

Hunter Valley Coal Network Access Undertaking

Further Submission for ARTC's 2021 Compliance Assessment

October 2023

ARTC



Table of Contents

| | | |
|-----|--|---|
| 1 | Introduction | 3 |
| 2 | HRATF Submission..... | 3 |
| 2.1 | Increased transparency by ARTC | 3 |
| 2.2 | Corporate overheads and business unit management costs | 4 |
| 2.3 | Network Control | 6 |
| 2.4 | Maintaining and improving service levels | 7 |
| | APPENDIX A..... | 8 |

1 Introduction

ARTC provides this further submission relating to the 2021 Compliance Assessment in response to matters raised in a submission by the Hunter Rail Access Task Force (HRATF).

ARTC notes that in addition to this submission, that it has engaged directly with the Rail Capacity Group (RCG) (which included all HRATF members) and in other appropriate forums on matters raised in HRATF's submission and provided further information to Customers and Rail Haulage Providers on a confidential basis. Copies of these presentations have also been provided to the Australian Competition and Consumer Commission (ACCC) as part of the compliance assessment process.

2 HRATF Submission

2.1 Increased transparency by ARTC

ARTC values HRATF's recognition of ARTC's continued efforts towards enhancing transparency and engagement with stakeholders regarding its operations, financial models and compliance process. ARTC has conducted extensive workshops and continued information sharing initiatives over several years and the positive response subsequently received from HRATF is indicative that this ongoing service delivery is of continuing value to our Customers and in line with ARTC's ongoing commitment to increased transparency with industry participants.

ARTC reiterates that, given the complexity of the HVAU regulatory model and ARTC's confidentiality obligations, thorough consideration was given to the most appropriate avenue to address stakeholder information requirements. The in-depth workshop-based approach that was undertaken involved facilitating and presenting on the following topics:

- Pricing Calculations underpinning Tariffs (included as part of the 2022 and 2023 Pricing Consultations).
- Overhead Cost Treatment in the HVAU - Schedule I
- Operating Expense Allocations (Maintenance and Overheads (Model))
- Regulatory Asset Base Calculation (Model)
- Ceiling Test Calculation (Model)

In addition to the workshops ARTC provided supporting materials and excerpts from the regulatory model which provided Customers access to the working calculations and the ability to complete scenario analysis for their operations.

ARTC believes that the thorough efforts invested in the workshops resulted in increased transparency and Customer confidence in the robustness of the calculations underpinning ARTC's results communicated throughout the year and as part of the annual compliance process.

ARTC respects the role of the ACCC as the regulator, and its independence to assess ARTC's annual compliance submission under the current HV Access Undertaking (of which submission of the regulatory compliance model is a fundamental component) to ensure the efficiency and prudence of expenditure and compliance with the HVAU.

Further, ARTC maintains its position that its ongoing transparency efforts surpass “best practice” industry standards as ARTC continue to be agile in responding to stakeholder feedback and offering stakeholders access to both information and context to enhance customer understanding. As always, ARTC remains committed to addressing customer matters on an ongoing basis while ensuring the preservation of confidentiality.

2.2 Corporate overheads and business unit management costs

ARUP Benchmarking Report

The HRATF references the recent findings of ARUP regarding their Hunter Valley Operating Cost Benchmarking Report (‘the Report’) published on 8 February 2023, regarding ARTC’s reported overhead and business unit management (Total Overhead) costs compared to perceived comparator businesses and note that the report suggests that “ARTC is allocating a higher amount of ‘Total Overheads’ to the Hunter Valley Network than would be appropriate for a prudent operator.

In response to the Report, ARTC responded in detail to this submission which was published on the ACCC website on the 9th of August. ARTC encourages stakeholders to read the full submission which is included in Appendix A of this document. Several significant distinctions exist in the operational approach, service offerings and cost structures between ARTC and the comparator organizations ARUP benchmarked throughout the Report. These distinctions pose a significant challenge to the conclusions drawn in the Report and fails to address these factors adequately, thereby diminishing the reliability of its conclusions and raising significant concerns for HRATF's assessment.

