over time.

If the ACCC required 'standalone basis' to have a different meaning to that which was documented and explained by ARTC in its communications and submissions to the ACCC before the approval of the HVAU, then amendments to the HVAU would have been required. However, the ACCC did not communicate to ARTC that 'standalone basis' should have a different meaning and therefore no amendments were made to the HVAU in that regard prior to approval of the HVAU.

The ACCC is therefore bound, by its own conduct in approving the HVAU in the relevant context, to give the term 'standalone basis' the meaning given to that term when the ACCC approved the HVAU, as documented and explained by ARTC. Given that ARTC's interpretation of 'standalone basis' was clearly communicated to, and understood by, the ACCC prior to approval of the HVAU and formed the basis of the ACCC's approval of the relevant provisions, the ACCC cannot now impose a new definition of 'standalone basis' which is inconsistent with the meaning given to the term when the ACCC approved the HVAU.

The ACCC's proposal to change the meaning of 'standalone basis' under the HVAU creates issues which are similar those issues which the common law seeks to address through the principles of estoppel by convention in the context of contractual arrangements. The conduct of relations between the ACCC and ARTC with respect to the application of the Ceiling Limit under the HVAU has been based on an assumed state of facts regarding the application of the Ceiling Limit and the reconciliation test. In applying the Ceiling Limit for the 2013 calendar year, ARTC acted upon the assumption that the state of facts was true and applied the Ceiling Limit in accordance with that assumed state of facts. By approving ARTC's application of the Ceiling Limit in previous annual compliance tests, the ACCC impliedly accepted the assumption as being true. To the ACCC's knowledge, ARTC has acted in reliance on the assumption being regarded by the ACCC as true and binding and has made the following pricing decisions based on ARTC's understanding of the pricing principles under the HVAU:

(A) 2013 coal pricing;

(B) 2014 coal pricing;

(C) price differentiation under the Initial Indicative Service variation;

(D) 2014 pricing proposed under the Gap to Turrawan variation; and

(E) 2015 pricing proposed under the Final Indicative Service variation.[24]

ARTC considers that it would suffer detriment if the ACCC was allowed to depart from the assumption. In particular, ARTC maintains the view that a change to revenue allocation permitted under the pricing principles in the HVAU will increase the timeframe for recovery of cost in PZ3 and also increase the risk of asset stranding in PZ3.[25]

Idemitsu considers that any attempt by the ACCC to change the meaning of 'standalone basis' during the term of the HVAU would exceed the ACCC's powers, is against accepted regulatory practice and is contrary to the fundamental principle of undertakings providing regulatory certainty during their term.

(7) (**Provision of information to the ACCC**) In the Draft Determination, the ACCC acknowledged that ARTC provided a significant amount of information to the ACCC and coal producers during the development of the HVAU and identified, in particular, confidential communications from ARTC to the ACCC in 2009.[26] The ACCC noted that these confidential communications were never consulted on with stakeholders before the HVAU was ultimately accepted.[27] On this basis, the ACCC considers that stakeholders did not appear to have sufficient transparency and clarity surrounding ARTC's intention.[28] However, the ACCC appears to have failed to recognise that these confidential communications were not the only means by which ARTC's intentions were communicated to the ACCC and stakeholders. As explained below, ARTC's

[24] ARTC, *ARTC submission to ACCC Discussion Paper*, August 2014, page 100.

[25] ARTC, *2013 Annual Compliance Assessment – Response to ACCC Position Paper*, page 37.

[26] Draft Determination, page 36.

[27] Ibid.

[28] Ibid.

intention was explained in a number of publicly available documents. Idemitsu is concerned that the ACCC's reference in the Draft Determination to confidential communications in isolation and without identifying the publicly available information provided by ARTC indicates the ACCC has not given due consideration to the publicly available information that explained ARTC's intention.

In addition, in the Draft Determination the ACCC notes that it is required to apply the provisions of the HVAU as it was ultimately accepted rather in accordance with ARTC's comments regarding its intended approach during the development of the HVAU.[29] Idemitsu is of the view that the information provided by ARTC to the ACCC in relation to the proposed revenue allocation method and the application of the Ceiling Limit under the HVAU, as discussed below, is relevant to the provisions of the HVAU as it was ultimately accepted and must therefore be taken into account by the ACCC.

