
ARTC 2016 Hunter Valley Access Undertaking

Hunter Rail Access Task Force submission to the ACCC

9 March 2016

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1 Executive summary

1.1 Introduction

The Hunter Rail Access Task Force (**HRATF**) welcomes this opportunity to respond to the proposed 2016 Hunter Valley Access Undertaking (**2016 HVAU**) and the associated consultation paper published by the Australian Competition and Consumer Commission (**ACCC**) on 8 January 2016.

The HRATF wishes to acknowledge the constructive efforts made by the Australian Rail Track Corporation (**ARTC**) in working with the HRATF during 2015 in developing the 2016 HVAU. This engagement has meant that a number of user issues are already adequately reflected in the terms of the 2016 HVAU, allowing the ACCC and stakeholders to focus on a modest number of key outstanding issues.

In approaching the 2016 HVAU, it is also important to recognise that much has changed since the approval of the original HVAU by the ACCC in 2011 (**2011 HVAU**).

Notably:

- While it had a long period of development (including two withdrawn draft undertakings in 2009 and 2010), the 2011 HVAU was the first Hunter Valley access undertaking to be approved by the ACCC under Part IIIA. Prior to that time, rail access in the Hunter Valley had been governed by the State rail access regime under the NSW Rail Access Undertaking (**NSWRAU**). In a number of respects, this meant that the 2011 HVAU was under-developed and based on the NSW precedent, which is not well suited to a coal rail network.
- Throughout the development of the 2011 HVAU, the coal industry remained relatively buoyant, with forecast high coal prices placing pressure on the Hunter Valley Rail Network to expand throughput and leading to, at times, pressure on the supply chain.
- Related to the demands of an expanding industry, the development process for the 2011 HVAU commenced in 2009, shortly after the Greiner Review in 2008 had identified the need for improved contractual alignment and coordination of the different elements within the Hunter Valley coal supply chain. The 2011 HVAU reflected this emphasis through a number of important coordination mechanisms, including embedding a role for the Hunter Valley Coal Chain Coordinator (**HVCCC**).
- Because of the focus at the time on expansion and facilitating capital expenditure and investment, the 2011 HVAU formalised and further developed the existing capital planning framework, which provided a role for users and other stakeholders in considering and endorsing capex through the 'Rail Capacity Group' (**RCG**).
- At the time of the 2011 HVAU, there was no immediate prospect of the privatisation of ARTC and its role as operator of the Hunter Valley Rail Network.

This context is critical – because it highlights why the 2011 HVAU has worked well in a number of areas where particular effort was taken to develop bespoke arrangements (e.g. capital expenditure, expansion and supply chain coordination), but it also explains why there are areas of substantial weakness, which now need to be addressed through the 2016 HVAU. Because of this history, the HRATF agrees with ARTC that a rewrite or fundamental overhaul of the 2011 HVAU is not needed.

The 2016 HVAU should build incrementally on the framework provided by the 2011 HVAU, focusing on those areas where the changes in circumstances over the last five years mean that the current regime is under-developed or out of date.

More detail in respect of each of these areas is set out below.

1.2 Key issues with the 2016 HVAU

While the HRATF acknowledges the engagement of ARTC to date, the HRATF submits that the ACCC should not accept the proposed HVAU in its current form.

We hold a number of material concerns with the current draft, as summarised in the table below.

Summary of key issues

Issue	HRATF Position
Regulatory certainty ahead of any potential privatisation	<ul style="list-style-type: none"> • Outside of the current ACCC HVAU process, HRATF will continue to press for legislative certainty as part of any sale or privatisation of ARTC, so that the 2016 HVAU remains in place with appropriate amendments to reflect the identity of the buyer. • The 2016 HVAU (and/or any sale legislation) must provide the ACCC with more extensive powers of oversight and direction to overcome the limitations currently associated with the ‘voluntary’ nature of the HVAU arrangements. • Even within the limitations of the 2016 HVAU process, greater certainty can and should be delivered through: <ul style="list-style-type: none"> ○ amending the Term of the 2016 HVAU so that it aligns with the life of the underlying regulated assets, with 5-yearly resets of key elements; and ○ fixing key elements of the regime, such as relevant cost of capital inputs and the methodology to be applied to resetting the Weighted Average Mine Life (WAML) at each reset.
Update the HVAU cost of capital	<p>On a forward looking basis, compelling evidence supports the view that ARTC faces lower level of risk for the next 5 years than might have been anticipated during the last review of these parameters in 2011.</p> <p>ARTC’s strong performance during the trough of the coal price cycle suggests that both equity and debt invested in ARTC face very low risks. This supports further reductions in asset beta and an improvement to ARTC’s benchmark credit rating.</p> <p>Based on a current point estimate, which would need to be updated for time sensitive parameters, the HRATF estimates that an appropriate pre-tax real WACC is 4.70%.</p> <p>This is based on the following:</p> <ul style="list-style-type: none"> • Risk Free Rate—should be equivalent to a twenty-day average of the ten-year Commonwealth Government bond yield, immediately before the start of the 2016-2021 regulatory period, as proposed by ARTC. We note that the twenty-day averaging period used to

calculate the risk free rate will need to be consistent with the twenty-day period used to calculate the debt risk premium.

- **Debt Risk Premium** — We agree with ARTC’s proposal to calculate the debt using the difference between the risk free rate and a twenty-day average of the 10yr yield on Australian nonfinancial corporation (NFC) bonds as published by the Reserve Bank of Australia (RBA)¹. Given that the RBA publishes NFC bond data based on observations at the end of each month, our position is to interpolate a daily estimate of NFC bond yields (using the number of business days between month-end observations) for the purpose of calculating a twenty-day average—this is similar to the approach used by the Australian Energy Regulator (AER).

We disagree with any extrapolation of the bond yield published by the RBA. This generates uncertainty for both parties and we note that the sample of bonds used by the RBA is generally representative of a 10-year debt tenor.

- **Debt Raising Costs**—We accept ARTC’s 0.095% allowance for debt raising costs, this is consistent with the 2011 HVAU.
- **Regulatory Credit Rating**—There is compelling evidence to support an **A-band credit rating** for the NFC reference bonds used to calculate ARTC’s debt margin. New evidence and changing circumstances suggest that ARTC’s credit risk is now significantly lower than in 2011.
- **Benchmark Gearing** — Leverage and credit rating are closely related. Consistent with the 2011 HVAU, we agree that the benchmark gearing ratio should remain at 52.5%, as proposed by ARTC.
- **Market Risk Premium** — The MRP is not observable and, therefore, prone to estimation error. Long-term historical MRP estimates continue to support a MRP estimate of 6 percent.
- **Gamma** — There is currently no agreed methodology for calculating gamma. We are aware of the Australian Competition Tribunal (Tribunal) decision to set a gamma of 0.25 for regulated returns on electricity networks.² We note that Castalia considers that given that ARTC has a different set of investors and potential owners to the power sector, it would be reasonable to maintain consistency with the 2011 HVAU decision by using a gamma of 0.45. However, in the circumstances and in order to expedite the resolution of the WACC elements as part of the 2016 HVAU process, the HRATF is nonetheless prepared to accept a gamma of 0.25, in line with the Tribunal decision.
- **Asset beta** — With the completion of ARTC’s major investment program, the asset beta adopted in 2011 now overstates its expected operational risks. Our view is that a careful analysis of risks faced by ARTC compared to other regulated rail service providers on the East

¹ Aggregate Measures of Australian Corporate Bond Spreads and Yields, <http://www.rba.gov.au/statistics/tables/>

² Application by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1.

Coast strongly supports our position that ARTC's asset beta should be materially lower than the level observed (and determined) for Aurizon and QR. In our view, the asset beta should be in the range of 0.3 to 0.4.

More detail on the proposed WACC inputs and approach is set out in the expert report of Castalia at Schedule 2 to this submission.

Update WAML and improve certainty around future methodology

Consistent with good regulatory practice, the WAML needs to be updated at each regulatory reset to reflect the best and most up to date information on the economic lives of applicable assets. In the case of the 2016 HVAU, this needs to reflect the long term likelihood of a continuing coal industry in the Hunter Valley – including operating and prospective mines.

The determination of remaining mine lives should not be subject to short term negativity around the coal industry and must recognise that, notwithstanding the cyclical nature of the industry, there is little prospect of coal mining coming to an end in the Hunter Valley.

The basic methodology for calculating WAML used in the 2011 HVAU should continue to apply. HRATF proposes a number of methodological improvements that would reduce uncertainty over data sources and align definitions with the regulatory time frames.

On the basis of independently and publicly available information, and based on a conservative approach to identifying prospective mines, we calculate WAML of **22 years**.

We note that two coal producers may separately submit to the ACCC that a different WAML should be adopted for Zone 3.

Overhaul the HVAU opex framework so that it is consistent with the object of Part IIIA, the pricing principles and so that it aligns with standard Australian regulatory practice

The 2011 HVAU was (understandably, given the market context at that time) focussed on coordination, capacity expansion and capital planning.

As a consequence, the operational expenditure (**opex**) framework under the HVAU is weak and does not reflect standard Australian regulatory practice – or the objects of Part IIIA, including the efficient operation of infrastructure.

HRATF considers the following are necessary at a minimum:

- An expanded role for Access Holders, through the RCG process, to endorse annual opex forecasts, with any endorsed forecasts providing a presumption of efficiency (or lack of efficiency) in the ex post annual compliance review.
- A means for ARTC to benefit from any efficiency improvements as an incentive for performance, with these gains to be 'locked in' through the resetting of baseline opex for future periods to ensure future benefits are passed to Access Holders.
- Substantial improvements to the annual compliance process, including providing minimum information requirements for ARTC around opex prudence and an improved process for ACCC engagement with Access Holders and other stakeholders – including the ACCC publishing guidelines, from time to time, outlining its approach to assessing opex prudence in the context of the HVAU.

Facilitate flexibility through an expedited variation process, with

HRATF accepts that, if the ACCC considers it consistent with the statutory framework, there is benefit in having an expedited process for variations that are minor or administrative in nature.

However this process needs to be made reciprocal (i.e. both Access

appropriate ACCC oversight	<p>Holders/the RCG and ARTC can propose variations) and there needs to be an appropriate means for disputes to be referred to the ACCC for resolution.</p>
A cost allocation manual	<p>The cost allocation principles proposed by ARTC are unclear, in a number of respects, but appear to have the effect of inappropriately shifting overhead costs from non-coal traffic to Access Holders, in circumstances where this is not justified.</p> <p>The Costing Manual in its currently proposed form should be rejected.</p>
Provide an appropriate transition to the 2016 HVAU	<p>In the event that any extension of the 2011 HVAU is required in order to complete the ACCC's approval process for the 2016 HVAU, the cost of capital under the 2011 HVAU should be varied from 1 July 2016 to reflect the ARTC 2016 HVAU proposal or any subsequent agreement reached.</p> <p>A further reconciliation will be required to reflect the final outcome of the ACCC decision on WACC and WAML.</p>

1.3 Other matters

We note that the views expressed in this submission are those where the members of the HRATF share a broadly common position. There are other issues where individual producers hold differences of view, and will engage with the ACCC process separately.

Without limitation, issues raised by the 2016 HVAU where there is not an aligned position within the HRATF include:

- the current structure of tariffs and whether any move to path-based pricing is warranted or appropriate;
- the approach to be adopted to defining any indicative service (and the proposed move by ARTC to a more flexible, 'service envelope' concept); and
- treatment of loss capitalisation in Zone 3.

The HRATF has taken the liberty of attaching with this submission a mark-up of the draft 2016 HVAU, which reflects our view of amendments that need to be made to reflect our views, as set out in this submission.

Finally, to the extent possible, HRATF has sought to address the various issues above in the same order in which they were raised by the Consultation Paper – including by specifically addressing each of the ACCC's questions.

2 Background

2.1 The HRATF

The HRATF is the unincorporated Hunter Valley coal rail network (**Hunter Valley Rail Network**) user group comprising the following nine coal producers that each operate coal mines in the Hunter Valley:

- Anglo American;
- The Bloomfield Group;

- Coal & Allied (Rio Tinto Coal Australia);
- Glencore Coal;
- Idemitsu Australia Resources;
- Hunter Valley Energy Coal Pty Limited (BHP Billiton);
- Peabody Energy;
- Whitehaven; and
- Yancoal Australia.

The HRATF was formed in 2009 and led combined industry engagement with ARTC in relation to the 2011 HVAU.

2.2 Regulatory background – the NSWRAU

As the ACCC is aware, prior to it accepting the 2011 HVAU, the Hunter Valley Rail Network was subject to the NSWRAU, which operates as a standing or ‘backstop’ state rail access framework pursuant to Schedule 6AA of the *Transport Administration Act 1988 (NSW) (TAA)*. The NSWRAU was introduced in 2004 to replace the earlier “Rail Access Regime” which emerged from the competition policy reforms of the mid-1990s.

The drafting of the 2011 HVAU makes it clear that the NSWRAU was the basis for the approach taken in a number of respects, and continues to influence the way that elements of the 2016 HVAU operate (such as the annual compliance process).

The NSWRAU does not put in place an access and pricing framework. Rather, it establishes a light-handed “negotiate-arbitrate” model for access together with high level pricing principles. The pricing principles provide for a combinatorial floor/ceiling model (based around full incremental/standalone cost). There is a basic process for Regulatory Asset Base (**RAB**) roll-forward, based on depreciation using mine lives, which the HVAU retains.

Unlike the HVAU, the NSWRAU pricing principles and roll forward does not operate over a 5-year regulatory period. Instead, each network owner must provide an annual compliance report to IPART, which demonstrates compliance with the RAB roll forward requirement. The compliance requirements do not apply if the operator’s revenues for the year are less than 80% of the (standalone) ceiling test.

The NSW Government, through Transport for NSW, undertook a review of the NSWRAU in 2012. This was completed in February 2013, but to this point there has not been any formal response or public recommendations.

2.3 Commercial and market background

In 2011, thermal coal was trading on commodity markets at approximately US\$140 per metric tonne and coal transported on the Hunter Valley Rail Network equated to approximately \$9 billion worth of export earnings per annum.³ At that time, Hunter Valley

³ ACCC Decision In relation to Australian Rail Track Corporation’s Hunter Valley Rail Network Undertaking, 29 June 2011, p 6

coal production was forecast to nearly double from approximately 130 Mtpa to 250 Mtpa by as early as 2018.⁴

Given the strength of these market conditions, as well as capacity constraints on the Hunter Valley coal supply chain, a critical point of focus for the HRATF and other access seekers at the time was having:

- a clearly defined process in the HVAU for ARTC allocating and investing in Additional Capacity; and
- certainty that ARTC would deliver Additional Capacity on time and be liable for Capacity Shortfalls when it has caused them.

This led to a considerable emphasis in the 2011 HVAU on the capital planning and expansion processes as well as coal chain coordination processes. The ACCC recognised the importance of capital expenditure to the HRATF and others in its final decision in relation to the existing HVAU:

Investment in additional capacity on the Hunter Valley rail network has been the subject of significant interest by stakeholders in the assessment of the April 2009 HVAU and September 2010 HVAU...

