Australian Competition & Consumer Commission

Consultation Paper

Australian Rail Track Corporation's 2017 Hunter Valley Access Undertaking

15 December 2016

Contents

1. Introduction

The Australian Rail Track Corporation Limited (ARTC) has submitted the 2017 Hunter Valley Access Undertaking (2017 HVAU) to the Australian Competition and Consumer Commission (ACCC) for assessment under Part IIIA of the *Competition and Consumer Act 2010* (Cth) (the Act). The undertaking 2017 HVAU is in relation to the provision of access to the Hunter Valley rail network operated by ARTC in New South Wales.

It is important to note that ARTC proposes to submit the 2017 HVAU for ACCC assessment in two stages. The first, the focus of this consultation paper, includes all matters except the operating expenditure (opex) efficiency regime. This opex efficiency regime is being developed in parallel with the current assessment process and in consultation with stakeholders. ARTC proposes to lodge the second stage of the 2017 HVAU with the ACCC in April/May 2017, which will incorporate the opex efficiency regime.

1.1. 2017 HVAU

Table 1 summarises the timeline of events leading up to the lodgement of the 2017 HVAU as a replacement to the 2011 HVAU.

Table 1: Timeline of events prior to lodgement of 2017 HVAU

Date	Event
29 June 2011	The ACCC accepts the 2011 HVAU under Part IIIA of the Act. The original expiry date of the 2011 HVAU was 30 June 2016.
23 December 2015	ARTC submits the 2016 HVAU for ACCC assessment as a replacement to the 2011 HVAU.
14 June 2016	ARTC withdraws the 2016 HVAU from ACCC assessment.
16 June 2016	ARTC submits a revised variation to extend the term of the 2011 HVAU to 31 December 2016.
22 June 2016	ACCC accepts the variation to extend the term of the 2011 HVAU to 31 December 2016.
7 July 2016	ACCC publishes a letter to stakeholders outlining its preliminary views on the 2016 HVAU.[1] This letter aimed to facilitate negotiations between ARTC and stakeholders in the development of a replacement to the 2011 HVAU and provide clarity on the ACCC's preliminary views of issues in the 2016 HVAU.
18 October 2016	ARTC submits a variation to extend the term of the 2011 HVAU to 30 June 2017.
23 November 2016	ACCC accepts the variation to extend the term of the 2011 HVAU to 30 June 2017.
9 December 2016	ARTC submits the 2017 HVAU for ACCC assessment as the first stage of replacing the 2011 HVAU.

[1] ACCC, *2016 Hunter Valley Access Undertaking – preliminary views*, 2016, www.accc.gov.au/system/files/2016%20HVAU%20-%20Letter%20to%20stakeholders%20providing%20preliminary%20views%20-%20FINAL%20-%207%20July%202016.pdf

1.2. Request for submissions

The ACCC, by publication of this Consultation Paper, is inviting submissions on the 2017 HVAU.

Section 2 of this paper outlines a range of matters to which the ACCC wishes to draw particular attention to, focusing on key differences between the 2016 and 2017 HVAU. The matters in section 2 do not represent a comprehensive summary of all aspects of the 2017 HVAU.

ARTC advised the ACCC that it engaged in its own consultation process throughout 2015 and 2016 in its development of the 2017 HVAU. As such, stakeholders are welcome to provide submissions on any relevant aspect of the 2017 HVAU including on any issues considered outstanding (if any).

In making a submission, please include detailed reasons to support the views offered. If there are aspects of the 2017 HVAU that are considered to be *not* appropriate, please provide suggestions of changes that could be made to address the relevant concerns, including to the level of drafting amendments where possible.

1.2.1. Invitation to make a submission

Submissions should be addressed to:

Mr Matthew Schroder
General Manager
Infrastructure & Transport – Access & Pricing Branch
Australian Competition and Consumer Commission
GPO Box 520
Melbourne VIC 3001

Email: transport@accc.gov.au

1.2.2. Due date for submissions

Given the 2017 HVAU was submitted to the ACCC for assessment on 9 December 2016, the ACCC is allowing a longer consultation period than normal in recognition of stakeholder availability over this period.

Submissions to this Consultation Paper are due by 3 February 2017. It is in stakeholder's interests that submissions are lodged by this date, as subsection 44ZZBD(3) of the Act allows the ACCC to disregard any submission made after this date.

1.2.3. Confidentiality

The ACCC strongly encourages public submissions. Unless a submission, or part of a submission, is marked confidential, it will be published on the ACCC's website and may be made available to any person or organisation upon request. If stakeholders wish to provide a confidential submission, the ACCC asks that stakeholders provide a full copy of the document and a public version with the confidential information omitted, that will be published on the ACCC website.

Sections of submissions that are claimed to be confidential should be clearly identified. The ACCC will consider each claim of confidentiality on a case by case basis. If the ACCC refuses a request for confidentiality, the submitting party will be given the opportunity to withdraw the submission in whole or in part.