(8) (**ACCC's acknowledgement of ARTC's approach**) The ACCC has previously acknowledged that the methodology for calculating any rebate payable pursuant to the application of unders and overs accounting should exclude revenue from customers that are only paying for the direct cost of their services, as discussed in further detail in paragraphs (a) to (c) below.

(A) (**Acknowledgement of ARTC's approach in Draft Determination**) In the ACCC's Draft Determination dated 5 March 2010 on a previous version of the HVAU, which was publicly available for stakeholder consultation, the ACCC stated that:

'…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**'.[30] [emphasis added]

This statement by the ACCC acknowledges that, in order to avoid cross-subsidisation, any rebate calculated in accordance with the reconciliation test should not include direct costs. This indicates that, at the time the HVAU was approved, the ACCC's assessment of the potential scope of cross-subsidisation was equivalent to direct costs rather than incremental costs. This is inconsistent with the position that the ACCC has since adopted in the Draft Determination that the deduction of only direct costs

[29] Ibid.

[30] ACCC, *Hunter Valley Coal Network Access Undertaking – Draft Determination*, 5 March 2010, page 597.

(rather than incremental costs) results in cross-subsidisation to the extent incremental costs exceed direct costs. The ACCC's change in position regarding cross-subsidisation constitutes a departure from the approved form of the HVAU.

This statement also indicates that the ACCC accepted the possibility that there may be Access Holders that pay access revenue for access to the Constrained Network that is not in excess of the Direct Cost and that the unders and overs amount should not be allocated to such Access Holders.

(B) (**Acknowledgement in Position Paper**) In addition, in the ACCC's Position Paper dated 21 December 2010 in relation to an earlier version of the HVAU, the ACCC noted that ARTC had included a new provision to provide clarity that an overs rebate would not provide any rebate of Direct Costs to Access Holders as follows:

'In the March 2010 Draft Determination, 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.*

The ACCC notes that ARTC has included a new section 4.8 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 Determination.

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 Determination'.[31]

This Position Paper was also publicly available for stakeholder consultation.

(C) (**Acknowledgement in other correspondence**) ARTC in its response to the ACCC's Position Paper in relation to ARTC's compliance with the HVAU for the 2013 calendar year also noted a number of specific examples where ARTC provided relevant information to the ACCC regarding the proposed revenue allocation method and the application of the Ceiling

[31] ACCC, *Position Paper in relation to the Australian Rail Track Corporation's proposed Hunter Valley Rail Network Access Undertaking*, 21 December 2010, page 89.

Limit.[32] In particular, ARTC identified the following correspondence:[33]

- email 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 "remaining revenue for Unconstrained traffics is allocated to that part of their journeys for those Unconstrained traffics outside of the Constrained Network"; and
- email attachments from ARTC to the ACCC in October 2010 in direct response to ACCC information requests 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 part of the network". ARTC also 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.

This correspondence clearly explains ARTC's revenue allocation methodology in terms of:

- the deduction of the Direct Cost of traffics that do not serve the Constrained Group of Mines and operate within the Constrained Network

[32] ARTC, *2013 Annual Compliance Assessment – Response to ACCC Position Paper*, page 20.

[33] Ibid.

from the full Economic Cost of the relevant Segment; and

- the allocation of any access revenue associated with unconstrained traffics utilising part of the Constrained Network (other than the Direct Cost associated with the operation of unconstrained traffics on the Constrained Network) to parts of the journey of such traffics outside the Constrained Network.

The ACCC approved the HVAU in the context of these communications. Given that ARTC's revenue allocation methodology was clearly communicated to the ACCC prior to approval of the HVAU, the ACCC cannot now impose a new definition of 'standalone basis' during the term of the HVAU which is inconsistent with the revenue allocation methodology explained by ARTC, and understood by the ACCC, at the time the ACCC approved the HVAU.

(9) (**Sufficient understanding**) Given that ARTC provided detailed information to the ACCC in relation to the proposed revenue allocation method and the application of the Ceiling Limit under the HVAU, it would be reasonable to assume that the ACCC had a sufficient understanding of the revenue allocation methodology and application of the Ceiling Limit to be applied prior to the approval of the HVAU. ARTC also considers that it would 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.[34] ARTC is of the view that it has not unreasonably relied on this assumption in making decisions around access pricing and substantial capacity investments in the Hunter Valley coal network.[35]

(10) (**ACCC's prior approval of ARTC's approach**) The ACCC approved ARTC's annual compliance assessments for 2011 and 2012. ARTC's revenue allocation methodology and application of the Ceiling Limit in 2011 and 2012 is the same as that used by ARTC in 2013. On this basis, it would be reasonable to assume that the ACCC had a sufficient understanding of the revenue allocation methodology and application of the Ceiling Limit under the HVAU after the approval of the HVAU.