While previous versions of the HVAU have included provisions dealing with the creation of additional capacity on the Hunter Valley rail network, coal producer stakeholders have expressed concern that those provisions were not sufficient to ensure timely and efficient investment in the network.⁵

It is now clear that the timing of the 2011 HVAU coincided with a turning point in global coal prices, and over the course of the term of the 2011 HVAU, the price of GCNewc thermal coal price index dropped by over 60% from approximately USD\$140 per metric tonne in January 2011, to approximately USD\$51 per tonne in January this year.

Nonetheless, despite this period of declining prices for both thermal and metallurgical coal, the Hunter Valley mines have delivered a significant growth in volumes and since the 2011 HVAU, **volumes through the Port of Newcastle have increased by about 30%**.

This outcome – of significantly increasing and sustained volumes during a period of falling prices – highlights that ARTC is a low risk business. This confirms that while ARTC's customers (coal producers) operate in a high risk environment, the same cannot be said for ARTC itself – and there is no correlation between a decline in coal prices and a decline in coal volumes. In fact, there has been a strong negative correlation.

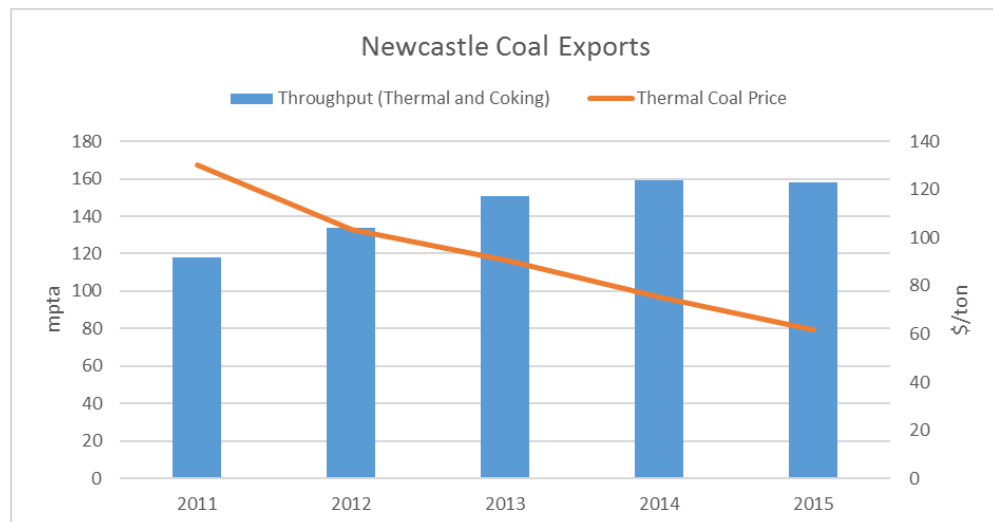
ARTC's Hunter Valley revenues are not directly affected by any change in coal price, but are based on the **volume** of coal passing over its network (or contracted to do so on a take or pay basis). Producers have an incentive to produce coal from their existing mines so long as each incremental tonne of coal produces a positive cash flow or contributes towards utilising fixed infrastructure capacity which has been contracted for on a take or pay basis.

⁴ See <http://www.internationalcoalnews.com/storyView.asp?storyID=1025104§ion=News§ionsource=s46&aspdsc=yes>

⁵ ACCC Decision In relation to Australian Rail Track Corporation's Hunter Valley Rail Network Undertaking, 29 June 2011, p 14

The shift to take-or-pay contracts and the provision of financial security by users, in the form of bank guarantees or parent company guarantees, further reduces ARTC risks, not just by locking in multi-year revenue streams, but also by reducing the incentive for mining companies to put mines into care and maintenance in the event of falling pricing. In essence, take-or-pay contracts with infrastructure service providers mean that at the margin, there is no saving from avoiding production, and hence an incentive to produce as long as the price is above the remaining marginal cost, excluding take-or-pay infrastructure charges.

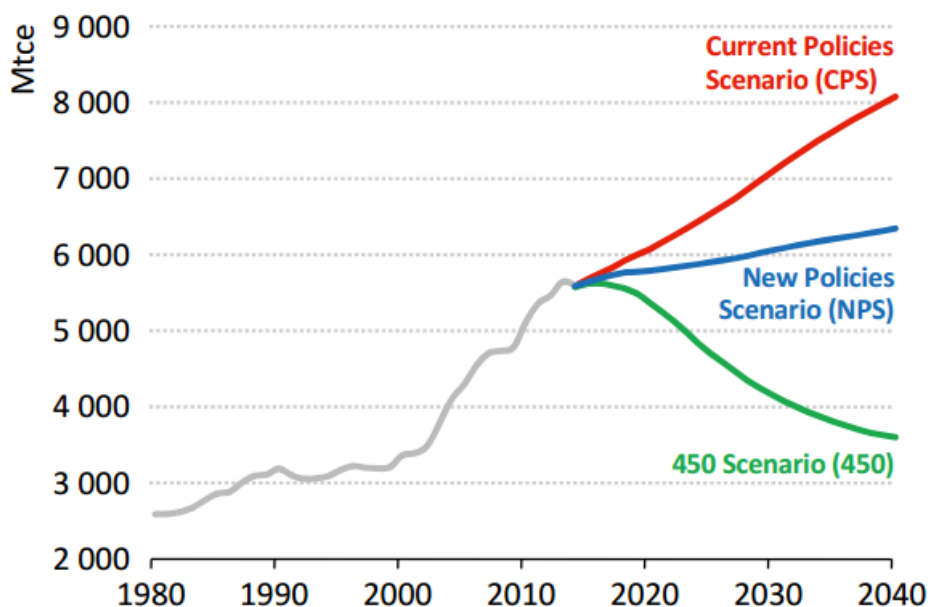
Figure 1: Coal Export Volumes relative to Newcastle thermal coal export price (GCNewc price)



ARTC's view that it faces significant businesses risks is an over-reaction to short-term coal market news which has had no impact on ARTC's business to date, and is unlikely to have any such impact in the foreseeable future. While the rapid capacity expansion seen during the previous regulatory period may have slowed or paused, the productive assets built during this period will continue to be operated (indeed, they are underwritten by long term take or pay commitments which mean they are largely 'fixed' costs) – and there will not be a significant drop off in production during the life of those assets.

Concern about the future of Hunter Valley coal is also not aligned with the long term consensus view of the coal market. According to the International Energy Association (IEA), global coal demand is expected to expand by an additional 2500 million tonnes per annum (mtpa) over the next 25 years (or by 100 mtpa each year). Even under the IEAs new policies scenario (its most negative scenario as far as coal use is concerned) coal demand is still expected to grow and remain a key energy source for the foreseeable future. Given the Hunter Valley's competitive position in the worldwide export market, this future demand will underwrite the development of new mines and expansions exporting through Newcastle.

Figure 2: IEA World Coal Demand Forecasts⁶



The Hunter Valley is a key exporter of premium quality coking and thermal coal, which is highly sought after in Korea, Japan, Europe and the Americas,⁷ due to the growing uptake of pulverised coal injection in the steel industry and with the growing use of modern boilers in the power sector.

The coal produced in the Hunter Valley is highly competitive both in terms of its cost of production as well as the operational advantages it affords its buyer. These advantages include:

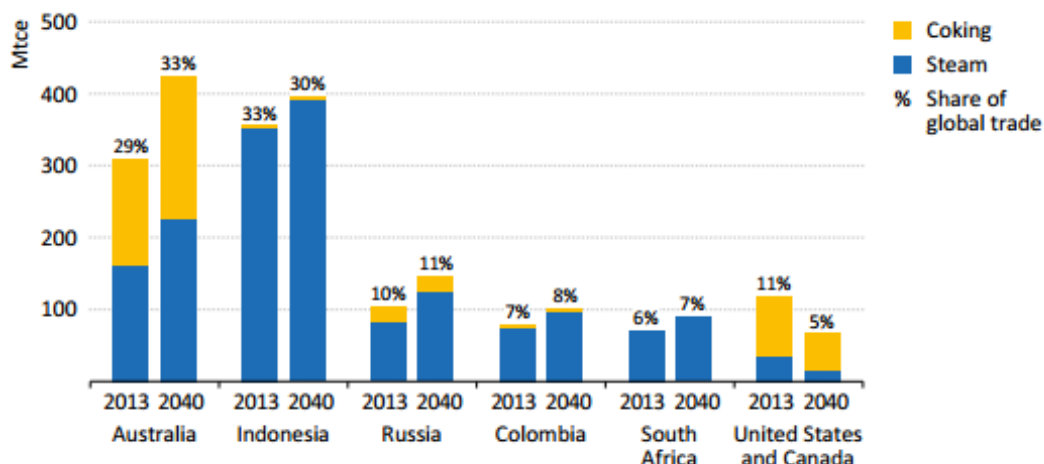
- high energy content
- relatively low ash and sulphur content, and
- combustion characteristics that assist in maintaining blast furnace stability at high injection rates, therefore improving productivity and efficiency

Reflecting Australia's position as the least cost supplier of high quality coal, the IEA estimates that Australia's share of the global coal trade is likely to increase from 29% in 2013 to 33% in 2040— even under its most conservative demand forecast. We note that under the IEAs baseline scenario, global coal demand is 1500 mtpa higher by 2040 than under its new policy scenario.

⁶ IEA 2015 World Energy Outlook, pg 270

⁷ Australian Atlas of minerals resources, mines, and process centres – Coal Fact Sheet http://www.australianminesatlas.gov.au/education/fact_sheets/coal.html

Figure 3: IEA Net Coal Exports based on New Policy Scenario Demand Forecasts⁸



ARTC's low asset stranding risks are further emphasised by the size of economic coal reserves identified in the Hunter Valley region. According to the Australian Energy Resource Assessment (AERA), Australia's recoverable Economic Demonstrated Resources (EDR) of black coal amounted to 61.6 Gt,⁹ some 9 per cent of the world's total recoverable EDR. Of that, 36% is located in NSW or some 22 Gt. These reserves would support current production rates for well over 100 years.

The efficient operation of the Hunter Valley Rail Network in a period of increasing volumes

While the above market realities mean that volumes will be sustained in the Hunter Valley, current pricing volatility continues to place powerful pressure on costs. In response, Australian coal producers have been amongst the most effective at reducing production costs (mostly through reducing the cost of extraction). However, it has proved more difficult for coal producers to drive similar cost efficiencies and reduction in their transport costs.¹⁰

Coal producers are increasingly concerned about the lack of incentives for ARTC to reduce its operating expenses at a time when the rest of the supply chain is rapidly taking out costs. The current pass through structure offers no incentive for ARTC to initiate cost saving measures. In its most recent energy outlook, the IEA has estimated that Free on Board cash cost of Australian coal producers has almost halved over the last three years¹¹. In contrast, ARTC's operating costs have increased from about \$100m in 2012 to \$140m in 2015.

In its recent Draft Decision on the Aurizon Network, the Queensland Competition Authority (QCA) highlighted the importance of improving the efficiency of rail operations

⁸ IEA 2015 World Energy Outlook, pg 313

⁹ Australian Energy Resource Assessment (second edition), Chapter 5
https://d28rz98at9flks.cloudfront.net/79675/79675_AERA.pdf

¹⁰ Developments in Thermal Coal Markets, T Saunders, Reserve Bank of Australia, June Quarter 2015.

¹¹ IEA 2015 World Energy Outlook, pg 286

given prevailing market conditions.¹² Specifically in relation to rail access charges the QCA has said:

*Due to the challenging market conditions, coal producers and their suppliers have undertaken wide ranging cost reduction strategies across their businesses in order to improve productivity and remain globally competitive.*¹³

*Rail access charges have been identified by industry as a key cost concern in this environment.*¹⁴ Stakeholders argued increases in rail access charges, even if seemingly minor, have a significant impact on the competitiveness of current coal mine operations and a chilling effect on investment. The QRC said:

*... coal miners are increasingly focussed on constraining costs, including corporate overheads, direct labour costs, reduced contract mining, maintenance and general contractor prices to stay competitive. Reduced transport costs are also needed to complement the incremental improvements made in other areas. ... Concerns of substantial increases in rail access charges and that Queensland's regulatory framework may be ineffectual in curtailing Aurizon Network's monopoly power will exacerbate the already poor investment sentiment.*¹⁵

The same factors and considerations apply to the Hunter Valley Rail Network.

At present, however, the 2011 HVAU is not well equipped to respond to this changed environment. While the capital planning and capex arrangements are relatively sophisticated, the 2011 HVAU lacks an effective or credible mechanism for ensuring incentives to improve the efficiency of opex.

The 2011 HVAU relies upon an annual, ex post 'compliance' process that requires the ACCC to assess prudence on an annual basis, through a process that currently lacks transparency or a meaningful role for users or other stakeholders (e.g. rail operators).

As the ACCC is aware, the objective of a regulatory regime of this kind (which incorporates a building block methodology and associated tariff framework) is to provide a 'proxy' for those incentives that would exist in a workably competitive market. The leading statement of the High Court of Australia, in the context of the former Gas Code, is equally relevant to the current circumstances facing the HVAU:¹⁶

The Code as a whole provides for a regulatory regime of a kind which is "a surrogate for the rewards and disciplines normally provided by a competitive market". Competitive pressures in a market stimulate efficiency of production and resource allocation, they stimulate efficient investment decisions and they minimise costs.

¹² Draft decision on the Aurizon Network 2014 Draft Access Undertaking – Governance and Access, January 2015

¹³ Aurizon Network, 2013 DAU, sub. no. 1: 12; BMA, 2013 DAU sub. no. 41: 2; Glencore, 2013 DAU, sub. no. 74: 2; QRC, 2013 DAU, sub. no. 46: 22–24; RTCA, 2013 DAU, sub. no. 73: 3

¹⁴ Aurizon Network said its proposed below rail tariffs make a very modest contribution to coal producers' costs – and would have an insignificant impact on potential mine development (see Aurizon Network, 2013 DAU sub. no. 3: 32; 77: 8)

¹⁵ QRC, 2013 DAU, sub. no. 46: 23

¹⁶ *East Australian Pipeline Pty Ltd v Australian Competition and Consumer Commission* (2007) 233 CLR 229 at [18].

As well as failing to respond to the current commercial realities in the market, as they have evolved since 2011, the draft 2016 HVAU fails to provide appropriate incentives for efficient investment and operation of the Hunter Valley Rail Network. In this regard, it is not consistent with regulatory practice or the pricing principles and objects of Part IIIA without significant improvements around the processes for ensuring efficient operations and expenditure.

This issue, including the HRATF's proposal to introduce an opex incentive framework more closely aligned with standard Australian regulatory practice and the relevant legal framework, is addressed in more detail at Part 10 of this submission.

2.4 The prospect of privatisation – and the importance of regulatory certainty and predictability

The other major commercial factor that needs to shape the ACCC's consideration of the 2016 HVAU is the potential for privatisation of ARTC, either in whole or in relation to the Hunter Valley Rail Network, over the near term.

This issue was highlighted by late amendments to the draft 2016 HVAU which introduced a new section 2.2(c) addressing the prospect of an asset sale. This section demonstrates that the continued existence and operation of the 2016 HVAU cannot be guaranteed post-privatisation and creates a high degree of uncertainty around the regime.

We discuss this issue in more detail in this submission in Part 14 (Potential Privatisation).

