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{by e-mail}

Mr Matthew Schroder
General Manager
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Australian Competition and Consumer Commission
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Dear Matthew

Whitehaven Coal Response to ACCC Draft Determination on ARTC Compliance to Financial Model 2013

Introduction

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

The ACCC Draft Determination dated 30 October 2015 outlining the findings of the assessment sought submissions from interested parties on aspects of the compliance. This included the prudency of capital expenditure, efficiency of operating expenditure as well as application of the ceiling test and its impact on revenue allocation calculations. The Whitehaven submission will focus on the ceiling test and revenue allocation due to its significant financial impact on our organisation.

Whitehaven again submits that changing the ceiling revenue limits through an adjustment to the stand alone cost test during the term of the current HVAU is not appropriate, leads to investment uncertainty and may reduce competition between producers and the international competitiveness of the Hunter Valley coal market.

The potential changes to the revenue allocation methodology is a major issue of misalignment within the producer group in the new access undertaking negotiations with ARTC. Whitehaven believes the ACCC should only include the proposed new methodology in the new HVAU commencing 1 July 2016 to allow alignment on this issue during HVAU negotiations.

There is also clearly a discrepancy in the Rail Asset Base values for the different pricing zones. An adjustment of these to a consistent $RAB per kilometre metric would adjust the allocation of costs between return on assets and maintenance and remove the requirement for loss capitalisation.

As argued by PZ1 producers in previous submissions to ACCC, producers contracting to capacity released by capital expenditure projects in PZ1 should contribute to the return on those projects. PZ3 capital projects have released over 15 million tonnes of capacity in PZ1 in calendar year 2015 therefore these PZ3 projects should be included in the PZ1 RAB.

To facilitate an agreement with all producers Whitehaven have used information from industry experts to provide advice on cost drivers and calculate an Incremental Cost for PZ3 using a methodology Whitehaven would recommend for inclusion in the new HVAU.

Effect on Competition

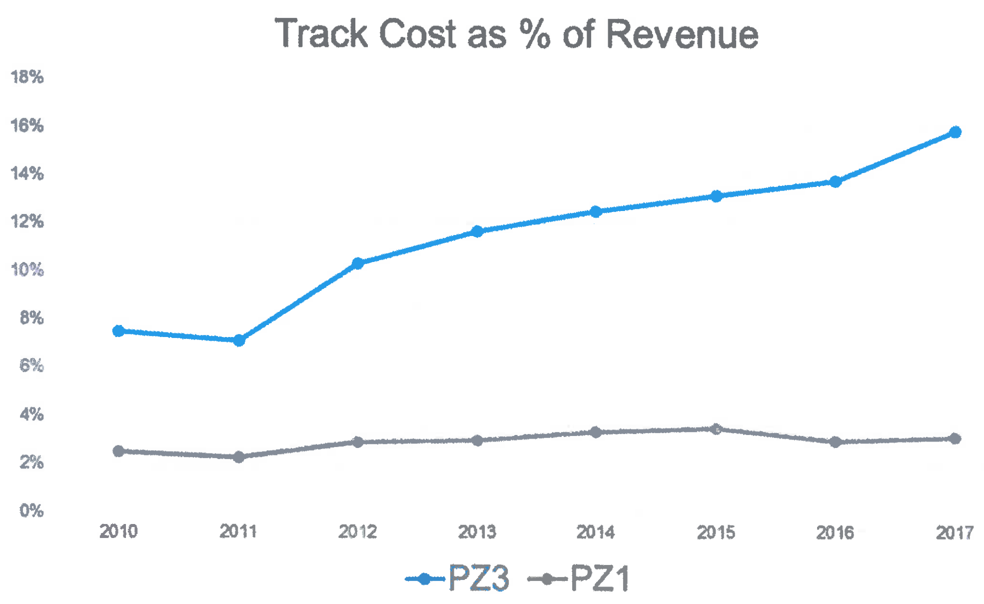
Whitehaven believes the adjustment to revenue allocation proposed by the Draft Determination could have the unintentional consequence of distorting competition both within the Hunter Valley coal market and internationally.

Competition between Hunter Valley producers will be directly affected. With the contracted tonnage in PZ1 being over 6 times greater than PZ3, any reallocation from PZ1 to PZ3 producers will have a similar multiplier, by way of example, an immaterial decrease of $0.10 per tonne for PZ1 producers would lead to over $0.60 per tonne increase in PZ3 producer costs. As ACCC would be aware, margins in the coal market have reduced significantly since 2013 and this quantum of increase could jeopardise the viability of some mines longer term.

