Submission to the
Australian Competition and Consumer Commission

December 2017 Variation to Hunter Valley Access Undertaking

Anglo American Metallurgical Coal Pty Ltd

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1 Executive Summary

Anglo American Metallurgical Coal Pty Ltd (***Anglo American***) welcomes the opportunity to provide submissions to the Australian Competition and Consumer Commission (***ACCC***) in response to ARTC's proposed variation to the Hunter Valley Access Undertaking (the ***HVAU***).

1.1 Incremental capital costs and take or pay

As the ACCC would be aware from Anglo American's previous submission in respect of the various iterations of ARTC's 2017 draft access undertaking, and the ultimately approved variations to the existing access undertaking, Anglo American is opposed to ARTC's proposed methodology for allocation of incremental capital costs and changes to take or pay.

This submission is therefore principally a response to the queries raised in questions 5 and 7 of the ACCC's Consultation Paper of 18 January 2018.

The approach proposed by ARTC is not a 'clarification' of the HVAU or a 'codification' of the ACCC's 2013 Annual Finance Determination with one minor change (as ARTC seeks to imply in its explanatory guide). Rather, what is proposed is a fundamental change to the methodology for allocation of incremental capital costs from the position WIK-Consult (***WIK***) and the ACCC have previously determined is appropriate and applies under the HVAU.

Anglo American acknowledges that clause 2.3(d) of the HVAU provides for ARTC to submit a variation application which incorporated certain matters. However, the ACCC made it very clear in its Decision on the recently approved variation to the HVAU (the ***HVAU Variation Decision***) that:[1]

> *the ACCC acknowledges Anglo American's concerns about including section 2.3(d). In particular, Anglo American submits that it has reservations about how the drafting of section 2.3(d) precludes other outcomes. <u>The ACCC considers that ARTC's intention to submit a variation application does not mean that the application will be automatically accepted.</u> As part of any variation to the HVAU submitted under section 44ZZA(7) of the Act, the ACCC would consult as per its usual regulatory process. <u>In considering whether or not a variation to an undertaking is appropriate to accept, the ACCC must have regard to all of the relevant legislative criteria under section 44ZZA(3) of the Act</u>.*
>
> *…*
>
> *<u>The ACCC had not formed a view on ARTC's proposed approach to allocating incremental costs in the 2017 HVAU</u>*

In other words, the variation is required to be assessed on its own merits.

In summary, Anglo American's concerns with the proposed changes to the allocator for incremental capital costs continue to be that:

(a) **it is inconsistent with the determination of the ACCC in the 2013 compliance assessment** (supported by the independent advice of WIK) as to the appropriate method of allocation;

(b) **the public interest in regulatory certainty favours continuing the current operation of, and incremental cost allocation methodology under, the HVAU**;

[1] Decision - Australian Rail Track Corporation's application to vary the 2011 Hunter Valley Access Undertaking at 31 and 43.

(c) **the change is not justified by revenue stability** which is already delivered by the existing system given the similarity between contracted and actual utilisation levels, the only difference to ARTC should be one of potential timing;

(d) **the change is not justified by cross-subsidisation** - that is also a feature of the proposed methodology, and practically a feature of all multi-user infrastructure systems;

(e) **the change has the potential to incentivise inefficient investment** – by allocating incremental capital costs to users which are not utilising the capacity, there will be an artificial reduction in the efficient price for new entrants for the remainder of the under-utilising user's contract term; and

(f) **the change is not justified by alignment to investment drivers** – given actual usage, not just contracted capacity, is critical to driving incremental capital investment to a brownfield network like the Hunter Valley network.

No new reasons have been provided to justify this particular change under Path Based Pricing (***PBP***) or at all and the concerns that Anglo American raised throughout the 2017 draft access undertaking process remain unaddressed. In fact, ARTC acknowledges in its Explanatory Guide (p17), as part of its submission, that this is the only departure.

Anglo American therefore continues to consider that it is appropriate for allocation of such incremental capital costs to occur by reference to actual usage, not contracted capacity, consistent with the ACCC's 2013 Annual Final Determination, the advice of the ACCC's independent consultant and current practice. In that regard, Anglo American notes that it appears PBP can still function on the basis proposed by ARTC with actual usage rather than contract as the allocator for the reasons previously stated and outlined again herein (particularly given it is to be recovered on a $/gtkm basis under a 3 part tariff).