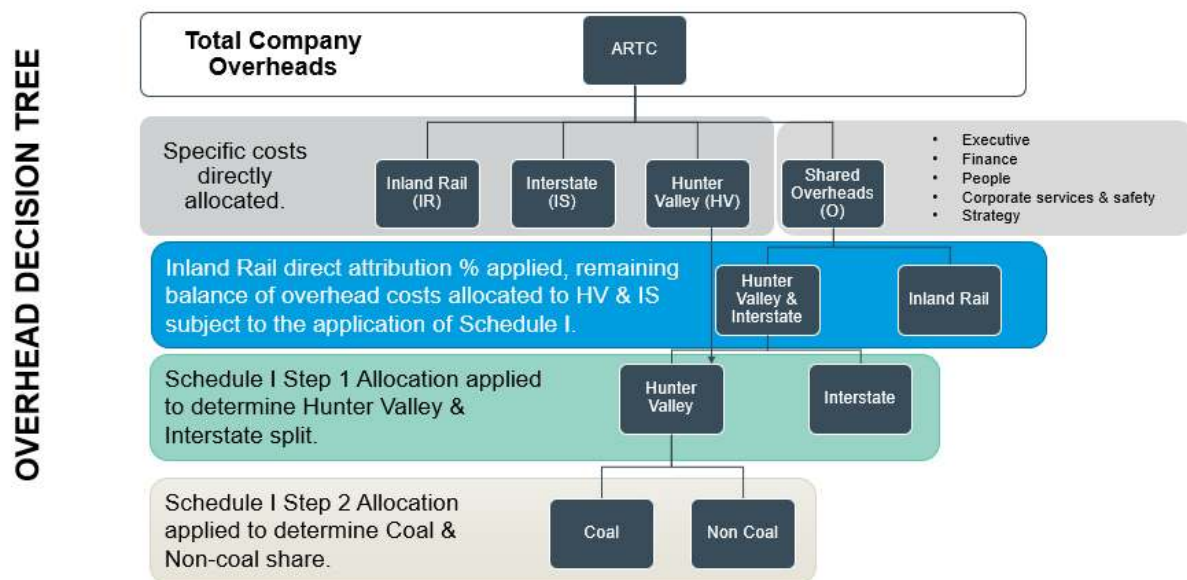
Cloud-Based Software Efficiency Project Costs

HRATF in their submission note that the “Total Overheads” increase appears to have been largely driven by the change in Accounting Treatment of Cloud Based software projects. ARTC acknowledges that this is the case. The rapid evolution of software development and the source of delivery has led to a situation where the International Financial Reporting Standards (IFRS), Australian Accounting Standards Board (AASB) and ARTC lacked guidelines and assessment tools to determine the accounting treatment of this emerging expenditure. ARTC sought external expert accounting advice on the matter and was provided with a ‘classification decision tree’ which enabled an internal review of all projects containing software development. Out of this review, some multi-year projects that were held in Capital WIP and were not yet capitalized were determined to be operating expenditure in the 2021 Compliance Return. The Compliance submission included a comprehensive breakdown, including descriptions of the cloud-based projects, along with an overview of the benefits that they have delivered. Notably, a significant portion of the expenditure is attributed to the development of the Decision Support Platform (DSP), which ARTC has extensively utilized and reported to the RCG for the purpose of condition-based maintenance prioritization.

'Total Overhead Costs' and alignment to Version 8 of the HVAU Schedule I

In relation to the 'Total Overhead Costs,' ARTC recognizes the previously raised concern regarding the "apparent potential for shifting of costs between different cost categories and different parts of ARTC's business." In response to this previous feedback, ARTC has undertaken several measures to enhance transparency and furnish supplementary information on the procedures and governance involved in allocating a share of "Total Overhead Costs" to the Hunter Valley Coal Network as outlined in Schedule I of the HVAU. Specific to this, in July 2022 ARTC held a workshop with customers and provided worked examples of the mechanics of the Overhead Allocation Framework that was negotiated and agreed.

To help with this understanding, ARTC developed and provided an overhead decision tree to provide Customers a visual snapshot of these requirements:



Customer interaction and feedback at this workshop indicated that the presentation was clear on how ARTC is applying Schedule I to the 'Total Overhead Costs'.

In addition to this, ARTC has implemented a robust and thorough process to calculate the HV Network allocation of 'Total Overheads' which aligns with the requirements of Schedule I in the HVAU which is reviewed in detail by the ACCC as part of the Compliance Submission Process. To elaborate further on the allocation method, ARTC also provided a comprehensive explanation in the "Further Submission for ARTC's 2019 and 2020 Joint Compliance Assessment." This detailed explanation described the specific steps for allocating overheads across the business units, as outlined in the Overhead Decision Tree above. To summarize, whether a cost falls under the category of BUM or OH does not determine its allocation method in Step 1 or subsequent steps of Schedule I; instead, it is the inherent nature of the cost itself that dictates its treatment. The principles prescribed by Schedule I by their nature and application effectively curtail the ability to shift costs and the attribution borne by Hunter Valley Coal customers.

