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

(By email: transport@accc.gov.au)

Dear Mr Schroder

**Position Paper - ARTC's Proposed Variation to the Hunter Valley Rail Network Access Undertaking to include Gap to Turrawan Segments**

Idemitsu Australia Resources Pty Ltd (**Idemitsu**) welcomes the opportunity to provide the following submission in regards to the Position Paper issued (12 December 2013) by the Australian Competition and Consumer Commission (**ACCC**) in relation to the Australian Rail Track Corporation (**ARTC**) application to vary the Hunter Valley Rail Network Access Undertaking (as varied on 17 October 2012) (**HVAU**) to include Gap to Turrawan Segments (**Proposed Variation**).

Idemitsu is an active coal producer located in both the Hunter Valley and the Gunnedah Basin, utilising the current Hunter Valley Rail Network (**Network**) as defined in Schedule B of the HVAU. As part of Idemitsu's logistics operation from its Boggabri Mine located in the Gunnedah Basin, coal is transported by rail originating in the Gap to Turrawan segment to the port of Newcastle.

Idemitsu has previously provided a submission in response to the ACCC's Consultation Paper issued 23 July 2013[1].

It is Idemitsu's understanding the Position Paper expresses the ACCC's preliminary view on the proposed variation and includes outstanding items based upon an independent review of the depreciated optimised replacement cost **(DORC)** valuation conducted by Marsden Jacob Associates **(MJA)**, engaged by the ACCC. Idemitsu is not an expert in DORC valuations for rail networks but has had the opportunity to consider this DORC review.

Idemitsu has provided responses to the preliminary views of the ACCC contained in the Position Paper and additional comments on the MJA review as follows:

## 1. Transition

Idemitsu acknowledges ARTC's original intent to have the Proposed Variation approved by the ACCC for inclusion in the HVAU from 1 January 2014, given time constraints this has not been possible. The ARTC has complied with the requirements of the HVAU and published annual prices for 2014 based upon the assumption Pricing Zone 3 incorporates the entire Gap to Turrawan segment and ARTC's expectation the Proposed Variation will be approved by the ACCC by 1 January 2014.

[1] Idemitsu submission to the ACCC – Consultation Paper, 22 August 2013

## 2. Extension of Pricing Zone 3

Idemitsu considers the inclusion of the Gap to Turrawan segment into the HVAU Network by way of extending the current Pricing Zone 3 as reasonable. Furthermore, Idemitsu supports the proposed division of the Gap to Turrawan into four sub-segments as outlined in the Proposed Variation, which is consistent with Pricing Zone 1 and Pricing Zone 2.

## 3. DORC Valuation

As considered in Idemitsu's previous submission, the Gap to Turrawan segment was not ascribed a regulatory asset value under the NSWRAU and as such clause 4.4(a)(ii) of the HVAU is applicable. A DORC method of valuing the assets of this segment should be applied to establish the initial Regulated Asset Base (**RAB**), subject to acceptance and approval by the ACCC.

In this submission Idemitsu expressed a number of concerns in regards to the DORC value proposed by ARTC in the Proposed Variation (establishing the initial RAB value for Gap to Turrawan as at 1 January 2013).

### 3.1. Assets Included in the DORC Valuation

#### 3.1.1. Assets for Hauling Coal

Gunnedah Basin coal producers share the Gap to Turrawan segment with non-coal services and on the basis of a standalone coal valuation it is appropriate only those assets relevant to perform the coal haulage task should be included in the DORC valuation.

The MJA report has identified 12 passing loops and sidings which should potentially be excluded from the DORC valuation. In particular:

a) three (3) sidings which are used solely for non-coal purposes as advised by ARTC:

b) one (1) loop is privately maintained and owned (non-coal) as advised by ARTC; and

c) six (6) of the passing loops and sidings are less than 500 metres long, which restricts the use for coal operations due to physical limitations.

The ACCC's preliminary view is the above loops and sidings should be excluded from the DORC valuation and any assets which are not required for the hauling of coal should be excluded from the DORC valuation (on a standalone coal basis). MJA in their review have estimated a reduction to the DORC value of approximately $8.3 million for the removal of these loops and sidings. Idemitsu supports the removal of these loops and sidings from the DORC valuation.

Idemitsu considers the exclusion from the DORC valuation of stations, overbridges and tunnels as appropriate for the reasons outline in the MJA report[2].

