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Mr Matthew Schroder
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via email: transport@accc.gov.au

Dear Matthew,

Australian Rail Track Corporation's Hunter Valley Rail Network Access Undertaking Revenue Allocation Review

Rio Tinto Coal Australia (RTCA), as manager of Coal & Allied Industries Limited, provided a submission to the ACCC revenue allocation review on the 28th of July 2014. With the additional information provided by ARTC in their August 2014 submission to the review, RTCA would like to make the following supplementary comments:

1. ***Transparency*** – ARTC maintain that various sources of information provided over a period of several years, dating back to the NSW rail access undertaking and negotiations for the HVAU, should have allowed Access Holders to be sufficiently aware of the methodology employed by ARTC for allocating revenue. RTCA submits that at no stage has sufficient detail been provided to Access Holders to *fully* understand or assess the implications of ARTC's approach and RTCA reiterates its concern that revenue allocation is not contemplated or clearly explained in the HVAU. Furthermore, based on submissions from other Access Holders to this review and the Initial Indicative and Final Indicative Services consultation processes, RTCA questions whether any one Access Holder was fully aware of the level of cross-subsidisation that occurs under ARTC's combinatorial approach to revenue allocation. It appears to RTCA that some Access Holders who could be expected to be net beneficiaries of ARTC's approach were also unaware of how revenue was being allocated across Pricing Zones.

   It is RTCA's view that the information provided by ARTC in their August 2014 submission represents the most comprehensive summary of ARTC's revenue allocation approach and that this level of detail would not have been available without the intervention of the ACCC. By way of example, RTCA questions whether the clear and succinct bullet point summary provided by ARTC on page 86 of their submission has ever been presented in previous documentation. ARTC imply that a loss of internal knowledge within Access Holder organisations may be the reason that Access Holders are unaware of the methodology. RTCA submits that the esoteric nature of ARTC's revenue accumulation and allocation methodology, principally complex terminology and limited available data, made it extremely unlikely that Access Holders would ever have fully understood the approach. Further, RTCA is of the view that it is only now that industry has a more complete picture of the methodology employed by ARTC and the full implications for Access Holders.

2. ***Misalignment with key provisions of the HVAU*** – on page 29 of their submission, ARTC state: "*The specification of a different access price for Pricing Zones under the HVAU may result in a perception that certain revenues collected may be applied to a pricing zone*". RTCA would like to reiterate the point that critical commercial aspects of the HVAU are based around Pricing Zones, specifically, investment voting rights, economic cost and access pricing. Based on this it was entirely reasonable, and in fact logical, for producers to also assume that all of the revenue earned in a given Pricing Zone would be applied to recover the full economic cost of that Pricing Zone. It is RTCA's view that the submissions made during the Initial Indicative and Final Indicative Service consultation processes suggest that the majority of Access Holders (if not all) believed that revenue earned by ARTC in a given Pricing Zone would be used to recover the economic cost of investment and providing capacity for specific train service types in that Pricing Zone.

3. ***ARTC's investment versus capacity benefit assessment appears flawed*** – on page 95 of their submission, ARTC provide two tables highlighting the level of volume growth and investment in all three pricings zones across the period of 2007/2008 to 2020. ARTC state that almost $2 billion in investment is required across the network to accommodate a total of 97Mtpa in growth over the period. ARTC also state that Zone 3 customers represent approximately 23% of this volume growth (i.e. 22Mtpa) such that the 25% share of total network investment dedicated to Pricing Zone 3 (i.e. $500 million) is roughly proportional to the share of "capacity benefits" received. To arrive at this position it appears to RTCA that ARTC has ignored the level of investment required in Pricing Zone 1 to accommodate increased growth from Pricing Zone 3.

   Figure 5 on page 92 illustrates that the majority of the $1.48 billion invested in Pricing Zones 1 and 2 (see Table 4 page 95) has been or will be directed to capacity expansion and congestion relieving projects in Pricing Zone 1. These include high value projects such as Maintland-to-Minimbah 3rd Road and the Hexham Holding Roads as well as additional arrival and departure roads at the port terminals. As all coal volumes from Pricing Zone 3 must pass through Pricing Zone 1 it follows that around 23% of the investment costs in Pricing Zone 1 can also be attributed to Pricing Zone 3 customers (save for some investments that may have occurred along Pricing Zone 1 branch lines). Of the $1.5 billion expected to be invested in Pricing Zones 1 and 2 over the period, RTCA estimates that the investment required in Pricing Zone 1 for infrastructure that would benefit all Pricing Zone 1 users could amount to approximately $1.3 billion. If Pricing Zone 3 Access Holders are attributed 23% of this figure (~$300 million) then combined with the $500 million of direct investment in Pricing Zone 3 it could be estimated that Pricing Zone 3 Access Holders are accountable for almost 40% of the total $2 billion in network investment and not the 25% stated by ARTC.