3 Term

3.1 Is the initial 10.5 year undertaking term an appropriate duration?

The proposal for a 10.5 year term with partial review after five years is a positive step toward improving the stability of the 2016 HVAU and would align the review period with the pricing year, which is welcome.

However, the HRATF does not consider that the 10.5 year term goes far enough, in that it falls short of delivering a comprehensive solution to the need for a predictable and long term regime – particularly in light of the risk of privatisation discussed above at Part 0 and Part 14 of this submission. A 10.5 year term would still permit the 2016 HVAU to expire before the expiration of existing Access Holder Agreements and while existing mines, which remain reliant on the Hunter Valley Rail Network, continue operating.

The Hunter Valley Rail Network is not, and was not ever intended to be, unregulated.

The 2016 HVAU is currently “voluntary”, only because of the use of the Part IIIA process to implement the framework. So much is clear from the continued existence of the NSWRAU as a ‘fall back’ regime under the *Transport Administration Act 1988* (NSW) (**TAA**). However, the HVAU has developed successfully over the last five years to a point where it is no longer reasonable to consider that regulation of the Hunter Valley Rail Network – and all supporting commercial arrangements such as Access Holder Agreements (**AHAs**) – could transition back to the NSWRAU without significant regulatory and commercial disruption.

While locking in the current framework in the event of privatisation is likely to require steps to be taken as part of the privatisation process, a number of immediate measures are nonetheless possible within the 2016 HVAU to ensure that it provides a long term and stable regulatory framework.

Align the Term of the 2016 HVAU to the remaining mine life used for depreciation purposes

In the circumstances, the Term of the 2016 HVAU should be aligned at each Review Date to the then remaining average mine life used for depreciation purposes.

As noted below at Part 5.3 of this submission, the HRATF proposes that this requires an update to the remaining mine life for the 2016 HVAU of 22 years. This ensures that existing and prospective users can invest in substantial mine and related projects and infrastructure during the next regulatory period with confidence that below rail pricing and other access conditions will remain appropriate and consistently regulated for the life of those assets.

This approach – of locking in a regulatory framework with the periodic resets of key elements – is consistent with the approach adopted in relation to most other Australian regulatory and access frameworks, including:

- Other State rail regimes, such as the Queensland rail access framework, which have put in place a long term statutory declaration of the Central Queensland Coal Network and the rail operations of Queensland Rail, with periodic updates to the terms of access through approval of updated undertakings required to be put in place by each of Aurizon Network and Queensland Rail.¹⁷
- The pricing and other commercial arrangements of NBN Co are governed by a 30-year special access undertaking, put in place pursuant to s 152CBA of the *Competition and Consumer Act 2010* (Cth) (**CCA**) and accepted by the ACCC on 13 December 2013. The Special Access Undertaking (**SAU**) operates using a modular format, in which different elements of the SAU are updated over the course of the 30-year life of the undertaking. The ACCC has described this as “allowing a balance between providing certainty about long term cost recovery and flexibility to respond to changing circumstances.”¹⁸
- Declaration and certification decisions under Part IIIA have often applied for periods up to 50 years. For example, the declaration of sewerage transmission and interconnection services provided by Sydney Water under Part IIIA is for a 50 year period¹⁹ and the declaration of the Goldsworthy Railway Service in the Pilbara is for 20 years.²⁰
- The fixed statutory period for a no-coverage determination for gas pipelines under s 151 of the National Gas Law is 15 years.

In this context, a term that aligns the life of the 2016 HVAU with the remaining useful life (and cost recovery timeframe) of the Hunter Valley Rail Network is consistent with Australian regulatory practice, particularly in respect of rail infrastructure, and promotes investment confidence in the framework. This is also consistent with the rationale adopted by the National Competition Council to the appropriate term of declaration, which

¹⁷ See Section 250 of the Queensland Competition Authority Act.

¹⁸ ACCC, NBN Co Special Access Undertaking, Final Decision, 13 December 2013 at page 8.

¹⁹ Application by Services Sydney for declaration of sewerage transmission and interconnection services provided by Sydney Water, NCC Final Recommendation, 1 December 2004.

²⁰ Fortescue Metals Group Limited [2010] ACompT 2.

it links to the period over which it is not likely to be privately profitable to develop an alternative facility.²¹

However, as these examples also demonstrate, for a long term 'standing' undertaking to operate effectively, it must include a review mechanism that provides a sufficient role for stakeholders and the ACCC to facilitate amendments. This reflects the fact that, once an undertaking is in place under Part IIIA, it is no longer possible for industry to apply for declaration of the Hunter Valley Rail Network.²²

It would not be appropriate for industry to be 'trapped' with a fixed, long term undertaking that can only be amended with the agreement of ARTC or where the process for determining what amendments are proposed is led and dictated by ARTC, which is the process currently proposed in section 2.3 of the draft 2016 HVAU.

The mandatory review process currently contemplated under section 2.3 does not do enough to balance the interests of Access Holders and other stakeholders, in the renewal process. For example:

- ARTC manages the process of determining what issues are considered and addressed in any variation proposed under section 2.3(d);
- the ACCC's role is limited to accepting or rejecting the variation as proposed, with no explicit power to direct ARTC in relation to those changes that are reasonably required in order to ensure that the 2016 HVAU remains consistent both with s 44ZZA and the objectives of the 2016 HVAU in section 1.2; and
- if the ACCC rejects a proposed variation, ARTC must (in all cases) challenge the matter by referring it to the Tribunal.

This approach would quickly lead to the 2016 HVAU becoming 'captured' by ARTC, making it difficult for stakeholders or the ACCC to require important evolution in the regime over time.

Therefore, as well as extending the Term to align with the WAML set at each Review Date, the HRATF also proposes the following changes to the mandatory review process proposed by ARTC in the 2016 HVAU:

- in addition to the existing right of ARTC to propose variations, a right should be granted for all stakeholders to make submissions directly to the ACCC as part of each mandatory review process, with any proposed modifications which they consider appropriate;
- the ACCC may, at the same time as it rejects a variation proposed by ARTC, also direct the ARTC as to how the HVAU would need to be varied in order for it to be approved;
- ARTC could, but would not be obligated (as currently drafted in section 2.3(e)), to seek review of the ACCC decision by the Tribunal – and it needs to be acknowledged that the right to challenge an ACCC decision is reciprocal (i.e. can also be undertaken by any other stakeholder with a relevant interest);²³ and

²¹ NCC, Declaration of Services, A guide to declaration under Part IIIA of the Competition and Consumer Act 2010, at page 54.

²² Section 44H(3).

²³ CCA s 44ZZBF.

- ARTC must either comply with the ACCC decision (if no review is taken) or with the determination of the Tribunal – and lodge a variation to the HVAU.

The HRATF submits that this approach – with a long term and stable undertaking periodically reviewed and overseen by the ACCC – provides the right balance between certainty, stability and flexibility to support efficient investment and operation of the Hunter Valley Rail Network and related markets.

Schedule 3 to this submission contains the HRATF's proposed drafting changes to section 2.3 of the 2016 HVAU.

A weaker alternative: provide greater certainty around the basis for any refusal to renew under the mandatory process in section 2.3

The current proposal by ARTC involves a rolling review process, by which the initial 10.5 year term is extended at each Review Date by a further 5 year additional term.

The HRATF welcomes the introduction of a process by which, at the least, they are provided with 5 years' notice of any intention on the part of ARTC not to renew the HVAU.

However, while this provides greater notice of the expiry of the HVAU, this does not constrain the discretion of ARTC. That is to say, it does not address the fundamental issue that the HVAU has become – and should remain – the long term regulatory framework governing the Hunter Valley Rail Network. As such, the 2016 HVAU should simply not remain subject to ARTC being able to arbitrarily withdraw it or allow it to expire, without justification.

In the absence of long term certainty about the Term of the HVAU (discussed above), at the least, the HRATF submits that ARTC needs to be subject to reasonable limitations on its ability to refuse to extend the Term, as contemplated under section 2.3.

Specifically, we consider that the right to refuse to extend should only exist where ARTC can reasonably demonstrate that:

- (a) the operation of the HVAU no longer meets the Objectives in section 1.2;
- (b) the expiration of the HVAU at the next Review Date has been endorsed by current Access Holders (we proposed on the basis of the standard 70% endorsement threshold used for other endorsement matters under the draft 2016 HVAU); and
- (c) appropriate steps, acceptable to the ACCC, have been taken to provide a transition for any current AHAs at the time of expiry of the HVAU.

Schedule 3 to this submission contains the HRATF's proposed drafting changes to section 2.3 of the proposed HVAU.

In all cases, the ACCC must ensure that existing AHAs retain key elements of the 2016 HVAU

Finally, the HRATF notes that the 2016 HVAU proposal does not address the impact which expiration would have on the terms of AHAs, which are linked to the ongoing operation of the HVAU.

At present, both the voluntary nature of the HVAU and the potential for privatisation, expose Access Holders to a degree of risk and uncertainty around their future access rights.

The HRATF submits that the terms of the standard AHA need to be amended so that, irrespective of what position is ultimately adopted with respect to the Term, the 2016 HVAU revenue cap and tariff framework continue to operate under AHAs that are in place, if the 2016 HVAU expires, is withdrawn or is revoked for any reason.

The HRATF submits that this could be achieved by having key elements of the 2016 HVAU building block methodology become automatically incorporated into the AHAs, if the 2016 HVAU ceases to operate for any reason, including:

- (a) fixing the opening asset base and RAB roll forward methodology (including the determination of a revenue cap and tariff structure consistent with those in the 2016 HVAU);
- (b) specifying the rate of return approach to apply (as proposed to be amended by HRATF); and
- (c) establishing the mine life and depreciation methodology.

HRATF acknowledges that modifying the HVAU building block arrangements to operate independently as part of the AHAs will require further engagement with ARTC and the ACCC. We submit that this should occur as part of the development of the ACCC's draft decision on the 2016 HVAU.

3.2 Is the alignment of the 2016 HVAU to calendar years appropriate?

Yes – subject to our view that the Term should be extended on each Review Date and linked to remaining mine life. However, aligning each 5-yearly Review Date with the calendar (i.e. pricing) year is supported.

3.3 Is a periodic review of elements of the undertaking six years prior to the termination of the HVAU appropriate? Are there concerns with the proposed process for ARTC's completion of the periodic review?

Yes there are concerns with the proposed process for ARTC's completion of the periodic review – the HRATF considers that the process proposed in the 2016 HVAU does not adequately provide for the interests of Access Holders and other stakeholders in the review process. See our comments above.

There is also insufficient scope for the ACCC to oversee and, if necessary, guide the development of the HVAU over time.

The HRATF has proposed amendments above that would better balance the legitimate interests of ARTC and Access Holders, as well as provide a more effective and direct oversight role for the ACCC.

3.4 Is the process sufficiently robust to take into account and if required implement any stakeholder concerns?

Please see answer to the question at Part 3.3.

3.5 Is the reoccurring option to extend the 2016 HVAU for an additional five-year term appropriate?

Please see our answer to the question at Part 3.1.

4 HVAU variation process

4.1 Statutory basis for the variation process

At section 2.4 of the proposed 2016 HVAU, ARTC introduces a new process for varying the proposed HVAU aimed at expediting the variation process for certain kinds of 'administrative' provisions.

Under this new process, ARTC may vary the Costing Manual and "Administrative HVAU Provisions" of the proposed HVAU without the ACCC's consent, provided that the RCG has endorsed the change with Access Holders controlling at least 70% of the contracted Train Km plus any prospective coal Train Km under section 9.2(g) of the proposed 2016 HVAU.

The HRATF accepts the value of an expedited variation process but recognises that the ACCC will need to consider whether such a non-statutory variation process is consistent with the statutory framework in Part IIIA of the CCA, especially section 44ZZA(7).

Provided that the ACCC is satisfied that the approach is capable of approval, the HRATF is concerned that while some of the provisions identified are clearly "administrative", others relate to important issues, where it would not be appropriate for amendments to be made without unanimous RCG support. If such a process were to be approved by the ACCC, we would suggest the inclusion of an additional test which specifies that the process may only be used for minor or administrative matters which are non-discriminatory in purpose and effect, and allowing any dispute to be referred to the ACCC.

It will prove difficult to define, with precision, those changes that are only administrative or 'minor' in nature and for which direct ACCC oversight should not be required. However, where a change is minor, it is doubtful that any user would reasonably object to a variation. If a user (or another stakeholder, such as a rail operator) considers that a proposed amendment is sufficiently material to object to it, then by definition that is unlikely to be appropriately treated as 'minor'.

4.2 ARTC proposed minor variations

In terms of those provisions that have been identified by ARTC as subject to the proposed variation process, the HRATF makes the following observations:

(a) The Costing Manual

ARTC appears to have in mind minor changes to the Costing Manual that are not directed at materially changing cost allocation between zones or in other ways that impact on tariffs, but rather to update the manual to reflect changes that are required in order to reflect internal reorganisations etc.²⁴

The HRATF generally agrees that minor changes to the Costing Manual such as resulting from changes in the names of groups following an internal restructuring would typically not be problematic. However, the Costing Manual is an important document, and amendments have the potential to materially impact upon tariffs and the position of individual users and zones relative to each other.

²⁴ Section D.6 of Appendix D to the Explanatory Guide.

Given that changes in the approach to allocation may have a disproportionate impact on a small number of users, applying a standard 70% approval threshold is unlikely to be appropriate (i.e. it may be that the change negatively affects less than 30% of producers in an RCG, but nonetheless impacts them substantially).

(b) Insurance

ARTC has not indicated what amendments to the insurance provisions are intended to be dealt with as minor variations. The value and scope of insurance required to be taken by ARTC under section 2.6 of the 2016 HVAU is an important commercial matter for stakeholders.

More information is needed to determine whether it is appropriate for amendments to these provisions to be dealt with as minor or administrative variations.

(c) Contact details

HRATF agrees that changes to contact details under section 2.7(a) would typically be an administrative matter.

(d) Services Envelope

ARTC proposes that amendments to any assumptions or characteristics of the Services Envelope will constitute minor variations, capable of expedited approval through standard RCG endorsement.

While HRATF acknowledges that it may not be appropriate for the full statutory variation process to apply to proposed minor variations in Service Envelope characteristics – it is not appropriate to view all such amendments as necessarily immaterial or minor. By their nature, changes of this kind are likely to disproportionately impact particular producers or rail operators (running rolling stock that is affected by the changes). For this reason, using the standard 70% RCG endorsement threshold is again unlikely to be appropriate.

(e) Network Key Result Areas and Performance Measurements

ARTC has proposed amendments to the key performance indicators reported under section 13.1 and Schedule D of the HVAU, and has proposed that these also constitute HVAU Administrative Provisions.

While these metrics, and the associated reporting process, are an important element of the performance reporting framework under the HVAU, it is appropriate that the RCG is responsible for managing engagement with ARTC about their ongoing development. While it may be appropriate for these to be able to be varied based on a standard RCG endorsement, the current proposal for variation set out in Schedule D is inadequate, as it does not provide for:

- amendments to the Network Key Result Areas to be initiated by the RCG (if agreed by 70%); and
- any disputes over the development of new or modified measures (or other changes to the performance reporting framework) to be escalated to the ACCC for resolution.