2.3 Network Control

In HRATF's submission, it notes that the ANCO project is yet to demonstrate any tangible cost savings, specifically referencing the proposed reduction in network control operating expenditure that was initially highlighted by ARTC in the original business case of the ANCO program.

The original ANCO commercial case highlighted a number of tangible benefits and outcomes expected to be achieved upon completion of the project. These included:

- 1) Targeted cost avoidance from deferred capital due to ANCO's ability to increase single line network utilisation ongoing by 5% through dynamic pathing without the need for additional loop infrastructure;
- 2) Reduced Network Control costs due to the automation of manual tasks, data capture and a decrease in work effort and associated overheads.

To date, ANCO has transformed service delivery in the Hunter Valley rail network by fundamentally changing the operational capability of the Hunter Valley network management. This change has brought about the opportunity to enable major efficiencies and additional savings for the entirety of the supply chain, from which Customers and stakeholders are continuing to benefit from. These benefits are consistent with, and in addition to, the desired outcomes outlined in the commercial business case in the form of:

- The targeted cost avoidance (return and depreciation) has been realised with technology deferring the need for capacity enabling infrastructure loops;
- An increase in the efficiency of real time train planning and execution, enabling a 5% improved utilisation of the available track capacity resulting in an increase in saleable capacity (paths) for Pricing Zones 2 and 3;
- An 8% improvement in network productivity by a change to a dynamic operating mode, where trains are dynamically pathed to minimise dwell, and enable a reduction in train hours, translating into increased supply chain capacity from existing infrastructure. The ANCO technology has unlocked the ongoing opportunity to reduce cycle time which should enable cost reduction to customers through above rail savings. This is not a controllable cost saving for ARTC but a direct benefit to customers.
- The move from an inefficient and archaic paper-based planning system to a live dynamic environment, making the progression toward an advanced integrated supply chain possible.

In the 2021 Compliance Assessment Submission, ARTC were transparent in stating that the envisaged reduction in Network Control operating expenditure, as articulated in the second targeted outcome above, has not been realized and will not be attainable in the immediate future.

During the implementation of ANCO, it became evident to ARTC that the ANCO project required significant resources to support the transition to an automated planning tool. This involved intensive training regimes, increased data entry requirements as well as the further continuous improvement work required to utilise the new system efficiently to further embed broader supply chain opportunities.

The criticality of NCCN staffing to ARTC's network resilience was highlighted during the implementation of ANCO which coincided with the COVID-19 pandemic, resulting in a review of staffing needs relative to the assumptions in the original ANCO business case. The review considered the following factors:

- Network controller function critical to network operation, that is, without manned boards network operations cannot continue. The ANCO solution delivered increased efficiency to network operations but was not proposed to replace the need for Network controller personnel.

- Assumptions underpinning staff reduction in the ANCO business case assumed a 12-hour staffing roster rather than the current 8-hour roster. 12-hour rosters were unable to be implemented due to ONSR fatigue concerns (discussed in 2018 Compliance Submission).
- Network control competencies require a long lead time (6 – 12 months initially for less complex network locations and multiple years post this for competency in more complex areas)
- Skill set is specialised, not immediately replaceable and transferable experience (other than direct role transfer) is generally not possible.
- Labour market is extremely competitive, attracting and retaining staff in these roles is not an insignificant risk to ongoing staffing requirements.
- Contingent of existing staffing resources are reaching retirement age.
- Continued COVID-19 impacts highlighted the fragility of staffing levels to support resilient operations due to the inability to source competent resources outside current staffing pool (due to the above points).

On consideration of these complexities, ARTC concluded that a reduction in headcount would pose an unnecessary risk to network resilience. Whilst ARTC is cognizant of the assumption made in the original ANCO business case, it is clear the current business context has evolved since 2016 when this was documented and that the customer benefit of ensuring ongoing network operations far outweighs the small cost saving originally proposed.

ARTC will continue to pursue cost efficiency across all areas of operations, while the review of staffing costs has not enabled a targeted reduction of costs at NCCN at this time, similar reviews of other operating cost areas have revealed opportunities for active management as described throughout the 2021 Compliance Submission.