For further information about the collection, use and disclosure of information provided to the ACCC, please refer to the ACCC publication *'Australian Competition and Consumer Commission / Australian Energy Regulator Information Policy – the collection, use and disclosure of information'* available on the ACCC website.

1.3. ACCC assessment

The test the ACCC applies in deciding whether to accept an access undertaking is set out in subsection 44ZZA(3) of the Act. Essentially, the ACCC may accept the undertaking if it thinks it appropriate to do so, having regard to various matters. The full test is set out in section 3 of this paper.

The ACCC has not yet formed a view on the appropriateness or otherwise of the 2017 HVAU. Statements in this Consultation Paper should not be taken as indicative of the ACCC's view of the appropriateness of the 2017 HVAU under the Act, nor the likelihood of its acceptance.

1.4. Indicative timeline for assessment

Under subsection 44ZZBC(1) of the Act, the ACCC must make a decision in relation to the application within the period of 180 days starting at the start of the day the application was received (referred to as 'the expected period').

Subsection 44ZZBC(2) of the Act also provides for 'clock-stoppers', meaning that some days will not count towards the 180 days of the expected period in certain circumstances. In particular, the clock stops where the ACCC publishes a notice inviting public submissions in relation to an undertaking application, or where the ACCC gives a notice requesting information in relation to an application.[2]

The ACCC will consider submissions and if necessary engage in further consultation with stakeholders and ARTC in January and February 2017 in order to clarify and obtain further details on any issues raised.

Table 2 outlines the indicative timeline for the ACCC's assessment of the 2017 HVAU.

Table 2: Indicative timeline for 2017 HVAU

Date	Event
9 December 2016	Lodgement of the 2017 HVAU.
15 December 2016	Consultation process begins.
3 February 2017	Closing date for submissions to Consultation Paper.
March 2017	Release of the draft decision.
March 2017	Consultation on draft decision.
April/May 2017	Lodgement of revised 2017 HVAU including opex efficiency regime.
April/May 2017	Consultation on revised 2017 HVAU.
June 2017	Final decision.
30 June 2017	Expiry of 2011 HVAU.

[2] See section 3 of this paper for further information on these provisions of the Act.

1.5. Further information

The 2017 HVAU and other relevant material, including supporting submissions from ARTC, are available on the ACCC's website at the following link:

http://www.accc.gov.au/regulated-infrastructure/rail/hunter-valley-access-undertaking-2017

Public submissions made during the current process will also be posted at this location.

The current 2011 HVAU is available on the ACCC's website at:

http://registers.accc.gov.au/content/index.phtml/itemId/1179990

For any queries about any matters raised in this document, please contact:

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2. Key issues

The ACCC has outlined in this section various matters that it seeks comments on. The issues raised and questions posed in this paper are not designed to limit stakeholders' submissions. As noted, the ACCC has not formed final views on any of the matters set out in this paper and stakeholders are welcome to make comments on any aspect of the 2017 HVAU.

2.1. Rate of return

2.1.1. 2011 HVAU

The 2011 HVAU accepted by the ACCC included a real pre-tax rate of return of 9.10 per cent and nominal pre-tax rate of return of 11.83 per cent (section 4.8 of the 2011 HVAU). This outcome was a result of negotiations between ARTC and Access Holders.

In December 2010, prior to the acceptance of the 2011 HVAU, the ACCC released a position paper stating that it considered a real pre-tax rate of return of 8.57 per cent and nominal pre-tax rate of return of 11.29 per cent was likely to be appropriate at the time.[3] The ACCC formed the view that this was more likely to reflect a rate of return consistent with the market conditions and commensurate with the commercial and regulatory risks borne by ARTC at the time.

In its final decision to accept the 2011 HVAU, the ACCC noted that the 'premium' proposed above the ACCC's view on the rate of return did not of itself appear unreasonable or excessive, as it reflected that ARTC had in turn agreed to assume additional obligations.[4] The ACCC also emphasised that as the 2011 HVAU included a specified rate of return and the ACCC had not been required to finalise its views on individual parameters.

2.1.2. 2016 HVAU

For the 2016 HVAU, ARTC proposed a real pre-tax rate of return of 6.74 per cent and a nominal pre-tax rate of return of 8.50 per cent.

ARTC engaged Synergies Economic Consulting (Synergies) to review the rate of return. Synergies concluded that an appropriate nominal pre-tax rate of return was 8.11 per cent. Following consultation with stakeholders prior to the submission of the 2016 HVAU, ARTC re-evaluated some parameter values for its rate of return. Key changes were:

- ARTC accepted that its risk was no greater than the market as a whole
- ARTC valued all market based parameters at a rate consistent with current market outcomes, rather than long term historical averages
- ARTC included an inflation rate that reflects the September 2015 Sydney (All Groups) Consumer Price Index (CPI), excluding the Sydney Housing component, resulting in a lower inflation rate than the initial long term forecast from Synergies.