(f) Network (Schedule B) and Segments (Schedule E)

It is evident that most amendments to the scope of the Network and the definition of Segments, as defined in the 2016 HVAU, could not be reasonably treated as 'minor

variations' to the HVAU or addressed through an expedited amendment process, involving only RCG endorsement applying the standard 70% threshold.

Subject to further clarification by ARTC, the HRATF would not support amendments to the scope of the HVAU (which is the consequence of such an amendment) being excised from the current standard variation process. Amendments to the scope of the Network and the number and definition of Segments will often (or even usually) be matters which require the direct oversight and consent of the ACCC, taking into account the factors in s 44ZZA(3).

4.3 An alternative approach: a flexible and reciprocal variation mechanism with a dispute right to the ACCC

The HRATF recognises the need to ensure that the HVAU can evolve flexibly, particularly in circumstances where there is a longer Term and only limited provisions are routinely reopened at each 'reset' (although we note that the reset process needs to allow for any issues to be raised, not limited to minor variations).

While the ARTC proposal goes some way to addressing this issue, the process which is proposed is one-sided and does not provide sufficient protection for stakeholders. As noted above, it also applies in relation to some provisions which could not reasonably be viewed as 'administrative' or 'minor' (such as the scope of the Network itself and the definition of Segments).

The HRATF therefore proposes the following alternative process:

- (a) The definition of Administrative HVAU Provisions would be amended to remove reference to Network and Segment.
- (b) For other Administrative HVAU Provisions and for the Costing Manual, a different process would apply:
 - (i) a variation could be raised by any member of an RCG at any time during the Term, by proposing it to the RCG - if an RCG accepted the proposal (based on the 70% endorsement threshold) then ARTC would be required to consider it;
 - (ii) ARTC could itself propose a variation at any time during the Term;
 - (iii) ARTC would deal with any variation under this process by undertaking a consultation process with the RCG;
 - (iv) a variation would be able to be endorsed subject to the 70% threshold, in which case ARTC would be committed to making the amendment, and subject to a right for any RCG member (or ARTC) to refer the matter to the ACCC as a dispute.

The process above would be in addition to the ability for any party to raise new issues for consideration as part of the 5-yearly 'reset' process for the HVAU.

Schedule 3 to this submission contains the HRATF's proposed drafting changes to section 2.4 of the proposed HVAU.

4.4 Answers to questions raised in ACCC Consultation Paper

Is a mechanism which allows for RCG endorsement of minor variations of certain provisions of the 2016 HVAU appropriate?

No – the scope of provisions included is too wide and the process as proposed is one-sided and does not provide for escalation of disputes to the ACCC for resolution.

Do stakeholders have any concerns about the scope of the matters that may be varied under this process without ACCC consent?

Yes – see above. In particular, the definitions of the Network and Segments.

Do stakeholders have any concerns with the RCG endorsement threshold for minor variations?

Yes – for the reasons set out above, there will be a number of amendments that risk disproportionately affecting a small number of users. In that case, they should not be viewed as ‘minor’ or administrative amendments only.

The alternative process proposed by HRATF responds to this concern by providing for:

- (a) a ‘reciprocal’ process in which variations may potentially be raised by any party – either ARTC or a member of the RCG; and
- (b) while subject to the standard 70% endorsement threshold, there is an overriding right for any RCG member, or ARTC, to refer a variation to the ACCC as a dispute. This protects the interests of those stakeholders that may be disproportionately impacted by a proposal, while providing an expedited process for variations where there are no objections.

5 Access Pricing Principles

5.1 Is the retention of loss capitalisation for Pricing Zone 3 in the 2016 HVAU appropriate?

This is not an issue in respect of which all members comprising the HRATF share a common position, and so members will respond to the ACCC individually.

5.2 Are the changes to section 4.4 of the 2016 HVAU (Regulatory Asset Base) appropriate?

ARTC’s proposal to roll over the opening RAB values from June 2016 closing values is supported. However, the RAB and RAB Floor Limits should be reviewed for consistency between zones to ensure there are no material changes.

5.3 Is it appropriate to roll over the existing mine lives from the 2011 HVAU, meaning an average remaining mine life of 16 years from 1 July 2016?

No – the HRATF does not consider that rolling over the remaining weighted average mine life (**WAML**) from the 2011 HVAU is appropriate, or consistent with the terms of the 2011 HVAU. We note, however, that two coal producers may separately submit to the ACCC that a different WAML should be adopted for Zone 3.

By definition, the asset lives of assets in the RAB are intended to reflect their remaining economic lives. As in other regulatory regimes (and standard accounting practice) this

requires the periodic reassessment of economic lives, taking into account any change in circumstances. In the case of the Hunter Valley Rail Network, the WAML should therefore be reviewed and updated at each 'reset'.

Economic efficiency requires rail assets to be depreciated over the period during which they can reasonably be expected to be used and remain useful. In general, the appropriate time period for depreciation is the expected physical life of the assets. Such an approach (for example, adopted by IPART for the NSW rail network) is based on the view that in a dynamic economic environment with a multitude of possible current and future uses, the assets are likely to be used for as long as they last.

In a multi-user asset with considerable potential developments in the region, the period for the exhaustion of the existing marketable reserves is overly narrow and does not represent a useful basis for setting the depreciation period. Indeed, focusing solely on the current marketable reserves and production arrangements would lead to mine life outcomes that are clearly out of step with the future of the industry. For example, in a mechanical sense, an increase in the production rates from one period to the next would appear to lead to faster exhaustion and hence shorter WAML. However, higher production rates are, in reality, likely to indicate continued (and potentially growing) demand for the commodity and this makes the development of other prospective developments more likely, which should have the opposite effect, and lengthen the WAML for the region.

The Hunter Valley contains numerous coal deposits and many reputable energy forecasting agencies (such as the IEA) anticipate that coal will remain one of the main global primary energy sources for the foreseeable future.

Any approach which sets the period of asset depreciation at WAML of only the existing and certain, stringently defined prospective mines represents a transfer of risk from the service provider to current users – and a transfer from future users to current users – by resulting in inefficiently “front-loaded” depreciation. Such accelerated depreciation may cause allocative inefficiency, by making some marginal mine developments in the Hunter Valley less viable.

It is therefore imperative that the criteria for deciding which mines to include and which not to include, and how to measure reserves, the HVAU does not bias risk allocation in favour of ARTC, but reflects a realistic view of the likely remaining life of the network infrastructure.

To this end, the HRATF has proposed a definition of 'prospective mines' for inclusion in the WAML calculation which is already highly conservative. The three alternatives which have been proposed for a 'prospective mine' under the HRATF drafting approach are:

- all reasonably necessary project approvals have been obtained;
- contracts have been executed for Network Exit Capacity (i.e. port/terminal capacity) sufficient to provide for the delivery and export of any coal forecast to be produced over the remaining Term or any Further Term; and
- in all other cases, there is otherwise a reasonable expectation that the mine will commence operations and coal will be produced within five years of the Review Date.

The HRATF submits that even this approach is likely to result in overly conservative (i.e. shortened) asset lives, because while our test, in each case, focuses on the next five years, when a more appropriate focus of any asset lives analysis should be on what

mines are likely to come into operation over the entire depreciable period (i.e. 22 years, not 5 years).

Nonetheless, despite its conservatism, we are prepared to offer this approach to the determination of mine lives in order to provide a degree of clarity and certainty around future resets, which we consider important.

There are also clear linkages between mine life and the asset beta used to calculate ARTC's regulated returns. If the approach to calculating the remaining mine life used in the 2016 HVAU biases the depreciation period downwards, which would be the consequence of the approach in the current 2011 HVAU and proposed by ARTC, then the accelerated depreciation would substantially and unfairly reduce the risk faced by the owners of the assets. In this case, an accelerated depreciation rate would further support a lower asset beta for ARTC than other rail infrastructure owners – given that it would effectively eliminate any of the residual asset stranding risk that is faced by other rail infrastructure owners in Australia.

HRATF generally supports the continued use of publicly available information, where this is available and up to date. Where this is not the case, ARTC should be required to engage with industry to obtain relevant information.

The approach used in the 2011 HVAU had the following characteristics:

- (a) Use a reserve weighted average to calculate an average mine life
- (b) Included operating and prospective mines expected to enter production over the regulatory period
- (c) Use reserve and production estimates based on publicly available data

Again HRATF members note that relying principally on publicly available information will tend to bias towards well developed mines and is therefore a conservative approach to defining prospective mines for the purposes of determining WAML. However, in the interests of achieving a degree of regulatory certainty, this approach is accepted by HRATF members (provided that publicly available data is readily available and appropriate).

In conclusion, while we consider that our accepted approach is still likely to bias risk allocation in favour of ARTC, we are prepared to accept these results for the sake of certainty. We do note, however, that the reduced risk to ARTC inherent in setting depreciation on the basis of conservatively determined WAML rather than the expected physical life of the assets needs to be recognised in ARTC's asset beta.

We set out in Schedule 3 our suggested amendments to the drafting of the 2016 HVAU to give effect to this proposed approach – with depreciation addressed at section 4.7.

Our approach to calculating WAML is summarised in the following steps:

- **Step 1:** Identify operating mines that currently utilise the Hunter Valley Rail Network **as well as** prospective mines that could enter into operation over the regulatory period. A prospective mine means a mine or project in which the proponent can reasonably demonstrate to ARTC that any of the following apply:
 - all reasonably necessary project approvals have been obtained;

- 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; and
 - in all other cases, there is otherwise a reasonable expectation that the mine will commence operations and coal will be produced within five years of the Review Date.
- **Step 2:** Use reserve and production estimates based on publicly available information that ARTC must take into account. The NSW Coal Industry Report should be the preferred source. If marketable reserves are not provided for prospective mines, then consistent with the 2011 HVAU, 30% of total resources should be used as an alternative estimate.
 - **Step 3:** The production rate for operating mines will be determined using the same publicly available information used in Step 2, equal to the reported production rate in the NSW Coal Industry Report (using the most recent reported year). This will ensure that the production rate of each mine matches the marketable reserve assessment. To avoid the uncertainty in forecasting the production rates of prospective mines, we propose that all prospective mines are assumed to have 30 year operating lives.
 - **Step 4:** Calculate a reserve WAML using the production rates and marketable reserves of each mine. Details of this calculation is given in Box 1.
 - **Step 5:** Adjust the WAML for timing differences. For example, based on the 2014 NSW Coal Industry Report two years should be subtracted from the average mine life to represent a 2016 estimate.

Applying the above approach for the 2016 HVAU **results in a weighted average remaining mine life of 22 years for the 2016 HVAU**. Details and data for this calculation are provided in Schedule 5.

Box 1: Standard calculation of weighted average remaining mine life

$$\text{Average Mine Life (yrs)} = \sum(\text{wt of mine reserve}_j \times \text{Remaining mine life}_j)$$

where

$$\text{wt of mine reserve}_j(\%) = \frac{\text{Reserves}_j}{\text{Total Reserves [all mines]}}$$

j = operating and prospective coal mines

for Operating mines:

$$\text{Remaining Mine Life (yrs)} = \frac{\text{Reserves}}{\text{Production}_j}$$

Reserve and production based on current estimates of the **mine production rate and marketable, proven and probable reserves** derived using the latest NSW Coal Industry Report or other relevant publicly available information

for Prospective mines:

$$\text{Remaining Mine Life (yrs)} = 30$$

Reserves estimates based on current estimates in the latest NSW Coal Industry Report or other relevant publicly available information.

5.4 Is ARTC's proposed Costing Manual an appropriate replacement for existing provisions under the 2011 HVAU?

No. While the HRATF welcomes the development of a Costing Manual by ARTC, the submitted version of the Costing Manual does not provide sufficient transparency on the contentious issues of cost allocation. While the Manual provides a reasonable description of such agreed and non-disputed issues as the roll-over of RAB, its description of the cost allocation rules is either too vague to apply in practice or applies allocation rules that are not justified.

We are particularly concerned by the proposed allocation of overhead costs between the Hunter Valley Rail Network and the remainder of ARTC businesses. In our view, ARTC has a strong incentive to allocate costs to the Hunter Valley Rail Network, where it can be assured of recovery. Based on ARTC's estimates the revised cost allocation would allocate an additional \$5.6 million in overhead costs onto the Hunter Valley Rail Network from other users of ARTC infrastructure. We note ARTC has not defined what indirect costs are driving this increase. If the increase is driven by the change in overhead allocation, this implies a 30% increase or an increase from ~\$17m to \$22m.

We agree with ARTC that overhead costs should be set by reference to a hypothetical efficient stand-alone Hunter Valley coal network provider. However, ARTC's derivation of the estimate is flawed. In its assessment, ARTC estimates corporate and support services would amount to \$31.3m. ARTC has neglected to perform the same analysis on its interstate network. Overhead costs on a stand-alone interstate network provider would

be significantly higher than its current allocation of overheads – owing to dis-economies of scale.

Using Aurizon to benchmark overhead costs is also concerning given that ARTC outsources a larger proportion of its operating expenses than Aurizon on its Central Queensland Coal Network. For example, Aurizon does not outsource grinding, tamping, re-railing, signalling, and turnout upgrading.²⁵ Outsourcing of costs would clearly reduce requirements for internal corporate services and thus overhead costs.

We see no compelling reason to support the new cost allocation. The proposal would also compromise the effectiveness of the Opex incentive scheme that ARTC is developing (and which we discuss in more detail elsewhere). The Opex incentive scheme would require overhead costs to be set by reference to what is efficient, rather than through mechanical allocation rules for the total existing costs.

5.5 Are the cost allocation provisions included in the Costing Manual an appropriate replacement for existing provisions on the allocation of Non Segment Specific Costs?

The HRATF has a number of questions and issues with the allocation approach set out in the Costing Manual, including:

- (a) While the first five allocation principles set out at page 4 of the Costing Manual appear reasonable, the sixth principle is ambiguous:

“Where a causal allocator is available to allocate a value to another Business Unit, Function, Division or group of Segments that is more directly associated with the value, then the value is allocated to that Business Unit, Function, Division or group of Segments and allocation to individual Segments, if necessary, will be carried out on an iterative basis.”

It is not at all clear what this means or whether, or to what extent, it provides for the allocation of costs that are causally allocated to a business unit to be otherwise allocated to another – and on what basis.

- (b) Likewise, the flow chart in figure 1 (at page 5) suggests that values associated with a particular business unit, which cannot be directly causally allocated to a Segment, may instead be allocated to another business function or unit, rather than applying a general allocator – yet this does not appear to be explained?
- (c) ARTC has clearly moved to using a general non-causal allocator of GTK for common and operational costs, not otherwise causally allocated to Segments. This clearly has the effect of moving the liability for operational expenditure from non-Hunter Valley traffic to Access Holders. However, it is not clear that GTK is an appropriate general allocator for these kinds of expenditure which, like head office corporate, IT and similar costs do not vary based on mass or tonnage. A better allocator would be the number of paths used (as a proxy for the time and administrative burden required to manage a particular user’s requirement).

In respect of other elements of cost allocation, the members of the HRATF do not share a common position, and so members will respond to the ACCC individually.

²⁵ Evans and Peck - Operating and Maintenance Costs: Investigation and Benchmarking (Appendix N)– Final Report, October 2012.

