Hunter Rail Access Taskforce – submission with response to further ACCC questions

20 February 2017

HRATF notes that this supplementary response is not supported by one of its members.

1. Further reasoning for the HRATF's support of ARTC's proposal to use contracted commitments as the basis of allocation of incremental capital costs.

Producers support the fundamental principle that capital costs (including Incremental Capital) of ARTC providing each Access Holder's Contracted Capacity should be recovered by ARTC through take or pay charges.

Producers believe that it is important to draw a conceptual distinction between the calculation of the Incremental Costs for the purposes of the calculation of the floor and ceiling prices, and the setting of take-or-pay charges. There may be confusion because references to "variable cost" may arise in two different contexts with two different meanings.

Following the ACCC's review, producers accept that the relevant incremental (variable) costs for the calculation of the floor and ceiling charges should be based on the long-term analysis of Incremental Costs (i.e. those that are avoidable over the long run), which includes incremental (variable) capital. In other words, to decide, for example, how much contribution users from Zones 2 and 3 must make to the costs of Zone 1, it is appropriate to consider the total additional cost imposed by those users. Clearly, the demand for capacity from such users will require commitment of additional capital, which needs to be recognised in the incremental cost.

The calculation of the floor and ceiling prices determines how the total costs incurred by the ARTC on the Hunter Valley network are to be efficiently shared between users (this method of *cost* allocation also should not be confused with the separate issue of *revenue* allocation). However, the methodology for the allocation of costs **among users** should not be confused with the efficient allocation of risks between users and ARTC.

The efficient allocation of risks between users and ARTC requires:

- The recovery of capital costs incurred in achieving the necessary level of capacity on the network through capacity (take-or-pay) charges.
- The recovery of short-term variable costs through variable charges.

Such a pricing structure will create incentives for efficient behaviour because:

- It would ensure that users only contract for the capacity they require.
- Users face the variable costs associated with their actual utilisation of that capacity.

If variable charges were to include some capital costs (that is, if the take-or-pay charges did not fully recover the cost of capital already sunk to create the available capacity), users would have an incentive to contract for more capacity than they need, thus prompting ARTC to invest inefficiently in excess capacity in response to user demand. This would happen because under such a pricing regime, users would benefit from the additional certainly offered by the contracted capacity, but would be able to avoid the full costs of carrying excess capacity.

This highlights the risk of confusing the principles of efficient cost allocation and of efficient pricing. If the incremental capital costs of creating additional capacity in Zone 1 for the use of Zone 3 customers were to be recovered through variable charges, Zone 3 customers would have an incentive to contract for excess capacity in Zone 1 knowing that they would only have to pay for what they use. This will lead to excessive and inefficient investment.

Coal producers wish to ensure that the allocation of risks between take-or-pay and variable charges drives efficient behaviours in the sector. All users benefit if no user has an incentive to under- or over-contract. Such incentives are achieved if all capital costs and fixed maintenance cost of the required capacity on the system are recovered through capacity charges—the take-or-pay portion—while costs that are genuinely variable in the short term are recovered through variable charges. Since the majority of costs on the rail network are fixed for any given level of capacity, coal producers expect that most cost recovery will occur through take-or-pay.

The same desire to drive efficient behaviours underpins users' preference for basing the allocation of incremental cost on contracted rather than actual utilisation (GTKs). Cost allocation **among users** affects efficiency to the extent that it influences ARTC's investment behaviour. Since ARTC only invests in incremental capacity on the basis of long-term contracts with users, it is the decisions about how much capacity to contract for rather than decisions about how much to use at any one time that drive investment.

Capital investments are irreversible (i.e. sunk). If ARTC invests to accommodate the incremental contracted capacity required by a user, it cannot undo that investment if that user chooses to utilise only a portion of the capacity. This would inappropriately shift the cost of any 'under-utilised' capacity to the other users. Hence, if the incremental cost for the purpose of the calculation of the floor and ceiling prices were based on actual usage, all other users would be left paying for the incremental capital investment caused by but not currently utilised by, a user, even though those paying users have no need of that investment.

If cost allocation were not based on the contracted volumes, each user would have an incentive to over-contract. Individually, a user would benefit by getting ARTC to invest in capacity which they could potentially need, but which for now would be paid by all other users. However, collectively, users will be worse off as they would be paying for excess capacity. This means that users who only contract for the necessary capacity would be forced to cross-subsidise those who over-contract.

There is also a risk that relying upon actual usage-based tariffs to pay for capital investment may impact upon the 'bankability' of some larger projects for ARTC. In the past, a long term revenue stream associated with future take or pay commitments has been a source of comfort for ARTC funding the capital cost of major expansions.

2. HRATF understanding of how contracted commitments are used to allocate incremental capital costs and how this allocation changes with using actual usage?

As noted in our primary submission, HRATF has little visibility of the impact of the change from contracted to actual usage – and how sensitive this is to changes in circumstances. The annual compliance process has largely operated as a "black box" under the 2011 HVAU. ARTC has provided very limited transparency in regards to pricing outside the annual compliance process.

One of the requests made in our primary submission was that, in reworking the drafting of the current 'floor and ceiling' provisions, ARTC be required by the ACCC to provide worked modelling and data that we can use (in consultation with our own experts) to better understand the operation of the annual compliance process.

Based on the information provided by ARTC to industry, we understand that the move from using actual to contracted as the allocator results in a change from a historical average of approximately 85-90% of Zone 1 access charges being constituted by TOP charges, to only approximately 50% of the Pricing Zone 1 access charges being TOP.

