

Hunter Rail Access Task Force

20 June 2017

By email

Mr Matthew Schroder
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Dear Mr Schroder

HRATF response to 2011 Hunter Valley Access Undertaking (HVAU) variation application

The Hunter Rail Access Taskforce (**HRATF**) welcomes this opportunity to respond to the application by ARTC to vary its 2011 HVAU to extend the term (to 31 December 2021), modify a number of commercial parameters and to introduce new cost allocation rules (the **Variation**).

The HRATF does not consider that the commercial parameters and allocation principles set out in the Variation as consistent with regulatory practice, including as identified by the ACCC in its recent draft decision.

However, ARTC withdrew its draft 2017 HVAU on 8 May 2017 and wrote to the HRATF on 1 June 2017 indicating that:

- ARTC was not prepared to accept the ACCC draft decision or resubmit a further HVAU that reflected the position set out in it; and
- instead, ARTC was considering the implications of allowing the regime to revert to IPART under the NSW Rail Access Undertaking (**NSWRAU**).

This is the second time over the last two years that the ARTC has withdrawn a draft HVAU because it does not accept the ACCC's views. The ACCC will recall that ARTC also withdrew an earlier draft HVAU on 14 June 2016, before the ACCC was able to issue a draft decision. ARTC objected to the ACCC even providing stakeholders with an outline of the ACCC's preliminary views in relation to the withdrawn HVAU, complaining that this would make commercial agreement more difficult.

As in previous iterations, the Variation is once again lodged extremely close to the expiry of the current HVAU and leaves no meaningful time for the ACCC or stakeholders to consider changes. Both in approach and timing, ARTC have put the Variation forward on a 'take it or leave it' basis. The alternative to the Variation being approved is a strong likelihood that the 2011 HVAU expires and regulation of the Hunter Valley Coal Network (**HVCN**) reverts to IPART under the NSW Rail

Access Undertaking. This is a likely outcome that ARTC notes in its recent correspondence to the HRATF.

The HRATF considers that any reversion of the current regulatory arrangement to the NSWRAU would be inefficient and result in considerable regulatory and commercial uncertainty. We note that:

- The NSWRAU has not had a requirement to evolve over the last decade to reflect developments in the coal sector and would therefore take the industry substantially backward to a less sophisticated and targeted framework.
- The suite of access agreements (and operator sub agreements) now used in the Hunter Valley has been developed under, and forms part of, the HVAU – it is not clear how these would transition to an ex post, bilateral ‘negotiate/arbitrate’ model of the kind contemplated by the NSWRAU.
- A range of industry (and Hunter Valley coal chain) coordination arrangements (such as the HVCCC, RCG and interactions with coal terminals at Newcastle) are explicitly addressed in the HVAU. These are important to the efficient operation of the industry (and Hunter Valley coal chain) and would be lost as part of any reversion to the state regime.
- ARTC has been receiving substantially higher tariffs over the last 12 months than are justified by any reasonable regulatory outcome, including as determined by the ACCC in its draft decision. However, industry would be likely to lose any right to recover these overpayments if the HVAU expires without being replaced.

As a consequence of these concerns, HRATF has no practical alternative but to support the Variation proposed by ARTC in order to ensure the continued operation of the 2011 HVAU beyond its currently scheduled expiry on 30 June 2017. We therefore support the Variation on the basis that it better satisfies the statutory requirements in section 44ZZA(3) than the only feasible alternative, which would be a reversion of the Hunter Valley regulatory framework to the NSWRAU from 1 July 2017.

In providing this reluctant support for the Variation, we make the following observations:

1. The process to date highlights the inherent weakness in a voluntary undertaking – and does not reflect the outcome of ‘commercial’ negotiations

The process involved in reaching this point has proven time consuming, costly, and frustrating for the industry. This experience highlights, in our view, the inherent weakness associated with a voluntary undertaking being used to seek to establish an enduring and predictable regulatory framework for the HVCN.

The HRATF’s support for the Variation should also not be construed as reflecting the outcome of “commercial” negotiations. To the contrary, as set out above, our support is evidence of a lack of balanced commercial approach and regulatory oversight available to the industry under the current arrangements – which forces us to accept an outcome that is materially less appropriate than the outcome of a standard, regulatory determination from the ACCC.

2. The approach in the ACCC draft decision provides the most appropriate starting point for any future HVAU renewal (or any alternative regulatory framework)

As noted repeatedly in our submissions to the ACCC (and direct engagement with ARTC) over the last two years, HRATF has remained firmly of the view that the regulatory framework governing the HVCN should set out a defined and repeatable methodology for determining key commercial parameters – such as WACC and WAML.

In our first submission, in March 2016, we proposed drafting that would lock down a set of workable and repeatable processes for determining both WACC and WAML in future resets. Our proposal was not adopted by ARTC.

There will evidently be periods where the application of any fixed WACC or WAML methodology delivers higher or lower outcomes for industry or ARTC, but that is inherent in all such regulatory processes. The key is that the approach is repeatable, transparent and predictable.

We submit that the ACCC's approach to interpreting and applying the HVAU as set out in its draft decision is sound and transparent and provides a better and more appropriate methodological framework for future resets than the Variation, if approved.¹

3. A workable opex efficiency framework is not feasible under the current, voluntary framework

While we consider that a opex efficiency scheme is likely to be beneficial and would bring the Hunter Valley regime into line with good regulatory practice, the development process over the last two years has highlighted that a balanced and reasonable opex regime is not likely to be able to be developed commercially with ARTC on a voluntary basis. We refer generally to the discussion at section 6 of our submission in response to the ACCC's draft decision.

