

Hunter Valley Coal Network Access Undertaking
Positive Performance Incentive Scheme

Report To

Australian Competition & Consumer Commission

June 2015

ARTC

An aerial, high-angle photograph of a long, straight railway track stretching from the foreground into the distance. The track is flanked by a dark gravel bed and a dirt shoulder. The surrounding landscape is flat and covered in low-lying, scrubby vegetation. The lighting suggests a low sun, creating long shadows and a warm, golden glow on the ground.

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1. EXECUTIVE SUMMARY

ARTC's Hunter Valley Coal Network Access Undertaking (**HVAU**) sections 13.3 and 13.5 require ARTC to prepare options and consult with stakeholders in relation to two forms of a positive performance incentive scheme (**PPIS**), a non-TUT related PPIS (**NTPPIS**) and a True Up Test (**TUT**) related PPIS (**TUTPPIS**) respectively.

ARTC has prepared consultation documents relating to both the TUTPPIS and NTPPIS and invited stakeholder submissions with regard to the options and issues raised in those documents.

Three submissions were received and these identified a number of concerns (see section 4 of this report for more detail). In summary, stakeholders did not support the proposed schemes being progressed through an amendment to the HVAU at this time. Apart from specific issues that would need to be addressed, respondents have indicated that the current market conditions make the consideration of an incentive scheme inappropriate. Some stakeholders have indicated a preference for the PPIS to be considered as part of the negotiation of the new HVAU, due to commence in July 2016. These views have also been expressed to ARTC informally by other stakeholders.

In light of this response, and in particular the small number of formal responses, ARTC has determined that it would be unproductive to pursue an amendment to the HVAU to incorporate a PPIS at this time. ARTC feels stakeholders would be more receptive to the consideration of a PPIS as part of the negotiation of the new undertaking. Therefore, ARTC intends to progress the development of proposals for a PPIS in further consultation with stakeholders as part of the 2016 HVAU consultation process. This will allow a PPIS to be tailored to the risks and requirements that may exist under the new undertaking and enact mechanisms that may enable a more integrated approach, at the same time providing an opportunity to address the issues raised.

2. INTRODUCTION & BACKGROUND

The Australian Competition & Consumer Commission (**ACCC**) approved the HVAU in June 2011. The HVAU has since been amended several times, most recently on 25 June 2014. References in this document to the HVAU refer to the most recently approved version. Terms used in this report have the same meaning as apply under the HVAU unless the context indicates otherwise.

For context, the TUT is set out in Schedule 2 of the Indicative Access Holder Agreement (**IAHA**) which forms Annexure A to the HVAU. A copy of the IAHA can be downloaded from the ARTC website at <http://www.artc.com.au/Content.aspx?p=225>.

This report does not contain any confidential information and may be published by the ACCC.

2.1 TUT Related Positive Performance Incentives

The HVAU sets out a requirement in section 13.5 for the development of a TUTPPIS, to provide ARTC with positive incentives to provide and utilise Capacity worked through the operation of the TUT. The need for such incentives was considered necessary by the ACCC to encourage ARTC to make Capacity available to Access Holders in an economically efficient manner. The intention was to balance the current negative incentive contained in the TUT, whereby ARTC could be required to forfeit revenue in certain circumstances where it had failed the TUT (and by implication had failed to provide contracted train path usages).¹

The requirements in HVAU section 13.5 are set out in Appendix A. In summary, the section requires ARTC to publish options on its website and invite submissions from stakeholders for a proposed performance incentive scheme which has the objectives of encouraging ARTC, through financial reward, to improve its performance in relation to making Capacity available for use either on a contracted or ad hoc basis. Once stakeholder submissions are received, ARTC is required to consider them in good faith and report the results to the ACCC. ARTC may propose an amendment to the HVAU to incorporate the scheme, if it considers this appropriate.

2.2 Non-TUT Related Positive Performance Incentives

HVAU section 13.3 set out the requirement for a more general positive performance incentive scheme, the NTPPIS. HVAU section 13.3 is set out in Appendix A. The obligations with regard to section 13.3 are similar to those in section 13.5 but the timing is different.

ARTC published a discussion paper relating to the NTPPIS in 2011 and submitted a variation to the ACCC for consideration in 2012. The variation application was subsequently withdrawn with the approval of the ACCC on the condition that the NTPPIS would be developed and lodged by ARTC when developing the TUTPPIS under HVAU section 13.5.

The basis for withdrawing the variation application was that whilst stakeholders generally supported the principle of having positive performance incentive mechanisms to drive improved efficiency and increase capacity in the Hunter Valley coal chain, they did not consider that applying resources to the development and finalisation of such mechanisms underpinning the variation to be appropriate at the time. ARTC recognised industry's desire to focus on coal chain capacity issues at the time and was willing to postpone its development of, and delay potential benefits arising from, a NTPPIS.