4. ***Investment approval by the Rail Capacity Group*** – on page 86 of their submission, ARTC imply that Pricing Zone 1 and 2 Access Holders had the ability to restrict investment in Pricing Zone 1 that was for the benefit of Pricing Zone 3 Access Holders, by exercising voting rights attributed under the Rail Capacity Group (**RCG**). ARTC suggest that Pricing Zone 1 and 2 producers did not restrict Pricing Zone 1 investment required to accommodate Pricing Zone 3 volumes as it was "*likely that PZ 1 and PZ 2 users recognised the wider benefits of the PZ1 expansions (in both the short and longer term) in addressing capacity constraints and accommodating future growth for all users"*. This position did not all reflect RTCA's thinking at the time for two important reasons.

   Firstly, the combination of investment approval by Pricing Zone and Access Charges that explicitly reflect differences in capacity consumption by train service type meant that RTCA had every reason to believe that Pricing Zone 3 users would contribute revenue toward economic cost recovery in Pricing Zone 1. As noted in ARTC's submission, Access Holders with mines only in Pricing Zones 1 or 2 have no right to vote on or approve/restrict investment in Pricing Zone 3. This limitation gave RTCA, and likely other RCG members and Access Holders, the *very strong* impression that the economic costs associated with investment in a given Pricing Zone would only be recovered from Access Holders who consume capacity within that Pricing Zone (i.e. a "user pays" system). In addition, the various efficient train service consultation processes led RTCA (and likely other Access Holders) to believe that Pricing Zone 3 Access Holders would pay Access Charges that reflected a fair and proportionate share of the capacity that they consumed as their train services travelled through Pricing Zone 1. On this basis, Pricing Zone 1 and 2 Access Holders had no incentive or reason to restrict investment in Pricing Zone 1 when it appeared that Pricing Zone 3 producers would immediately and directly contribute toward the full economic cost of required investment in Pricing Zone 1.

   Secondly, prior to this review, ARTC has never provided Access Holders with any evidence to suggest that Pricing Zone 1 and 2 users have somehow benefited from the volume growth related to Pricing Zone 3, therefore, RTCA believes it highly unlikely for users to simply arrive at this position. As highlighted in point 2 above, a significant share of the network investment in Pricing Zone 1 can be directly attributed to actual and expected volume growth in Pricing Zone 3 and the increased train paths required for the smaller train services utilised by Access Holders in that Pricing Zone. With expansion of rail network capacity often being incremental in nature (e.g. additional passing loops and dump station departure roads etc), it is entirely likely that some of the projects completed in Pricing Zone 1 in recent years may not have been required were it not for the need to accommodate Pricing Zone 3 volumes. It could be argued, for example, that the volume growth, long haulage distances and smaller train services required for Pricing Zone 3 contributed to the relatively recent problem of network congestion and the need for network investment and changes in above rail operating mode to solve the problem. As such, it is unclear to RTCA what the “wider benefits” are, given they have never been clearly demonstrated to Access Holders.

5. ***ARTC’s limited justification of the benefits to Pricing Zone 1 and 2 Access Holders is poor*** – while the benefits of ARTC’s current revenue allocation approach to Pricing Zone 3 Access Holders are obvious, in their submission ARTC offer only qualitative justification of the supposed benefits to Pricing Zone 1 and 2 Access Holders. RTCA’s view is that to make an assessment on whether ARTC’s approach is economically justified, ARTC must provide a more detailed and quantitative assessment of the true cost and benefits to all Access Holders.

   For example, ARTC implies at several points in their submission that existing Pricing Zone 1 and 2 Access Holders have somehow benefited from investment ahead of demand for Pricing Zone 3 volumes. RTCA submits that this assumption is incorrect as it applies to the Hunter Valley coal chain in recent years and potentially over the long-term. The Hunter Valley coal chain has been severely track constrained for several years, with ARTC’s network investment only just keeping pace with actual coal chain demand. Contributors to this include volume growth from all Pricing Zones, delays in receiving planning approvals for expansion projects and also ARTC’s response to addressing the issue of system congestion. In a capacity constrained environment, it is not at all clear to RTCA how ARTC could arrive at the view that Pricing Zone 1 and 2 users have somehow benefited from capacity being built ahead of demand for Pricing Zone 3 Access Holders.

