# ARTC 2017 Hunter Valley Access Undertaking

## Hunter Rail Access Task Force submission in response to ACCC draft decision

**24 May 2017**

# 1 Executive summary

HRATF make this submission notwithstanding the withdrawal by ARTC of its 2017 HVAU.

The current process for development of a replacement HVAU commenced over two years ago, in early 2015. The HRATF, and no doubt other stakeholders consider that it is now important that this process is completed quickly. The HRATF is mindful of the adverse effect which ongoing regulatory uncertainty is having for the coal industry in the Hunter Valley, including requiring producers to pay higher interim tariffs (although subject to later backdating) and requiring continued distraction of management and time for both ARTC and industry.

The current process has highlighted to HRATF that there may be benefit in looking for a mandatory framework in the future that facilitates resolution of this periodic reset in a timely way and without reliance the voluntary submission-withdrawal-resubmission of undertakings.

In relation to the current process, the HRATF position is as follows:

- **ACCC draft decision is clear.** HRATF in this submission have sought to focus only on key outstanding issues so that we can move efficiently to final resolution of the 2017 HVAU. Where the ACCC has made its position clear in the draft decision, we are content to accept that position in the interests of moving this process quickly forward.

- **A new HVAU by 1 July 2017.** It remains important to industry that the replacement HVAU is in place to commence on 1 July 2017. Other than opex, which for the reasons below we consider should no longer form part of the current process, the ACCC's draft decision provided clear direction on the outstanding material matters (notably WACC and RML). This should allow ARTC to prepare and submit an acceptable undertaking over the next 3-4 weeks. To the extent that any redrafting is required, HRATF invites ARTC to develop that drafting collaboratively with industry to avoid any further unnecessary delays.

- **Backdating of tariffs to 1 July 2016.** Consistent with the original ACCC decision to extend the 2016 HVAU, whatever renewal or extension arrangements are put in place for 1 July 2017 – they must provide for full backdating of tariffs effective from 1 July 2016 and the rebating of any overpaid amounts as part of the next compliance assessment. This should be based on assessing what tariffs and revenue should have been recovered if the WACC and RML under the final determination were in place from 1 July 2016.

- **ACCC rate of return is reasonable and appropriate.** HRATF accepts the ACCC's decision on rate of return, which it recognises is consistent with recent comparable decisions across a number of sectors, including rail, made by the ACCC, AER and state economic regulators. Once adjusted for some time-sensitive variables (i.e. risk free rate and DRP) and differences in gearing, it is more generous than the WACC allowed to Aurizon by the QCA. In this submission, we demonstrate that given its consistency with standard regulatory approach, the WACC is consistent with market expectations and strongly satisfies any financeability check.

- **Once further sensitivity work is done, as requested by the ACCC, a conservative approach to applying the approach to RML in the draft decision delivers 29-30 years.** The ACCC has sought further information from the parties on the calculation of RML, taking into account the views expressed in the draft decision. While the HRATF generally accepts the approach adopted by the ACCC to determining WAML, we have not been able to replicate its calculation. Based on HRATF's analysis (and applying the data set and approach of the draft decision) HRATF calculates a WAML of 29-30 years.

- **ARTC's proposed opex framework is unsound and any further development should be left until after a new HVAU is in place.** The opex framework proposed by ARTC is entirely unsatisfactory. It would provide little, if any, discipline around opex costs and is fundamentally at odds with other regulatory precedent (including the gas and electricity frameworks around

which ARTC claims it has been modelled). Despite the efforts of ARTC and industry over recent months, any further work on an opex efficiency framework needs to be left until after a new HVAU is in place to avoid this causing any further delay to closing out the HVAU. While HRATF would welcome the opportunity to continue to work with ARTC on a framework during the next renewal period, there is not time to do so now. Instead, HRATF submit that modest improvements can and should be made to the existing ex post compliance process, through ARTC providing improved transparency of opex cost data and drivers to the RCG.

- **HRATF reiterates its view on the approach to Incremental Costs – and implementation of the floor and ceiling.** The HRATF accepts the use of a 'dual ceiling' model for the purpose of allocating Incremental Costs, and the principle of Pricing Zone 3 producers paying Incremental Cost only in Pricing Zone 1 for the term of the HVAU. As set out in our earlier submission, the implementation of this approach in the HVAU needs more refinement and clarity. With the exception of one member, the HRATF continues to consider that the allocation of Incremental Capital Costs on the basis of contracted positions provides a more efficient and appropriate signal for investment.

We now look forward to working with the ACCC and ARTC to close out this process as quickly as possible.

## 2 Timing and commencement of 2017 HVAU

HRATF makes the following comments in relation to the resubmission of any new 2017 HVAU:

(a) It remains critical to industry that a new undertaking is in place by 1 July 2017. Ongoing regulatory uncertainty has adverse consequences for the coal industry in the Hunter Valley, including requiring producers to pay higher interim tariffs (although subject to later backdating) and requiring continued distraction of management and time for both ARTC and industry.

There is no reason why a new undertaking should not be in place by 1 July 2017. The ACCC draft decision provides sufficient guidance to ARTC to enable an amended draft HVAU to be developed and submitted, consistent with that guidance, and approved by 30 June 2017.

(b) To the extent that some redrafting needs to be done (such as clarifying the intended operation of the dual ceiling approach to allocation of incremental capital costs), to avoid any further delays HRTAF encourages ARTC to work on this reworking collaboratively with industry, rather than lodging the revised drafting 'sight unseen'.

(c) As noted in section 6 of this submission, the opex framework proposed by ARTC is fundamentally flawed. The proposed scheme is unworkable, would lead to inefficient and costly outcomes for industry and is inconsistent with regulatory practice (including the National Gas Rules around which ARTC suggests it has been modelled). There is no feasible way of determining whether cost reductions are due to increased efficiency or a reduction in service quality and performance. Despite the efforts of ARTC and industry, it is now too late to seek to include any opex framework in the 2017 HVAU. While industry are open to continuing to work on an efficiency incentive scheme to apply in the future, this should not delay moving forward with a new undertaking. A new HVAU should not be delayed by the opex negotiations. As an interim step, we repeat our submission that greater transparency should be provided to industry through the RCG around opex as part of the current ex post prudency process, by having the RCG provided with the same information, and at the same time, as it is provided to the ACCC as part of any annual compliance process.

(d) Any new HVAU must provide for full backdating of charges. The ACCC draft decision was somewhat unclear in this regard, however HRATF notes that the original extension to the 2016 HVAU was explicitly on the basis that all tariffs would be backdated to 1 July 2016 based on the final HVAU. Any rebates would then be calculated and paid as part of the annual compliance process.

# 3 Rate of return

The ACCC draft decision on the appropriate risk adjusted rate of return for ARTC aligns with recent decisions made by the ACCC, AER and other regulators such as the QCA (including in their decisions related to Aurizon and QR), IPART and the ESC.

In Table 3.1 we compare the ARTC WACC with the determinations by the QCA for QR and Aurizon (UT4). We also show those decisions on a comparable basis using the ACCC values for time sensitive parameters (RFR and DRP) and at a common gearing level.