5.6 Is it appropriate that the RCG be tasked with approving ARTC's changes to the Costing Manual rather than the ACCC?

The RCG is the appropriate entity to first consider cost allocation issues, although as discussed above, a right to escalate matters to the ACCC is required given that allocation decisions can disproportionately impact a small number of Access Holders (so that using a standard 70% threshold for approval of amendments, as proposed, will not always be appropriate).

5.7 Does ARTC's proposed Costing Manual address transparency concerns?

No, ARTC does not provide enough detail for Access Holders to be placed in a position to be able to replicate the effect on pricing.

5.8 Are there any other comments on ARTC's proposed changes to the Access Pricing Principles?

This is not an issue in respect of which the members of the HRATF share a common position, and so members will respond to the ACCC individually.

6 Rate of Return

6.1 Are the key assumptions underpinning ARTC's proposed WACC parameter values appropriate?

No – ARTC's proposal does not reflect its current or expected operating risks, nor is it sufficiently forward-looking to set the cost of capital for the next five years.

In general, in recent years, various Australian regulators have come to the view that the operating risks of the regulated entities are substantially lower than has been previously thought. Regulated entities enjoy a high degree of revenue stability. This growing perception of low revenue risk has been reflected in gradual reductions of asset betas applied to regulated entities.

With respect to ARTC, it is clear that ARTC revenues are not subject to unsystematic variability. In particular, coal volumes on the Hunter Valley Rail Network have grown despite sharp declines in coal prices.

Unlike the previous 5-year period, there is no expectation that ARTC will be required to undertake significant new investments over the next 5 years. Market acceptance of the on-going strength of the ARTC's balance sheet has been reflected in the A-grade credit rating accorded to ARTC bonds.

On a forward looking basis, we believe there is compelling evidence to support a view that ARTC faces lower levels of risk for the next 5 years than might have been anticipated during the last review of these parameters in 2011. ARTC's strong performance during the trough of the coal price cycle suggests that both equity and debt invested in ARTC face very low risks. This supports further reductions in asset beta and an improvement to ARTC's benchmark credit rating.

Similarly, ARTC's proposal to lower the expected inflation adjustment (hence increasing the real WACC) is based on backward looking analysis, rather than on the forward looking review of inflation expectations over the next 5 years. While the last few years have indeed delivered lower than expected inflation, the mid-point of the RBA target range, at 2.5%, remains the best available forward-looking measure of expectations.

Below we have set out in broad terms our position for WACC parameters. Detailed evidence is set out in the Castalia cost of capital report at Schedule 2.

- **Risk Free Rate**—We agree that the risk-free rate should be equivalent to a 20 day average of the 10yr Commonwealth Government bond yield, immediately before the start of the 2016-2021 regulatory period, as proposed by ARTC. We note that the 20 day averaging period used to calculate the risk free rate will need to be consistent with the 20 day period used to calculate the debt risk premium.
- **Debt Risk Premium**—We agree with ARTC’s proposal to calculate the debt using the difference between the risk free rate and a twenty-day average of the 10yr yield on Australian NFC bonds as published by the RBA²⁶. Given that the RBA publishes NFC bond data based on observations at the end of each month, our position is to interpolate a daily estimate of NFC bond yields (using the number of business days between month-end observations) for the purpose of calculating a 20 day average – this is similar to the approach used by the AER.

We disagree with any extrapolation of the bond yield published by the RBA. This generates uncertainty for both parties and we note that the sample of bonds used by the RBA is generally representative of a 10-year debt tenor.

- **Debt Raising Costs**—We accept ARTC’s 0.095% allowance for debt raising costs and note that this is consistent with the 2011 HVAU.
- **Regulatory Credit Rating**—There is compelling evidence to support an **A-band credit rating** for the NFC reference bonds used to calculate ARTC’s debt margin. New evidence and changing circumstances suggest that ARTC’s credit risk is now significantly lower than in 2011. This is because:
 - ARTC has now completed its heavy investment program, leading to lower credit risk. For example, in December 2010, ARTC issued unsecured 7 year bonds that were rated Aa2 by Moody’s; and
 - ARTC’s benchmark gearing ratio is comparable with the gearing used by an A-rated entity and lower than comparable rail networks such as Aurizon and Queensland Rail.
- **Benchmark Gearing**—Leverage and credit rating are closely related. Consistent with the 2011 HVAU, we agree that the benchmark gearing ratio should remain at 52.5%, as proposed by ARTC. However, as mentioned, ARTC receives a significant benefit in the form of lower borrowing costs which are partially attributable to its gearing ratio—our position is to reflect this benefit into its regulatory credit rating.
- **Market Risk Premium**—The MRP is not observable and, therefore, prone to estimation error. Long-term historical MRP estimates continue to support a MRP estimate of 6 percent. As the markets have settled after the disequilibrium of the global financial crisis, such historical estimates are again likely to be the best predictors of MRP over the next 5 years. An estimate of 6% would also be consistent with the ACCC’s recent determinations for NSW State Water and for Telstra. By definition the MRP is the long-term average equity premium that should not fluctuate unless the value falls outside an acceptable range. We note that the current value also falls inside the accepted range proposed by ARTC’s WACC consultants, Synergies.

²⁶ Aggregate Measures of Australian Corporate Bond Spreads and Yields, <http://www.rba.gov.au/statistics/tables/>

- **Gamma**—Given there is no agreed methodology for calculating gamma, our position is to maintain consistency with the 2011 HVAU decision by using a gamma of 0.45. This is at the mid-point of the generally accepted range and below that used by the QCA in its recent decisions for Aurizon and QR.

We are aware of the Tribunal decision to set a gamma of 0.25 for regulated returns on electricity networks. We do not think this is an appropriate value for ARTC, since ARTC operates in a different sector with a different set of investors and potential owners to the power sector.

- **Asset beta**—With the completion of ARTC’s major investment program, the asset beta adopted in 2011 now overstates its expected operational risks. Our view is that a careful analysis of risks faced by ARTC compared to other regulated rail service providers on the east coast of Australia strongly supports our position that ARTC’s asset beta should be materially lower than the level observed (and determined) for Aurizon and QR. In our view, the asset beta should be in the range of 0.3 to 0.4.
 - Both ARTC and Aurizon are regulated under a revenue cap, which ensures revenue certainty within the regulatory period. Queensland Rail is regulated under a price cap which exposes it to movements in the economy.
 - Queensland Rail has little diversification in coal producers. In contrast, ARTC obtains revenues from approximately 25 mines, and Aurizon’s revenue is from approximately 50 mines.
 - The Hunter Valley contains some of the lowest cost marginal producers of coal in Australia and they are thus better equipped to deal with market challenges.
 - Coal producers provide additional financial security to ARTC in the form of bank guarantees and parent company guarantees.
 - Aurizon operates several different coal systems with limited cross system traffic, with each individual coal system having lower volumes and less diversification of users than the Hunter Valley.
 - Aurizon’s coal systems are each located in remote regional Queensland, and are geographically dispersed.
 - Aurizon and Queensland Rail are exposed to the risk of cyclones.
 - ARTC has rolling 10 year agreements, meaning that ARTC has volumes contracted for the next 10 years. Aurizon access agreements have a term of 10 years with a right to renew, meaning that for an individual user the total future volume contracted to Aurizon will decline each year until renewal.
 - Aurizon faces the risk that the QCA may remove from its regulated asset base the value of infrastructure which is deemed no longer to be required. This is not a risk faced by ARTC.
 - Aurizon’s depreciation profile is not based on weighted average mine life.

On a separate issue, ARTC is proposing to use a remaining mine life based on an economic assessment of each mine. If adopted, this would lead to a mine life well below reasonable estimates, substantially reducing ARTC’s asset stranding risk. We have responded to this issue separately, but in the event that ARTC’s proposal is adopted, the asset beta will need to be reflective of the unequal risk allocation.

- **Inflation**—Inflation is used to translate a nominal WACC to a real WACC. Consistent with the approach used in the 2011 HVAU, we believe inflation should continue to be set at 2.5%, the mid-point of the official RBA target. This would ensure there is continued alignment between the inflation rate used to index the regulatory asset base and the inflation rate used to calculate a real WACC.

We provide a comparison of our WACC position relative to that of ARTC and the approach used in the 2011 HVAU.

	2011 HVAU	HRATF Position	ARTC Position
Nominal Risk Free Rate	'On-the-day' rate using 10yr CGBs	'On-the-day' rate using 10yr CGBs	
Inflation	2.5%	2.5%	1.5 %
Credit Rating	BBB	A-Band	BBB
Debt margin	'On-the-day' margin using 10yr bond yields from Bloomberg yield curve ²⁷	'On-the-day' margin using 10 yr RBA NFC bonds ²⁸	
Debt raising costs	0.095%	0.095%	
MRP	6.0%	6.0%	6.5%
Debt funding	52.5%	52.5%	
Equity funding	47.5%	47.5%	
Gamma	0.45	0.45	0.40
Corporate tax rate	30%	30%	
Asset beta	0.50	0.40	0.47
Equity beta ²⁹	1.044	0.838	0.984

²⁷ The RBA has only recently published bond yield data and this was not available during the 2011 HVAU.

²⁸ Subject to small differences in the interpretation of RBA data.

²⁹ Indicative equity beta value only.

7 Capacity Management

7.1 Preliminary comments

The HRATF considers that the capacity management provisions in section 5 of the existing 2011 HVAU have generally worked well, but as set out below, should be improved.

Responses to the specific questions raised by the ACCC in its Consultation Paper in relation to capacity management are set out below.

7.2 Are the additional obligations regarding consultation with the HVCCC appropriate?

In its Explanatory Guide, ARTC states that at the request of members of the HRATF the principles for its consultation with the Hunter Valley Coal Chain Coordinator (HVCCC) have been strengthened to clarify the process.³⁰

The HRATF welcomes the greater clarity around engagement between ARTC and the HVCCC that has now been reflected in Schedule G. The HVCCC is a critical and important part of the operation of the Hunter Valley coal chain, and it is important to HRATF members that it continues to play a central coordinating role across stakeholders.

The HRATF acknowledges that ARTC has taken on feedback from the HRATF and improved the consultation process in Schedule G of the proposed HVAU. However, the HRATF considers that the process requires further strengthening and identifies the following areas where it proposes tightening of the current arrangements:

- under Schedule G, ARTC should be required to use “best endeavours” rather than “reasonable endeavours” when engaging with the HVCCC;
- clause 2 of Schedule G should include a specific timeframe for ARTC to work with the HVCCC to establish the mechanisms referred to. The HRATF considers that 60 Business Days is an appropriate timeframe;
- in clause 3 of Schedule G, ARTC proposes to add the words “as reasonably determined by it” (with “it” being ARTC), in reference to a request from ARTC to the HVCCC to provide a view. The HRATF considers that the addition of these words materially weakens the consultation process as ARTC is currently under an obligation to **always** request the HVCCC to provide a view, not just when ARTC determines to do so – this stronger obligation needs to be retained;
- under clause 6 of Schedule G, if ARTC disagrees with a view of the HVCCC which materially affects an Access Holder’s rights under their respective Access Holder Agreements, ARTC will notify the affected Access Holders of, and provide its reasons for, its disagreement with the HVCCC view. The HRATF welcomes ARTC’s agreement to be bound by this obligation. However, the clause risks being ineffective because the process in Schedule G does not provide Access Holders with any opportunity to make submissions to the HVCCC and ARTC about the materiality of a change. The proposed HVAU should provide for an interested party consultation stage;

³⁰ See section 3.6 of the Explanatory Guide.

- under clause 7(b) of Schedule G, there are no timeframes specified for ARTC to publish its reasons for disagreeing with the views expressed by the HVCCC. The HRATF considers that 10 Business Days would be appropriate;
- under clause 8 of Schedule G, there should also be a timeframe by which ARTC and the HVCCC are to provide the other party with the requested information. The HRATF considers that 5 Business Days would be appropriate; and
- clause 9 of Schedule G should be amended so that ARTC is required to make its personnel aware of their responsibilities under Schedule G by the Commencement Date;
- use best endeavours to cooperate with the HVCCC and individual Coal Chain stakeholders to facilitate the operation of the Capacity Transfer System.

In Schedule 3 to this submission, the HRATF suggests drafting changes to reflect the points raised above.

7.3 Is the removal of the capacity losses provision appropriate?

The HRATF agrees with ARTC that now that the review under section 5.8 of the 2011 HVAU has been completed, the provision is no longer required.

7.4 Should the relinquishment process be refined and improved?

The HRATF supports the further refinement of the relinquishment process, so that ARTC is required to assist and facilitate the transfer of excess capacity.

HRATF considers that this relinquishment process should also be undertaken by ARTC as part of the following processes:

- (a) when assessing whether there is Available Capacity in order to meet a request for Access Rights; and
- (b) prior to ARTC proposing a new project to respond to a Capacity Shortfall, or to provide for Additional Capacity.

This ensures that existing capacity is most efficiently utilised (including through transfers) before more costly capex projects are undertaken or proposed. In Schedule 3 to this submission, the HRATF suggests drafting changes to section 5.2 and section 8.5 to give effect to this additional requirement.

8 Capacity Investment Framework and the RCG

8.1 Background to and value of the RCG

In its 2011 decision in relation to the existing HVAU, the ACCC said:

[T]he RCG process, and the provision for endorsement of capital expenditure, should promote efficient investment decisions and mitigate risks of 'gold-plating.' That is, the RCG process should provide users with the ability to veto inefficient investments proposed by ARTC.

The HRATF's experience has been that the RCG process has achieved this objective. There is no doubt that, overall, the RCG has proven to be an effective and, therefore, valuable mechanism for balancing the interests of ARTC with those of Access Holders.

The benefits of having the RCG process in place can be quantified easily when a comparison is done with other regulatory regimes where this type of industry consultation is absent, for example, in Queensland.

The benefits arising from the RCG engagement process include the following:

- providing the opportunity for Access Holders to seek to ensure that investment in the Hunter Valley Rail Network would align with capacity expansions at the coal terminals at the Port of Newcastle and underpin complementary investment in mine expansions;
- acting to incentivise ARTC to invest efficiently and consistent with the objects of Part IIIA of the CCA; and
- providing for a number of stages where the RCG is asked to endorse a project for it to proceed to the next stage.

8.2 Is the extension of RCG membership to all Access Holders with coal access rights appropriate?

HRATF members may respond to the ACCC individually on this point.

8.3 Will the consultation on maintenance plans, forecast operating costs and reporting of actual costs and operational outcomes through the RCG provide sufficient transparency and understanding of ARTC's costs and performance? If not, are there any actions ARTC could take, or further information that could be provided by ARTC, that may provide sufficient transparency and understanding?

The HRATF welcomes ARTC's proposed amendments in this regard as a step in the right direction towards increased transparency and understanding. However, the HRATF considers that ARTC's proposed amendments do not go far enough and suggests that further amendments are required as:

- these amendments are not a substitute for a clear prudence requirement, especially because under section 9.2(i)(i) ARTC may elect to continue to the next stage of a project development without RCG endorsement and without ACCC endorsement; and
- reporting and metrics around efficiency are not specified, for example, benchmarking and independent assessment.