Accordingly, it is not appropriate for the ACCC to approve ARTC's proposed variation in this regard.

1.2 Previous submissions

Anglo American has provided comprehensive submissions on the issue of allocation of incremental capital costs in previous processes.

In particular, Anglo American refers the ACCC to each of the following Anglo American submissions:

(a) Submission of 8 February 2017 on the 2017 Hunter Valley Coal Network Draft Access Undertaking

(b) Supplementary submission of 28 February 2017 on the 2017 Hunter Valley Coal Network Draft Access Undertaking – Incremental Cost

(c) Submission of 7 June 2017 on the ACCC Draft Decision on the 2017 Hunter Valley Coal Network Draft Access Undertaking

(d) Submission of 20 June 2017 on the extension of the Hunter Valley Coal Network Access Undertaking.

The points raised in relation to allocation of incremental capital costs (and take or pay) in each of those submissions should be treated as part of this submission and taken into account in the assessment of ARTC's current proposed variation.

Without repeating each of those submissions in full, Anglo American has addressed in summary form below each of the issues raised by ARTC in its Explanatory Guide.

1.3 Path based pricing

Anglo American also has some concern in relation to the proposed change to path-based pricing.

Those concerns are not so much as to the principle as they are to the lack of transparency about how that change impacts on individual user's charges in different scenarios. In particular, it is not entirely clear how a change to path based pricing would impact on pricing.

Unfortunately, based on how opaque the disclosures around transition in the proposed pricing regime and pricing impacts have been, Anglo American cannot currently support the change to path based pricing as it is currently framed.

2 Allocation of Incremental Capital Costs

2.1 Inadequacy of further information provided

The HVAU Variation Decision specifically noted that:[2]

> *the ACCC expects that ARTC will engage with the ACCC as early as possible after 1 July 2017 as to the information the ACCC requires (as set out in Appendix A) as part of this process*

In that regard the ACCC sought for ARTC to *'provide worked examples of the relationship between setting TOP Charges and reconciliation with the ceiling revenue tests through the annual compliance process*', with the view that those examples *'would provide clarity and certainty to Access Holders regarding this relationship'*.

Anglo American continues to consider that the worked examples provided do not fully demonstrate how the pricing is calculated under ARTC's proposed methodology in showing the transition from the current charging methodology to PBP and the revision of the allocator for incremental capital costs.

Anglo American has, like other coal users, never had full visibility as to the charge setting process and continues to consider that it remains inappropriate for approval to be given to a pricing methodology which stakeholders cannot provide properly informed comments on and in any event is a clear departure from the approved WIK approach.

2.2 Revenue certainty / stability

It is not true that high proportions of TOP Charges are required to provide a high degree of revenue certainty for ARTC as ARTC appears to assert.

As noted in earlier submissions, as Anglo American understands the application of the ACCC's 2013 compliance assessment, revenue variability is caused by the differences between forecast and actual usage (which are then reconciled as part of the subsequent annual 'unders and overs' calculations). That appears to be consistent with the ACCC's understanding as set out in the Draft Decision on the 2017 DAU. Anglo American shares the ACCC's understanding that the 'unders and overs' reconciliation is based on all revenue earned by ARTC, not just revenue from TOP Charges.

Anglo American notes the ACCC indication that the difference between contracted and actual volumes in recent years has not been large (page 59, Draft Decision on the 2017 DAU) and that appears consistent with ARTC's commentary about system capacity constraints (page 15 of ARTC Explanatory Guide for the HVAU Variation). That also accords with Anglo American's understanding.

Any potential variance would not be anticipated to be significant because:

(a) the forecast usage ARTC assumes for the purpose of allocation during the year is presumably based heavily on the work of the HVCCC, who have visibility of all elements of

[2] at 44.

the coal supply chain and have a track record of providing accurate forecasts as well as ARTC’s own information (i.e. – forecasting) and modelling; and

(b) for there to be aggregate variability in pricing there would need to be aggregate variability in actual usage of zone 1. Whereas, what would be anticipated is that variability in usage by individual users will not all occur in the same direction (i.e. if one user under produces while another is overproducing, that will 'balance out' in terms of the aggregate differences between forecast and actual usage).

As such, the discussion about the alleged importance of the proportion of charges constituting TOP Charges appears to be substantially overstated. The differences in allocation methodology should be only potentially changing the timing in ARTC's receipt of revenue, not the aggregate amount.