#### 3.1.2. Allocation of Network Control Centre Costs

It would seem the concern raised by Asciano[3] in regards to double counting in different parts of the Network for network control centre costs has been satisfied by the ARTC in the interim ACCC information requests and considered by MJA in their review. However, Idemitsu considers the allocation of network control costs to the Gap to Turrawan section as excessive noting the comments by MJA[4]:

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2 Marsden Jacob, Review of Australian Rail Track Corporation's valuation for the Gap to Turrawan Segment of the Hunter Valley rail network, 30 November 2013, p17

3 Asciano Submission to the ACCC relating to the ARTC Hunter Valley Access Undertaking Proposed Variation to Include Turrawan to Gap, 20 August 20

4 Marsden Jacob, Review of Australian Rail Track Corporation's valuation for the Gap to Turrawan Segment of the Hunter Valley rail network, 30 November 2013, p20

*"The allocation of costs to the Gap to Turrawan segment is high relative to the Dartbrook to Gap segment. In particular, the allocated cost is more than double ($690,000 compared to $340,000) for a similar length of track."*

It remains Idemitsu's view the allocation of network control cost by distance within the Network does not provide a true representation of the required capital or application of such capital and the DORC valuation should be reduced accordingly.

### 3.1.3. Financing Costs

The MJA report has questioned the appropriateness of including the costs of financing construction in the DORC valuation.

Idemitsu considers the inclusion of cost of financing construction as inappropriate for the reasons outlined by MJA[5]:

a) there appears to be no consistent approach taken across other valuations;

b) previous ARTC valuations of the interstate network and Dartbrook to Gap valuation do not appear to include financing costs; and

c) the critical link to the construction timeframe and schedule.

In relation to this last point, Idemitsu has concerns regarding the level of accuracy and reasonableness that would be essential in identifying and calculating construction financing costs. Such cost could only be based upon an indicative forecasted construction timeframe which is likely to have limited correlation to reality. It is Idemitsu's view the inclusion of the cost of financing construction in the DORC is not appropriate.

Idemitsu notes as part of the ARTC's recent Annual Compliance assessment submissions to the ACCC actual interest during construction has been included based upon a definitive construction schedule, which would appear to be reasonable.

## 3.2. Benchmark Replacement Costs

### 3.2.1. Mark Ups

Idemitsu's previous submission considered the mark ups on direct costs in the DORC valuation used to establish indirect costs (and ultimately replacement values) appear to be excessive when compared to comparable benchmarks. It has been identified in the MJA report the indirect costs have a "material impact" on the DORC valuation. This impact is approximately 50% of the DORC value, hence establishing appropriate mark ups is critical[6].

Despite the challenge of available information for benchmarking from the ARTC for similar rail projects, MJA has been able to conduct benchmark comparisons from other sources for DORC valuation components such as ballast, sleepers, rail and signalling. MJA have proposed a reduction of the DORC valuation of between $9.5 and $16.4 million due to the comparably high mark-up used by ARTC.

Idemitsu supports the ACCC's preliminary view that the proposed mark ups used by ARTC in the DORC valuation components are "comparatively high" to relevant benchmarks and are unlikely to be appropriate.

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[5] Marsden Jacob, Review of Australian Rail Track Corporation's valuation for the Gap to Turrawan Segment of the Hunter Valley rail network, 30 November 2013, p17

[6] Marsden Jacob, Review of Australian Rail Track Corporation's valuation for the Gap to Turrawan Segment of the Hunter Valley rail network, 30 November 2013, p54

## 3.3. Optimisation

### 3.3.1. Operating and Maintenance Cost Savings

As part of their review MJA has considered the issues which arise when replacing existing assets with a modern engineering equivalent (optimised assets) and the impact of modern design and technologies of the asset on future ongoing operating and maintenance costs.

The DORC valuation will reflect the cost of the optimised asset, however the operating and maintenance costs may not reflect any potential differences between the modern engineering equivalent and existing assets.

MJA have identified two alternative approaches to allow for the treatment of operating and maintenance costs[7]:

a) adjust the initial DORC
b) adjust the ongoing operating and maintenance costs (inclusion in the Annual Compliance assessment)

MJA consider there is a strong case for option a) based upon a standard assessment framework which has been applied to other sectors and requires a relatively small administrative cost and regulatory burden when compared with applying option b).

Although ARTC have expressed a preference for option b), the ACCC have outlined a number of valid concerns with this option[8]:

a) eliminate cost savings if an asset was disposed of before the end of its expected useful life (likely from infrastructure upgrades);
b) potential practical difficulties when implementing the Annual Compliance assessment (actual operating costs v hypothetical costs), the Annual Compliance assessment should be limited to actual costs only;
c) the development of these hypothetical costs (assumptions to be determined);and
d) potential for "perverse" incentives for ARTC – minimising operating and maintenance expenditures between existing and optimised assets where it is unable to recover the actual expenditure due to the adjustment.