(b) **Meaning of 'incremental cost'**

(1) (**Background**) Although Idemitsu does not agree with the ACCC's proposal that the Ceiling Limit should be calculated by deducting incremental costs (rather than Direct Costs), this section sets out Idemitsu's preferred interpretation of the term 'incremental costs' in the context of the Ceiling Limit in the

[34] ARTC, *2013 Annual Compliance Assessment – Response to ACCC Position Paper*, page 21.

[35] Ibid.

event that the ACCC's proposal to deduct incremental costs is adopted.

(2) (**Relevance of incremental cost to Ceiling Limit**) As noted above, the meaning of 'standalone basis' is not expressly defined in the HVAU. Given that the term 'standalone basis' is used in the calculation of the Ceiling Limit, this has given rise to differing views as to how the Ceiling Limit must be calculated (despite ARTC's approach being documented and explained to the ACCC prior to approval of the HVAU by the ACCC). The ACCC proposed that the Ceiling Limit is 'equal to the Economic Cost for the Segments in Pricing Zones 1 and 2 minus the **incremental costs** for the use of those segments by Access Holders originating outside those Segments (i.e. Pricing Zone 3 Access Holders)' [emphasis added].[36]

(3) (**ACCC's preferred definition**) The term 'Incremental Cost' is defined in the HVAU as 'all costs that could be avoided in the medium term if a Segment was removed from the Network'. Despite there being a definition of 'Incremental Cost' in the HVAU, the ACCC in the Draft Determination considered that the term 'incremental cost', if it is to be used in the calculation of the Ceiling Limit, should not be given the meaning specified in the HVAU but should instead be taken to mean the 'costs that a firm incurs in providing a service relative to not providing that service at all assessed over the long term'.[37]

(4) (**ARTC's response to ACCC proposal**) ARTC is of the view that the ACCC's approach improperly imports a new definition of incremental cost into the meaning of standalone in the context of:

(A) the HVAU already having a definition of Incremental Cost;

(B) the HVAU not using that definition or concept in the Ceiling Limit in section 4.3;

(C) the issue of incremental cost having already been extensively considered in relation to the approval of the HVAU and its application to the Ceiling Limit (by way of the meaning of Direct Cost);

(D) 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); and

(E) the ACCC's interpretation of standalone creating an inconsistency in the application of the floor and ceiling tests on the basis that the ACCC's interpretation excludes 'incremental costs' rather than 'direct costs', whereas the Floor Limit is determined by reference to

[36] Draft Determination, pages 39-40.

[37] Draft Determination, page 33.

Direct Costs – the ARTC considers that this inconsistency is inappropriate and should be avoided.[38]

(c) **Consistency of floor and ceiling test**

(1) (**Floor test**) The HVAU prescribes both a mandatory floor test and a target floor test. The mandatory floor test, which is set out in section 4.2(a), provides that Access revenue from every Access Holder must at least meet the Direct Cost imposed by that Access Holder. The target floor test, which is set out in section 4.2(b), provides that, for each Segment or group of Segments, Access revenue from Access Holders should, as an objective, meet the Incremental Costs of those Segments. As discussed in further detail below, it would be an absurd result if the mandatory floor test was never able to be triggered due to the revenue allocation method used to reconcile access revenue with the applicable Ceiling Limits.

(2) (**Ceiling test**) In the Draft Determination, the ACCC proposed that the Ceiling Limit is 'equal to the Economic Cost for the Segments in Pricing Zones 1 and 2 minus the incremental costs for the use of those segments by Access Holders originating outside those Segments (i.e. Pricing Zone 3 Access Holders)'.[39] If this formulation is adopted then:

(A) revenue equivalent to the incremental costs of the use of the Constrained Network by an unconstrained coal customer would be allocated to the Constrained Network; and

(B) any other access revenue from the unconstrained coal customer would be allocated to parts of the unconstrained coal customer's journey outside the Constrained Network.[40]

(Implications of deduction of incremental costs) Given that:

(A) the mandatory floor test requires that Access revenue from every Access Holder must at least meet the Direct Cost imposed by that Access Holder; and

(B) Direct Cost is, in the longer term, a subset of incremental costs,

the combined application of the ACCC's interpretation of the 'Ceiling Limit' and the revenue allocation process would mean that the Floor Limit for unconstrained coal customers on the Constrained Network would never be triggered. This is because the Access revenue allocated to the unconstrained coal customers for the Constrained Network would be equivalent to the incremental cost and therefore always higher than the Direct Cost imposed by the unconstrained coal customers with respect to the Constrained Network.