Following this approach, ARTC calculated a real pre-tax rate of return of 6.83 per cent and a nominal pre-tax rate of return of 8.43 per cent. ARTC stated that it had further discounted the real pre-tax rate of return to 6.74 per cent 'to demonstrate its commitment to a workable

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3 ACCC, *Position paper in relation to the Australian Rail Track Corporation's proposed Hunter Valley rail network access undertaking*, 2010, www.accc.gov.au/system/files/Position%20Paper%20-%20ARTC%202010%20HVAU%20-%2021%20December%202010.pdf , p. 103.

4 ACCC, *Decision in relation to the Australian Rail Track Corporation's Hunter Valley rail network undertaking*, 2011, www.accc.gov.au/system/files/ACCC%20Final%20Decision%20on%2023%20June%202011%20application.pdf, p. 48.

solution with Industry'.[5] ARTC advised that by making a CPI adjustment to further discount the real pre-tax rate of return, it also led to an increase in the nominal pre-tax rate of return. As such, ARTC stated that the nominal pre-tax rate of return of 8.50 per cent in the 2016 HVAU reflected the status of negotiations with industry at the time.

In response to the 2016 HVAU, Hunter Rail Access Task Force (HRATF), a group representing nine coal producers in the Hunter Valley, proposed a real pre-tax rate of return of 4.70 per cent.[6] HRATF engaged Castalia Strategic Advisors (Castalia) to review ATRC's proposed rate of return. It is worth noting Castalia initially recommended a real pre-tax rate of return of 4.38 per cent and nominal pre-tax rate of return of 6.99 per cent.[7] Overall, HRATF disagreed with several issues raised by ARTC to support its higher rate of return value.

In the letter provided to interested parties regarding the 2016 HVAU, the ACCC noted that the proposed rate of return was unlikely to be appropriate, as the proposed real pre-tax rate of return of 6.74 per cent was considered too high.[8]

2.1.3. 2017 HVAU

For the 2017 HVAU, ARTC proposes a real pre-tax rate of return of 6.51 per cent and a nominal pre-tax rate of return of 7.86 per cent. In addition, ARTC proposes that the rate of return forms part of the mandatory review (section 2.3 of the 2017 HVAU).

In developing the rate of return value for the 2017 HVAU, ARTC engaged Synergies to review their previous report and provide an updated assessment of an appropriate rate of return. Synergies recommended a real pre-tax rate of return of 7.73 per cent and a nominal pre-tax rate of return of 9.10 per cent.

Following this assessment, ARTC submits that it 'balanced the recommendations of Synergies with the understanding of the position of stakeholders, being both the ACCC and customers'.[9] As a result, ARTC proposed to adjust some parameters to provide a rate of return outcome that ARTC considers it can accept. The key changes are:

- adjusting the market risk premium to be consistent with previous regulatory decisions
- reducing the asset beta to provide an equity beta less than 1.0.

Table 3 outlines the rate of return and parameter values proposed by ARTC and HRATF for the 2016 HVAU and by ARTC for the 2017 HVAU.

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5 ARTC, *2016 Hunter Valley coal network access undertaking: explanatory guide*, 2015, www.accc.gov.au/system/files/2016%20HVAU%20Explanatory%20Guide.pdf, p. 33.

6 HRATF, *ARTC 2016 Hunter Valley Access Undertaking - Hunter Rail Access Task Force submission to the ACCC*, 2016, www.accc.gov.au/system/files/HRATF%20submission%20-%202016%20HVAU%20consultation%20paper.pdf, p. 2.

7 Castalia, *Review of Synergies WACC analysis for ARTC*, 2016, www.accc.gov.au/system/files/HRATF%20submission%20-%202016%20HVAU%20consultation%20paper%20-%20Castalia%20report.pdf

8 ACCC, *2016 Hunter Valley Access Undertaking – preliminary views*, 2016, p. 6.

9 ARTC, *2017 Hunter Valley coal network access undertaking: explanatory guide*, 2016, www.accc.gov.au/system/files/ARTC-%202017%20HVAU%20-%20Submission%20-%20Explanatory%20Guide.pdf, p. 30.

Table 3: Rate of return and parameter values

Parameters	ARTC proposal in 2016 HVAU (December 2015)	Castalia's recommendation to HRATF in response to 2016 HVAU (March 2016)	ARTC proposal in 2017 HVAU (November 2016)
Risk free rate (nominal)	2.89%	2.45%	2.14%
Debt	52.50%	52.50%	52.50%
Equity	47.50%	47.50%	47.50%
Debt risk premium	2.86%	2.67%	2.70%
Debt issuance cost	0.095%	0.095%	0.095%
Market risk premium	6.50%	6.00%	6.50%
Inflation	1.50%	2.50%	1.27%
Gamma	0.40	0.45	0.25
Tax rate	30%	30%	30%
Asset beta	0.47	0.40	0.475
Equity beta	0.98	0.84	0.99
Return on equity	9.26%	7.48%	8.60%
Return on debt	5.85%	5.22%	4.94%
Nominal post-tax rate of return	7.47%	6.99%	6.68%
Real post-tax rate of return	5.89%	3.70%	5.34%
Nominal pre-tax rate of return	8.43%	6.29%	7.86%
Real pre-tax rate of return	6.83%[a]	4.38%[b]	6.51%

Note: **a** ARTC proposed a real pre-tax rate of return of 6.74 per cent, incorporating a discount of 0.09 per cent 'to demonstrate its commitment to a workable solution': **b** HRATF proposed a real pre-tax rate of return of 4.70 per cent.