See slide 6 of the attached pack provided to industry by ARTC to explain its intended implementation of the framework in the 2017 HVAU.

3. HRATF understanding of the cost drivers for incremental capital costs

Apart from the 2013 Compliance Assessment Report, HRATF has no visibility of incremental capital costs. Producers are still awaiting the final determination of the 2014 Compliance Assessment, which we would expect to reinforce and illustrate the application of the 2013 Compliance Assessment principles, taking into consideration the submissions by a number of producers that expressed disagreement (and have provided justification) with the use of actual GTK rather than contracted GTKs as an allocator.

HRATF believes the principle that should be followed in the HVAU is that all capital costs should be recovered by ARTC through the take or pay commitments of each producer.

One potentially perverse consequence of using a producer's actual usage rather than contracted usage for the purpose of determining capital cost allocation, is the potential for this to undermine the Rail Capacity Group **(RCG)** process regarding the endorsement of capital projects. The RCG process would mean it is possible for an Access Holder to endorse an infrastructure project whilst having no need for the additional capacity and having no financial accountability for the decision, due to that producer not currently utilising its contracted capacity. At the same time, an Access Holder who has no requirement of an infrastructure project successfully endorsed could end up funding a significant portion of the project because they are fully utilising its full contracted capacity. Fundamental to the endorsement of projects at the RCG is contracted GTK's coupled with financial accountability, and this has been the case to date on all capital projects (during the 2011 HVAU). Changes to this process therefore risk undermining the fairness of the operation of the RCG voting process for future capital projects.

Put simply, over contracted Access Holders, who do not use capacity, should not be subsidised through the non-TOP component paid by those who are efficiently utilising their contracted capacity.

4. HRATF understanding of how allocating incremental capital cost using actual usage leads to a lower share of Take-Or-Pay charges in total access charges?

HRATF understand from ARTC that any costs that are allocated based on actual usage are classified as variable and therefore are not included in the take or pay charges. Therefore the reallocation of incremental costs based on actual usage had the effect of reducing the proportion of total costs recovered through take or pay tariffs.

Our understanding of the change in allocation reflected in the 2013 decision is as set out below in a note provided by ARTC to the HRATF.

> *The effect of the 2013 compliance determination was to require an incremental cost methodology in Pricing Zone 1, with incremental costs (including incremental capital costs) being allocated on the basis of actual volumes within the year (and therefore variable in nature). As a consequence, the relativity between the TOP and Non-TOP components of the access charges has changed in Pricing Zone 1. The TOP charge has historically been in the order of 85-90% of the access charges, however pricing reflecting the outcome of the 2013 compliance decisions has resulted in the TOP charge reducing*

to approximately 50% of the Pricing Zone 1 access charges. Access Holders are now exposed to volume reductions of other Access Holders which leads to a high degree of price uncertainty through the unders and overs process. Access Holders who are utilising train paths in accordance with their contractual commitments will fund the incremental capital costs of Access Holders who are not utilising their contracted train paths, notwithstanding they may have triggered the need for the capital investment.

5. Rationale for coal producers paying a larger share of their access charges through Take-Or-Pay?

As noted in response to question one, the recovery of capital costs (both fixed and incremental) through TOP charges reflects that the capital cost of the network is underwritten by long term, TOP commitments. This provides a higher degree of certainty and predictability for users and ensures that producers are incentivised to contract for capacity only to the extent that they are likely to use that capacity.

This approach is consistent with other parts of the Hunter Valley supply chain. For example, the coal terminals at PWCS and NCIG operate on a 100% take or pay basis. This approach was also the foundation of the Capacity Framework (2010) for the entire Hunter Valley Coal Chain.

6. HRATF understanding of the 'dual ceiling limit'

At present, the approach adopted by ARTC to implementing the 'dual ceiling limit' in the 2017 HVAU is unclear and, we submit, unworkable.

Conceptually, we understand that it is intended that the Ceiling Limit for Zones 1 and 2 would be reduced by the Incremental Costs associated with Zone 3 producers. This appears to be what was intended by amendments made to the definition of "Standalone Cost". These costs would then be recovered separately from Zone 3 producers either through incorporating them into the Zone 3 Ceiling Limit, or by creating an alternative basis for recovery. This should mean that access charges for Zone 1 and 2 producers do not include any Incremental Costs associated with Zone 3 usage. In effect, for the purpose of allocating these costs, there would become two Ceiling Limits – one comprising Zone 1 and 2 producers, and the other comprising Zone 3 costs, together with the Zone 1-2 Incremental Costs of Zone 3 users.

Unfortunately, it is unclear how the 2017 HVAU is intended to operate in this regard. As noted in our primary submission:

- definitions used in relation to increment cost should be clarified, to provide greater certainty and consistency around how they will be calculated;
- the amendments made to the definition of "Standalone Basis" appear intended to remove Zone 3 Incremental Costs from the Zone 1 and 2 Ceiling Limit – however, clause 4.3 then contemplates the allocation of revenues from Zone 3 to the Zone 1 and 2 Ceiling Limit (i.e. costs and revenues are not aligned);
- there is no change made to the approach to determining the Zone 3 Ceiling Limit – so it is not clear how the Incremental Costs removed form Zones 1 and 2 are intended to then be recovered;
- ARTC proposes to carve out of the Ceiling Limit any costs comprised within the Floor Limit – which would appear to have the effect of allowing ARTC to recover **more** than the standalone cost of a Segment or Segments; and

- there is no process for verifying that Ceiling Limits have been complied with across groups of Access Holders.

As noted in our submission, the HRATF would welcome the opportunity to work with ARTC on refining its approach to implementing the relevant allocation principles.