3. CONSULTATION PAPER

As required under HVAU section 13.5, and in compliance with ARTC's commitment to the ACCC regarding NTPPIS, in February 2015 ARTC published a Consultation Document on its website at <http://www.artc.com.au/Content.aspx?p=314> and invited stakeholder comments regarding both the TUTPPIS and NTPPIS. Stakeholders were provided a 6 week period in which to provide submissions.

¹ Australian Competition and Consumer Commission, Position Paper in relation to the Australian Rail Track Corporation's proposed Hunter Valley Rail Network Access Undertaking, 21 December 2010, p.236

Attachment 1 contains the letter sent to stakeholders inviting submissions regarding both the TUTPPIS and NTPPIS.

Attachment 2 contains the TUTPPIS Consultation Document. The consultation paper canvassed a number of issues related to the adoption of a TUTPPIS and proposed a scheme based around ARTC retaining revenue related to the operation of ad hoc train paths in certain circumstances, whereby such retained revenue would not form part of the revenue Ceiling Limit, thereby incentivising ARTC to provide additional ad hoc train paths.

The documentation relating to the NTPPIS from the previous consultation process is extensive and remains relevant. ARTC has not changed its view as to an appropriate NTPPIS since the previous consultation exercise. In light of this, ARTC decided that the best approach to revisiting the NTPPIS was to make that documentation, including previous stakeholder submissions, available to stakeholders for review and comment rather than to create a new consultation document with essentially the same content. This documentation was made available on ARTC's website at <http://www.artc.com.au/Content.aspx?p=314> and stakeholders were directed to this location in the letter of invitation.

4. STAKEHOLDER RESPONSES

Submissions were received from:

- Glencore
- Hunter Valley Energy Coal
- Vale

ARTC understands that the ACCC will wish to form its own views on the submissions. However, HVAU sections 13.3 and 13.5 require ARTC to consider stakeholder submissions in good faith and this necessarily requires ARTC to form a view as to stakeholder expectations. The following summarises ARTC's understanding of the general tenor of the submissions received and this view has informed ARTC's position going forward:

- Only one submission directly addressed the NTPPIS and that submission was not supportive of the proposed scheme.

The rest of these dot points relate to the TUTPPIS or to PPIS in a more general sense:

- At a high level there was a generally positive view towards the concept of a TUTPPIS. However, at the more detailed level there was a tendency within the submissions to place significant caveats around the proposed scheme such that its utility may be compromised, either impacting on the way in which the scheme would operate, the level of oversight required or the additional administrative burden compared to the potential benefit. One submission expressly did not support the proposed TUTPPIS others were somewhat ambiguous on the point, but given the caveats expressed, it is unlikely that any respondent would support the TUTPPIS without amendment at this time.
- The submissions tended to emphasise the need for transparency both relating to the TUTPPIS and more generally to matters relating to the HVAU.

- Any positive financial reward should have clear, unambiguous targets and/or baseline and should be audited.
- ARTC should have a commensurate risk to its Ceiling revenue – it does not appear from the submissions that the current TUT and the resulting TOP Rebates are seen as providing this.
- There was reasonable support for the exclusion of the incentive from the Ceiling.
- There was some recognition of the problem of separating ARTC performance from that of the coal chain. However, there were views that ARTC should not be rewarded when its out-performance does not result in actual benefits through the coal chain (i.e. there needs to be a tangible benefit received, not merely a potential benefit), and also ARTC should not benefit from other coal chain improvements not contributed to by ARTC – how this might be measured was not addressed.

This is a particularly complex issue in that, except in the case where ARTC is the constraining element of the coal chain, ARTC's positive performance is unlikely to result in more coal delivered to port in isolation from the performance of other service providers. The need to link a performance measure to performance outside ARTC's control will detract from the effectiveness of the incentive. This has the potential to complicate the operation of a PPIS and may invalidate some options.

- Several stakeholders were concerned about the impact of the proposed TUTPPIS on trading (i.e. that ARTC would have an incentive to discourage or prevent trading to maximise Ad Hoc paths).
- Some stakeholders expressly referred to the poor market conditions facing the coal industry and were of the view that it was not an appropriate time to consider providing additional rewards to ARTC. Some stakeholders supported continued discussions now, while others preferred to move the development of the PPIS into the new HVAU negotiations.

The three formal submissions received were provided on a non-confidential basis and have been posted on ARTC's website. The submissions are also provided as Attachment 3 to this report.