For the above reasons, Idemitsu supports the ACCC's preliminary view that savings in operating and maintenance expenditures which arise between new and optimised assets over their expected remaining useful life should be identified and reduce the DORC valuation by deducting the present value of any such potential cost savings.

## 3.4. Depreciation and Remaining Life

The proposed DORC valuation has used straight-line depreciation to the Optimised Replacement Costs having regard to the condition and remaining life of the asset. This approach is consistent with the depreciation methodology required under the HVAU.

Critical to applying the straight-line depreciation methodology is determining the useful life/remaining life of an asset or asset class. As part of the MJA review it was identified the remaining life of a number of assets (i.e. bridges, signalling assets and sleepers) are considered

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7 Marsden Jacob, Review of Australian Rail Track Corporation's valuation for the Gap to Turrawan Segment of the Hunter Valley rail network, 30 November 2013, pp18-19

8 ACCC Position Paper, 12 December 2013, p26

not reasonable[9]. MJA are proposing a reduction to these asset's remaining lives with the exception of bridges.

Idemitsu supports the ACCC's preliminary view that a decrease to the DORC valuation is appropriate by $6.1 million for adjustments to the remaining life assumptions as outlined in the MJA review.

Idemitsu remains concerned that the DORC valuation may not be appropriate in regard to assets which will soon be scrapped. A significant infrastructure upgrade project is currently being undertaken in the Gap to Turrawan section (and in the Dartbrook to Gap section) converting 25 tonne axle load infrastructure to 30 tonne axle load infrastructure. It should be noted there are other capacity related projects scheduled for construction in this section of the Network within the immediate future (and occurred throughout 2013). Idemitsu is concerned a number of assets will be given an estimated useful life which is inappropriate as it is about to be scrapped in the next 12 to 18 months as a result of Network improvements and upgrades. It would seem inequitable for a DORC value to be placed upon an asset which has an effective remaining life of only 12 to18 months unless the DORC value is calculated by reference to this very short remaining life. While the relevant assets may well have a physical remaining life which is greater than 12 to 18 months, it seems clear that the remaining life of these assets will come to an end in 12 to18 months and be written off at the expense of access holders and thus providing unintended gains for the ARTC.

## 4. Modelling Inconsistences

The MJA report has identified a number of proposed modelling inconsistencies contained in the DORC valuation which results in increasing the valuation by a net amount of approximately $5 million. Idemitsu is unable to comment on these modelling inconsistencies as these appear to have been identified in the E&P spread sheet model which was provided to MJA but not made publicly available.

## 5. Indicative Service

Idemitsu supports the ACCC's preliminary view that incorporating the Gap to Turrawan segments into Pricing Zone 3 by way of extending Pricing Zone 3 and applying the same Initial Indicative Service as existing Pricing Zone 3 is appropriate.

## 6. Pricing Transparency

In late October 2013 in accordance with the HVAU, the ARTC published the 2014 pricing incorporating the extended Pricing Zone 3. These prices saw a significant increase in the Non TOP component of the access charges for Pricing Zone 3 with the inclusion of the extended Pricing Zone 3. What was not sufficiently transparent in this pricing information was the amount of loss that will be capitalised for future recovery. Such transparency is essential for all applicable access holders to not only understand the proposed annual pricing but the potential exposure to future loss recovery by ARTC.

Idemitsu notes the comments provided by the ARTC as part of the information request in relation to estimating the magnitude of the capitalised losses, however Idemitsu supports the ACCC's view that the ARTC could provide an estimate of likely losses to be capitalised as part of the annual pricing process each year, which could subsequently be reviewed for accuracy and reference as part of the Annual Compliance assessment. Furthermore, Idemitsu would support an amendment to clause 4.20(d) of the HVAU for this information to be provided to access

9 ACCC Position Paper, 12 December 2013, p 27

holders in the future. Idemitsu is willing to work with the ARTC on developing this transparency of capitalised losses as part of the annual pricing process for 2015 and would welcome available information for 2014.

In conclusion, Idemitsu has reviewed the ACCC position paper and the accompanying MJA review and in the majority of instances supports the preliminary views of the ACCC. Idemitsu acknowledges the importance of establishing a reasonable and equitable initial RAB value for the Gap to Turrawan segment by using a DORC valuation. From the independent review process conducted by the ACCC a number of valid concerns have been raised in regards to the inputs and methods of the DORC valuation with proposed adjustments quantified. It is in the interest of all stakeholders the initial RAB is independently tested and reviewed for reasonableness to ensure confidence in the basis for future pricing.

Idemitsu would like to thank the ACCC for its consideration on these matters and if further discussion is required please do not hesitate to contact Mr Craig Forster (Ph +61 7 3222 5623).

Yours sincerely

Lee Gordon
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