[38] ARTC, *2013 Annual Compliance Assessment – Response to ACCC Position Paper*, page 8.

[39] Draft Determination, pages 39-40.

[40] Draft Determination, page 39, paragraph (g) and ARTC, *Submission to ACCC Discussion Paper*, August 2014, paragraph 10 on page 25.

(3) (**The problem of inconsistency**) If the combined application of the ACCC's interpretation of the 'Ceiling Limit' and the revenue allocation process means that the mandatory Floor Limit for unconstrained coal customers on the Constrained Network would never be triggered, then the mandatory Floor Limit would become redundant, which is an absurd result. This is inconsistent with the notion that all provisions in a document should have a purpose.

(4) (**Response to ACCC's position**) The ACCC is of the view that while the mandatory floor and ceiling limits form the boundaries of the range of permissible ARTC revenue, the existence of such boundaries does not indicate that the limits must be determined on the same basis.[41] Whilst Idemitsu agrees that the mandatory floor test and the Ceiling Limit must not necessarily be determined on the same basis, Idemitsu is of the view that the method for calculating the Ceiling Limit should not render the mandatory floor test redundant. This is consistent with the notion that all provisions in a contract should have a purpose. Therefore, Idemitsu considers that ARTC's method of calculating the Ceiling Limit, which does not render the mandatory floor test redundant, is preferable to the ACCC's method.

8 Technical assessment

As was explained in Section 7 of this submission, Idemitsu considers that the proper application of the ceiling revenue limit of the HVAU requires that standalone costs be interpreted as the economic costs of PZ1/2 less the Direct Costs of PZ3 users while passing through PZ1. However, for completeness, Idemitsu has undertaken a technical assessment of WIK's report. This section of our submission responds to the WIK report, identifies material concerns with the WIK approach, and discusses a series of alternative approaches to the assessment of PZ1/2 stand-alone costs. Idemitsu's technical assessment is without prejudice to Idemitsu's legal rights which it will assess after reviewing the final decision.

For the purposes of commenting on the WIK analysis, we have engaged Lunarr Advisory and TSG. The scope of this work and the credentials of the consultants are provided in the Lunarr Advisory report, which is provided separately. Idemitsu advised Lunarr Advisory to ignore the interpretation of 'stand-alone' which our legal advice suggests is required based on the HVAU, and to adopt a definition based on all costs which could have been avoided in 2013 had PZ1/2 existed on a stand-alone basis (that is, without PZ3). That is, an approach consistent with the ACCC's approach was adopted for the purpose of this review.

The technical assessment concludes that the WIK assessment is unlikely to provide a reasonable estimate of the stand-alone costs of PZ1/2 standalone costs. Specifically, a number of projects which WIK identifies as being incremental (the cost of which is shared between PZ1/2 and PZ3) would have been required by PZ1/2 on a standalone basis. This is because:

[41] Draft Determination, page 40.

(a) Some of the projects, despite delivering capacity which was required by both PZ1/2 and PZ3 users, would have been required to deliver the requirements of PZ1/2 users alone.

(b) Some of the projects were wholly or predominantly undertaken to reduce congestion or reduce the impacts of maintenance activities, and these issues would have existed and required resolution with or without the demand of PZ3 customers.

(Project triggers and 'lumpy' investments): An example of the first issue (based on the Maitland to Minimbah 3rd track project – Stage 1) demonstrates the problem:

Capacity prior to project	90mtpa
Capacity after project	140mtpa
PZ1/2 forecast demand at time of commitment	137mtpa
Total PZ1,2,3 forecast demand at time of commitment	155mtpa

Clearly this project would have been undertaken with or without the existence of PZ3 (i.e. the project costs would have been incurred on a standalone basis for PZ1/2 users), yet, because the project adds capacity, WIK allocates a share of the project cost to PZ3. This would be appropriate only in the unlikely case that the project was capable to being scaled to meet the specific needs of PZ1/2 customers (i.e. 137mtpa). Clearly it is more likely that the third track is a 'lumpy' investment, and the additional capacity which became available to PZ3 as a result of the project would have been created with or without this demand. Therefore, the standalone cost of PZ1/2 users includes the full cost of this project, rather than a share, because the additional PZ3 demand has not caused an incremental cost to be incurred. The WIK methodology fails to consider the triggers for particular projects (other than classifying projects are being for, or not for, the purpose of capacity enhancement) and therefore fails to consider whether specific projects would have been required on a standalone basis for PZ1/2 users.