In discussions with ARTC it has been highlighted that the Draft Determination if adopted will result in PZ1 producers receiving an access price decrease over the next 5 years while PZ3 producers will receive an access price increase over the same period. As PZ3 is the major growth region in the Hunter Valley this price distortion may have a significant effect on growth opportunities and subsequently the level of competition.

Graph 1 shows estimated ARTC access pricing as a percentage of revenue for PZ1 and PZ3 under an adoption of the Draft Determination. This highlights the risk to competition.

Graph 1



Source : Whitehaven analysis

With regards to international competition, in recent years the Hunter Valley has seen a drift away from the traditional high quality markets to lower quality ones as existing mines move into lower coal quality sections. PZ3 provides high quality coal to the Hunter Valley. With over 80% of the Hunter Valley exports estimated to be blends from different mines it is expected that PZ3 coal will be utilised to blend with lower quality coal for traditional markets.

The Revenue Allocation process was included in the HVAU to foster growth in new geographic areas of the Hunter Valley coal market. Changes to this process could lead to a reduction in production from PZ3, leading to less ability to blend and a significant decrease in the international competitiveness of Hunter Valley coal.

Rail Asset Base discrepancies

Table 1 provides a summary of the estimated RAB's for different pricing zones and the relevant distances upgraded to similar track standards.

	RAB ($m)	Km	$RAB/km
PZ 1	1250	320 *	$ 1.95
PZ 2	230	145	$ 1.59
PZ 3	710	250	$ 2.84

* PZ1 estimates km adjusted for multiple tracks and $RAB/km for bidirectional signaling

It is understood that initial RAB values were determined as part of the ARTC lease process but there was limited transparency or understanding of the impact of this.

Comparing the $RAB per kilometre of track highlights a significant difference between pricing zones. As PZ2 and PZ3 have similar track characteristics (single line, passing loops per kilometre, tunnels, signaling) it would be expected there would be minimal difference in the $RAB per kilometre index but in reality there is an 80% differential.

An adjustment of the pricing zone RAB's to produce similar $RAB per kilometre levels would have the result of adjusting the ceiling limit and therefore revenue allocated to return on assets and maintenance.

Whitehaven believes a review of the RAB by pricing zone should be undertaken to ensure all producers are paying proportionally equitable returns on ARTC assets.

PZ3 Capital Projects increasing PZ1 Capacity

In previous submissions other PZ1 producers have argued that PZ3 producers should contribute to capital projects that increase capacity to the PZ1 network.

In 2013 PZ3 producers were operating 3,000 and 5,400 tonne trains. A significant amount of capital has been expensed from 2013 in PZ3 to increase trains to their current operating capacity of 8,000 tonnes. This has provided an estimated capacity increase in PZ1 of over 15 million tonnes in 2015.

Following the argument put forward by PZ1 producers, any PZ3 project which increases capacity in PZ1 thereby negating or delaying PZ1 major capital expenditure should be contributed to by PZ1 producers using the agreed ACCC methodology.

Illustrative Calculation of Incremental Costs

As outlined in previous submissions, Whitehaven believes changing the ceiling revenue limits through an adjustment to the stand alone cost test during the term of the current HVAU is not appropriate and should only be agreed in advance and included in the next HVAU.

The ACCC Draft Determination includes a report from WIK-Consult (WIK) to estimate the incremental costs of Pricing Zone 3 Access Holder's use of Pricing Zone 1. WIK estimated the incremental costs of Pricing Zone 3 Access Holders' use of Pricing Zone 1 as $14.6 million for the 2013 calendar year compared to the $2.5 million Direct Costs calculated by ARTC.

For illustrative purposes Whitehaven have utilised industry experts to analyse the information provided by ACCC and the WIK Consult Group. This analysis demonstrates a methodology for ACCC to use in the new HVAU.

The drivers which should be used for calculating Incremental Costs are outlined in detail in the EJC and Lycopodium reports attached. A summary of these findings are below.

<u>Axle Load & Train Length – factors for major capital and renewal projects</u>

The 30 tonne axle load (tal) track standard and 1,600 metre trains required for PZ1 is not required for PZ3 producers. It has a significantly higher capital and renewal cost.

Whitehaven believes a 0.84 factor should be applied to all PZ1 capital project costs when allocating to PZ3 producers to adjust for higher capital costs of 30tal and longer trains.