**Table 3.1: ARTC QR and Aurizon WACC Comparison**

| | ACCC ARTC | QCA QR as made | QCA Aurizon as made | QCA QR - ARTC RFR , DRP & Gearing | QCA Aurizon - ARTC RFR, DRP and Gearing |
|---|---|---|---|---|---|
| Nominal risk free rate | 2.12% | 2.00% | 3.21% | 2.12% | 2.12% |
| Inflation | 2.40% | 2.50% | 2.50% | 2.50% | 2.50% |
| Debt margin | 2.81% | 2.52% | 2.94% | 2.81% | 2.81% |
| Debt raising costs | 0.01% | 0.00% | 0.00% | 0.01% | 0.01% |
| Market risk premium | 6.00% | 6.50% | 6.50% | 6.50% | 6.50% |
| | | | | | |
| Debt funding | 52.5% | 55.0% | 55.0% | 52.5% | 52.5% |
| Equity funding | 47.5% | 45.0% | 45.0% | 47.5% | 47.5% |
| Total funding (debt+equity) | 100% | 100% | 100% | 100% | 100% |
| | | | | | |
| Gamma | 0.40 | 0.47 | 0.47 | 0.40 | 0.40 |
| Corporate Tax Rate | 30% | 30% | 30% | 30% | 30% |
| | | | | | |
| Asset Beta | 0.45 | 0.45 | 0.45 | 0.45 | 0.45 |
| Debt Beta | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Equity beta | 0.94 | 0.80 | 0.80 | 0.80 | 0.80 |
| | | | | | |
| Cost of equity (nominal post-tax) | 7.78% | 7.20% | 8.41% | 7.32% | 7.32% |
| Cost of equity (real post-tax) | 5.26% | 4.59% | 5.77% | 4.71% | 4.71% |
| | | | | | |
| Cost of debt (nominal pre-tax) | 4.94% | 4.52% | 6.15% | 4.94% | 4.94% |
| Cost of debt (real pre-tax) | 2.48% | 1.97% | 3.56% | 2.38% | 2.38% |
| | | | | | |
| **Nominal Vanilla (Post-tax nominal) WACC** | 6.30% | 5.73% | 7.17% | 6.07% | 6.07% |
| **Post-tax real WACC** | 3.81% | 3.15% | 4.55% | 3.49% | 3.49% |
| **Pre-tax nominal WACC** | 7.11% | 6.34% | 7.88% | 6.84% | 6.84% |
| **Pre-tax real WACC point estimate** | 4.60% | 3.74% | 5.25% | 4.23% | 4.23% |

While there are slight differences in parameters such as the MRP, Gamma, Equity Beta and technical differences arising from the timing of some parameters (risk free rate and DRP at the relevant points in time), once adjusted to use a common RFR, gearing level and DRP, the ARTC WACC is higher than that given to the Queensland networks.

Given this result, in this submission rather than focusing on the particular values for individual parameters, we assess the overall "reasonableness" of the WACC.

We do this in two ways:

- An assessment of the market reaction to the similar Aurizon decision; and
- An assessment of the financeability and credit metrics of the ARTC resulting from this decision.

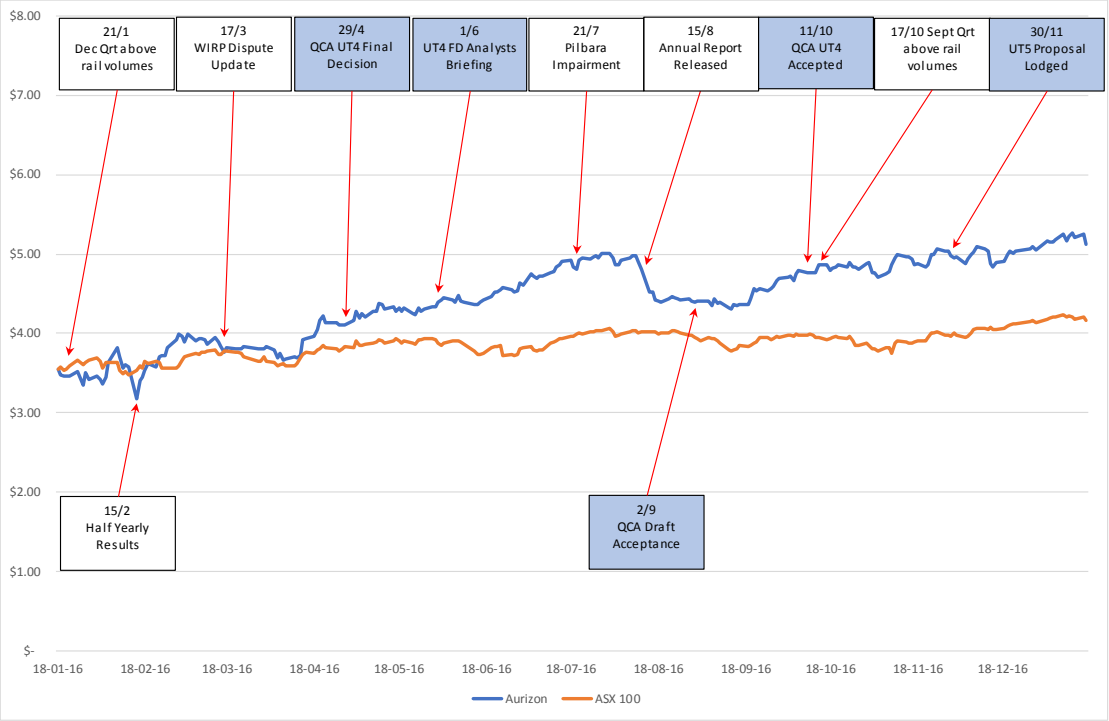
### 3.1 Market Reaction to Aurizon WACC

As Aurizon is a listed company, the QCA's decision on WACC would be expected to have an impact on the share price.

If the UT4 WACC was flawed, unpredictable, or likely to give rise to other major capital raising concerns, then there should have been a noticeable adverse impact of the QCA decision on the share price of Aurizon.

In Figure 3.1 we show the Aurizon stock price over the last twelve months to mid-January 2017 and compare it to movements in the ASX 100 Index. We also show the timing of all of Aurizon's ASX announcements, including the QCA decisions on UT4.

**Figure 3.1: Aurizon and ASX 100**




Source: ASX data

Aurizon's share price, like that of all listed companies, is influenced by a multitude of factors and it is impossible to isolate the impact of any regulatory decision with any certainty. However, what is clear is that Aurizon outperformed the ASX 100 Index over the last twelve months.

While Aurizon, the listed company, also operates more than the regulated below rail network, during the period:

- Aurizon wrote off its investment in the project to construct rail infrastructure in the West Pilbara;
- above rail volumes, mainly coal in Queensland and the Hunter Valley, remained steady or slightly declined over the period and future levels are uncertain; and
- Aurizon received notice of termination from the WIRP Deed customers, an unregulated part of below rail network.

Indeed, overall, the announcements with respect to the unregulated parts of Aurizon's business have been consistently negative in recent years.

If Aurizon as a listed company was a pure regulatory play, then we would expect the share price to remain relatively constant over time . This is because in the regulated businesses, the WACC allowance varies over the cycle (by contrast, in competitive businesses, cyclical variations in WACC do not affect cash flows, but rather lead to variability in the share price).

The fact that despite generally negative announcements for the unregulated parts of the business the share price continued to rise suggests that the QCA could not have surprised the market. To the contrary, there is little evidence that regulatory announcements from the QCA over the relevant period have had any material impact on share prices in either the short term—immediately after the announcement— or across the entire period. If anything, the underlying slow rise in the share price suggests that the regulatory WACC for UT4 may have been perceived by the market as positive for Aurizon.

Given the similarities between ARTC and Aurizon in regards to the nature of their regulated businesses, the ARTC WACC proposed by the ACCC can be expected to be similarly consistent with market expectations (given it is close to, but higher than Aurizon's, once adjusted for timing of RKR and DRP and for the difference in assumed gearing).

### 3.2 Financeability of the ARTC

Some regulators, for example IPART, in making price determinations, undertake a final 'test' of the reasonableness of a WACC outcome by assessing its likely effect on the regulated business's 'financeability' over the determination period.