5. ARTC RESPONSE

It is clear from the submissions received that there is little support at present for a PPIS in the form proposed by ARTC at this time. It is also a fact that the majority of stakeholders invited to make submissions chose not to do so. In discussing the issue with these stakeholders, ARTC has received similar informal advice to the written submissions, that the timing was not appropriate and that the matter should be considered as part of the HVAU replacement consultation process. In light of this lack of support, ARTC is not proposing to submit an amendment of the HVAU to the ACCC to incorporate either a NTPPIS or TUTPPIS at this time.

ARTC recognises three circumstances currently operate to reduce the chances of a PPIS being received positively at this time:

- 1) Market conditions for coal producers are very difficult, making the reduction of costs the main focus of efforts and making the potential for increased costs through PPIS

payments to ARTC unpalatable, notwithstanding that this would only arise through productivity improvements or cost efficiencies;

- 2) The current HVAU is due to terminate in June 2016, necessitating that stakeholders concentrate their regulatory/commercial related resources on the consultation and negotiation of the new undertaking over the next year; and
- 3) The major expansions of Capacity that might be of benefit to coal producers in the short term have been completed and there is currently sufficient Capacity in the network to provide the majority of near term forecast volumes. Therefore, stakeholders are unlikely to see the incentivisation of ARTC to provide additional Capacity as a priority in the short term, notwithstanding there is general support in the future.

In light of these circumstances, ARTC has determined that stakeholders would be more receptive to the pursuit of a PPIS and the mechanism to enact as part of the negotiation of the 2016 HVAU. It is ARTC's view that this is likely to be a more productive endeavour. It also provides an opportunity to consider a PPIS that is integral to the 2016 HVAU rather than as an adjunct to it and therefore provide to better tailor the mechanism to meet contemporary stakeholder requirements and to address any asymmetries in the balance of risks arising under the 2016 HVAU. Therefore, ARTC intends to progress the development of proposals for a PPIS in further consultation with stakeholders as an integral part of the 2016 HVAU.

6. CONTACT DETAILS

For any further information or clarification in relation to this report please contact:

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APPENDIX A EXTRACTS FROM HVAU

Below are extracts from the HVAU for sections 13.3 and 13.5, relevant to this report.

13.3 Development of non-TUT related ARTC performance incentives

- (a) Within six months of the Commencement Date, ARTC will:
 - (i) prepare and publish on its website options for a proposed performance incentive scheme which has the objectives of encouraging ARTC, through financial reward, to improve operating, maintenance and capital expenditure efficiency, and achieve desirable safety performance, to be included in the Undertaking; and
 - (ii) invite submissions from Access Holders and other stakeholders on the proposed performance incentive scheme, within a specified time (which must be not less than 6 weeks from the publication of the options).
- (b) ARTC will in good faith consider the submissions provided within the specified time and by no later than 12 months from the Commencement Date will:
 - (i) prepare a report addressing options for a proposed performance incentive scheme having regard to the submissions and containing ARTC's proposed variation to the Undertaking to include its proposed performance incentive scheme;
 - (ii) provide the report to the ACCC; and
 - (iii) lodge a variation application with the ACCC under section 44ZZA(7) of the CCA consistent with the report.
- (c) To avoid doubt, the performance incentive scheme under this section 13.3 may be developed separately from the TUT-related performance incentive scheme to be developed under section 13.5 and is not required to include performance incentives to the extent they would overlap with those to be developed under section 13.5.

13.5 Development of TUT-related ARTC performance incentives

- (a) ARTC will either in parallel with, or following completion of, the TUT Review:
 - (i) prepare and publish on its website options for a proposed performance incentive scheme which has the objectives of encouraging ARTC, through financial reward, to improve its performance in relation to making Capacity available for use either on a contracted or ad hoc basis and balancing the negative consequences of failing the system wide TUT, to be included in the Undertaking; and

- (ii) invite submissions from Access Holders and other stakeholders on the proposed TUT-related performance incentive scheme, within a specified time (which must be not less than 6 weeks from the publication of the options).
- (b) ARTC will in good faith consider the submissions provided within the specified time and prepare a report addressing options for a proposed TUT-related performance incentive scheme having regard to the submissions and containing ARTC's proposed variation to the Undertaking to include its TUT-related proposed performance incentive scheme and:
 - (i) provide that report to the ACCC; and
 - (ii) may lodge a variation application with the ACCC under section 44ZZA(7) of the CCA consistent with the report, or if it chooses not to, will set out in the report reasons why it is not submitting a variation,

at the same time as it submits the TUT Review report to the ACCC for approval under section 13.4(d) or as part of the TUT Review report.

- (c) If ARTC decides to conduct the development of a TUT-related ARTC performance scheme after completion of the TUT Review, ARTC will complete development of a TUT-related ARTC performance scheme within 6 months of the completion of the TUT Review or such longer period as required to consider or address any variations that may be proposed or required by the ACCC.