Questions

1. Are the key assumptions underpinning the rate of return parameter values appropriate?
2. Is ARTC's proposed rate of return appropriate?

2.2. Remaining mine life (RML)

2.2.1. 2011 HVAU

In the 2011 HVAU, section 4.7 stated that the calculation of depreciation must have regard to, among other factors, 'the average remaining mine life of coal mines utilising the Pricing Zone of which that Segment or group of Segments forms part'. In addition, all assets (including new assets) would be depreciated using a straight-line method.

ARTC proposed a RML of 22 years from 1 July 2010, calculated using a weighted average mine life. The ACCC considered this average RML to be appropriate for the purposes of the 2011 HVAU.

2.2.2. 2016 HVAU

In the 2016 HVAU, ARTC did not propose to alter the average RML, with asset lives to remain as 22 years from 1 July 2010. As such, new assets would have an average expected life of 16 years from the commencement of the 2016 HVAU at 1 July 2016. Appendix B of ARTC's Explanatory Guide further describes ARTC's proposal to retain the current estimate of average RML in the 2016 HVAU.

In addition, ARTC proposed that RML would form part of the mandatory review (section 2.3 of the 2016 HVAU).

In response to the 2016 HVAU, five stakeholders made submissions in relation to ARTC's proposed RML:

- HRATF proposed a RML of 22 years using estimates from the 2014 NSW Coal Industry report and public sources, and proposed that prospective mines be included[10]
- Independent Pricing and Regulatory Tribunal (IPART) proposed that Unit of Production or the Longest-Lived Substantial Mine methods should be used to calculate depreciation[11]
- Whitehaven Coal proposed that separate RMLs should be calculated for each Pricing Zone, with a RML of 30.2 years for the unconstrained network[12]
- Idemitsu proposed that separate RMLs should be calculated for each Pricing Zone with RMLs of 21 and 27 years for Pricing Zones 1 and 3 respectively [13]
- Glencore supported a single RML for all Pricing Zones because 'Pricing Zone 3 customers are effectively being cross-subsidised by the existing user [Pricing Zones 1 and 2]'.[14]

In the letter provided to interested parties regarding the 2016 HVAU, the ACCC noted that the proposed RML was unlikely to be appropriate as 16 years for RML from 1 July 2016 was too short, and the ACCC considered that prospective mines should be included in the RML calculation.[15]

2.2.3. 2017 HVAU

In the 2017 HVAU, ARTC proposes a RML of 16.5 years as at 1 July 2016, calculated using a weighted average mine life. ARTC submits its updated RML calculation resulted in an average RML of 15.5 years. However, ARTC proposes the average RML be 'maintained' at 16.5 years.[16]

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10 HRATF, *Hunter Rail Access Task Force submission to the ACCC, Hunter Rail Access Task Force,* 2016, p. 23.

11 IPART, *IPART submission to ACCC on its 8 January 2016 Consultation Paper*, 2016, www.accc.gov.au/system/files/IPART%20submission%20-%202016%20HVAU%20consultation%20paper_0.pdf, p. 6.

12 Whitehaven Coal, *Whitehaven Coal response to ACCC Consultation Paper on ARTC's draft 2016 Hunter Valley Access Undertaking*, 2016, www.accc.gov.au/system/files/Whitehaven%20Coal%20submission%20-%202016%20HVAU%20consultation%20paper.pdf, p. 3.

13 Idemitsu, *Consultation Paper – Australian Rail Track Corporation's 2016 Hunter Valley Access Undertaking*, 2016, www.accc.gov.au/system/files/Idemitsu%20submission%20-%202016%20HVAU%20consultation%20paper.pdf, p. 5

14 Glencore, *Submissions to the Australian Competition and Consumer Commission: Hunter Valley coal network access undertaking submitted by Australian Rail Track Corporation*, 2016, www.accc.gov.au/system/files/Glencore%20submission%20-%202016%20HVAU%20consultation%20paper.pdf, p. 2.

15 ACCC, *2016 Hunter Valley Access Undertaking – preliminary views*, 2016, p. 5.

16 ARTC, *2017 Hunter Valley coal network access undertaking: appendix B*, ARTC, 2016, www.accc.gov.au/system/files/ARTC-%202017%20HVAU%20-%20Submission%20-%20Appendix%20B%20RML%20estimate.pdf, p. 5.

ARTC proposes a method for including prospective mines in the weighted average mine life calculations and incorporates RML as part of the mandatory review (section 2.3 of the 2017 HVAU). ARTC also proposes to update the applicable RML for any mine meeting its prospective mine criteria during the term of the 2017 HVAU, rather than wait until the mandatory review.

Table 4 compares the key assumptions for calculating RML that ARTC proposes in the 2017 HVAU and those proposed by HRATF.