IPART states that:

> *The objective of the financeability test is to assess the short-term financial sustainability of the utility. This means that we assess whether the utility will be able to raise finance, consistent with an investment grade-rated firm, during the regulatory period.*

IPART use three credit rating metrics in their test:

- **Funds from operations (FFO) interest cover:** calculated as FFO plus interest expense divided by interest expense. This is a coverage ratio and measures a utility's ability to service its debt prior to repayment.
- **Debt gearing (regulatory value):** calculated as debt divided by the regulatory value of fixed assets plus working capital. This is a leverage ratio and measures a utility's ability to repay its debt.
- **FFO over net debt:** calculated as FFO divided by net debt. This is a more dynamic measure of leverage than debt gearing and a useful indicator of a utility's ability to generate cash flows.

IPART look at these measures and assess if the regulated utility can maintain an investment grade credit rating over the period. The criteria used in shown in Table 3.2.

**Table 3.2: Credit Rating Metrics**

| | A3 | Baa1 | Baa2 | Baa3 | Ba1 |
|---|---|---|---|---|---|
| **FFO/interest** | >2.9 | 2.3x–2.9x | 1.7x-2.5x | 1.4/1.5x- 1.7x | <1.4/1.5 |
| **Debt/RAB[a]** | <60% | 80%-85% | 60%-91% | 90%->100% | >100% |
| **FFO/debt** | >10% | >10% | <6-10% | 5-8% | <4% |

Source: IPART

In these Moody's ratings, Baa1/Baa2 corresponds to the S&P BBB+/BBB ratings that most regulators consider to be investment grade and the minimum level for a creditworthy regulated entity.

We apply two of these ratios (FFO/Interest and FFO/Debt)) to a simple financial model of the ARTC using data from the 2014 compliance report. We do not use the Debt/RAB metric as we have no information of the ARTC's actual debt levels as the Hunter Valley operation is part of an integrated rail network.

We show the results in Table 3.3 below.

**Table 3.3: ARTC Financeability Metrics**

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Parameters** | | | | | | | | | | | | |
| | CPI | 2.5% | | | Cost of Debt | | 4.94% | | | | | |
| | WACC (Pre-tax Nominal) | 7.11% | | | Debt Gearing | | 52.5% | | | | | |
| | WAML | 23 | years | | | | | | | | | |
| | | **2015** | **2016** | **2017** | **2018** | **2019** | **2020** | **2021** | **2022** | **2023** | **2024** | **2025** |
| **Regulated Asset Base (Real, escalated)** | | | | | | | | | | | | |
| | Opening RAB | $ 2,017 | $ 1,993 | $ 1,968 | $ 1,942 | $ 1,914 | $ 1,884 | $ 1,851 | $ 1,817 | $ 1,779 | $ 1,739 | $ 1,694 |
| | Depreciation | $ 88 | $ 91 | $ 94 | $ 97 | $ 101 | $ 105 | $ 109 | $ 114 | $ 119 | $ 124 | $ 130 |
| | Capex | $ 64 | $ 66 | $ 67 | $ 69 | $ 71 | $ 72 | $ 74 | $ 76 | $ 78 | $ 80 | $ 82 |
| | Closing RAB | $ 1,993 | $ 1,968 | $ 1,942 | $ 1,914 | $ 1,884 | $ 1,851 | $ 1,817 | $ 1,779 | $ 1,739 | $ 1,694 | $ 1,646 |
| **Maximum Allowed Revenue** | | | | | | | | | | | | |
| | Return of capital | $ 88 | $ 91 | $ 94 | $ 97 | $ 101 | $ 105 | $ 109 | $ 114 | $ 119 | $ 124 | $ 130 |
| | Return on Capital | $ 143 | $ 142 | $ 140 | $ 138 | $ 136 | $ 134 | $ 132 | $ 129 | $ 127 | $ 124 | $ 121 |
| | Opex | $ 120 | $ 123 | $ 126 | $ 129 | $ 132 | $ 136 | $ 139 | $ 143 | $ 146 | $ 150 | $ 154 |
| | MAR | $ 351 | $ 355 | $ 360 | $ 364 | $ 369 | $ 374 | $ 380 | $ 385 | $ 391 | $ 398 | $ 404 |
| **Profit and Loss** | | | | | | | | | | | | |
| | Revenue | $ 351 | $ 355 | $ 360 | $ 364 | $ 369 | $ 374 | $ 380 | $ 385 | $ 391 | $ 398 | $ 404 |
| **Less:** | | | | | | | | | | | | |
| | Opex | $ 120 | $ 123 | $ 126 | $ 129 | $ 132 | $ 136 | $ 139 | $ 143 | $ 146 | $ 150 | $ 154 |
| | Depreciation | $ 88 | $ 91 | $ 94 | $ 97 | $ 101 | $ 105 | $ 109 | $ 114 | $ 119 | $ 124 | $ 130 |
| | Interest | $ 52 | $ 52 | $ 51 | $ 50 | $ 50 | $ 49 | $ 48 | $ 47 | $ 46 | $ 45 | $ 44 |
| | | $ 260 | $ 265 | $ 271 | $ 277 | $ 283 | $ 289 | $ 296 | $ 303 | $ 311 | $ 319 | $ 328 |
| | PBT | $ 91 | $ 90 | $ 89 | $ 88 | $ 86 | $ 85 | $ 84 | $ 82 | $ 80 | $ 79 | $ 77 |
| **Financeability Metrics** | | | | | | | | | | | | |
| | Funds from Operations | $ 231 | $ 232 | $ 234 | $ 235 | $ 237 | $ 239 | $ 241 | $ 243 | $ 245 | $ 248 | $ 251 |
| | FFO/Interest | 4.4 | 4.5 | 4.6 | 4.7 | 4.8 | 4.9 | 5.0 | 5.1 | 5.3 | 5.5 | 5.7 |
| | Debt Gearing | 52.5% | 52.5% | 52.5% | 52.5% | 52.5% | 52.5% | 52.5% | 52.5% | 52.5% | 52.5% | 52.5% |
| | FFO/Total Debt | 22% | 22% | 23% | 23% | 24% | 24% | 25% | 25% | 26% | 27% | 28% |

Based on these criteria, IPART would assess the ARTC as well above A3, clearly investment grade.

Substituting the HRATF value of 29 years for the WAML as calculated in Table 4.1 does not materially change the financeability rating as shown in Table 3.4 below.

**Table 3.4: ARTC Financeability Metrics (29 Year WAML)**

| | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Financeability Metrics** | | | | | | | | | | | | |
| | Funds from Operations | $ 213 | $ 215 | $ 217 | $ 219 | $ 221 | $ 223 | $ 226 | $ 228 | $ 231 | $ 234 | $ 237 |
| | FFO/Interest | 4.1 | 4.1 | 4.2 | 4.2 | 4.3 | 4.3 | 4.4 | 4.5 | 4.6 | 4.7 | 4.8 |
| | Debt Gearing | 52.5% | 52.5% | 52.5% | 52.5% | 52.5% | 52.5% | 52.5% | 52.5% | 52.5% | 52.5% | 52.5% |
| | FFO/Total Debt | 20% | 20% | 21% | 21% | 21% | 21% | 22% | 22% | 23% | 23% | 24% |

These results show that the WACC in the ACCC draft decision can be expected to continue to enables ARTC to raise debt and equity on favourable terms as the Hunter Valley network, considered separately, would have an above investment grade credit rating.

# 4 WAML

The HRATF strongly supports the ACCC draft decision which requires a WAML approach and methodology that is clear, transparent and based on appropriately robust JORC data. This will result in the economically efficient operation of, use of and investment in the ARTC's infrastructure.