2.4 Maintaining and improving service levels

ARTC recognizes the significance of maintaining and improving services levels for Customers and remains steadfast in its commitment to prioritize the safety and reliability of the Hunter Valley Network for all rail traffic. We are dedicated to meeting customer capacity and availability requirements through the efficient optimization of our existing network infrastructure and are delivering our committed service offerings noting that HRATF support these efforts.

In its submission, the HRATF also expresses its support for measures aimed at improving service levels noting this is of equal importance to users as cost efficiency. ARTC would point to the increase in BUM costs driven by cloud-based software costs primarily relating to the Decision Support Platform (DSP) tool as an example of such a measure. The DSP tool plays an instrumental role in providing ARTC with critical information and insights for making optimal decisions concerning asset condition and ultimately delivering more efficient maintenance and asset reliability for Customers. ARTC observes that the HRATF commentary calling on focus on rising overhead costs at times lacks reference to the causation and benefit of these costs and the linkage to improved service levels.

CONCLUSION

ARTC are dedicated to continuing to lead industry consultation and collaboration and, as we move forward, remain committed to transparency, efficiency, and ongoing dialogue with our customers. We appreciate the HRATF's positive feedback in respect to efforts to date and look forward to continued stakeholder engagement in the pursuit of a robust and sustainable future for the rail network.

APPENDIX A

ARTC

Stakeholder response to ARUP Benchmarking

2019 and 2020 Joint Compliance Assessment

June 2023

ARTC



Table of Contents

| | | |
|-----|---|---|
| 1 | Introduction | 3 |
| 2 | Prior Benchmarking Assessment..... | 3 |
| 3 | ARUP Benchmarking Comparators | 3 |
| 3.1 | Mode of Operation and Service Offering | 4 |
| 3.2 | Description of Dynamic Movement Planner (ANCO)..... | 5 |
| 3.3 | Application of Comparator Benchmarks..... | 5 |
| 3.4 | Denominators of Comparison | 6 |
| 3.5 | Inclusions and Exclusions for Aurizon | 6 |
| 3.6 | Conclusion | 7 |

1 Introduction

As part of the 2019 and 2020 Joint Compliance Assessment, the Australian Competition and Consumer Commission (ACCC) engaged ARUP to complete an Operating Cost Benchmarking Report ('the Report'). ARUP notes on page 7 of the Report that the particular focus of this benchmarking report is overheads.

ARTC provides this stakeholder response to address ARUP's final report published on 8 February 2023.

2 Prior Benchmarking Assessment

In 2018, as part of its review of the efficiency of ARTC's 2015 operating costs, the ACCC engaged WIK-Consult (WIK) to complete a study "Assessing the efficiency of Australia Rail Track Corporation's Operating Expenditures for the 2015 Calendar Year." At page 103 WIK highlighted the difficulties of benchmarking against international companies:

"Due to ARTC's very specific company objectives and scope of work as well as the difficulty of finding comparable RU's, it was refrained to provide an international benchmark analysis."*

**Railway Undertakings*

ARTC agreed with WIK's assessment of the difficulties of providing a benchmarking analysis. ARTC maintains this view and believes that the principle of matching ARTC's company objectives and scope to comparators also applies to the ARUP report; and particularly the ability to draw conclusions from it.

3 ARUP Benchmarking Comparators

For ease of reference, the comparator organisations identified in the Report as appropriate comparisons for benchmarking purposes are outlined in Table 1.

TABLE 1 – Comparator organisations identified in the Report

| Rail Businesses | Non-Rail Businesses |
|------------------------------|---------------------|
| Aurizon Network | Seq Water |
| Arc Infrastructure (WestNet) | SA Water |
| Queensland Rail | Jemena Gas |
| UK Network Rail | |

Critical differences in the mode of operation, service offering and cost structures between ARTC and the comparator organisations that challenge the benchmarking analysis are discussed herein.

3.1 Mode of Operation and Service Offering

The Hunter Valley Coal Chain

The Hunter Valley Coal Chain (HVCC) is operated as an integrated, shared supply chain with a formalized centrally coordinated function being the Hunter Valley Coal Chain Coordinator (HVCCC). The premise of this operating model is that assets in the supply chain, which are owned by different parties, are operated at the 'system' level to ensure the most efficient outcome for the supply chain; strategic, operational and tactical decisions made by individual asset owners must make sense at the 'system' level. ARTC's role in the HVCC is outlined in detail in ARTC's submission to the ACCC provided in 2018 "The context for ARTC's role in the Hunter Valley Coal Chain".

