Coal & Allied Industries Limited

Response to
ARTC's Consultation Document on Options for Positive Performance Incentive Mechanisms

In relation to
the 2011 Hunter Valley Rail Network Access Undertaking

24 February, 2012

Summary

Coal & Allied (**C&A**) considers the key components and their relative importance in a positive performance incentive mechanism to be the following:

Priority	Measure	Indicative relative weighting*
1	Safety	20%
2	TUT related (capacity)	To be determined
3	Operating efficiency	35%
4	Capital efficiency	35%
5	Cost efficiency	10%

* Non-TUT related basis

With the exception of safety, all the other non-TUT related (efficiency) incentives are of lesser importance than capacity availability, and as such should be available to Australian Rail Track Corporation Limited (**ARTC**) only if, based on an assessment by an independent body (potentially the Hunter Valley Coal Chain Coordinator (**HVCCC**)), ARTC is able to deliver contracted capacity. In C&A's view, making capacity available to fulfil contracted volumes is the key objective of the Network and therefore C&A places greater emphasis on the TUT related positive performance incentives. C&A recognises, however, that these will be developed at a later stage.

The standards set in the proposed non-TUT related incentives package should be subject to review and approval by the Rail Capacity Group (**RCG**). The RCG should also be the industry body which determines, based on evidence presented by the ARTC (including, where appropriate, an independent assessment), whether ARTC has achieved or exceeded the standards. The reward should be based on ARTC's combined performance across all the incentives (including the TUT related incentives, once developed), and could take the form of an increase in the Regulated Rate of Return, an adjustment to the Regulated Asset Base, and/or an increase in the Ceiling Limit. In any case, the quantum must be appropriate relative to the value created for users.

ARTC's proposed positive performance incentives incorporate all four of the above key non-TUT related measures but no indication of relative importance has been provided at this stage. C&A is broadly supportive of ARTC's proposed approach to developing the mechanisms but has four key concerns:

1. All the incentives, with the exception of safety, need to be contingent on ARTC first being able to deliver contracted capacity.

2. Too much emphasis seems to be placed on cost efficiency. C&A does not consider this appropriate, especially given the recent letter from ARTC to producers stating that, in the HVCCC's view, there is insufficient available coal chain capacity to fulfil ARTC's contracted entitlements, which C&A understands to be driven principally by a shortage of track infrastructure.

3. The baseline against which ARTC is measured for each incentive must be based on broadly accepted industry best practice, for example, capital efficiency which is achieved through a "soft asset" solution (innovation-driven) that is already widely accepted as best practice should be the baseline and not result in an incentive payment.

4. The reward must always be less than, and appropriate relative to, the value to users of the improved performance which warrants the relative incentive payment.

Introduction

C&A welcomes the opportunity to comment on the ARTC's Proposed Options for Positive Performance Incentive Mechanisms as relating to the Hunter Valley Rail Network Access Undertaking (**June 2011 HVAU** or **HVAU**).

As per C&A's submission to the Australian Competition and Consumer Commission (**ACCC**) in October 2010 in relation to the draft HVAU, C&A supports the development of a positive performance incentive mechanism for ARTC. It is C&A's view that the alignment of Hunter Valley Coal Chain interests would best be achieved through incentives to increase output and a performance-based incentive determined by ARTC achieving safety targets. C&A places relatively less importance on an incentive to reduce ARTC's costs.

C&A's view is that before any positive performance efficiency incentives are considered, however, ARTC's first priority should be delivering contracted entitlements. If ARTC is unable to deliver contracted capacity, incentives for efficiency should not be available; i.e. if any producer receives a rebate under the TUT then ARTC should be ineligible for performance payments. In this regard, ARTC's letter to producers in February 2012 states that, in the HVCCC's view, there will be insufficient available coal chain capacity in 2012 to fulfil ARTC's contracted entitlements, which C&A understands to be driven principally by a shortage of track infrastructure. As such, ARTC's immediate focus should be to increase available capacity to fulfil the contracted entitlements and to consider the development of efficiency incentives as a secondary, longer-term priority. Once an independent body, potentially the HVCCC, has determined that there is sufficient capacity for ARTC to fulfil its contracts or that any shortfall is not caused by the Network, then efficiency incentives can take effect. C&A considers that safety remains a fundamental objective at all times, and therefore the safety incentive would be an exception to this priority order.