The ACCC notes that the use of the WAML for depreciation is only one of a number of components that, taken together, significantly decrease the ARTC's stranding risk. In addition to the WAML, the other mitigants are:

- long term rolling TOP contracts;
- a revenue cap model with unders/overs accounting;
- loss capitalisation;
- financial security for a portion of TOP payments; and
- standard economic lives of the ARTC's assets.

We note that in submissions and the draft decision itself, there appear to be some inconsistencies of terminology regarding reserves and production. It is not always clear if the data is:

- "Coal Reserves" or "Marketable Coal Reserves" or
- "As Mined (ROM) Production" or "Saleable Production".

To provide clarity and transparency, we have used these terms in full and in accordance with the JORC Code and provide full disclosure of data, data sources, assumptions and formulas used in our proposed WAML. In this section, we comment on the ACCC's proposed approach to:

- JORC reserves
- End of life discount
- Production rate
- Mandatory review

Finally, we attempt to replicate the ACCC's point estimate methodology using publicly available data.

## 4.1 JORC Reserves

In previous submissions the HRATF has strongly promoted the use of JORC data of reserves as a robust and verifiable basis for the calculation of the WAML.

HRATF has noted that JORC, as well as being a well-developed and standardised industry approach, is also the basis for mining companies to make share price sensitive announcements to shareholders—announcements that have material legal consequences for the company and its executives if found to be false or misleading.

We see no reason why the JORC data should be subject to arbitrary "adjustment" by the ARTC, especially based on the advice of a confidential consultant. The ACCC's consultant, Geoscience Australia supports this view, stating that:

> *Geoscience Australia strongly recommends that the JORC Code estimate provided by the Competent Person for each mine is used as reported to the financial markets. To (publicly) do otherwise is to imply that the ARTC has more knowledge of ore bodies and mining methods than the Competent Person, who therefore must have misled the financial markets by overestimating the Ore Reserve.*[1]

While the ACCC's other consultant, ACIL Allen, does suggest that the JORC proven and probable reserve estimates may have different confidence levels, they acknowledge that they do not have the level of mining expertise to suggest what those different levels might be. However, ACIL Allen miss the point that the JORC estimate is an "expected value" and as such the confidence intervals have an equally valid upper bound as well as the lower bound used by the ARTC.

The HRATF continues to support the use of unadjusted JORC data to estimate reserves.

We also note that the ACCC refer to mining reserve information as being based on "ARTC data". For clarity, we suggest the more accurate term "JORC data" be used—that is publicly available data provided to the ASX and prepared by a Competent Person in accordance with the JORC Code.

### 4.2 End of Life Discount

As discussed in Section 4.1 the HRATF does not see any reason to adjust the JORC reserve data and thus disagrees with the concept of an end of mine life adjustment.

The JORC data for the Hunter Valley mines states reserves as "Marketable Coal Reserves" that are based on geological modelling of the anticipated yield from "Recoverable Coal Reserves". This means that any end of life adjustment, for coal that may remain is already included as the JORC definition of "Marketable Coal Reserves", represents:

> *…. beneficiated or otherwise enhanced coal product where modifications due to mining, dilution and processing have been considered*[2]

Previous HRATF submissions of reserves used in our calculation of the WAML have always been expressed as "Marketable Coal Reserves".

However, the ACCC's proposed "end of life" discount of 3 percent makes no material difference to the WAML.

### 4.3 Production Rate

The ACCC considers that the annual production rate in the WAML calculation should be the contracted commitments of the coal miners.

The HRATF has previously proposed production rate as defined by JORC, but used the 2015 actual saleable production as a proxy.

While we recognise that the use of contract commitments is appropriate, our preference would be to continue to use actual production data in the interests of transparency and replicability. This is because the contracted commitments under the rolling TOP contracts between the individual miners and the ARTC are commercial in confidence and thus not publicly available. Alternatively, we would

[1] Geoscience Australia, Geoscience Australia advice to the Australian Competition & Consumer Commission regarding certain geotechnical aspects of the Australian Rail Track Corporation submission to the 2017 Hunter Valley Coal Network Access Undertaking, 20 February 2017, p. 9.

[2] Joint Ore Reserves Committee, The JORC Code - 2012 Edition, December 2012, p. 22.

support a process under which the ARTC makes detailed contract data available to the ACCC, which then confirms the individual levels on a confidential basis with each access seeker.

We note that previous HRATF submissions of production rates used in our calculation of the WAML have always been expressed as “Saleable Coal”, not ROM and reserves as “Marketable Coal Reserves, making the ACCC’s proposed conversion factor (from saleable to run of mine production) unnecessary.

### 4.4 Mandatory Review

The HRATF concurs with the ACCC that the recalculation of the WAML should be done at the Mandatory Review and that the methodology and criteria should be the same as that used in the Final Decision, unless that methodology is found to be incorrect and a materially better (preferable) methodology can be applied.

Prospective mines or mines placed in care and maintenance should be subject to the same criteria as established in the Final Decision.

### 4.5 ACCC’s Point Estimate

In this section, we attempt to replicate the ACCC’s point estimate of the WAML. It was derived using the following data and assumptions:

- ARTC’s data (presumably JORC reserves but not stated);
- Production rates measured by contracted capacity;
- A saleable to run of mine conversion factor of 76 per cent;
- A 3 per cent end of mine life adjustment; and
- No proved or probable reserve adjustment.

The ACCC draft decision states that this results in a WAML of 23 years. The HRATF has been unable to replicate this calculation, possibly due to inconsistencies in the data used by the ACCC.

The data used by the ACCC as reserves is described as “ARTC data” with no explanation and no reconciliation to the publicly available and granular JORC “Marketable Coal Reserve” data contained in our August 2016 submission. It is also not clear if the data used by the ACCC is “Coal Reserves” or “Marketable Coal Reserves” or a mixture.

If they are “Marketable Coal Reserves”, this means that the conversion factor is superfluous and understates the WAML. If they are “Coal Reserves”, then they may be inconsistent with publicly available JORC data as in most cases only “Marketable Coal Reserves” are disclosed.

We have conducted our own WAML calculations using the ACCC point estimate assumptions and:

- “Marketable Coal Reserves” JORC data for all mines; and
- “Saleable Production” for annual production.

Thus, no conversion between reserves, ROM production and contracted capacity is needed.

We include prospective mines and mines under care and maintenance. For prospective mines, we assume a 30-year mine life and equated saleable production to this life. For care and maintenance mines, we assume a nominal 1.0 Mt saleable production as their contribution to total reserves and thus the WAML is not material (less than 2 percent).

As each mines' individual contract capacity levels are commercial in confidence—see Section 4.3—we have used two alternative approaches to proxy contracted capacity:

- 2015 actual saleable production of 163.4 Mt plus prospective mines estimated saleable production of 30.3Mt for a total 193.7Mt; and
- 2015 actual and estimated prospective saleable production of 193.7 Mt scaled down to the estimated contracted capacity of 190.0 Mt. The reduction has been applied to prospective mines only.

The results of our calculations are shown in Table 4.1.

**Table 4.1: HRATF WAML Calculation**

| Reserve and Production Data | Marketable Coal Reserves Mt | Saleable Production Mt |
|---|---|---|
| All Mines | 4893.9 | 194.7 |
| Operational Mines | 3938.8 | 163.4 |
| Prospective Mines (incl. care and maintenance) | 955.1 | 31.3 |
| | | |
| **Weighted Average Mine Life (WAML)** | **Saleable Production Mt** | **Years** |
| All Mines, 2015 actual saleable production plus assumed prospective and care and maintenance mines | 194.7 | **28.9** |
| All Mines, 2015 estimated contracted capacity | 190.0 | **29.8** |

The results are substantially different to the ACCC's WAML estimate of 23 years. We note that the 76 percent saleable to ROM conversion factor, if incorrectly applied to our calculations, would account for the difference.