   In addition, as the Hunter Valley coal chain has had limited (if any) latent rail network capacity for the past several years, available capacity has not simply been absorbed by new and existing Access Holders. Instead, network capacity has had to be built, especially in Pricing Zone 1. If significant latent capacity had existed, it could be expected that this might reduce Access Charges for all Pricing Zone 1 Access Holders by spreading the large fixed economic cost base over a wider volume. Instead, Access Holders have experienced increasing Access Charges in recent years which appeared to be in-line with Pricing Zone investment and volume growth. It is now clear, however, that the increases in Pricing Zone 1 are in part due to ARTC pushing full economic cost recovery of Pricing Zone 1 investment onto Access Holders within the Constrained Network only. RTCA contends that the flexibility afforded to ARTC under their current revenue model ensures that Access Holders in Pricing Zones 1 and 2 have no certainty or insight with regard to potential Access Charges over the short, medium and long-term. With this in mind, RTCA believes that any justification of benefits by ARTC must include future expected price paths" by Pricing Zone.

6. ***ARTC's approach is distortionary and inequitable*** – at numerous points throughout their submission ARTC make it clear that their revenue allocation methodology is centred on supporting the development of Pricing Zone 3 coal customers by establishing total access charges in the early years that are in-line with what ARTC considers to be their ability to pay. It is now clear that ARTC's approach requires Pricing Zone 1 and 2 Access Holders to cover roughly 90% of the fixed costs associated with providing network capacity to Pricing Zone 3 users in Pricing Zone 1, in order to minimise Access Charges in Pricing Zone 3. This has the obvious effect of distorting prices by increasing total Access Charges payable for Pricing Zone 1 and 2 Access Holders for an uncertain and undefined period of time. ARTC contends that this is only required during the early stages of development of Pricing Zone 3 and that over the long-term Pricing Zone 3 Access Holders will eventually contribute to the common costs of providing network capacity in Pricing Zone 1. Putting aside the uncertainty around potential timing, unless ARTC envisages that in the future Pricing Zone 3 customers will pay a higher Access Charge in Pricing Zone 1 relative to other long-standing Pricing Zone 1 Access Holders, then it is difficult to see how Pricing Zone 1 Access Holders will ever be compensated for the higher effective Access Charges they are paying today. Furthermore, If over the long-term Pricing Zone 3 Access Holder's ability to pay or volumes do not increase as ARTC predict then long-standing Pricing Zone 1 and 2 Access Holders could continue to cover the full economic cost of investments made in Pricing Zone 1. This is unacceptable to RTCA given that a significant share of the investment in Pricing Zone 1 was required to accommodate volume growth from Pricing Zone 3.

7. ***Inconsistency of argument around the long-term recovery of network investment related to Pricing Zone 3 Access Holders*** – on page 101 of their submission ARTC put forward their view around the viability of Pricing Zone 3 Access Holders and their ability to pay Access Charges that reflect the full economic cost of providing access in Pricing Zones 1 and 3. It appears that ARTC is concerned with utilising loss-capitalisation in Pricing Zone 3 due to the risk of Pricing Zone 3 Access Holders' volumes or ability to pay being insufficient over the long-term to recover the capitalised loss. At the same time, however, ARTC expects Pricing Zone 1 and 2 Access Holders to accept their argument that over time Pricing Zone 3 volumes will eventually be sufficient to contribute to the common costs of providing access in Pricing Zone 1. These two positions appear contradictory: if ARTC expects Pricing Zone 3

volumes/ability to pay to be sufficient at some point to recover the full economic cost of Pricing Zone 3 *and* contribute to the common costs of providing access in Pricing Zone 1, then ARTC should be satisfied that capitalised losses related to investment in Pricing Zone 3 would also be recoverable in the future. It is RTCA's view that Pricing Zone 3 Access Holders could be contributing today to the full economic cost of access in Pricing Zone 1 with loss capitalisation employed more extensively in Pricing Zone 3. Under this model, increased volume growth and improved ability to pay over time would allow for the capitalised losses to be repaid. ARTC's approach to revenue allocation, therefore, appears to be centred entirely on cash flow and risk management for ARTC at the expense of Pricing Zone 1 and 2 Access Holders.

8. ***Industry structure and the potential impact on downstream markets*** – the Hunter Valley coal industry is predominately exported oriented, with the vast majority of coal mined in the region transported to the coal export terminals at the Port of Newcastle. Export coal is commonly sold on a free-on-board (FOB) or delivered (CFR) basis with reference to local and global market prices. Coal market prices are generally reflective of fundamental principles of economics, such as the supply-demand balance at the time, foreign exchange rates and the willingness of the marginal producer/s to sell at certain price points. Given this industry structure and with coal markets in the midst of a period of sustained low market prices, RTCA is genuinely concerned with the distortionary impact of ARTC's revenue allocation approach. RTCA believes there are Access Holders in Pricing Zones 1 and 2 today with mines that are marginal at prevailing market prices. As argued in our July submission, these mines are effectively subsidising transportation charges for mines in Pricing Zone 3 despite some of the latter mines potentially being profitable or at least "less marginal". RTCA questions how it could be considered efficient for an existing user in a given market to subsidise the costs of a new entrant at the expense of their own long-term profitability and competitive advantage. Furthermore, given the significance of the Hunter Valley coal industry in seaborne global coal markets, there is the potential for this cross subsidisation to impact market prices. For example, it could be argued that some Pricing Zone 3 mines may be putting downward pressure on market prices by accepting prices for coal today that are lower than what they might otherwise be willing to accept if their cost structure was fully reflective of their below rail Access Charges.