(WIK projects which were not driven by demand): Lunarr Advisory and TSG have identified that the following projects were driven predominantly by considerations other than increases in demand. Therefore, it is reasonable to presume that the projects would have been required PZ1/2 on standalone basis (note: the analysis was limited to projects with a cost of over $10m):

(a) Bi-Directional signalling, Maitland to Branxton ($45.9m). The purpose of this project was set out in the 2006 and 2007 ARTC Hunter Valley Corridor Capacity Strategies under a chapter headed "Reducing maintenance impacts and increasing operational flexibility". The detailed description of the requirement for the project was consistent with the heading.

(b) Maitland to Minimbah Third Road – Stage 2 ($353.2m). This project is also described in the 2006 and 2007 ARTC Hunter Valley Corridor Capacity Strategies under the chapter headed “Reducing maintenance impacts and increasing operational flexibility”, but as a longer term solution to these issues.

(c) No 3 Departure Road at KCT ($30.8m). This project is described in the 2013 ARTC Hunter Valley Corridor Capacity Strategy under a chapter headed “Terminals, congestion and system issues”.

Exclusion of these projects from the WIK assessment would reduce the value of projects (of which a share is allocated to PZ3) from $762m to $333m. However, Idemitsu acknowledges that the level of demand may have had some impact on the need for these projects, even where the projects were driven predominantly by maintenance or other considerations.

(Approach to resolving these concerns): Lunarr Advisory have identified four alternative methodologies for the identification of standalone costs. The first method involves a Qualitative Assessment, along the lines of the analysis presented in the previous section.

The remaining three methodologies seek to identify projects which would have been incurred by PZ1/2 on a stand-alone basis using volume measures. Projects are considered PZ1/2 stand-alone projects under the each method if the relevant criteria is met for that method, as follows:

Method	Test of PZ1/2 standalone
Qualitative Assessment	Expert view of the drivers for the project, based on a review of project documentation, indicates that the project was not predominantly driven by demand. This indicates that the project would have proceeded in the absence of PZ3.
Trigger project basis	Forecast PZ1/2 demand for the year of project completion, as forecast at the time of project commitment, exceeds forecast capacity in the absence of the project.
Actual Use	Actual PZ1/2 volumes at time of ceiling test exceeds capacity in the absence of the project
Expected Use	Forecast PZ1/2 demand for the year of assessment (in this case, 2013), as forecast at the time of project commitment, exceeds capacity in the absence of the project.

None of the alternative methodologies are perfect. In some cases, the facts surrounding a particular project will lead to a clear conclusion, based on one or more of the analysis methods, as to the standalone or incremental nature of the project. In other cases, judgement must be applied based on assessment of a range of approaches. The Lunarr Advisory report assesses each of WIK's incremental projects with a cost of greater than $10m using each of the criteria, and reaches a conclusion as shown in the following tables:

Projects	Value	Qualitative assessment	Trigger project basis	Actual use basis	Expected use basis	Recommended PZ3 incremental? (i.e. NOT PZ1&2 stand-alone)	Summary of recommendation
357901 - Antiene to Grasstree Stage 1 duplication - 0961	$42.7	✔	✖	✖	✖	✖	Duplication of single track is generally predominantly conducted to improve capacity and is therefore demand driven. However PZ1&2 demand alone for all approaches was consistently higher than the documented capacity of the line section without the project.
388401 - St Helliers to Muswellbrook Duplication	$31.4	✖	✖	✖	✔	✖	The documentation clearly states that duplication of this section provides capacity well in excess of demand requirements but that cost synergies with Antiene to Grasstree Stage 1 duplication (above) warrant this project. This position is backed up by 2 of the 3 quantitative approaches confirming that total demand was less than capacity without the project
6928 - Drayton Junction Upgrade (Capital)	$19.9	✖	✖	✖	✖	✖	Strong evidence in documentation that the major driver for this project is improved maintenance rather than capacity and is therefore stand-alone. Quantative analyses reinforces position by identifying that PZ1&2 demand in isolation is sufficient to cause the project in any case (and therefore is stand-alone) with the other approach identifying that total demand was insuffcent to drive the project (and therefore is not demand driven and stand-alone)
346801 - Newdell Junction Upgrade	$15.7	✖	-	✔	✖	✖	As per Drayton Junction, Strong evidence in documentation that the major driver for this project is improved maintenance rather than capacity and is therefore stand-alone.
5811 - Nundah Third Track - All Phases	$77.8	✔	-	✖	✔	✔	Clearly a demand driven project aimed at improving headways on capacity constraining location (Nundah Bank) reinforced by quantative analysis.