The need for alignment across the Coal Chain is a key driver for ARTC's mode of operation and service offering and more tactically the possession strategy that shapes the patterns of maintenance of the Hunter Valley Network. The Business Units contained in the Hunter Valley BMC costs are built up to provide a level of service that allows ARTC to conduct its maintenance in condensed and planned time frames that are aligned with the Coal Chain objectives and creates the flexibility and reliability that customers have requested. This enhanced service delivery model ensures alignment with the entirety of the Coal chain and provides significant ARTC Management oversight, customer consultation and detailed reporting and transparency which form part of these benchmarked overhead resources.

Comparator organisations – differences

ARTC has concerns with the comparison assessment contained in the Report as the analysis does not reflect the key corporate structural differences and subsequent impact on overheads between the vertically integrated nature of Aurizon and Queensland Rail. ARTC has more significant concerns, however, in respect of the analysis of the service provision provided by comparator organisations and the link to commercial considerations.

Whilst Aurizon Network reflects the closest service comparator to the Hunter Valley, there are significant differences in the level of service, the maintenance strategy implemented and the involvement of external parties in coordinating coal movements. These concerns are amplified by the timing of the comparator data being ahead of the most recent service changes under UT5, amplifying the service differential and making comparator conclusions redundant.

The assessment of services provided on ARC and Queensland Rail does not account for the frequency and intensity of freight movements, the quality of track and the volume hauled. The differences between the two networks are of such a magnitude, that this removes any value of conclusions made on comparisons.

Finally, UK Network Rail was excluded from WIK's analysis on the basis of absence of fit with ARTC's business and service, which is supported by the Report, disqualifying any value from comparisons with ARTC.

The Report has not considered the differences in the service offerings or the costs that are associated with the additional levels of service that ARTC provides to the Access Holders of the Hunter Valley Coal Network. ARTC note that there are additional issues with the base cost data as explained below, however notwithstanding, a differential in the costs between differing levels of service should be expected and noted in the Report.

In line with the WIK conclusion of 2018, the differences in corporate structure, service provision and commercial consideration creates the absence of comparable businesses both domestically as well as internationally. The failure to reflect the significant differences across these areas between ARTC and the comparators ensures that any conclusions drawn from ARUP's report are inconclusive.

3.2 Description of Dynamic Movement Planner (ANCO)

ARTC reference page 9 of the Report, which states that the increase in ARTC's Network Control costs between 2018 – 2020 was "predominately driven by the implementation of a new signalling system and increase in labour costs".

ARTC highlight that the above statement is factually incorrect as it was not a new signalling system that was implemented. This statement is referring to ARTCs Network Control Optimisation (ANCO) system, a dynamic train movement planning and scheduling tool for the Hunter Valley Coal Network. This project and associated costs enable real time train planning, moving away from a static paper-based planning system providing an enhanced service offering to Customers and enabling additional capacity through improved utilisation of existing infrastructure, without the need to build more crossing loop infrastructure.

ARTC believe that further explanation of these costs and linkage to overall service offering is required to support comparators.

3.3 Application of Comparator Benchmarks

The ARTC cost data used in the Report is sourced from the ARTC 2019 and 2020 Joint Compliance Submission and are the actual cost results for those periods.

The Report has used source base data information for the comparator organizations from financial year reports prior to 2019 and 2020 and has subsequently applied CPI each year up until 2020 to calculate comparative costs to use in the bench marking activities.

As an example, in the Report ARC's 2013 costs and 2017 Aurizon's costs have been escalated with CPI to compare against ARTC's 2019 and 2020 actual costs.

This method of escalating prior period costs for the comparators relies on the inherent assumption that comparative costs have only increased by CPI from 2013 and 2017 respectively, and therefore does not factor in any significant sector specific costs or new costs associated with a change in service offering. The step change and service offering which would have occurred due to the implementation of Aurizon's new systems of work and the UT5 service offering changes would not be factored into these costs. Furthermore, the implementation of ARTC's Network Control Optimisation (ANCO) system in 2019 and 2020 does includes costs for the change in service offering, and therefore should be viewed as not suitable comparison years for benchmarking purposes.