Table 4: Key differences in calculating RML

Issue	ARTC proposal in 2017 HVAU	HRATF submission in response to 2016 HVAU
Reserves	All marketable reserves estimated using the JORC Code reduced by 10 per cent.[17]	All marketable reserves estimated using the 2014 NSW Coal Industry Report and other public sources.[18]
Prospective mines	A mine is prospective if it: • is licenced, and • has contracted for export capacity.[19]	A mine is prospective if it: • has obtained all reasonably necessary project approvals, or • contracts have been executed for Network Exit Capacity sufficient to provide for the delivery and export of any coal forecast to be produced over the remaining Term or any Further Term, or • there is otherwise a reasonable expectation that the mine will commence operations and coal will be produced within five years of the Review Date.[20]
Prospective mine life	The years before the licence expires.[21]	All prospective mines have a mine life of 30 years.[22]
Production rate	The greater of historic production or future contract levels. [23]	The most recent year's production published in the NSW Coal Industry Report or publically available information.[24]

17 ARTC, *2017 Hunter Valley coal network access undertaking: appendix B*, 2016, p. 13.

18 HRATF, *Hunter Rail Access Task Force submission to the ACCC, Hunter Rail Access Task Force*, 2016, p. 23.

19 ARTC, *2017 Hunter Valley coal network access undertaking: appendix B*, 2016, p. 14.

20 HRATF, *Hunter Rail Access Task Force submission to the ACCC, Hunter Rail Access Task Force*, 2016, p. 21.

21 ARTC, *2017 Hunter Valley coal network access undertaking: appendix B*, 2016, p. 14.

22 HRATF, *Hunter Rail Access Task Force submission to the ACCC, Hunter Rail Access Task Force*, 2016, p. 23.

23 ARTC, *2017 Hunter Valley coal network access undertaking: appendix B*, 2016, p. 15.

24 HRATF, *Hunter Rail Access Task Force submission to the ACCC, Hunter Rail Access Task Force*, 2016, p. 23.

Questions

3. Are the variables and the assumptions used in the calculation of the average RML appropriate?
4. Are the calculations and assumptions underpinning the amount of reserves and production volumes appropriate?
5. Are the criteria for the inclusions of prospective mines appropriate?
6. Is the methodology for calculating the prospective mine life appropriate?

2.3. Floor and Ceiling Revenue Limits

2.3.1. 2011 HVAU

In the 2011 HVAU, the floor revenue limits (section 4.2) state that the access revenue from every Access Holder must at least meet the Direct Cost imposed by that Access Holder and for each segment, access revenue must meet the Incremental Cost of those segments ('Floor Limit'). The ceiling revenue limits (section 4.3) caps the maximum level of access revenue for ARTC for each segment ('Ceiling Limit'), based on the Economic Cost of each segment.

2.3.2. 2016 HVAU

When ARTC submitted the 2016 HVAU to the ACCC for assessment, the 2013 Annual Compliance assessment had not been finalised and ARTC did not seek major changes to the Floor and Ceiling Limits.

For the Ceiling Limit, ARTC proposed that the access revenue did not include any Innovation Payment and any Efficiency Incentive Payment. This reflected ARTC's proposed incentive mechanisms (outlined in section 9.3 and section 13.3 of the 2016 HVAU).

ARTC maintained the Loss Capitalisation mechanism for the 2016 HVAU. However, it proposed that it would be reviewed as part of the mandatory review (section 2.3 of the 2016 HVAU).

2.3.3. 2017 HVAU

In June 2016, the ACCC released its Final Determination for the 2013 Annual Compliance process.[25] This determined that Pricing Zone 3 producers should contribute their Incremental Cost (including maintenance and capital) when traversing Pricing Zone 1. Previously, Pricing Zone 3 producers only contributed Direct Costs (a subset of incremental cost) when traversing Pricing Zone 1. As part of the 2013 Annual Compliance Final Determination, the ACCC considered the method developed by WIK to calculate Incremental Costs was appropriate, which allocated incremental capital costs based on actual volumes.

In response to the Final Determination, ARTC proposes several changes to the floor and ceiling revenue limits for the 2017 HVAU. ARTC states the intention of these changes is to:

- enshrine the Incremental Cost principles outlined in the 2013 Annual Compliance assessment

[25] ACCC, *Final determination: Australian Rail Track Corporation's compliance with the Hunter Valley coal network access undertaking financial model for the 2013 calendar year*, 2016, www.accc.gov.au/system/files/ACCC%20final%20determination%20-%20HVAU%20Annual%20Compliance%202013.pdf

- provide certainty to Pricing Zone 1 producers that a defined amount of revenue from Pricing Zone 3 producers is allocated towards meeting ‘Incremental Costs’ (not only variable or Direct Costs) when Pricing Zone 3 producers traverse Pricing Zone 1
- provide certainty to Pricing Zone 3 producers that their contribution to Pricing Zone 1 cannot exceed ‘Incremental Costs’ (with the remainders of revenue from Pricing Zone 3 producers allocated to meeting costs of Pricing Zone 3)
- provide certainty to ARTC that Pricing Zone 3 producers ‘Incremental Cost’ in Pricing Zone 1 (no longer recovered from Pricing Zone 1 producers) are recoverable as take or pay charges from Pricing Zone 3.[26]