In general, C&A considers maximum capacity and throughput to be the key objectives of positive performance incentives for ARTC. As such, C&A places greater importance on the positive performance TUT related capacity incentives, which will be developed by ARTC at a later stage in accordance with the HVAU. As ARTC notes, the efficiency incentive mechanisms proposed will need to be considered as part of a package with the positive performance incentives relating to the TUT review, when these are developed.

C&A broadly agrees with the incentive mechanism categories and development approach proposed by ARTC. C&A's view, however, is that at least an indicative relative importance weighting should be assigned to each of the incentives, with a low weighting for cost efficiency, for example. C&A also

has several concerns regarding the proposed baseline against which incentives will be measured and some specific aspects of either the proposed development approach or details of the incentive, which are discussed in the following sections. C&A notes that much of the detail around the specific nature and quantum of the incentive mechanisms, which will significantly affect their appropriateness, is yet to be developed.

Comments on incentive mechanism directly linked to achievement of safety targets

In C&A's view, safety is a fundamental objective for the Hunter Valley Coal Chain and must be included in conjunction with other performance incentive mechanisms. C&A believes that the objective of any safety incentive should be a continuing and consistent reduction in injuries towards a zero injury outcome. C&A also, in concept, supports the development of a composite safety measure, although appropriate weightings across a small number of safety measures would need to be agreed to make this work. C&A contends, however, that ARTC's proposed approach, in which a reward for efficiency incentives is still attained even if safety incentives are not, is not appropriate. C&A proposes that all efficiency incentive rewards should be contingent on achieving agreed safety standards, i.e. the reward for all other incentives is cancelled or reduced substantially if ARTC fails to achieve agreed safety standards. C&A agrees that the reward can be increased if agreed safety standards are exceeded, although the appropriate uplift would need to be determined. A reward for achieving or exceeding safety standards where ARTC does not achieve any of the other defined incentives may also be appropriate, however, the reward quantum should be appropriate relative to the value to users, which will differ significantly depending on the measure.

As a related matter, C&A notes that ARTC's proposed approach to the safety incentive reward on the unconstrained part of the Network seems inconsistent to the pricing principles outlined by ARTC in its 2012 Interim Indicative Access Charges document (issued in November 2011). In that document, ARTC effectively defines the proposed Access Charge on the unconstrained Network to be 'revenue maximising'. If this is the case, it is unclear to C&A how the achievement of safety standards allows ARTC to increase its total revenue (cost recovery) above the 'revenue maximising' level by charging users more via an incentive reward to ARTC.

Comments on incentive mechanism directly linked to Network KPIs

C&A is generally supportive of an incentive mechanism around Network KPIs, to serve as the operating efficiency incentive, and considers ARTC's approach to their development to be sensible, with the exception of a few details outlined below.

C&A recognises that the monitoring and reporting process for the Network KPIs set out in the HVAU has only recently commenced and a reasonable period will be required in order to determine the most appropriate measures to include in a positive performance incentive mechanism and the respective appropriate standards. C&A's view is that the standards for the incentive mechanism should be subject to review and approval by the RCG and that the RCG should also determine, based

on evidence presented by ARTC (including, where appropriate, an independent assessment), whether ARTC has achieved or exceeded the set standards to warrant a reward.

In prioritising rewards, ARTC includes "the relative cost associated with achieving performance levels in relation to the relevant Network KPIs" as a factor in determining the relativity of financial rewards for different KPIs. C&A does not consider this to be appropriate. The relative financial reward should be based on the net value created for Network users(which ARTC also includes as a factor) – that is, the value created less the cost – not the cost of achieving it, as this could lead to the perverse outcome of rewarding expensive and less value creating activities more than cheaper and more valuable ones. Of course, if relatively expensive investments create value for Network users, ARTC should be entitled to recoup the costs of their investment along with a share of the benefits for users.