3.4 Denominators of Comparison

The comparative cost denominators of GTK or TKM viewed on their own are problematic units of standardization. As an example, an anomaly of this can be seen on the graph on page 32 of the report. It presents ARTC's Network Control costs being lower than ARC when reviewed on a GTK basis, however, are above on a TKM basis.

As highlighted in 3.3 above, if the Report had thoroughly provided the provision of the differing service offerings between the comparator organisations, this would have provided the reader of the report an opportunity to interpret the benchmarking results correctly.

3.5 Inclusions and Exclusions for Aurizon

The Report notes three categories of Overhead Costs that are included in ARTC's base costs for comparison:

- Network Control (NC)
- Corporate Overheads (OH)
- Business Unit Management (BMC)

The Report has assessed the types of activities that sit across Corporate Overheads (COs) and Business Unit Management (BMCs) Costs and consider that including BMCs in Total Overheads (CO + BMC) is appropriate for comparison purposes.

In 2018, ARTC submitted the "Operating and Maintenance Expenditure Analysis" report completed by Deloitte to the ACCC. In Deloitte's analysis BMC costs were not included as an overhead cost. Deloitte noted that this approach was taken due to the magnitude of costs contained in BMC that relate to Maintenance Support Costs (Asset Management Delivery, Asset Management Development and Corridor Works) which the report recognised would be in the maintenance costs for the comparator organisations.

These BMC costs relate to the engineering development and delivery management of ARTC's capital and maintenance program, asset assurance and systems as well as indirect costs (maintenance overhead) associated with ARTC's provisioning centres. From initial review of the Aurizon (AUR) information referenced in the Report, these costs are not classified in the same manner for AUR and are instead classified as Maintenance Expenditure under a different category called "Infrastructure Management" (IM),

On page 40 in Appendix A of the Report, it is noted that the base costs used for Aurizon did not include IM Costs or Infrastructure Delivery Allowance (IDA) for the entirety of the Report with the exception of a second scenario included on page 28 where the costs for AUR included the addition of IM Costs only.

The Report noted that the "approach was consistent with Deloitte's approach where indirect maintenance costs were assessed as part of its maintenance cost review." However, ARUP only followed this approach for Aurizon's overhead costs and did not exclude them in ARTC's overhead cost base where it is included as part of BMC. ARTC are unclear as to why ARUP only followed the approach of excluding Indirect Maintenance Costs for Aurizon and not ARTC but note that all the conclusions drawn in the report are based on this misaligned cost profile.

Infrastructure Delivery Allowance (IDA)

ARUP note in Appendix A that Aurizon’s UT5 overhead costs include an allowance for Infrastructure Delivery which include the design and delivery of new capital projects, asset renewal and maintenance activities. ARTC note that due to the uncertainty of the cost treatment, ARUP have excluded these costs from the benchmarking comparison significantly distorting cost comparisons.

However, these activities are included as part of ARTC’s BMC cost spread across the Corridor Works and Planning Teams.

On page 148, as part of the Queensland Competition Authority (QCA) decision on the Aurizon Networks 2017 Draft Access Undertaking, QCA notes the impact of including this for the first time in the IDA costs “increase the base year corporate overhead cost by around \$11 million”. Based on this information, table 2 below summarises the impacts of excluding these two categories of IM and IDA in AUR overhead cost base but including them in ARTC’s cost base.

TABLE 2

| FUNCTION CENTRE COSTS INCLUDED IN ARUPS BENCHMARKING | ADDITIONAL COSTS THAT SHOULD HAVE BEEN INCLUDED IN AUR’s |
|--|--|
| | 2017 Report |
| Infrastructure Management (IM) | \$17.5M* |
| Infrastructure Delivery Allowance (IDA) Per Year | \$11.0M** |
| Total | \$28.5M |

*IM cost differential between Scenario 1 and Scenario 2 ARUP Benchmarking report.

** IDA noted in Queensland Competition Authority (QCA) decision on the Aurizon Networks 2017 Draft Access Undertaking

3.6 Conclusion

ARTC acknowledges and understands benchmarking exercises and that it can be subjective in nature due to different business structures across organizations, however as identified above, the stated report has some key material differences in the base data used to perform this benchmarking which significantly distort the financial outcomes presented. Further, the report does not take into consideration the unique service offering ARTC provides to Access Holders, which, without this context challenges the validity of conclusions provided in this report to stakeholders. ARTC continues the commitment to the level service offering to customers including operational efficiency and performance and how we engage transparently.