While we support the ACCC's approach and methodology, we ask that any WAML calculation be fully detailed and transparent with full disclosure of data and sources.

# 5 Floor and ceiling limits and recovery of Incremental Cost

## 5.1 Floor and Ceiling limits

HRATF agrees with the broad principles for treatment of Incremental Cost set out by the ACCC in the draft decision at page 34, being that:

(a) Incremental Costs should be recovered based on two constrained networks and ceiling limits (one governing Zones 1 and 2 and the other Zone 3);

(b) Incremental Cost should comprise both Incremental Maintenance Cost and Incremental Capital Cost; and

(c) Access revenues received from a customer should be allocated to only one ceiling limit (although this is subject to the final approach adopted to implementing the dual ceiling model – which was unclear in the original 2017 HVAU drafting).

(d) Traffic that operate in Pricing Zone 3 pay the Incremental Cost (i.e. both Incremental Maintenance and Incremental Capital) of any use of Pricing Zone 1/2 for the term of the HVAU.

The HRATF Support maintaining the dual ceiling approach for the term of the undertaking, irrespective of what happens with loss capitalisation during the initial term of the 2017 HVAU (i.e. up to the first Review Date). This will provide greater certainty and stability in the approach to tariffs throughout this initial 5-year period.

While HRATF supports the general principles above, we reiterate our concerns with the drafting proposed by ARTC. We would welcome the opportunity to work with ARTC in refining the approach to implementing the above principles in a resubmitted 2017 HVAU.

### 5.2 Defining Incremental Cost

HRATF agrees with the ACCC's view in the draft decision that more clarity is needed around the scope and definition of Incremental Cost.

As noted in our earlier submission, HRATF accepts the general position of WIK that the approach to incremental costs should be consistent with standard economic principles and reflect the long run avoidable costs of providing services. This general position should be reflected in any definition of incremental costs – whether maintenance or capital costs.

At the same time, we acknowledge that ARTC and producers need certainty on 'day one' about what costs will be treated as Incremental Costs for the purpose of the annual compliance process. To that end, we consider that the specific allocation of minor capex and maintenance costs treated as incremental by WIK, and identified in the draft decision, should operate as the starting point for this purpose under the 2017 HVAU. To provide certainty, these should be set out and specified in the 2017 HVAU.

Once this 'baseline' has been established, all future capital expenditure will be treated as incremental, unless the RCG approves for it to be treated as a Fixed Cost.

We are also concerned that, in the absence of a cost allocation manual, there is no transparency around the capitalisation rules that are applied by ARTC in this regard. This had originally been seen as less important because those principles would form part of any new opex efficiency mechanism. However, given the need to progress the 2017 HVAU without a fully worked mechanism, we consider that the 2017 HVAU needs to impose an obligation on ARTC to prepare and submit (within a short period following commencement) a cost allocation manual, that includes capitalisation rules. There needs to be a process for consultation, and a right for the ACCC to direct ARTC in relation to those rules. Any variations should also be subject to consultation and ACCC approval.

In summary, therefore, we consider that the approach to defining and dealing with Incremental Costs under the 2017 HVAU should take the following approach:

- The definitions of both Incremental Maintenance and Incremental Capital Costs should be defined as costs that are reasonable avoidable in the long run (and should not refer to costs that vary with usage).

- As presently in the draft 2017 HVAU, all capital costs moving forward should be treated as Incremental Costs, unless the RCG specifically approves for them to be treated as Fixed Costs.

- As noted in our original submission, and accepted in the draft decision (at page 220), this means that there needs to be a process to refer disputes to the ACCC concerning the approach adopted to determining that costs are Fixed Costs (and that could otherwise give rise to unfairness as between Coal Producers).

- ARTC must produce a cost allocation manual that defines capitalisation rules. This manual (and the associated capitalisation principles) must be approved by the ACCC and any change to those rules must also be subject to consultation with industry and ACCC approval.

### 5.3 Allocation of Economic Cost[3]

HRATF continues to consider that the use of actual railed tonnes for the allocation of Incremental Capital Cost is not consistent with the objective of promoting efficient investment in the rail infrastructure. The reason for this is that the investment framework in the HVAU is built around providing the right incentives for ARTC *investing* in capacity to meet its contracted position.

As a general principle, we understand the ACCC's theoretical position – costs that vary with usage (either variable or incremental capital) in workably competitive markets would usually be recovered through usage-based charges. In most markets, firms invest in anticipation of usage, and then recover their costs through such usage charges.

However, this is not how the market works in this case. ARTC does not invest in anticipation of usage. It invests in response to specific contracted positions. ARTC would not proceed with an investment on the expectation that it could recover costs through selling uncontracted train paths. Rather, it commits sufficient capital to meet its incremental obligations under new take-or-pay contracts. In other words, variable charges (non-take-or-pay) play no role in sending new investment signals. Rather, investment is signalled by the willingness of users to enter into new take-or-pay contracts.

Given this investment context, we reiterate that the most efficient pricing structure would be one where:

- Capital costs for the contracted volumes were recovered through take-or-pay charges; and
- Variable costs were recovered through variable charges.

Given this, we believe that cost structures and tariff structures should be aligned, and do not agree that the Act does not require tariff structures to align with cost structures – this is central to providing a pricing framework that promotes efficient use of infrastructure. Using contracted volumes for the calculation of incremental costs is the only approach consistent with the current investment framework and the optimal tariff structure. By contrast, using actual volumes would mean that the charging structure is essentially divorced from the actual investment framework.

It should not be assumed that actual use typically aligns with or should be expected to align with contracted position in any given year, for all producers. Rather, producers enter into long-term contracts for the capacity they believe they will need. If their actual requirement changes—either temporarily or permanently—the fact that they have already caused the investment to occur does not change.

## 6 Opex

On 12 April 2017, HRATF was provided by ARTC with a draft HVAU (**Opex HVAU**) containing ARTC's proposed approach to implementing an opex efficiency incentive framework.

[3] As with our previous submission, HRATF notes that one of its members (Anglo American) does not support the position set out in this section 5.3 in relation to the allocation of Incremental Capital Costs on the basis of contracted tonnage. All other HRATF members support the position in this submission.

While ARTC's proposed draft opex framework was not included in the 2017 HVAU which was the subject of the draft decision, we take this opportunity to respond to the Opex HVAU, given its relevance to any resubmitted HVAU.

HRATF has very significant concerns with the opex framework proposal that has been advanced by ARTC. The proposed framework is fundamentally inconsistent with the objects of Part IIIA and the pricing principles, in that:

- it provides scope for ARTC to recover significantly more than the efficient costs of providing access;
- it therefore would not promote the economically efficient operation of, use of and investment in, the Hunter Valley network;
- it does not provide adequate incentives to reduce operating costs and improve productivity; and
- it is inconsistent with the approach to access regulation in other industries, including the approach of the AER in the energy sector and the ACCC in telecommunications.

ARTC states that its proposed opex framework is "broadly based" on the National Gas Law, but is designed to ensure that ARTC has the ability to obtain the equivalent of merits review. We do not agree that the opex framework is consistent with the NGL/NGR or any other workable efficiency incentive scheme used in other Australian regulation.