C&A agrees that the quantum of the reward should be such that it is less than the value created due to ARTC's contribution but sufficient to incentivise higher performance. This logic holds true for all of the proposed incentives. Despite recognising this, ARTC proposes that the reward should be based, at a minimum, on the level sufficient to incentivise higher performance, as the value created is difficult to determine. C&A recognises this difficulty, however, contends that a reward cannot be determined as appropriate unless the value to the industry / users can be demonstrated in some way. For example, ARTC's proposed reward of a 0.5% increase in the rate of return is substantial but may be appropriate if ARTC can demonstrate that the value created for the users by achieving the agreed standards is significantly greater. In general, C&A supports a more holistic approach to determining standards and the respective rewards by considering all the efficiency incentives and the safety incentive in combination, with the appropriate weightings for each of the incentives and the measures that underpin them.

C&A agrees with ARTC that the efficient operation of the Network will help to promote the efficient use of the coal chain and therefore maximise throughput. ARTC states "even if all service providers perform well, this does not guarantee the coal chain will perform well, although the possibility of this occurring is higher. It could, however, be said that if an individual service provider does not perform well, the possibility that the coal chain will not perform well is higher". C&A notes, however, that this statement seems to contradict ARTC's assessment in its Supporting Documentation to the Proposed Variation to the HVAU that Network and Coal Chain Capacity efficiency is fundamentally different in the context of appropriate Network Access Charges.

Comments on incentive mechanism focussed around encouraging use of innovation (soft assets) to achieve outcomes that could be delivered through hard assets (infrastructure)

C&A supports the inclusion of a capital efficiency incentive mechanism which promotes innovation. C&A is also not opposed to an equal, 50/50, sharing of the overall value created between ARTC and users, as proposed by ARTC. C&A has concerns, however, around the definition of the appropriate baseline cost, i.e. the cost of the incremental capacity without innovation ("ICHA" in ARTC's Consultation Document). The appropriate baseline cost without innovation should be efficient and in

line with broadly accepted industry best practice. If widely accepted industry best practice already implies that a soft rather than hard asset investment is the appropriate solution to increasing capacity at a given point in time, then this should not lead to a bonus payment to ARTC based on the cost of a hard asset solution baseline. C&A agrees with ARTC's proposal for the RCG to review and approve this baseline. In the case where ARTC makes additional capacity available without incurring capital expenditure, C&A agrees with ARTC that these types of investments should be assessed by an independent expert. The selection of the independent expert must, however, be subject to RCG approval.

Once the development process of the TUT related positive performance mechanisms has commenced, it may be appropriate to integrate the elements related to this capital efficiency incentive with the TUT related capacity incentives.

Comments on incentive mechanism to improve ARTC productivity

As C&A stated in its 2010 submission to the ACCC in relation to the draft HVAU, it places less importance on an incentive to reduce ARTC's costs. Although C&A believes that in general productivity should be encouraged, it has serious concerns around the risks associated with a productivity incentive in the specific context of the Hunter Valley Network. The risk that excessive cost reduction could result in the required Path Usages being unavailable (for example, as a result of poor maintenance) is sufficient reason that cost reduction should not be a substantial part of an incentive package for ARTC. ARTC itself states that "minimum cost may not always be in the best interest of the coal chain and a measure that did not reflect the desired trade-off could be counter-productive, even though, prima facie, it encouraged 'efficient costs' ". Given the context of the current capacity shortages, which C&A understands to be principally driven by a shortage of track infrastructure, C&A's view is that cost efficiency should not be ARTC's primary focus.

Once the more critical capacity issues are resolved, C&A supports the inclusion of a cost efficiency incentive within the overall mechanism, albeit with a low weighting relative to the other incentives. In general, C&A's view is that ARTC's proposed approach, where multi-year 'efficient cost' targets are agreed and approved by the ACCC, is sensible. Of the two options proposed by ARTC around overhead costs, C&A's view is that the unit costs approach as per Section 4.6(a) of the HVAU is more appropriate than the approach of creating a 'true stand-alone' cost benchmark, as the stand-alone benchmark is not reflective of reality, and very difficult to assess.

ARTC's proposed reward for this incentive does not seem to imply any benefit to the users at all, as all the cost savings are retained by ARTC. C&A's view, and a view which ARTC states in relation to the other incentive mechanisms, is that the value created should be shared. As with the other incentives discussed earlier, however, C&A's view is that the efficiency incentives and the safety incentive should be considered in combination rather than separately when determining the appropriate reward.