To achieve an appropriate level of transparency and understanding of ARTC's forecast and actual maintenance costs and maintenance performance efficiency, the consultation processes in section 9 should be amended to address the points above. The HRATF particularly submits that ARTC's maintenance performance efficiency should be measured against appropriate industry benchmarks and assessed annually by an independent expert if a majority of the participants in the RCG deem it appropriate.

Under the amendments sought by the HRATF, the objective of ARTC's Concept Assessment Report should change from being to "enable a preliminary assessment of the potential costs, benefits and risk" (see section 9.4(b)) to instead be to provide users with full details of the assessment and the reasons for it.

The HRATF also considers it desirable that the following amendments be made:

- section 9.2(a) should be amended so that ARTC is obliged to give 10 Business Days' written notice to all RCG members if it considers that an RCG meeting for a particular month is not required; and

- ARTC should not have unilateral discretion to determine whether a monthly meeting occurs. If, having received notice from ARTC that it does not propose to convene a meeting in a particular month, any RCG member disagrees, then that member should have the right to convene the meeting.

Schedule 3 to this submission contains the HRATF's suggested changes to the Capacity Investment Framework and RCG provisions in the proposed 2016 HVAU.

8.4 What would be the effect of adjusting weighting for voting at the RCG from GTK to contracted Train Km?

HRATF members may respond to the ACCC individually on this point.

9 User Funding Option

9.1 Are there any concerns with the 2016 HVAU user-funding provisions?

ARTC has not proposed any material changes to the user funding framework established under section 10 of the 2011 HVAU.

Unlike other regulated utilities, ARTC is not subject to any direct obligation to invest in new and expanded capacity to respond to the needs of current or future Access Holders and Access Seekers. This means that Access Holders and Access Seekers are exposed to the 'hold up' risk associated with monopoly control of the Hunter Valley Rail Network, and means the user funding framework is an important part of the 2016 HVAU.

Coal producers on the East Coast have had experience, on several occasions over the last 15 years, of rail and port infrastructure owners refusing to fund expansions unless miners were prepared to underwrite this investment with rates of return substantially higher than regulated rates, and at times, higher than the internal funding costs of miners themselves.

The principle of user funding is simple: if ARTC is not prepared to fund an expansion of capacity at the regulated rate of return, but existing or new users are prepared to do so, they should be able to.

While the HRATF acknowledges the value in section 10 being retained in the 2016 HVAU, this remains untested and its value is predominantly in establishing the principle that Access Holders and Access Seekers should not be exposed to the risk of a 'capital strike' which prevents access to market-competitive rates of funding for investment in, and expansion of, the network. In practice, the HRATF considers that section 10 in its present form is unlikely to be sufficient to mandate and support user funding of an expansion, in circumstances where ARTC refused to do so or sought to use any lack of capacity to extract higher returns from any expansion project.

The experience of the industry in Queensland negotiating the Standard User Funding Agreement (**SUFA**) process has been that developing and documenting such a framework is complex and time consuming. The SUFA process took several years (including several aborted negotiations) and the final package, currently being assessed by the QCA as part of the UT4 approval process, involves a set of eight pro forma agreements, running to over 600 pages.

A result of the complexity of and transaction costs associated with user funding, it is likely to be feasible only for large, high value expansions. This means that the user funding requirement (even if it was fully implementable) is unlikely to place a meaningful

constraint on the exercise of monopoly pricing power by ARTC in respect of small and medium sized capacity expansions.³¹

Therefore, while the user funding commitment is important, section 10 would be manifestly insufficient if it needed to be relied upon, in its current form. That being said, the HRATF considers it unlikely that there will be substantial demand for expansion over the next five years and so the time and expense associated with developing a fit for purpose user funding framework is not justified, at present.

However, HRATF notes that the user funding provisions are likely to become far more significant in the event of privatisation. A private operator would face heightened incentives to maximise returns from the standalone operation of the Hunter Valley Rail Network, without the same regard as a state-owned ARTC has for the public interest in the form of the wider economic benefit to the state economy which arises from efficient and timely expansion.

It follows that while no further or detailed development of user funding is needed as part of the 2016 HVAU process, it should be one of the provisions that is required to be considered and assessed by the ACCC as part of approving any amendments to the HVAU following privatisation, as discussed at Part 14 of this submission.

9.2 Do the user-funding provisions continue to meet their objectives? If not, please describe how this may be achieved and/or any amendments that may be required.

See above regarding the likely inadequacy of the section 10 process if it were to be required.

The HRATF also observes that there is an asymmetry in the current process to approve investments. Currently, if the RCG gives approval but ARTC vetoes a project, there is no basis to proceed other than through user funding. On the other hand, if the RCG refuses an investment project then ARTC can still proceed by seeking approval through the ACCC.

There needs also to be a clear mechanism for referral of user funding issues and disputes to the ACCC.

10 Efficiency Incentives

Section 2.9 of the Consultation Paper addresses three separate, but related, issues associated with performance measurement and incentives:

- (a) proposed changes to the process for ARTC measurement performance against service level indicators;
- (b) schemes to promote improvements in operating cost efficiency; and
- (c) mechanisms designed to provide ARTC with incentives to innovate, where this has a benefit to other parties in the supply chain.

³¹ While the QCA did not identify a solution to this problem, in the absence of any voluntary commitment to fund smaller expansions, they have identified that it would be appropriate for Aurizon Network to “develop a range of tax efficient financing arrangements for user and third-party financing of small/medium-sized expansions.”

The issue of operating cost efficiency – which the HRATF considers to be the most important of the issues raised in section 2.9 of the Consultation Paper – is dealt with in this Part.

10.2 Introduction – importance of prioritising the efficient operation of the Hunter Valley Rail Network

The current review process provides an important opportunity for the ACCC to lead the development of the 2016 HVAU to align it more closely with Australian regulatory standards, and promote more efficient operation of the Hunter Valley Rail Network through enhanced oversight of ARTC's operating expenditure and the introduction of an appropriate forward-looking efficiency incentive regime.

Promoting more efficient operation of the Hunter Valley Rail Network is clearly important to promoting the objects of Part IIIA of the CCA and ensuring consistency with the pricing principles. A central object of Part IIIA is to promote the economically efficient operation of, use of, and investment in, the infrastructure by which services are provided.³² In a similar vein, the Part IIIA pricing principles state that access pricing regimes should provide incentives to reduce costs or otherwise improve productivity.³³

Also relevant in this regard are the interests of Access Holders and Access Seekers (i.e. current and potential users of the Hunter Valley Rail Network).³⁴ This submission has already outlined, at Part 2.3, the challenging global market conditions facing Hunter Valley coal miners. Australian coal producers have led the world in reducing their extraction/production costs in order to respond to the changed global conditions.

However, reducing the transportation costs associated with supply chain activities requires the cooperation of rail and port operators, and in the case of ARTC, should be supported by an appropriate regulatory framework.

To place this issue in context, as already noted above, the IEA estimates that Free on Board cash cost of Australian coal producers has almost halved over the last three years,³⁵ in circumstances where ARTC's operating costs have **increased approximately 40% to \$140m in 2015**. This would constitute more than **one third of the total annual allowable revenue** and highlights how important and urgent it is that the ACCC address opex efficiency and incentives as a cost driver within the 2016 HVAU.

Within this statutory and commercial context, the HRATF does not consider that the 2016 HVAU is capable of acceptance unless the ACCC can be satisfied that it appropriately provides for an opex efficiency and incentive framework that is transparent, robust and which aligns with good regulatory practice.

10.3 Deficiencies in the current framework

The current operating expenditure assessment / incentive framework (i.e. the framework applied under the 2011 HVAU) is a rudimentary one that evolved out of the NSWRAU. It is not fit for purpose in relation to the Hunter Valley.

³² CCA, s 44AA.

³³ CCA, s 44ZZCA(c).

³⁴ CCA, s 44ZZA(3).

³⁵ IEA 2015 World Energy Outlook, pg 286

The introduction of a Part IIIA undertaking in 2011, however, assumed that the regime operates as a 'voluntary' one and therefore, picking up the limited annual review mechanism in the NSWRAU, there is an emphasis on limited, ex post oversight of tariffs and other processes, rather than the more comprehensive processes that are a feature of more mature regulatory frameworks.

The HRATF is concerned that this framework provides weak oversight of operating expenditure efficiency (and transparency to Access Holders), and does not provide any incentives for ARTC to improve operating efficiency.

(a) ***Lack of transparency around the ex post "annual compliance" review process.***

Currently, the only opportunity to ensure efficiency of ARTC's operating expenditure is through ex post review by the ACCC as part of the annual compliance process.

This can be contrasted with other regulated industries, such as telecommunications and energy, where the regulator conducts an ex ante efficiency review of forecast expenditure as part of a public review and approval process (for a review of opex review mechanisms in other regulated industries, see Schedule 1).³⁶

The HRATF notes that it is likely to be difficult for the ACCC to identify and remove all inefficiencies through the ex post review process, since the ACCC will not have the time and complete information it needs to conduct a thorough and effective efficiency review on an annual basis (i.e. there will be a degree of information asymmetry). For example, the annual compliance process under Schedule H anticipates a 6 months 'end to end' process. This contrasts with the substantially longer and more detailed prudency reviews undertaken in other sectors, where a revealed cost approach is adopted to opex based on 5-yearly forecasts (such as telecommunications, energy and other rail regimes).

The time, information and transparency limitations imposed by an annual process create a significant risk that inefficient costs will be borne by users.

Further, the HRATF is concerned that the current ex post review process lacks sufficient transparency to users and other stakeholders. This lack of transparency increases the risk that some inefficient expenditure may not be properly identified and removed through this process.

Indeed, the current Annual Compliance Assessment process set out in Schedule H to the 2011 HVAU (and which is not proposed to be materially amended in the 2016 HVAU):

- does not provide for the evidence, if any, that is required to be provided to the ACCC to establish prudency of opex (as part of assessing compliance by ARTC with the Ceiling Limit); and

³⁶ For example, under clause 6.5.6 of the National Electricity Rules, the AER conducts an ex ante review of forecast operating expenditure to be included in the building block revenue allowance for a distribution network service provider for each regulatory period (a distribution determination by the AER is predicated on, among other things, the decision on whether to accept the forecast of operating expenditure included in a service provider's proposal, under clause 6.5.6(c) – clause 6.12.1(4)). Similarly, under rule 91 of the National Gas Rules, the AER/ERA conducts an ex ante review of forecast operating expenditure to be included in the calculation of reference tariffs for covered gas pipelines as part of each access arrangement review process.

- there is a broad discretion allowed to ARTC to seek to limit the ACCC's publication of information provided as part of this process. In other processes, confidentiality is tightly constrained so that stakeholders can comment on prudence.

(b) ***No real incentive for ARTC to improve efficiency over time.***

Under the current framework there is little or no incentive for ARTC to seek out operating cost efficiencies and improvements over time. Since there is no ex ante process whereby an efficient benchmark allowance can be set, there is no efficiency target for ARTC to try to achieve or “beat”. Rather, ARTC may recover whatever expenditure it incurs, subject to any disallowance where the ACCC detects inefficiency as part of its ex post review.

The combination of weak incentives and limited ability for the ACCC to address inefficiency means that there is a high risk of inefficient operating costs being borne by users under the current framework.

The current process is also out of step with standard Australian regulatory practice, as demonstrated in Schedule 1.

10.4 ARTC proposal

The HRATF has been working with ARTC on the development of an opex incentive regime. We recognise that implementation of an effective opex incentive regime can deliver benefits for both ARTC and users, and would represent a significant improvement on the current opex assessment / incentive framework, in terms of promoting more efficient operation of the Hunter Valley Rail Network.

The HVAU reflects a shared desire of ARTC and coal producers to develop an effective incentive regime, but as set out in the 2016 HVAU, it currently stops short of specifying a regime to apply from the commencement of the next undertaking period. Rather than specifying an incentive regime, the HVAU includes a commitment by ARTC to prepare an “Efficiency Incentive Proposal” as soon as reasonably practicable after the Commencement Date (and, in any event, within 18 months).³⁷

While the 2016 HVAU also sets out at a high level, some of the features that the Efficiency Incentive Proposal must include, under section 9.3 as proposed, ARTC is not ultimately required to adopt an Efficiency Incentive Proposal. The 2016 HVAU therefore fails to provide coal producers (and other stakeholders) with either (a) a workable, best practice opex framework; or (b) any certainty that any efficiency regime at all will be adopted.

The HRATF had been engaging with ARTC around a relatively limited opex efficiency model, in the context of an overall negotiated ‘package’ of outcomes. This package was ultimately not agreed and the scheme that has been proposed by ARTC is materially different from what was discussed between HRATF and ARTC to date.

While the HRTAF therefore welcomes the commitment made by ARTC in the 2016 HVAU to develop an efficiency incentive regime, the framework and principles as currently proposed in section 9.3 are one-sided and substantially deficient. They do not provide a long term model to drive improved incentives for efficient operation of the Hunter Valley

³⁷ HVAU, cl 9.3.

Rail Network. Indeed, as currently drafted, there is no certainty that any efficiency regime will be introduced at all, or will only be used as a means for ARTC to obtain additional “unregulated” revenues (i.e. outside of the cap).

The HRATF’s key concerns include:

- The scheme envisaged in the 2016 HVAU does not provide any real incentives for ARTC to improve overall operating efficiency over the longer term, since it only provides for application of the incentive regime to “components” of operating expenditure in individual years where ARTC has chosen to “opt in”. Given the ability of ARTC to exclude particular cost components and/or years from the operation of the incentive mechanism, there is significant scope for costs to be shifted between cost components and/or years in order to maximise ARTC’s short term incentive payments, but to the detriment of overall network efficiency.
- As noted above, it is not clear that any efficiency gains will be “locked in” for the benefit of current and future Access Holders. This is for two reasons:
 - first, the framework and principles set out in the 2016 HVAU do not deal with whether, or to what extent, in determining an Opex Component Allowance for any given year, efficiency gains from prior years must be taken into account and form part of the baseline efficient level of expenditure;
 - secondly, given the scope for ARTC to “opt out” in respect of any cost component and/or year, ARTC may effectively decide to take an “efficiency holiday” for a year or more.

There is a real risk that any efficiency gains achieved in one year may not be sustained in subsequent years. This means that over the long term, users may see only very limited benefit from efficiency gains (potentially only 30% of any gain in the year it is achieved, then little or no benefit thereafter).

At worst, the framework could operate to allow ARTC a mechanism to shift costs between components and years in a way that enables it to extract short term but strong incentive payments (of 70%) with no commitment to deliver sustainable, long term savings.

- The mechanism operates in a one-sided way – in that if ARTC spends within the agreed opex cap, its expenditure is deemed to be efficient. However, if it overspends, this is not required to be separately justified – in that it does not give rise to a presumption of inefficiency. This gives ARTC the revenue benefit, but not the discipline of the efficiency requirement.
- Payment of the ‘Efficiency Incentive Charge’ occurs outside of the standard revenue process, rather than as an integrated part of the opex and revenue setting process. Amongst other things, this limits scope for disputing the claimed efficiencies (see clause 5.4A of the proposed AHA).
- The 2016 HVAU does not indicate how (if at all) sharing of benefits would change if ARTC chose to opt out. As noted above, one possibility discussed between the HRATF and ARTC was a tiered benefit structure, under which less of the benefit from any efficiency gain would accrue to ARTC if it chose to opt out then opt back in again. The intention of having a tiered structure would be to provide ARTC with some incentive to remain “opted in”. However the HVAU does not refer to there being a tiered benefit structure as part of a proposed incentive mechanism.
- Under the HVAU framework, the setting of a “baseline” based on an independent efficiency study appears to have limited practical impact. All that is required is that

any Opex Component Allowance be “consistent with the relevant baseline cost and the planned activities to be undertaken in that year”.