While HRATF had understood that the opex framework being developed by ARTC would be modelled on those used in the energy sector, the framework ultimately proposed departs from standard practice in a number of important respects, including:

- there is no explicit standard to be applied by the ACCC in assessing forecasts (e.g. a requirement that the forecast reflect prudent and efficient costs) – rather, the Draft HVAU only contains high-level principles that forecasts are to be consistent with, and matters that ARTC must "take into consideration" in developing forecasts;
- it is likely that the triennial opex review process will become messy and drawn out, due to the proposed timeframes and lack of clarity around methodologies and standards to be applied;
- scope for pass through of costs associated with "incidents" and other events is too broad. In seeking the right to pass through costs associated with these events, ARTC is seeking a level of risk protection that is not afforded to regulated businesses in other sectors;
- there is no provision for oversight or assessment of pass through amounts by the ACCC, to ensure that only the *efficient* costs of dealing with an event are passed through to users – again, this can be contrasted with the position in other regulated industries; and
- the proposed merits review regime is effectively asymmetric – merits review would only be available where ARTC's expenditure forecast is rejected by the ACCC in a final decision, and not where forecasts are accepted.

Because of the extent and seriousness of the flaws with the proposed framework, HRATF do not consider that it provides an appropriate starting point for taking the development forward. Given the extent of the concerns, and timing considerations, HRATF submit that the opex development process now needs to be left until after the 2017 HVAU is finalised and in place.

We expand on each of our high level concerns below.

### 6.1 Framework for assessment of opex forecasts for future periods

The Opex HVAU provides very little guidance around the methodology to be applied in forecasting opex for future periods. Unlike the National Gas Rules (**NGR**) and National Electricity Rules (**NER**), there is no explicit standard that a forecast must meet, which creates difficulties for the ACCC in assessing forecasts – and no clear basis for resolving disputes on review.

The Opex HVAU principles offer little guidance on the methodology to be applied in developing forecasts.

Where a regulator is required to review and approve expenditure allowances, there is typically an explicit standard to be applied in undertaking that assessment. For example:

- under Chapter 6 of the NER, the forecast of required operating expenditure for a regulatory control period must reasonably reflect:[4]
  - the efficient costs of achieving the operating expenditure objectives;
  - the costs that a prudent operator would require to achieve the operating expenditure objectives; and
  - a realistic expectation of the demand forecast and cost inputs required to achieve the operating expenditure objectives.
- under the NGR, operating expenditure must be such as would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of delivering pipeline services;[5] and
- under the fixed principles applied by the ACCC in regulating fixed-line telecommunications access services, forecast operating expenditures should reflect prudent and efficient costs.[6]

The Draft HVAU does not provide a similar standard. Consequently, there is nothing for the ACCC to assess a proposed forecast against, other than general principles and matters that must be taken into account. It will therefore be difficult for the ACCC to ensure that a forecast reflects prudent and efficient costs.

The Opex HVAU also provides very limited guidance on the methodology to be applied in determining forecasts. Again, this can be contrasted with the practice in other infrastructure sectors.[7]

Under the Opex HVAU, ARTC would be required to prepare a New Opex Proposal in accordance with the principles set out in proposed clause 4.8C(c). However, these principles are at a very high level, and are unlikely to impose any meaningful constraint on ARTC's choice of methodology and inputs. For example:

- there is no requirement that particular costs be forecast using a 'base-step-trend' approach, as is commonly applied in other sectors, including energy – rather, the proposed principles would

[4] NER, cl 6.5.6(c). The 'operating expenditure objectives' are set out in cl 6.5.6(a).

[5] NGR, rule 91.

[6] ACCC, Final Access Determinations no 2, 3, 4, 5, 6, 7, and 8 of 2015, 7 October 2015, cl 6.9.

[7] For example, under the NER, the AER is required to publish guidelines that specify the approach the AER proposes to use to assess the forecasts of operating expenditure and capital expenditure that form part of Distribution Network Service Providers' regulatory proposals, and the information the AER requires for the purposes of that assessment. The current guidelines state that the AER will apply a 'base-step-trend' approach to assessing most opex categories. The guidelines also set out how the AER will apply this approach.

appear to offer flexibility for ARTC to choose which costs (if any) are to be forecast using a 'base-step-trend' approach, and which costs are to be forecast using a bottom-up approach, or indeed some other approach;

- where ARTC chooses to apply a 'base-step-trend' approach, there is only a general requirement that realised efficiency gains "inform" the forecast of costs for the Future Opex Period (proposed cl 4.8C(c)(i));

- there are no guiding principles for the determination of trend factors or forecast step changes; and

- where ARTC chooses to apply a bottom-up approach, the Draft HVAU only requires ARTC to "take into consideration" certain matters (proposed cl 4.8C(c)(ii)).

The failure to lock in efficiency gains for future periods is clearly a fundamental flaw in the design that is proposed.

These principles are clearly important. Under the Draft HVAU, the ACCC **must** approve a New Opex Proposal if it is "consistent with" the proposed principles (proposed cl 4.8C(d)). Therefore, for these principles to have meaningful effect, they must constrain the way in which ARTC prepares its proposal. If they offer significant latitude and discretion around the methodologies that may be applied, there will be little that the ACCC can do to ensure efficiency of forecast expenditure.

HRATF is concerned that simply requiring ARTC to "take into consideration" certain matters will not provide sufficient constraint on its choice of methodology and input parameters, and will not ensure that forecasts reflect only prudent and efficient costs.

HRATF suggests that, at a minimum, there be mandatory requirements for a New Opex Proposal that go to the *prudency* and *efficiency* of that proposal. Such requirements could be modelled on the requirements of the NGR and/or NER – for example, the HVAU could include the following requirement (modelled on rule 91 of the NGR):

> *Forecast operating expenditure must be such as would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing Access.*

Additionally, the HVAU should set parameters around the choice of methodology. For example, the HVAU could require that recurrent opex items be forecast using a 'base-step-trend' approach, and non-recurrent items be forecast using a bottom-up approach. This would ensure that, at least for recurrent cost items, the scope for disputation is minimised (i.e. dispute would be limited to trend factors and step changes).

### 6.2 Network and service standards to be maintained

The Opex HVAU does not require ARTC to meet or maintain benchmark service levels or network reliability standards as it seeks out cost reductions. There is therefore a risk that, once an opex allowance is set, ARTC may reduce operating expenditure in a way that reduces service levels and/or network reliability. This would be to the benefit of ARTC (as it would keep the financial benefit of any opex reduction), but to the detriment of users.

ARTC should not be able to benefit from reducing network reliability or service levels provided to customers. Rather, ARTC should only benefit from genuine efficiency improvements – i.e. where ARTC is able to reduce the cost of providing the same level of service and reliability.

As noted above, under the NER, the opex forecast for each period is tied to the achievement of specific objectives, referred to as the 'operating expenditure objectives'. These objectives are

directed at maintaining compliance with regulatory obligations (including jurisdictional service standards) or otherwise maintaining the quality, reliability and security of supply.[8]

Electricity network businesses are also subject to performance and service standard monitoring schemes. Under these schemes, businesses may face financial penalties if they fail to meet and maintain specified service standards.[9]

Similarly, any opex framework that is applied to ARTC must be designed to ensure that network reliability and service levels are maintained. ARTC should not be financially rewarded for reducing the level of service provided to users. Rather, the opex framework should only reward genuine efficiency improvements by ARTC.

### 6.3 Process for determining opex allowances for future opex periods

ARTC proposes a 'propose-respond' process for setting Base Opex for future periods. There is provision for an initial proposal, an initial ACCC decision, a revised proposal, and further ACCC decision. If the ACCC does not approve a revised proposal, it may either seek a further revised proposal or prepare and approve its own proposal. If the ACCC approves its own proposal, ARTC must then submit a "final proposal" as an application to vary the undertaking ( proposed cl 4.8C(f)(v)).