Independent rail experts also believe renewal costs should use the following factors :

- Rail renewal = 0.54
- Track Geometry = 0.59
- Other costs = 0.84

<u>New Capacity projects</u>

The allocation of new capital to PZ3 should be based on the stand alone cost of PZ1. That is, new capacity projects should only be included in an Incremental Cost analysis if they meet the following guidelines :

1. Be used by PZ3 producers (no PZ2 projects)
2. Be required by PZ1 if PZ3 producers did not exist

A summary of the capacity projects within the WIK report that do not pass these tests is included in Table 2.

Table 2 – Projects that are required for PZ1 if PZ3 did not exist (stand alone test)

	FY 05-06	FY 06-07	FY 07-08	FY 08-09	FY 09-10	FY 10-11	FY 11-12	CY 2012	CY 2013
Othr project (<A$20m)	3.22	14.8	4.1	1.1	24	12.4	0.4		22.3
St Heliers to Muswellbrook duplication Segment 961				0					
Bi Direction Signalling Maitland to Braxton Segment 946/947				0					
Antiene to Grastree stage 1 duplication Segment 961				0					
Sandgate Grade Seperation Segment 931		79							
Hexham Dep/Arr roads Segment 930	1.05								32.3
Nundah Segment other									7.8
Nundah Segment 956								33	
Nundah Segment 955								13.5	
Nundah Segment 418/956				0.3					
Mininbah Segment other									33.3
Mininbah Segment 428/948		0.3	0.6	0.2	42.6	19		155.1	
Mininbah Segment 416/947					87.9	8.3		184	
Mininbah Segment 415/946					5.2	0.5			
Total	4.27	94.1	4.7	1.6	159.7	40.2	0.4	385.6	95.7

This analysis shows the Nundah Bank is the only project that would not have been required if PZ3 contracted tonnes did not exist.

Therefore if Zone 3 did not exist 85% of the program since 2008 would have still been required. This proportion is closer to 95% for projects since mid-2010.

The new capital projects that meet the guidelines would therefore total $46m from 2010 to 2013 after adjustments for the 0.84 factor (for 30tal) and proportioned by the contracted tonnes in PZ1.

The resultant Incremental Cost is less than $2m for PZ3 producers.

Maintenance Costs

Whitehaven primarily agrees with the WIK treatment of maintenance cost allocations. Again based on industry expert advice, all maintenance costs apportioned to PZ3 producers from PZ1 should be adjusted by the factors of :

- Rail renewal = 0.54
- Track Geometry = 0.59
- Other costs = 0.84

Summary

As the WIK-Consult report does not separate different components of the Incremental Cost allocation to PZ3 producers, Whitehaven is only able to provide a total allocation amount based on the methodology and calculations of the industry experts.

The comparison of incremental costs from different sources are contained in the table below. Whitehaven recommends ACCC utilise the methodology of the industry experts as provided in the attached reports.

	ARTC Submission	WIK (2008)	WIK (2011)	EJC / Lycopodium
Incremental Cost 2013	2.5	14.6	10.5	3.4

Whitehaven requests ACCC take into consideration the following issues when making their determination with regards to the ARTC compliance with the HVAU financial model :

- remove investment uncertainty and install an agreed methodology for revenue allocation in the new HVAU to commence on 1 July 2016;

- implementation of the proposal in the Draft Determination from 2013 onwards will lead to material changes in the ARTC pricing differentials between zones thereby a lessening of competition both within the Hunter Valley in the short term and internationally in the longer term;

- a review of the Rail Asset Base for all pricing zones would remove the existing kilometre based discrepancies and ensure all producers are paying proportionally equitable returns on ARTC assets;

- any major project from PZ3 that increases capacity in PZ1 should have contribution by all PZ1 producers through inclusion in the PZ1 RAB;

- utilise the methodology described in this submission when endorsing the new HVAU in 2016
    - exclude from the Incremental Cost calculation those major capital projects would not have been required if PZ3 contracted tonnes did not exist
    - adjusting major capital and renewal capital expenditure by the proposed factor for PZ3 producer allocations of PZ1 costs
    - adjusting maintenance costs by the proposed factor for PZ3 producer allocations of PZ1 costs
    - adopt the methodology proposed by WIK-Consult for the allocation of Network Control and corporate overheads

Attached for your reference are reports from industry experts EJC Projects and Lycopodium. Whitehaven requests these reports remain confidential for ACCC's use only.

Please contact me if you would like further clarification on the above.

Yours sincerely,

Keiron Rochester

GENERAL MANAGER – INFRASTRUCTURE