To achieve this, ARTC proposes the following changes:

- replacing the current cost categories in the 2011 HVAU with three cost categories: Incremental Maintenance Costs, Incremental Capital Costs and Fixed Costs
- Incremental Costs is the sum of Incremental Maintenance Costs and Incremental Capital Costs
- creating two constrained networks (one for Pricing Zones 1 and 2 and one for Pricing Zone 3 once capitalised losses are fully recovered) and the application of a separate Ceiling Test and reconciliation for each
- removing the existing definition of Incremental Cost in the 2011 HVAU.[27]

ARTC proposes to alter the method of allocating Incremental Capital Costs to be based on contractual commitments rather than actual usage, which was determined in the 2013 Annual Compliance process. ARTC proposes that this method will reduce pricing uncertainty and volume risk for Access Holders.

In section 9.2(a)(ii) of the 2017 HVAU, ARTC proposes to allow Incremental Capital Costs be treated as Fixed Costs after consultation with and endorsement from the Rail Capacity Group (RCG). ARTC states that this is to ensure a coherent understanding during the approval process of capital costs.

Questions

7. Are the changes to section 4.2 and 4.3 of the 2017 HVAU appropriate?
8. Is the use of contracted commitments rather than actual commitments appropriate as the method of allocating incremental cost?
9. Should incremental cost be allocated according to train km rather than gross tonne kilometres (GTK)?
10. Is the dual ceiling limit approach, to create two constrained networks, appropriate?
11. Should actual and forecast opex be reconciled under clause 4.3(d)(i) of the 2017 HVAU?
12. Is it appropriate that Pricing Zone 3 producers pay at most their Incremental Cost for traversing Pricing Zone 1?
13. Are the terms in section 9.2(a) of the 2017 HVAU appropriate?

[26] ARTC, *2017 Hunter Valley coal network access undertaking: explanatory guide*, 2016, p. 13.
[27] ARTC, *2017 Hunter Valley coal network access undertaking: explanatory guide*, 2016, p. 13.

2.4. Operating expenditure (opex) efficiency regime

2.4.1. 2011 HVAU

Under section 13.3 of the 2011 HVAU, ARTC was required to develop non-True Up Test (non-TUT) performance incentives within 6 months of the commencement of the 2011 HVAU. The non-TUT performance incentives were intended to encourage ARTC, through financial reward, to improve operating, maintenance and capital expenditure efficiency, and achieve desirable safety performance.

In August 2012, in accordance with section 13.3(a) of the 2011 HVAU, ARTC submitted a proposed variation to the ACCC for assessment. In December 2012, ARTC withdrew this variation following consultation with stakeholders. Stakeholders generally supported the principle of having a non-TUT performance incentive scheme however considered it inappropriate to devote resources to the development of such a mechanism at that time. ARTC also proposed to reconsider non-TUT performance incentives at the time of the TUT review required by section 13.5 of the 2011 HVAU.[28]

ARTC made no further applications for variation in relation to a performance incentive scheme during the term of the 2011 HVAU.

2.4.2. 2016 HVAU

In the 2016 HVAU, ARTC proposed in section 9.3 that, in consultation with the RCG, it will develop an 'opex incentive mechanism' proposal within 18 months of the commencement of the 2016 HVAU. Section 9.3 included at a high level, some features to be included in the proposal (unless otherwise agreed between ARTC and the RCG) and described the process by which a proposal would be endorsed by Access Holders.

In response to the 2016 HVAU, two stakeholders made submissions in relation to ARTC's opex incentive mechanism proposal:

- Asciano (now Pacific National) was concerned that ARTC would consult primarily with Access Holders in the development of a proposal. Asciano highlighted the importance of involving other parties, including train operators, noting that incentives to reduce operating costs may impact train operations rather than access rights. Asciano noted its support for subsection 9.3(b) of the 2016 HVAU, which required ARTC to consider submissions from other parties on the opex incentive mechanism.[29]
- HRATF was concerned that ARTC was required only to develop the opex incentive mechanism proposal but not adopt it. HRATF considered that ARTC's commitment did not 'provide a long term model to drive improved incentives for efficient operation of the Hunter Valley Rail Network'.[30] HRATF listed the minimum requirements of an opex efficiency regime mechanism:
    - as ARTC providing a genuine forecast of efficient opex that is set to 'baseline' expenditure
    - where opex has been forecast and endorsed that it be subject to a cap, unless ARTC can demonstrate there has been unforeseen costs

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[28] ARTC, *Variation of Hunter Valley coal network access undertaking (HVAU) to adopt a positive performance incentive scheme (PPIS) – withdrawal of variation application*, 2012, www.accc.gov.au/system/files/ARTC%20Letter%20of%20Withdrawal%20-%2024%20December%202012.pdf, pp. 1–2.