For that reason, it is unlikely to be of value for the industry to incur any further immediate cost or distraction seeking to work with ARTC around developing such a framework.

However, we would nonetheless welcome the ACCC providing greater engagement with the RCG and transparency around the ACCC's ex post opex prudency assessment as part of future annual compliance processes. The HVAU requires the ACCC to have regard to the submissions of industry when determining whether ARTC had appropriately complied with the roll forward requirement in clause 4.4 (including the determination of Efficient outturn opex). Clause 4.4 contemplates the ACCC engaging directly with industry "*in relation to the matters for its determination*" in relation to the roll forward.

HRATF submits that this therefore allows the ACCC considerable flexibility in the manner in which it approaches its consultation around the annual assessment of opex prudency. The priority for the ACCC should be to ensure that it has properly and thoroughly understood and tested the prudency of opex each year, and has taken into account the views of Access Holders in this regard.

Given the absence of any ex ante opex efficiency framework, HRATF submits that it is appropriate for the ACCC to develop a consultation framework that ensures that all opex documentation obtained under clause 4.10 (or otherwise through its new information request power in clause 1.5) is shared with Access Holders, if necessary on a confidential basis. One of the few benefits of the aborted process for developing an opex framework is that industry now have a better understanding of the nature of opex in ARTC's network business – and the level and granularity of cost data which is available, but has not been shared with Access Holders to date.

Once data is provided, there should be a short process of direct engagement with both industry and ARTC to understand and test any opex claims. Given the flexibility that already exists under the HVAU, any consultation process does not need to be explicitly spelt out in the HVAU now. However, we would encourage the ACCC to flag that it will develop a more comprehensive approach to the

¹ This is subject to the qualifications made in our response to the draft decision, which flag some queries around the application of the ACCC's approach to determining WAML – and in particular our inability to replicate a point estimate of 23 years, based on the data set used by the ACCC.

annual compliance process, in consultation with ARTC and the industry, once the current Variation is in place.

4. HRATF supports the approach to backdating proposed in the Variation

ARTC has provided for backdating of tariffs to reflect the varied commercial parameters – with the new parameters to be effective from 1 July 2016. This is consistent with our submission to the ACCC in relation to both the earlier HVAU Extension, as well as the draft 2017 HVAU process.

We are comfortable with the approach which has been proposed by ARTC for dealing with backdating through an ‘overs and unders’ process to be undertaken as part of the 2016 annual compliance process and to be submitted within four months of the ACCC decision in relation to the 2015 annual compliance process. The Variation indicates the rebate arrangement for Pricing Zone 3 will be developed separately in direct consultation between ARTC and Pricing Zone 3 Access Holders due to the absence of an unders and overs process.

5. The approach to cost allocation in the Variation is not agreed or appropriate – but is unavoidable in the circumstances

ARTC has adopted a cost allocation approach developed by it in consultation with Deloitte. The HRATF (and industry) has had little meaningful engagement with Deloitte around this process and the draft Deloitte report was made available to the wider HRATF members only very recently, following considerable internal review with and by ARTC, and subject to confidentiality constraints.

The allocation approach in the Variation therefore does not reflect any agreement with industry and, as noted in our earlier submissions, we consider that the approach adopted to cost allocation is likely to lead to a shift in costs (of approximately \$6-\$8m) from non-coal users to the coal sector.

However, ARTC have made clear that they will not accept any extension of the current HVAU without the Deloitte allocators for overheads being adopted. We support the amended cost allocation methodology in Schedule I of the Variation on that basis but request the ACCC undertake a rigid and thorough validation of actual ARTC overhead costs as to their prudence and appropriateness to the Hunter Valley through the annual compliance process.

6. The further variation contemplated needs to address a range of other matters

ARTC has proposed at clause 2.3 of the Variation a requirement that it submit a further variation application within 6 months to address a number of outstanding issues, notably around the approach to addressing path based pricing, incremental costs and their recovery (through a dual ceiling revenue cap) in the HVAU.

Given the urgency of providing for an extension of the 2011 HVAU, we agree with the approach of leaving this drafting for a subsequent variation. The HRATF notes however that any future variation should not be limited to these two issues (path based pricing and incremental cost). There are a range of other amendments previously raised by ARTC, HRATF and/or the ACCC as part of the earlier 2017 HVAU which should be incorporated into that process. As part of its good faith engagement around the future variation, we encourage ARTC to consider incorporating those various other issues and would welcome the opportunity to work collaboratively with ARTC in developing these amendments.

For example, we note the amendments previously considered by the ACCC in relation to:

- membership and operation of the RCG;
- improvements in the operation of the TUT;

- various changes to the AHA and Operator sub-agreement (as suggested at page 110 of our submission in response to the ACCC consultation paper in relation to the 2017 HVAU).

The HRATF notes that the amendments proposed by ARTC include a commitment to engage in 'good faith negotiations with Access Holders' in relation to the subsequent variation. Given the experience which industry has had with ARTC's engagement to date, we submit that it would be appropriate and helpful for the ACCC to specify in any decision on the Variation a minimum engagement model (and timing) that it considers is needed to satisfy this standard.

Please direct any queries in relation to this letter to our advisers, Alex Sundakov (+61 433 043 337, alex.sundakov@castalia-advisors.com) or Simon Muys (+61 3 8656 3312 smuys@gtlaw.com.au).

Yours sincerely



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