- Finally, in addition to the incentive framework, the issue of lack of transparency around the ex post review process remains a concern. This is an important issue given that, wherever the incentive mechanism does not apply (i.e. where ARTC “opts out” in respect of a particular cost component or year), the ex post review process is the only remaining check on the efficiency of ARCT’s operating expenditure. We address this issue in more detail below at Part 10.5.

The following section identifies some options for addressing these concerns.

10.5 Options for strengthening the opex efficiency framework

The HRATF recognises that there is considerable work to be done around the issue of opex and so we have held back from proposing any concrete drafting of either proposal at this stage – but that this should be developed over coming weeks in conjunction with ARTC, the HRATF and other stakeholders.

To be clear, however, the HRATF considers that no change to the opex efficiency framework under the 2016 HVAU is simply not an option. The continued operation of the current ‘light touch’ ex post prudency review is inconsistent with standard regulatory practice and the objective of efficient operation of infrastructure, which is central to the objects and pricing principles for Part IIIA.

The minimum that need to be done as part of the 2016 HVAU process in order to deliver a basic and workable opex framework for the next 5-year period would be the following:

- (a) *Introduce a requirement for ARTC to propose to the ACCC and the RCG a reasonable annual forecast for all expenditure components, linked to “baseline” expenditure.***

In each year, ARTC should be required to put forward, to the RCG, a genuine forecast of efficient operating expenditure for each opex component for the coming year.

It should also be required that the forecast for each component be set to the most recently established baseline, with any changes from the baseline only permitted where it can be established by ARTC that there is a trend or expected step change in an opex component that would justify any deviation. This would reduce the risk that ARTC could effectively opt out for a particular year and/or cost category, simply by not putting forward a genuine forecast linked to baseline expenditure.

The ACCC should publish guidance to assist ARTC and the RCG on the assessment of annual opex forecasts (and its own approach to assessing any ex post requests justifying a departure from forecasts).

- (b) *Expenditure to be capped at the allowance, subject to pass through of unforeseen costs.***

Where an Opex Component Allowance has been forecast and endorsed by the RCG, this should set a cap on efficient expenditure for that year, subject to ARTC demonstrating unforeseen costs that ought to be passed through to users (e.g. costs associated with natural disasters).

This could be given effect to in the 2016 HVAU by creating a presumption, for the purposes of the ACCC’s ex post review, that any expenditure in excess of an Opex Component Allowance is not efficient. This presumption would be rebuttable

where ARTC can show that the excess expenditure was a prudent and efficient response to an unforeseen event. This kind of “pass through” mechanism would deal with material and unforeseen changes in circumstances that drive substantial additional cost. These could potentially be endorsed by the RCG and/or approved by the ACCC through an annual ex post process.

To facilitate this, ARTC and the RCG should also be required to provide copies of all opex forecasts and the RCG assessments to the ACCC.

(c) *Efficiency gains to be locked in and fully passed through to users after 2 years.*

Any incremental efficiency improvements obtained during periods when ARTC has opted into the incentive scheme should be reflected in future, forecast baseline expenditure (and therefore Opex Component Allowances). Given timing (i.e. efficiency gains in Year 1 are not likely to be identified and able to be incorporated into forecasts until Year 3), this will not flow through to prices until two years after the year in which the efficiency is achieved.

The effect of this would be that ARTC “keeps” a 70% share of incremental efficiency gains for a rolling period of two years, after which those gains are then locked in and, from that point, 100% of the benefit is passed through to Access Holders.

The HRATF considers that these changes are the minimum necessary to ensure that any efficiency incentive scheme that is developed can be effective in promoting the efficient operation of the Hunter Valley Network, and passing through the benefits of greater efficiency to users over time.

While this process would occur over a shorter timescale than other ‘revealed cost’ opex frameworks that typically operate over a full 5-year regulatory cycle, it would have a similar benefit of revealing trends in opex over a period of time. It would also improve transparency and provide similar (and strong) incentives for ARTC to maintain and improve efficiencies.

10.6 Improvements to the annual compliance process

Under the proposed model, the annual compliance process would play a more important and transparent role in testing any departures from forecast opex each year (as well as governing other aspects of the roll forward and TUT processes).

To facilitate this important expansion of the process, the following changes would be required:

- (a) **Information to be specified.** To the extent that it deals with the ACCC assessing prudence of opex, neither section 4.10 nor Schedule H currently provides clarity around the information which is required by the ACCC to assess prudence. The information made available to stakeholders, including Access Holders, by both ARTC and the ACCC is also limited, subject to confidentiality claims by ARTC that go beyond what is typical of regulatory process.

ARTC should be required to provide a comprehensive opex forecast (with supporting evidence) for each year to the RCG and this should be the same forecast provided to the ACCC.

Consistent with the approach in other utility regimes, such as energy or telecommunications, claims for confidentiality over ARTC information should be limited. There should be a presumption incorporated into clause 4 of Schedule H

that all ARTC opex and prudency information is suitable for disclosure to Access Holders. If necessary, an appropriate and 'standing' confidentiality regime could be put in place to manage this issue.

- (b) **Endorsement by the RCG.** As noted under Option 1 above, the ex post process needs to be amended to provide for the endorsement of annual opex forecasts by the RCG, which would then support a presumption of Efficiency as part of the annual compliance review (if expenditure was at or below the forecast). Equally, if performance is not within the forecast, this will lead to a presumption of inefficiency – unless ARTC can justify any departure.
- (c) **ACCC opex guidelines.** The ACCC approach to assessing prudency as part of the annual compliance review should be set out in guidelines, which are developed in consultation with ARTC and the RCG. The ACCC should adopt a best practice approach to testing prudency, taking into account developments in other sectors and other state rail regimes.

10.7 Innovation Incentives (section 14)

Finally, the HRATF notes that ARTC has incorporated an additional form of 'incentive' associated with innovations that benefit other stakeholders in the coal chain. ARTC indicates that this is intended to provide an incentive for it to pursue investments or changed operating practices, where the benefit is obtained by third parties, and there is not otherwise an incentive under the 2016 HVAU for it to do so.³⁸

In these circumstances, the amendments proposed would allow ARTC to seek endorsement from the RCG (based on the standard 70% threshold) for the work to be undertaken – in which case a scheme of payments is also agreed, which would exist outside the Ceiling Limit (i.e. it would effectively be unregulated).

In principle, the HRATF welcomes any steps by ARTC to explore improvements in its activities that give rise to benefits for other stakeholders. We also acknowledge that the current regulatory framework does not provide a means for ARTC to share in those benefits in a way that would incentivise it to explore these kinds of activities. Although, it is not immediately apparent why ARTC could not nonetheless explore these types of commercial activities and innovations outside of the HVAU.

Nonetheless, the HRATF would not object to the inclusion of an Innovation Incentive mechanism provided that it remains clear that any incentives around innovation for the benefit of third parties is secondary to the primary obligation on ARTC under the HVAU to continually work to improve efficiency in the operation of the Hunter Valley Rail Network. There should not be any scope for 'cherry picking' by characterising projects that improve efficiency in the operational activities of the network (and which should therefore be rewarded through the opex incentives) as 'innovation projects'.

The HRATF considers that activities such as R&D associated with lowering future operational expenditure within the Hunter Valley Rail Network are not appropriately dealt with outside the regulatory Ceiling Limit (in this regard, we do not agree with the examples proposed by ARTC in section 14.1(b)).

The HRATF proposes the following alternative definition of an Innovation Project, which is based upon the proposed example in section 14.1(b)(iii):

³⁸ Explanatory Guide at page 17-18.

means a project where substantially all of the benefit obtained from the project is external to ARTC and the Network, such that the costs of undertaking the project would not ordinarily be considered Prudent or Efficient.

Where an Access Holder considers that a project falls outside of this definition (for example, if they consider that a project should fall within ordinary opex), this needs to be a matter that can be referred to the ACCC for determination.

The HRATF is also concerned that, as drafted, there does not appear to be any audit or other mechanism for determining that an Innovation Project has been successful and delivered targeted benefits, prior to payment being required – although we accept that this may be a matter that is dealt with in each individual Innovation Proposal.

10.8 Responses to ACCC consultation questions

Is the proposed structure for developing the Efficiency Incentive Proposal appropriate?

No – the proposed ‘Efficiency Incentive Proposal’ is deficient in a number of important respects. Refer to Part 10.4 above. Options for addressing this issue are set out in Part 10.5 above.

Is the proposed frequency for Efficiency Studies in section 9.3(vii) appropriate?

Yes, the proposed frequency for Efficiency Studies (i.e. around each Review Date) is appropriate. However, as discussed in Part 10.4 above, the HRATF has concerns regarding the practical impact of the Efficiency Study (and the resulting “baseline”), under the proposed 2016 HVAU. Options for addressing this issue are set out in Part 10.5 above.

11 Performance measures

The HRATF considers that the performance indicators provided by ARTC are of limited value in isolation – given that the interests of Access Holders (and other stakeholders) are focussed on the effective operation of the Coal Chain.

To this end, the more important focus of performance reporting and information is ensuring that ARTC continues to facilitate the Coal Chain reporting which is undertaken by the HVCCC.

12 True Up Test / Liability Regime

12.1 Has the TUT process proven effective as a liability regime? Why / why not?

The HRATF is not aware of any TUT rebates being paid since the scheme was introduced in 2011. Far from demonstrating that there has been no material loss of capacity caused by ARTC over the period, the HRATF submits that this simply highlights that it is complex, lacks transparency and simply does not function effectively.

The TUT process has not proven effective as a liability regime for reasons unrelated to the liability outcomes determined by the ACCC. First, as the ACCC has recognised in its Consultation Paper, while the TUT is an innovative feature of the existing HVAU, its operation is extremely complex and has lacked sufficient transparency.

Secondly, as the ACCC has determined that ARTC has not been liable for any rebates in any of the 2011, 2012 or 2013 calendar years, the HRATF is concerned that the TUT has been designed to only operate in extreme circumstances and limit ARTC's liability as a consequence.

12.2 Is the structure of the auditing mechanism appropriate?

While the auditing mechanism appears appropriate, the complexity and lack of transparency around the TUT itself means that this is of limited value.

12.3 Is a TUT review mechanism required?

Yes. A review of the TUT mechanism is appropriate.

12.4 Are the transitional arrangements, as they apply to the TUT, appropriate?

The HRATF does not oppose the proposed transitional arrangements for the TUT.

12.5 Is the relationship between the TUT and the financial model transparent?

No, however, path based pricing may improve transparency compared to the current pricing mechanism and so this should be an item for review.

13 Indicative Access Holder Agreement / Operator Sub-Agreement

As noted above, the HRATF considers that changes are likely to be required to the AHA to reflect the following::

- As noted in Part 3, the AHA needs to include a trigger to incorporate relevant pricing provisions from the 2016 HVAU in the event of the HVAU expiring or terminating, including in the course of any privatisation.
- Amendments are required in order to incorporate incentive mechanisms (both the Operational Efficiency Incentive Scheme and Innovation Incentive) – and the existing drafting needs to be amended to reflect the comments set out above. The current drafting in the AHA in relation to incentive payments is not acceptable.

In the circumstances, the HRATF considers that it is premature to provide proposed drafting amendments to the AHA until the matters above have been better developed, in consultation with ARTC and the ACCC.

Finally, the HRATF notes that ARTC has proposed amendments to the AHA to remove flexibility which currently exists in relation to the nominated terminal (between PWCS and NCIG). This is not a matter on which the HRATF hold a common position and members will respond individually to the ACCC on this issue.

14 Potential privatisation

The federal government is presently undertaking a Scoping Study in relation to the potential privatisation of ARTC, which is expected to report prior to the May budget. The prospect of privatisation of ARTC is both real and imminent.

At the time of accepting the 2011 HVAU, the ACCC noted that the HVAU needs to *provide an appropriately clear and certain framework for the regulation of the Hunter Valley rail network.*³⁹ For the 2016 HVAU to continue to satisfy this requirement in the current context, which includes the likelihood of privatisation of ARTC during the next regulatory period, it needs to expressly and appropriately address two potential alternative privatisation scenarios:

- a change in control of ARTC through a share sale process; and
- an 'asset sale' involving the transfer of the lease for the Hunter Valley Rail Network to an entity other than ARTC.

The 2016 HVAU does not currently deal at all with the first scenario but ARTC has included a new section 2.2(c), which appears intended to respond to the risk of the second scenario (i.e. an asset sale). Section 2.2(c) relevantly provides:

If during the Term the lease for the Network is transferred or granted to an entity other than ARTC:

- ARTC may by written notice to the ACCC withdraw this Undertaking; and*
- if the notice in paragraph (i) is given, ARTC must at the same time as issuing a withdrawal notice use best endeavours to procure that the lessee of the Network given an undertaking to the ACCC on the same terms of this Undertaking.*

The ACCC will approve a withdrawal of this Undertaking and submission of a new undertaking which complies with section 2.2(c)(ii) above.

For the reasons set out below, the HRATF has serious concerns about the intent and the operation of section 2.2(c) – including whether it is legally valid. The HRATF notes that particular HRATF members intend to make further specific submissions in relation to the operation of the proposed section 2.2(c) and other matters the subject of this Part 14.

The HRATF's concerns include:

- There is currently no prohibition against vertical integration (including any change in ownership or business operations that would result in a synthetic vertical integration) of the Hunter Valley Rail Network by a future owner. The HRATF suggests this could be overcome by incorporating relevant provisions in enabling sale legislation and agreements, or by reflecting this in amendments to the Hunter Valley Rail Network lease.
- The section does not address a change of control of ARTC through a share sale – were this to occur, it should trigger a requirement for the ACCC to assess what changes may be required to the 2016 HVAU (discussed further below).
- ARTC is required only to use its 'best endeavours' to procure that the buyer of the ARTC assets submits a replacement HVAU – which simply highlights the lack of certainty that Access Holders have about the future of the 2016 HVAU (given that if the asset transfer is effected through a statutory novation process as has occurred in state privatisation processes, ARTC may have very limited commercial leverage to procure any commitment from the new lessee). The HRATF submits that it

³⁹ ACCC, *Decision in relation to Australian Rail Track Corporation's Hunter Valley Rail Network Undertaking*, 29 June 2011, p 5.

should be mandatory under the 2016 HVAU for ARTC to procure that any future lessee of the Hunter Valley Rail Network gives an access undertaking to the ACCC on substantially the same terms as the 2016 HVAU (with appropriate mechanics for WACC adjustments), as a condition to the implementation of any change of control in the entity holding the Hunter Valley Rail Network lease or the transfer of the Hunter Valley Rail Network lease.