[29] Asciano, *Submission to the ACCC: 2016 ARTC Hunter Valley coal network access undertaking*, 2016, www.accc.gov.au/system/files/Asciano%20submission%20-%202016%20HVAU%20consultation%20paper.pdf , p. 21.

[30] HRATF, *Hunter Rail Access Task Force submission to the ACCC, Hunter Rail Access Task Force*, 2016, pp. 37–38.

- where ARTC has opted into the opex incentive mechanism, that any realised opex efficiency gains are reflected in future, forecast baseline expenditure.

In the letter provided to interested parties regarding the 2016 HVAU, the ACCC noted that the opex incentive mechanism proposal was unlikely to be appropriate, as it only required ARTC to engage in a *process* to develop an opex incentive mechanism.[31] Given the experience of the 2011 HVAU, the ACCC noted its concern with the delay in implementing an opex incentive mechanism, and the lack of detail provided in the 2016 HVAU.

2.4.3. 2017 HVAU

ARTC proposes to incorporate an opex efficiency regime in the final 2017 HVAU. However, the current 2017 HVAU application does not specify how the opex efficiency regime will work in practice, as ARTC is currently working with stakeholders to develop the opex efficiency regime. Section 9.3 of the 2017 HVAU contains a statement of intention to implement the opex efficiency regime by the commencement of the 2017 HVAU. This differs from the 2011 HVAU and the 2016 HVAU, which only provided a process for developing an opex efficiency regime during the term of the undertaking. ARTC has stated it will submit a revised 2017 HVAU application, including the opex efficiency regime, to the ACCC in the week ending 28 April 2017.

Section 9.3 of the 2017 HVAU additionally provides broad principles that will govern the opex efficiency regime. These include:

- an ex-ante opex allowance established through a forecasting and benchmarking process
- an initial forecast period established with a reset of the opex allowance after the initial period
- an efficiency incentive for ARTC based on the right to retain the benefit of any underspend relative to the allowance and an obligation to bear the cost of any overspend relative to the allowance.

Section 9.3(c) of the 2017 HVAU requires ARTC to develop the opex efficiency regime in accordance with the following milestones set out in Annexure B:

- confirm the forecasting and benchmarking methodology in the week ending 23 December 2016
- determine the preliminary forecasting and benchmarking reports in the week ending 17 February 2017
- determine the final forecasting and benchmarking reports in the week ending 17 March 2017
- determine the mechanisms of the opex efficiency regime in March–April 2017
- submit the final 2017 HVAU, including the opex efficiency regime to the ACCC, in the week ending 28 April 2017.

However, section 9.3(f) states that ARTC will not be in breach of the 2017 HVAU if by the commencement of the undertaking, it has not met a milestone set out in Annexure B.

Sections 9.3(d) and 9.3(e) of the 2017 HVAU requires ARTC to regularly consult with, update and consider feedback provided by Access Holders on the development of the opex efficiency regime. ARTC has removed the requirement to consider submissions from other

31 ACCC, *2016 Hunter Valley Access Undertaking – preliminary views*, 2016, p. 9.

parties on its opex incentive mechanism (section 9.3(b) of the 2016 HVAU).

Questions

14. Are the proposed principles governing the opex efficiency regime appropriate?
15. Are the requirements on ARTC to consult with Access Holders in the development and implementation of the opex efficiency regime adequate?
16. Are the milestones appropriate?
17. Are there any issues with the coexistence of the opex efficiency regime and the Innovation Incentive Mechanism (section 14 of the 2017 HVAU)?

2.5. Other changes from 2016 HVAU to the 2017 HVAU

ARTC submits that the 2017 HVAU is an 'evolution' from the 2016 HVAU.[32] The following provides a summary of other changes between the 2016 HVAU and 2017 HVAU that are not covered above. The ACCC welcomes any submissions from stakeholders in respect of the following.

2.5.1. Information gathering

A request for information provision has been included at section 1.5 of the 2017 HVAU. The provision sets out that the ACCC can request, by written notice, that ARTC provide information or documents that are required to enable the ACCC to exercise its powers or functions in relation to a material obligation, right or process under the 2017 HVAU.

The section also sets out that ARTC is not required to comply if provision of the information or documents would be 'onerous or oppressive', are subject to privilege, or are unnecessary for the ACCC to undertake its functions in relation to 2017 HVAU.

2.5.2. Term

ARTC proposes reducing the term of the 2017 HVAU from 10.5 years to 9.5 years to account for the twelve-month extension period under the 2011 HVAU. The initial expiry date of 31 December 2026 remains unchanged from the 2016 HVAU.

2.5.3. Privatisation

ARTC has removed section 2.2(c) in the 2016 HVAU, which stated that ARTC would use its 'best endeavours' to ensure any new owners develop an undertaking on the same terms of the 2016 HVAU. ARTC notes this section was initially inserted in response to requests by its shareholders.[33]

2.5.4. Mandatory review of the undertaking

Section 2.3(e)(ii) of the 2016 HVAU proposed a mandatory referral to the Australian Competition Tribunal (ACT) in circumstances where the ACCC decides to reject a variation application arising from the mandatory review of the undertaking. Under the 2017 HVAU, ARTC proposes to retain discretion to seek review by the ACT, but that if it does, ARTC must accept the decision made by the ACT.