Projects	Value	Qualitative assessment	Trigger project basis	Actual use basis	Expected use basis	Recommended PZ3 incremental? (i.e. NOT PZ1&2 stand-alone)	Summary of recommendation
358401 - Bi-Dir signalling Maitland to Branxton - 946/947	$45.9	✖	✖	✖	✖	✖	Strong evidence in documentation that the major driver for this project is improved maintenance rather than capacity and is therefore stand-alone. All quantative approaches indetify that PZ1&2 demand was consistently higher than the documented capacity of the line section without the project in any case.
3585 - Maitland to Minimbah Third Road – Stage 1 – All Phases	$146.4	✔	✖	✖	✖	✖	Clearly a demand driven project aimed at improving headways on capacity constraining location (Minimbah Bank). However, all quantative approaches show that PZ1&2 demand alone was well in excess of documented capacity without the project and hence project is stand-alone.
5255 - Maitland to Minimbah Third Road – Stage 2 – All Phases	$353.2	✖	✖	-	✖	✖	Strong evidence in documentation that the primary driver for this project is improved maintenance rather than capacity and is therefore stand-alone. Reinforced by 2 of 3 quantative approaches identfying that PZ1&2 demand is sufficient to drive the project in any case.
8665 - No.3 Departure Road at KCT	$30.8	✖	✖	✖	✖	✖	Strong evidence that the project provided minimal direct capcaity benefit, but was implemented to improve efficiencies in the operation, hence stand-alone. Reinforced by all quantative approaches identifying that total demand was less than capacity prior to the project.
Other Projects of value < $10m	$13.8	Not assessed					
TOTAL	$777.6						

The analysis highlights two key concerns:

(a) First, the WIK approach is likely to substantially overestimate PZ3 incremental costs and underestimate PZ1/2 standalone costs.

(b) Second, the complexity of the issue and the imperfect nature of any of the alternative approaches highlights the inappropriateness of seeking to develop a new measure of incremental and standalone costs during the term of the undertaking. Issues of such complexity are best dealt with during the development of an undertaking, so that an approved approach can be reflected in the undertaking itself. As was explained in Section 7, Idemitsu considers that this issue was in fact considered during the development of the HVAU, and that the measure of incremental costs deemed appropriate by the ACCC was Direct Costs as currently defined.

9 Conclusion

The Draft Determination is not based on an appropriate interpretation of the ceiling revenue limit of the HVAU. The appropriate interpretation is that which has been proposed by ARTC, which:

(a) Was communicated to and understood by the ACCC prior to the ACCC's approval of the HVAU;

(b) Formed the basis on which the relevant provisions of the HVAU were approved by the ACCC; and

(c) ACCC subsequently applied in 2011 and 2012.

Without prejudice to our rights, we provide a review of the technical assessment conducted by WIK. This review concludes that many of the projects which contributed to WIK's estimate of incremental PZ3 costs were likely to have been required on a standalone basis for PZ1/2. A range of alternative methodologies indicate a higher standalone cost for PZ1/2 and a lower PZ3 incremental cost.

It is critical that in reaching its final decision, and in making any future decisions on this matter (including in regard to the new undertaking), that the ACCC considers how these decisions will impact regulatory certainty and competition in coal markets. Idemitsu considers that the contribution by PZ3 of Direct Costs to PZ1 is sufficient in the short term and is appropriate taking into account the objects of the Act. In the long term, the approach is in the interests of NSW coal producers as a whole. Any review of approaches to pricing needs to consider the package of measures which make up pricing arrangements under the HVAU. Idemitsu considers that a number of the existing measures are inequitable to PZ3 producers and that implementing a change to a single aspect of the undertaking without reassessing the full package of measures would be inappropriate.