- The timing of any withdrawal and the approval of any new HVAU is not made clear.
- The section purports to exclude the operation of s 44ZZA by preventing the ACCC from exercising any discretion in respect of its acceptance of the new HVAU lodged by the buyer, provided it is in the same terms as the 2016 HVAU. This is despite the fact that, as discussed below, there are a number of provisions of the 2016 HVAU that are likely to require amendment to reflect private ownership – whether or not vertically integrated. This is also likely to be a legally impermissible fettering of the ACCC's discretion under s 44ZZA.

14.2 Under the current terms of the 2016 HVAU, in what circumstances would a change in ARTC's ownership cause concerns? What are the specific issues that are likely to arise?

Under the current terms of the proposed 2016 HVAU, any change in ARTC's ownership would cause concerns for the HRATF.

As already noted above, in Part 2, any privatisation of ARTC (whether through a share or asset transaction) would materially change the incentives of a new operator and, depending upon its structure, may also provide it with an incentive and ability to distort competition in related markets. Even if the new owner has no other interests in related markets, privatisation is likely to intensify its incentives to engage in profit maximising behaviour in respect of the "standalone" operation of the Hunter Valley Rail Network – leading to a heightened risk of monopoly pricing and 'hold up' behaviour, and is likely to see it give less regard to the public interest in the health and efficient expansion of the coal sector in NSW.

In the event that a buyer holds other related interests, and especially vertically integrated interests, the new owner may also have the incentive and ability engage in discriminatory conduct or to otherwise take advantage of its position to favour the competitive position of related businesses. The nature of these concerns was well canvassed recently by the ACCC in the Statement of Issues issued in the Brookfield/Asciano transaction on 15 October 2015.⁴⁰

The terms of the 2016 HVAU fail to adequately address these issues because:

- (a) The 2016 HVAU is voluntary and therefore may not be renewed by a new owner. This risk can be mitigated, to some extent, by adopting the proposed changes outlined above in Part 3 of this submission.
- (b) The proposed 2016 HVAU does not provide for any change to be made to the 2016 HVAU to reflect the different incentives associated with a private owner. To the contrary, section 2.2(c) would appear to limit the ACCC from being able to require variations to be made to the 2016 HVAU to address the new incentives associated with private ownership.

⁴⁰ ACCC, Statement of Issues, Brookfield consortium – proposed acquisition of Asciano Limited, 15 October 2015.

- (c) The operation of section 2.2(c) of the 2016 HVAU is otherwise inadequate and gives rise to a number of specific concerns, discussed above.

Section 1.1(c) of the Preamble to the 2016 HVAU (and also the 2011 HVAU) makes clear that the undertaking has been developed and approved by the ACCC on the basis that ARTC is a vertically separated provider of access.

14.3 The 2016 HVAU needs to explicitly deal with the prospect of privatisation and what amendments may be necessary

Other than section 2.2, the 2016 HVAU is silent in relation to the prospect of the future privatisation of ARTC. This is simply not sufficient.

The HRATF considers that the risks associated with privatisation, discussed above, mean that the 2016 HVAU must expressly address the potential for privatisation – either through a share or asset sale process. While the HRATF is prepared to constructively engage with ARTC and the ACCC around what amendments and processes would be most appropriate to build into the 2016 HVAU in this regard, we submit that any amendments and processes (as applicable) should to provide for the following, at a minimum:

- The ACCC should undertake a process of public engagement with the new owner, Access Holders and other stakeholders about the implications of privatisation for ARTC and the operation of the Hunter Valley Rail Network (including the identity and other business activities of the buyer).
- Without limitation, the ACCC needs to seek input on those provisions that are likely to require amendment, including:
 - the term of the HVAU should be assessed to ensure that it provides appropriate regulatory certainty and avoids the potential for future ‘gaming’ by the new owner;
 - the introduction of ring fencing and non-discrimination obligations, in the event that a buyer (or its related entities) holds any vertical or conglomerate interests;
 - enhanced user funding, access conditions or other provisions dealing with the future efficient funding of capital expansions;
 - the implementation of a full and best practice regime for ensuring the efficiency of opex;
 - accounting and other transparency measures to limit or prevent cost-shifting, related party transactions or other inefficient pricing practices;
 - provision is made to ensure that all existing AHAs must be secure; and
 - the new buyer continues to be required to participate actively in coal chain activities, including working closely with the HVCCC on capital planning and operational activities.
- The ACCC should publish a determination setting out those changes that are required to be made to the 2016 HVAU, which must be adopted and implemented by the buyer in a variation submitted to the ACCC. If necessary, the ACCC may consider making compliance with this process a condition of any competition clearance under s 50 of the CCA.

14.4 Should the 2016 HVAU be amended to deal with these matters? What could these provisions look like?

The HRATF does not consider that it is reasonable or practical to develop detailed drafting for provisions in respect of each of the matters above prior to privatisation. Indeed, in many cases, the identity of any private operator will influence the appropriate approach.

However, the process for addressing these issues post-privatisation and ensuring that the 2016 HVAU provides the ACCC with the necessary power to consider and direct relevant amendments in the event of privatisation need to be incorporated now.

In Schedule 3, the HRATF puts forward drafting changes to the proposed 2016 HVAU that address the points above.

14.5 Are there other legislative or regulatory mechanisms that would alleviate these concerns (for example, section 50 of the Act)? Please give reasons why or why not.

The HRATF considers that there are no other legislative or regulatory mechanisms that would alleviate the concerns set out above. Those concerns relate to the terms and conditions of access to an essential facility and Part IIIA is clearly the mechanism by which these concerns were intended to be addressed.

As the ACCC is aware, it is not the purpose of section 50 to deal with these concerns, even if an undertaking is given under s 87B of the CCA. The purpose of section 50 of the CCA is to prohibit mergers and acquisitions that substantially lessen competition in a market. This is not what concerns the HRATF.

The ACCC and Government should, therefore, not permit any attempt by the new owner of ARTC to circumvent the operation of the access undertaking provisions in Division 6 of Part IIIA through sections 50 and 87B of the CCA.

The HRATF believes that the most appropriate process for privatisation is a dual-track process under section 50 and Division 6 of Part IIIA. Under this approach the timeframe for the Part IIIA process would be set so as not to delay the section 50 process.

15 Expiry of the 2011 HVAU before acceptance of the 2016 HVAU

15.1 Should the term of the 2011 HVAU be extended until the 2016 HVAU is accepted by the ACCC? Are there alternative approaches that would provide sufficient certainty for industry?

The HRATF agrees that it is appropriate to consider the possibility that the start of the 2016 HVAU may be delayed, in order to allow sufficient time for the 2016 HVAU to be properly developed.

If more time is needed, an extension of the 2011 HVAU (modified to update the relevant cost of capital, as discussed below) is the most appropriate way to provide certainty for industry during the transition. It is not practical to allow the 2011 HVAU to expire, as this is likely to give rise to commercial uncertainty and disruption under AHAs and in relation to capital planning, coal chain coordination and revenue related process, all of which are governed by the existing HVAU.

However, it is not appropriate for any extension to simply continue pricing under the 2011 HVAU, when it is clear (including from ARTC's own submission) that the market linked WACC parameters have changed significantly since 2011 and need to be updated.

15.2 If the 2011 HVAU is extended, should the current rate of return continue to apply? Alternatively, should an alternative rate of return apply, and a reconciliation process conducted once a final figure is settled on in the 2016 HVAU? What mechanism could be used to conduct this reconciliation?

In the event the approval and commencement of the 2016 HVAU is delayed beyond 1 July 2016, the HRATF would accept the use of the WACC value submitted by ARTC with its 2016 HVAU proposal, as an interim solution until the 2016 HVAU is finalised. A reconciliation process would then need to occur once the final WACC outcome has been determined by the ACCC.

Alternatively, if the HRATF and ARTC reach agreement on a WACC and WAML value before 1 July 2016, then the 2011 HVAU should be varied to reflect those changes from 1 July 2016 until the 2016 HVAU commences.

16 Final 2011 HVAU Compliance Assessment

16.1 Is the proposed approach to the final annual compliance assessment under the 2011 HVAU appropriate?

Section 15.1 of the 2016 HVAU outlines the provisions for the final annual compliance assessment under the 2011 HVAU. As annual compliance is conducted on a calendar year basis, the 2016 HVAU proposes that the ACCC conduct a compliance assessment for the Transitional Period.

Under section 15.1(a) ARTC will submit documentation to the ACCC for the purposes of the annual compliance assessment, taking into account:

- revenue received in the Transitional Period;
- capital expenditure during the Transitional Period; and
- a pro-rata adjustment to CPI and depreciation.

Taking the Transitional Period into consideration, section 15.1(b) proposes that the ACCC will determine whether ARTC has complied with the 2011 HVAU in relation to:

- the provisions in section 4.4 (the RAB);
- the applicable Ceiling Limit, including the calculation of the total unders and overs amount; and
- incurring efficient costs and operating expenditure.

The HRATF does not oppose the proposed approach to the final annual compliance assessment under the 2011 HVAU. However, the HRATF considers the annual compliance assessment provisions in the proposed HVAU should be amended to:

- require ARTC to respond to an ACCC information request by a date specified by the ACCC rather than “as soon as practicable”;
- expressly allow the ACCC to request information from stakeholders and not just invite comments from them; and
- require the ACCC to publish a draft of its determination and invite comments from stakeholders by a specified date.

Schedule 1 Comparison of Australian regulatory approaches to assessing operating expenditure

Sector / regulated entities	Regulator	Form of regulation	Timescale of forecasts required	Requirements for opex proposal?	Forecasting approach	Regulator's decision-making criteria?	Efficiency incentives?	Pass through mechanism / reopener?
ARTC – 2016 HVAU	ACCC	Ex post	Annual	✗ Not specified	✗ None	✗ Not specified	✗ None	Not relevant (ex post)
Electricity – distribution and transmission network service providers (NSP)	Australian Energy Regulator (AER)	Ex-ante	5 year forecasts of opex	✓ National Electricity Rules and AER expenditure guidelines set out requirements for opex proposal	✓ “Base-step-trend” approach. AER relies upon benchmark reporting and other tools – e.g. modelling, trend and cost-benefit analyses	✓ Whether opex is compliant with against specific opex objectives, opex criteria and factors specified in the NER.	✓ General ex-ante regulation efficiency incentives – plus, specific incentive mechanisms in the form of carry-over of efficiency gain/loss allowances in subsequent regulatory control period.	✓ Tariff/revenue variation to enable pass through of expenditure for defined pass through events in the regulatory year the event occur such as “regulatory change event”, “service standard event”, “tax change event” etc.
Telco – Telstra’s declared fixed line services	ACCC	Ex-ante	4 year forecasts of opex	✓ Requirements for opex proposal informed by formal information request in accordance with Building Block Model Record Keeping Rule.	✓ “Base-step-trend” approach. ACCC’s methodology involves top down and bottom analyses, modelling and some benchmarking tests.	✓ Whether opex is prudent and efficient in accordance with opex fixed principles set out in ACCC determinations.	✓ General ex-ante regulation incentives (i.e. Telstra is entitled to retain any costs within the efficient forecasts).	✗ No cost pass through / reopener mechanism.
Aurizon (UT4)	Queensland Competition Authority (QCA)	Ex-ante	4 year forecasts of opex	✗ No explicit requirements in respect of preparing opex proposal. Aurizon prepares forecasts for purposes of determining allowable revenue and tariffs to be included in access undertakings.	✓ “Base-step-trend” approach. QCA uses historical cost and efficiency benchmarking and trend analysis.	✓ QCA assesses undertakings against factors set out in s 138(2) of the QCA Act, including the pricing principles which provide for recovery of “efficient costs”.	✓ As above.	✓ Proposed undertaking includes reference tariff variation mechanism for certain events. Similar to approach under the NER above.
Water – NSW water utilities	Independent Pricing and Regulatory Tribunal (IPART)	Ex-ante	3-5 year forecasts of opex. (regulatory periods may vary)	✓ IPART publishes guidelines for required contents of a pricing submission incl. specific requirements for opex proposal.	✓ “Base-step-trend” approach. IPART uses mix of analytical tools incl. review of historical expenditure, benchmarking analysis and variance analysis.	✓ IPART assesses whether opex is prudent and efficient in accordance with high level principles set out in s 15 of the IPART Act.	✓ General ex-ante regulation efficiency incentives – plus, IPART may set opex efficiency targets as part of price review process.	✓ Precedent for IPART approval of cost pass-through mechanisms where additional costs of supply from alternative water source may be automatically passed through to customers.

Schedule 2 Castalia cost of capital report

See attached

Schedule 3 2016 HVAU – with HRATF proposed amendments

See attached

Schedule 4 HRATF calculation of remaining mine life for 2016 HVAU

Using the step by step process to re-calculate RML for the upcoming 2016 HVAU, would result in an average RML of 22 years. Marketable reserves and production estimated were derived almost exclusively from the 2014 NSW Coal Industry report. We have detail production rates and reserves data for each mine including for prospective mines in the table below.

As indicated above, please note that there are two coal producers that may separately submit to the ACCC that a different WAML should be adopted for Pricing Zone 3.

Table S5.1: Summary of calculation

Pricing Zone	Wt Mine Life 2014	Wt Mine Life 2016 Adjusted
All Regions (Average)	23.8	21.8 (22 rounded)

Table S5.1: Production and reserve data used to derive the 2014 weighted RML

Mine	2014 Reported Production	2014 Proved & Probable Marketable Reserves ⁴¹	Remaining Mine Life
Region 1			
Abel	1.6	37.8	23.0
Ashton	3.3	19.6	6.0
Austar	1.6	37.8	23.0
Bengalla	10.7	120	11.2
Bloomfield	1.1	10.2	9.4
Bulga Complex	17.5	231.9	13.3
Drayton	5.2	5.1	1.0
Duralie & Stratford	3.2	34.6	10.9
Glendell	4.0	22.6	5.7
Hunter Valley Operations	17.7	227	12.9
Integra	3.0	44.3	14.9
Liddell	6.9	33.9	4.9
Mount Arthur	25.1	837	33.3
Mount Thorley	18.8	255	13.6
Mt Owen	10.2	57.7	5.7
Muswellbrook	1.4	10.66	7.7

⁴¹ For prospective mines, some industry data used when information was not found in the NSW Coal Industry Report

Mine	2014 Reported Production	2014 Proved & Probable Marketable Reserves ⁴¹	Remaining Mine Life
Ravensworth East	0.9	5.1	5.7
Ravensworth Narama & North	9.9	177.8	18.0
Rixs Creek	2.9	24	8.3
Wambo	9.8	107.2	10.9
Mount Pleasant (Prospective)		326	30
West Muswellbrook (Prospective)		186	30
Region 2			
Mangoola	11.3	107	9.5
Moolarben	8.5	239.2	28.0
Ulan	8.0	171	21.4
Wilpingjong	17.3	150.9	8.7
Bylong (Prospective)		127	30
Region 3			
Boggabri	5.3	137	25.8
Maules Creek	13.0	350	26.9
Narrabri	5.7	208	36.7
Rocglen (Belmont)	1.3	4.4	3.3
Tarrawonga	2.2	41	18.6
Werris Creek	2.4	18	7.5
Caroona (Prospective)		300	30
Vickery (Prospective)		180	30
Watermark (Prospective)		100	30