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32 ARTC, *2017 Hunter Valley coal network access undertaking: summary of key changes to draft 2016 HVAU*, 2016, www.accc.gov.au/system/files/ARTC-%202017%20HVAU%20-%20Submission%20-%20Summary%20of%20key%20changes.pdf, p. 3.

33 ARTC, *2017 Hunter Valley coal network access undertaking: summary of key changes to draft 2016 HVAU*, 2016, p. 4.

2.5.5. Minor Variation

ARTC has updated section 2.4 of the 2017 HVAU to remove the minor variation regime proposed in the 2016 HVAU.

2.5.6. Annual True Up Test Audit

Under section 4.11(e) of the 2017 HVAU, ARTC can appoint an auditor to perform the annual TUT Audit for up to three consecutive years. The ACCC and ARTC can agree to the appointment of an auditor for a longer period. Under the 2011 HVAU, there is no limit on the number of consecutive years an auditor can perform the annual audit.

The process of ARTC informing the ACCC of the Proposed Auditor, and the ACCC notifying ARTC whether it does or does not object to the Proposed Auditor, remains unchanged from the 2011 HVAU.

2.5.7. Indicative Access Holder Agreement (IAHA)

Clause 16.4 of the 2016 IAHA proposed requiring Access Holders to nominate a port terminal exit point for their coal export volumes. ARTC noted that binding terminal exits would create efficiencies. In the 2017 IAHA, ARTC has removed this provision, submitting it has considered stakeholder concerns as to binding users to nominate a particular terminal exit.

Clause 5 of Schedule 3 of the 2016 IAHA proposed an ‘efficiency incentive charge’ payable to Access Holders when the RCG endorsed an efficiency incentive proposal (outlined in section 9.3 of the 2016 HVAU). In response to the development of the opex efficiency regime, ARTC has removed the ‘efficiency incentive charge’ from the 2017 IAHA.

3. Legal framework for accepting an access undertaking

In assessing an access undertaking under Part IIIA of the Act, the ACCC must apply the test set out in subsection 44ZZA(3), which provides that the ACCC may accept the undertaking if it thinks it appropriate to do so, having regard to the following matters:

- the objects of Part IIIA of the Act, which are to:
  - promote the economically efficient operation of, use of and investment in the infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets; and
  - provide a framework and guiding principles to encourage a consistent approach to access regulation in each industry;
- the pricing principles specified in section 44ZZCA of the Act (see further below);
- the legitimate business interests of the provider of the service;
- the public interest, including the public interest in having competition in markets (whether or not in Australia);
- the interests of persons who might want access to the service;
- whether the undertaking is in accordance with an access code that applies to the service; and
- any other matters that the ACCC thinks are relevant.

In relation to the pricing principles, section 44ZZCA of the Act provides that:

- regulated access prices should:
  - be set so as to generate expected revenue for a regulated service that is at least sufficient to meet the efficient costs of providing access to the regulated service or services; and
  - include a return on investment commensurate with the regulatory and commercial risks involved; and
- access price structures should:
  - allow multi-part pricing and price discrimination when it aids efficiency; and
  - not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operators is higher; and
- access pricing regimes should provide incentives to reduce costs or otherwise improve productivity.

3.1. Timeframes for ACCC decisions and clock-stoppers

Subsection 44ZZBC(1) of the Act provides that the ACCC must make a decision on an access undertaking application within the period of 180 days starting at the start of the day the application is received (referred to as 'the expected period').

If the ACCC does not publish a decision on an access undertaking application under section 44ZZBE of the Act within the expected period, it is taken, immediately after the end of the expected period, to have:

- made a decision to not accept the application; and

- published its decision under section 44ZZBE and its reasons for that decision: see subsection 44ZZBC(6).

The Act contains ‘clock-stoppers’ that mean certain time periods are not taken into account when determining the expected period (see subsection 44ZZBC(2)). In particular, the clock may be stopped:

- by written agreement between the ACCC and the access provider (in this case, ARTC), and such agreement must be published: subsections 44ZZBC(4) and (5);
- if the ACCC gives a notice under subsection 44ZZBCA(1) requesting information in relation to the application;
- if a notice is published under subsection 44ZZBD(1) inviting public submissions in relation to the application;
- if a decision is published under subsection 44ZZCB(4) deferring consideration of whether to accept the access undertaking, in whole or in part, while the ACCC arbitrates an access dispute.

3.1.1. Information requests

Subsection 44ZZBCA(1) provides that the ACCC may give a person a written notice requesting the person give to the ACCC, within a specified period, information of a kind specified in the notice that the ACCC considers may be relevant to making a decision on an access undertaking application.

As noted above, the period within which the ACCC requests information constitutes a clock-stopper.