9. ***Central Queensland Coal Network pricing*** – RTCA is not in a position to comment on pricing methodology comparisons with other Australian or international rail networks, but as a coal producer in Queensland as well as New South Wales, RTCA would like to make the following observations:

(1) ARTC highlighted the use of a distance taper with respect to pricing for some customers in the CQCN and the fact that this approach is not employed in the Hunter Valley, potentially to the detriment of Pricing Zone 3 Access Holders. Access pricing in the CQCN has been negotiated over several years and iterations of new undertaking periods. The various charges and tariffs reflect negotiated outcomes that ultimately took into account the pressures and demands of the coal industry at a given time, views of the regulator, and the public interest and commercial requirements of the rail network owner (in particular the Queensland Government). With this context in mind, RTCA believes it is important to exercise a degree of caution when attempting to compare the vastly different pricing structure in the CQCN with that of the Hunter Valley.

In support of this, it is important to note that access charges in the CQCN are not always favourable to new users and coal growth regions. Aurizon Network (formerly QR National) has been successful on a number of occasions in negotiating above regulated rates of return prior to network expansion, generally citing volume and asset stranding risk associated with a given group of customers. This is analogous to Pricing Zone 3 investment in the Hunter Valley. Although affected CQCN users have argued strongly against what is inevitably a higher cost of access, a fundamental outcome has been that users who do not utilise or benefit from the expansion are made no worse off. This principle is clearly not applied by ARTC considering there is evidence to suggest that Pricing Zone 1 users are in fact worse off under ARTC's revenue allocation approach.

(2) It is important to emphasise that the pricing regime in Queensland has evolved considerably over time, rarely remaining static between undertaking periods. Changes have generally reflected a mix of improvements to the commercial terms under former pricing structures or the inclusion of new mining regions and customer groups. RTCA therefore considers it inappropriate for ARTC to suggest that their current approach is effectively the only right approach and that their incentive to invest will diminish if changes to the current methodology are proposed during negotiations for the next iteration of the HVAU.

In addition to the above comments, ARTC's submission has raised several questions that RTCA would like the ACCC to consider as part of its review/assessment:

1. If cross-subsidisation between ARTC's Hunter Valley network Pricing Zones is deemed by the ACCC to be efficient and in the public interest, as ARTC contends, then what is an *equitable* level of cross-subsidisation that somehow balances the cost burden and

erosion of competitive advantage for existing users with the objectives of funding network expansion for new users? In addition, should ARTC be given the high level of pricing flexibility they currently have to determine this?

2. If ARTC considers PZ3 to be a risk in terms of revenue recovery, then why did they support such a significant level of investment for a comparatively small or prospective volume base? Is it appropriate that Pricing Zone 1 and 2 Access Holders are asked to share much of this risk, via higher access charges, when it was ARTC who made the decision to contract with Access Holders in Pricing Zone 3?

3. Can ARTC provide evidence to justify the contradictory positions they have adopted around the risks associated with utilising loss capitalisation in Pricing Zone 3, versus the likelihood of Pricing Zone 3 users ever contributing substantially to the common costs of Pricing Zone 1?

4. If ARTC's revenue allocation methodology was not fully understood by stakeholders including the ACCC and Access Holders when reviewing the WACC applicable under the HVAU, is the ACCC confident that sufficient information is now available to better inform a determination under the next undertaking? It appears to RTCA that if the current methodology is allowed to continue, then the combination of a revenue cap that is supported by long-term take-or-pay contracts, significant annual pricing flexibility, cross-subsidisation by Pricing Zone, and annual "unders and over" presents minimal revenue risk to ARTC across the entire Hunter Valley coal rail network. If this assessment is correct then it will be an important consideration as part of any future WACC determination.

RTCA and Coal & Allied provide consent for this submission to be made available for publication by the ACCC in the usual manner. As always, we would welcome the opportunity to discuss these matters directly with the ACCC and if you require any additional information, please call me on (07) 3625 5078.

Yours sincerely,

Adam Viertel

Manager – Infrastructure