2.3 Cross subsidisation

ARTC asserts that the methodology for allocation of incremental capital costs should be changed on the basis that it involves the prices users pay being impacted by the conduct of other users.

The practical reality is that that is an outcome which is typical of most multi-user systems (particularly those which are regulated through some form of revenue cap, such that unders and overs driven through fluctuations in volumes are socialised). Users in such a system will always be sharing risk and thereby assuming a degree of risk related to other users' conduct. For example, the Aurizon Network regulatory arrangements involve reference tariffs being derived from a system allowable revenue based on volume forecasts (i.e. forecast usage) and contractual take or pay charges being subject to a 'system trigger', such that users not railing to their contracted capacity are not charged take or pay where railing above forecast by other users means that the system allowable revenue has still been derived.

Mine production will never perfectly match contracted capacity for any producer. Consequently, the fact that an individual user may rail under contract in a particular year and from another user's over-railing (and that those reverse would be true in the event their positions were reversed in the next year) is part of the 'swings and roundabouts' of being part of a multi-user system.

In addition, Anglo American continues to consider that ARTC's proposed methodology also involves cross-subsidisation between users.

Under ARTC's proposed change, a mine that has contracted capacity which it is not using that capacity) and is not responsible for triggering capital investments would effectively be required to continue to pay for capital investments triggered by others. That situation could well continue for a significant period given the long term basis upon which capacity is contracted on ARTC's Hunter Valley network.

In addition, the exposure to other users usage levels is far less than ARTC appears to be asserting, given that the vast majority of users' actual usage is closely matched to their contracted capacity.

2.4 Impact on investment

ARTC appears to assert that the proposed change to the allocation methodology is justified by facilitating efficient investment in the network.

However, Anglo American is concerned that basing incremental cost allocation on contracted paths will also impact on efficient investment, and incentivise inefficient over-investment. Because, as noted above, existing mines that are ‘over-contracted’ will effectively be cross-subsidising new mines which triggered the incremental capital, which will make access to the network lower cost than would be efficient. Consequently there is a risk of coal miners making inefficient investment decisions in mines based on the lower pricing, which then become problematic when the over-contracted positions of existing mines cease.

In addition, as noted previously, ARTC acknowledges in its Corridor Strategy that it has regard to long term forecasts not just contracted capacity when looking at additional capacity requirements particularly those that are capital related.

2.5 Alignment with causation of investment

ARTC appears to assert that contracted positions are what cause capital investment, such that the change in methodology is justified by greater alignment.

That may be the case for greenfield infrastructure, where there is no history of actual usage and which, for financing purposes, requires the investment to be underwritten by long term contracts. However that frankly does not reflect reality for incremental capital investments in an established multi-user brownfield network such as ARTC's Hunter Valley network.

What drives incremental investment in the Hunter Valley network is actual demand. Anglo American does not dispute that often contracted capacity will provide a reasonable proxy for actual demand – but where usage is materially different to contracted capacity, actual usage will clearly be taken into account by both ARTC and the rail capacity group.

For example, it is simply incorrect to say that when investment decisions are made they are made on the basis of:

(a) a closed but contracted mine utilising their full contractual entitlement; and

(b) a mine that has contracted capacity on the basis of a scheduled opening timeframe but has experienced regulatory, contractual or operational difficulties such that it remains unopened, utilising their full contractual entitlement.

3 Conclusion

For the reasons set out above, and its earlier submissions, Anglo American remains convinced that the methodology of allocating incremental capital costs based on actual usage is appropriate, particularly given the 2013 Compliance Assessment outcome and the WIK approach.

Anglo American considers that the case for departing from the ACCC's conclusions of June 2016, reached after a thorough consideration of this issue in the 2013 compliance assessment, has not been convincingly made by ARTC.

The contracted capacity based methodology being advocated for by ARTC is flawed (involving cross subsidisation and incentivising inefficient investment) – and those issues have not been addressed by ARTC in the recently submitted variation, and the other grounds which are claimed to support it (revenue stability and alignment with the causation of investment) have either been substantially overstated or do not appear true.

Consequently, for the reasons set out in this and prior submissions, Anglo American considers it remains appropriate for incremental capital costs to continue to be allocated to users based on actual usage, not contracted capacity, and for that reason ARTC's proposed variation should be refused.