While this 'propose-respond' process is broadly consistent with the process for review and assessment of expenditure proposals in the energy sector, in this case the ACCC is not empowered to make a determination setting the allowance where it does not accept the ARTC proposal – rather the ACCC can only accept or not accept what is put forward by ARTC.[10] This has a number of implications, including:

- as discussed above, there must be a clear standard against which the ACCC can assess the forecast, and make a decision on whether or not to accept it – otherwise, the ACCC may be forced to accept a forecast that does not reflect prudent and efficient costs; and

- there is the potential for the review process to become drawn out, since an additional step is required (i.e. the step of ARTC putting forward a "final proposal" which reflects the ACCC's final decision, and the ACCC then accepting that proposal). There is therefore the potential for some delay in finalisation of the opex review process. HRATF notes that the Opex HVAU caters for the circumstance in which a final decision on the forecast is not made in time for the start of the new opex period, by providing for adoption of the most recent ARTC or ACCC proposal, and then a subsequent true-up, if the process is not completed by 30 September in the prior year (proposed cl 4.8C(g)). However we note that in practice, this is likely to mean that ARTC's proposal will apply for at least the first year of each period, regardless of whether it is ultimately approved by the ACCC.[11] While there is provision for a 'true-up', this may not occur until late in the Opex Period, particularly if ARTC seeks merits review of the ACCC's final decision.

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[8] NER, cl 6.5.6(a) (for distribution) / 6A.6.6(a) (for transmission).

[9] Under the NER, the AER is required to develop and publish a scheme to provide incentives for service providers to maintain and improve performance (NER, cl 6.6.2 (for distribution) / 6A.7.4 (for transmission)). The AER has developed a Service Target Performance Incentive Scheme (STPIS), under which it imposes penalties and offers incentive payments linked to performance against specified reliability and service metrics. Penalties or incentive payments under these schemes are included in the calculation of building block revenue allowances.

[10] Although the ACCC can prepare and approve its own proposal, this proposal only takes effect once it is incorporated into an undertaking variation proposal by ARTC, and that proposal is accepted by the ACCC. This can be contrasted with the position under NER, where the AER must determine its own forecast of opex where it does not accept a forecast that is set out in a regulatory proposal.

[11] ARTC is only required to submit its proposal 10 months prior to the commencement of a period (by 1 March in the prior year), and the ACCC has 6 months (until 1 September) to make its initial decision on whether to approve it. If the ACCC does not accept the initial proposal and seeks a revised proposal from ARTC within 2 months, the initial proposal will be the most recent one as at 30 September, and so will apply for at least the first year.

The risk of process delays would be mitigated by tightening up the rules and principles that govern the ACCC's assessment. As noted above, there should at least be an explicit standard that forecasts must meet. Additionally, the HVAU should set parameters around the choice of methodology, in order to reduce the scope for disputation at each reset.

Consideration needs to also be given to amending the timeframes for ACCC assessment, with a view to having the process completed by 30 September in the year prior to commencement of the New Opex Period. This may involve bringing forward the date for ARTC to submit its initial proposal and/or shortening of the timeframe for the ACCC's initial consideration (currently 6 months).

### 6.4 Pass through and reopeners

ARTC proposes an unacceptably broad scope for pass through of costs associated with "incidents" and other events. The proposed scope for pass through under the Draft HVAU is much broader than is typically provided for under the NGR and NER.

Under the NER:

- 'pass through events' are tightly defined through the NER itself and revenue determinations made by the AER. These are typically limited to the four events identified in the NER ('regulatory change event', 'service standard event', 'tax change event' and 'retailer insolvency event')[12] plus a small number of additional events approved by the AER in revenue determinations;[13]

- the approach of the AER to assessing proposed additional pass through events (in addition to those specified in the NER) is to apply the 'nominated pass through event considerations'.[14] These include:[15]

  - whether the nature or type of event can be clearly identified at the time the determination is made for the service provider;

  - whether a prudent service provider could reasonably prevent an event of that nature or type from occurring or substantially mitigate the cost impact of such an event; and

  - whether the relevant service provider could insure against the event;

- a business may only pass through additional costs associated with a 'positive change event' with the approval of the AER. In determining the amount that may be passed through in respect of a positive change event, the AER must take into account various factors, including:[16]

  - the efficiency of the business' decisions and actions in relation to the risk of the positive change event, including whether the business has failed to take any action that could reasonably be taken to reduce the magnitude of the eligible pass through amount in respect of that positive change event and whether the business has taken or omitted to

[12] NER, cll 6.6.1 (for distribution) / 6A.7.3 (for transmission).

[13] For example, in its recent distribution determination for Powercor, the AER approved the inclusion of an 'insurance cap event', an 'insurer credit risk event', a 'natural disaster event', a 'terrorism event' and a 'retailer insolvency event' (the NER-prescribed retailer insolvency event is not available to Victorian businesses). See: AER, Final Decision: Powercor distribution determination 2016 to 2020, Attachment 15 – Pass through events, May 2016.

[14] NER, cl 6.5.10(b).

[15] See definition of nominated pass through event considerations' in Ch 10 of the NER. See also: AER, Final Decision: Powercor distribution determination 2016 to 2020, Attachment 15 – Pass through events, May 2016, p 15-11.

[16] NER, cl 6.6.1(j).

take any action where such action or omission has increased the magnitude of the amount in respect of that positive change event;

- the need to ensure that the business only recovers any actual or likely increment in costs to the extent that such increment is solely as a consequence of a pass through event; and

- whether the costs of the pass through event have already been factored into the calculation of the business' annual revenue requirement for the regulatory control period in which the pass through event occurred or will be factored into the annual revenue requirement for a subsequent regulatory control period;

- a business must notify the AER where a 'negative change event' occurs (i.e. where costs are lowered by a 'pass through event'), and the AER may require the business to pass through to network users a negative pass through amount, as determined by the AER.[17]

By contrast, the Opex HVAU provides for the **automatic** addition of any "Pass Through Amount" to the Opex Allowance for each Opex Year. Under the Draft HVAU, Pass Through Amounts may be associated with an incredibly wide range of events, including "Significant Incidents", as discussed below.

There is no provision for oversight or assessment of pass through amounts by the ACCC – this can be contrasted with the position under the NER, as outlined above. The absence of any ACCC oversight means that there can be no assurance for users that only the *efficient* costs of dealing with genuine pass through events are passed through to users.

Of the events for which ARTC seeks the right to pass through additional costs, only a small number are typically allowed for by the AER under the NER and NGR. These are the regulatory change event, tax change event, terrorism event and some insurance-related events.

All of the other events proposed by ARTC – including the 'Additional Volume Event', 'Net Loss on Disposal Event', 'Expensed Project Event', 'Capital Program Event' and 'Opex Scope Event' – are not typically provided for under the NER and NGR (see Table 6 below). In seeking the right to pass through costs associated with these events, ARTC is seeking a level of risk protection that is not afforded to regulated network businesses in the energy sector.

**Table 6: Comparison of ARTC proposed pass through events with those under NER[18]**

| Proposed pass through event | Provided for under NER? |
|---|---|
| Significant Incident Events | |
| Incidents (including a breakdown, accident or emergency on the Network) which individually meet the $1 million cost threshold | X |
| Multiple Incidents which collectively meet the $10 million cost threshold | X |

[17] NER, cl 6.6.1(b) and (f).

[18] This uses, as an example, the AER's recent determination in respect of Powercor (see fn 13 and 15 above).

| Proposed pass through event | Provided for under NER? |
|---|---|
| Uncontrollable Events | |
| Regulatory Change Event | ✓ |
| Insurer Credit Risk Event | ✓ |
| Insurance Cap Event | ✓ |
| Insurance Premium Event | X |
| Expensed Project Event | X |
| Terrorism Event | ✓ |
| HVCCC Levy Event | X |
| Tax Change Event | ✓ |
| Net Loss on Disposal Event | X |
| Other events | |
| Additional Volume Event' | X |
| Capital Program Event | X |
| Opex Scope Event | X |

The proposed pass through of costs associated with "Significant Incidents" is particularly problematic. The definition of "Incident" is very broad and potentially includes Incidents which ARTC was responsible for, was insured for, and/or could have taken steps to avoid or mitigate. The proposed definition of "Significant Incident Event" would also allow ARTC to aggregate the costs associated with many small "Incidents". Adopting such a broad definition of a pass through event would be inconsistent with the approach under the NER / NGR, and would not provide appropriate incentives for cost efficiency and efficient risk management by ARTC.

Finally, the Draft HVAU does not provide a clear requirement for ARTC to notify the ACCC, or to pass through cost savings, where a negative change event occurs (i.e. where its costs are lowered). As noted above, under the NER there is a requirement for businesses to notify the AER when a "negative change event" occurs. There are some similar requirements in the Draft HVAU, but they vary depending on the type of event – a "reasonable endeavours" requirement in relation to "Incidents", a more definite requirement in relation to "Uncontrollable Events", and no requirement in relation to the other types of event (e.g. it does not appear to be contemplated that there might be a volume reduction which causes a reduction in ARTC's costs). HRATF proposes that, for any pass through events that are included in the HVAU, ARTC should be under an obligation to notify the ACCC and pass through any cost savings whenever a negative change event occurs.

### 6.5 Merits review of opex decisions

Under ARTC's proposal, merits review of opex forecast decisions would effectively only be available to ARTC. This is because, under ARTC's proposal, the merits review framework in Part IIIA of the

CCA would only be triggered where the ACCC does not approve a revised proposal from ARTC and instead approves its own proposal (that decision triggering a requirement for ARTC to lodge an undertaking variation proposal). Merits review would not be available for users where the ACCC simply accepts ARTC's proposal (or revised proposal) for Base Opex, because that does not trigger an undertaking variation process.

If merits review is to be available for opex forecast decisions, it must be available to all parties, regardless of the ACCC's decision. This could be achieved by requiring ARTC to submit a variation proposal, regardless of whether the ACCC accepts or rejects its proposed opex forecast. HRATF notes that, in the energy sector, merits review is available to any 'affected or interested person or body', and may be taken regardless of whether the AER accepts or rejects a service provider's proposal.[19]

HRATF also notes that there are important differences between the energy merits review frameworks and the Part IIIA framework. In particular:

- grounds for review are narrowly confined in the energy frameworks. Under the NEL and NGL, an application may only be made on the grounds that there has been an error of fact in the original decision, that the exercise of the AER's discretion was incorrect, or the AER's decision was unreasonable, having regard to all the circumstances.[20] This limits the matters that may be raised on merits review in the energy sector, and effectively prevents a full re-hearing of all arguments and issues that were raised before the AER – in short, the scope of review is limited to correcting errors; it is not a *de novo* review; and

- there are strict limits on the evidence and other material that parties may rely on in merits review in the energy sector.

To the extent that merits review of opex decisions is to be provided for under the HVAU, this should be a 'limited' review, as it is in the energy sector. Given that opex forecast assessment involves significant regulatory discretion and judgements around efficiency, any review mechanism should be limited to correction of errors in the exercise of that discretion – this mechanism should not provide for a full re-exercise of that discretion by the review body.

### 6.6 Interrelationships with other elements of the ACCC's decision

The opex framework proposed in the Draft HVAU offers significant risk protection to ARTC. This is most clearly in the case in relation to the proposed pass through mechanism, which would allow ARTC to pass through costs associated with a range of events and incidents – including volume changes, changes in capex requirements, and opex scope changes – without ACCC oversight.

This is clearly relevant to the ACCC's assessment of ARTC's risk profile and the allowed rate of return. To the extent that the ACCC allows ARTC any of the risk protections it is seeking, this must be taken into account in setting risk parameters.

### 6.7 Conclusions and proposed response

Evidently, the Opex HVAU is fundamentally flawed and does not reflect the kind of orthodox 'base-step-trend' model that had been anticipated.

In the circumstances, therefore, HRATF considers that the following approach be taken:

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[19] NEL, s 71B / NGL, s 245. An 'affected or interested person or body' includes the service provider, a regulatory process participant or a user or consumer association.

[20] NEL, s 71C / NGL, s 246.

- Any further work on an opex framework be left until after a replacement HVAU is in place. The Opex HVAU is not an appropriate starting point for that further work and future development of drafting and approach should be worked on collaboratively with HRATF, as originally envisaged.

- Improvement be made to the existing ex post prudency test for opex, by ensuring that the RCG is provided with the same data set, and at the same time, as it is submitted to the ACCC. A process then needs to be included for the ACCC to consult with and take into account the views of industry in relation to prudency of opex.

- The innovation mechanism should be scrapped, as proposed in the draft decision.

# 7 Other

## 7.1 Cost allocation

HRATF had, in its earlier submission, acknowledged that the development of detailed cost allocation rules may occur as part of the opex development exercise. At that time, some useful and relatively detailed material was being developed by ARTC that was thought might be useful for this purpose.

However, given that the opex development process has not delivered a workable framework, we consider that the use of a cost allocation manual is warranted – and consistent with the approach adopted in most other regulated industries. HRATF agrees that the high level allocators proposed are not sufficiently granular or justified (i.e. ARTC has not demonstrated that they are cost-causative), particularly in relation to the allocation of Non-Segment Specific Costs as between coal and non-coal users.

In the absence of any other sufficiently detailed approach to cost allocation (such as through the opex framework) the 2017 HVAU should require ARTC to develop and submit a detailed cost allocation for approval. To the extent that the ACCC does not accept any cost allocation proposed, it should be open to the ACCC to require ARTC to amend the manual accordingly.

## 7.2 Term and renewal

HRATF reiterates support for a longer term (minimum 10 years), with provision for mandatory reopening of the key elements at 5 years. We support the draft decision in requiring the scope of the mandatory reopening be expanded to include:

- rate of return;

- remaining mine life;

- RAB methodology and roll-forward;

- opex regime (to the extent that one is subsequently adopted); and

- network performance standards.

There should always be scope for the ACCC to also consider whether the continuation of the HVAU remains appropriate. This is especially the case in circumstances where there is a risk of privatisation.

## 7.3 Functional Coal Paths

Finally, HRATF notes the ACCC has sought clarification around the way in which Functional Coal Paths are determined for the purpose of the True-up Test. We reiterate that for the purpose of

determining Network Path Capability, it is important that this reflects the capacity which is actually available for coal producers to plan their logistics solution around.

Coal producers generally align ARTC track contract capacity with Port and Above Rail contracts. This provides the most efficient supply chain solution by minimising total costs. It follows that the Network Path Capability should be calculated based on the train paths that ARTC are able to contract to coal producers, as the ability for coal producers to utilise paths beyond this is limited and highly inefficient.

The HRATF believes the definition of Network Path Capability should therefore relate to Functional Coal Paths that the network would be capable of providing based on the reasonable assumption that non-coal users utilise the paths allocated to them, or as an alternative, Function Coal Paths to be calculated based on the network capacity ARTC are willing and able to contract with coal producers. This means that non-coal paths should be excluded from the calculation of Network Path Capability. For consistency, non-coal paths should also not be included in the calculation of Total Path Usages Required.

The location at which Functional Train Paths are measured should also be adjusted to the furthest location from the port for each Pricing Zone. This is because the number of effective paths is likely to reduce with greater distance from the port, thus making the true-up test more relevant and important. We note that no adjustment would be required to the measurement point for Pricing Zone 2, since this already set to Ulan Junction. However adjustments would be required for Pricing Zones 1 and 3.

Finally, consideration should be given to the period over which the true-up test is to be conducted, given that it may yield differing results depending on the period used. HRATF is giving further consideration to this issue and may provide additional comments in due course.