ARTC HUNTER VALLEY ACCESS UNDERTAKING
RATE OF RETURN

1 ARTC'S CONCERN

ARTC has strong concerns with the position taken in the ACCC December 2010 Position Paper relating to the value of the asset beta and hence the maximum rate of return allowed in ARTC's Hunter Valley Access Undertaking (HVAU). The positions of ARTC and ACCC are set out in the table below, with the right-hand column adjusting ARTC's position to reflect an asset beta of 0.5 and updating market related parameters. The difference between ARTC's revised position and the ACCC position is 53 basis points.

	ARTC September 2010 HVAU	**ACCC December 2010 Position Paper**	**ARTC 2011 Revised HVAU (April 2011)**
Asset Beta	0.55	0.45	0.50
WACC (Pre-tax real)	9.16%	8.57%	9.10%

For the most part, ARTC accepts the ACCC's values as published in the Position Paper. The main area of disagreement that remains is the asset beta. The asset beta has a significant impact on the value of the weighted average cost of capital and hence the maximum regulated return allowed to ARTC. ARTC has three concerns with the ACCC's position:

(a) The ACCC position has changed from the March 2010 Draft Decision without any substantial justification. In the main, the return proposed in the Draft Decision was supported by stakeholders.

(b) If the position is maintained it will put at risk investment that underpins substantial export earnings.

(c) The consequences of an inappropriately low decision are disproportionately large compared to adopting a more reasonable (but still justifiable) value for the asset beta.

2 UNJUSTIFIED CHANGE OF POSITION BY ACCC

ARTC contends that there is no justification for the reduction in asset beta in the Position Paper.

The ACCC, in its April 2010 Draft Decision adopted an asset beta of 0.50, after extensive review. However, the Position Paper adopted a value of 0.45, claiming that the previous view was "overly conservative".[1] An asset beta of 0.5 results in an equity beta of around 1.0. This is within the range of asset beta values considered feasible by IPART in each of the Rate of Return assessments in 1999, 2004 and 2009.

ARTC accepts that there have been substantial changes in the commercial and operational characteristics in the Hunter Valley already and going forward. What is not clear, however, is whether the aggregation of changes to the commercial and operational risks faced by ARTC in the Hunter Valley has resulted in an increase or decrease in risk. Offsetting any reduction in risk that may arise from the change in commercial and operational arrangements is a range of factors increasing risk including

[1] Australian Competition and Consumer Commission, "Position Paper in relation to the Australian Rail Track Corporation's proposed Hunter Valley Rail Network Access Undertaking", 21 December 2010, p112

climate change concerns, increasing global competition, the higher unit cost to increase capacity and increased investment needed in the riskier upper Hunter network, and increased regulatory risk inherent in the undertaking. These factors are all considered by investors in the network in coming to a risk/return conclusion. In such a circumstance, a movement away from what was previously considered a feasible range for equity beta would seem imprudent.

The Position Paper discusses a number of factors leading to its decision, but of these considerations, only the QCA decision on the QR Access Undertaking is new, with all of the other matters having been fully considered in the Draft Decision.

With respect to the QCA determination of an asset beta of 0.45, the QCA specifically refers to the ACCC Draft Decision and distinguishes its own decision: "The Authority does not consider that the ACCC's HVCN decision provides a relevant precedent for QR Network given the particular circumstances."[2] Clearly, if the QCA distinguishes the ACCC's decision as not being relevant to its own decision, the corollary must be that the QCA decision must similarly be irrelevant to the ACCC's Hunter Valley decision.

As an example, ARTC notes that the QR Network access undertaking provides for QR network to seek (and obtain) concession, possibly in the form of a higher return, for significant investments, where the risk associated with such investments is higher. The HVAU contains no such provision and it is therefore important that the regulated return (and view on beta) cater for significant higher risk investments.

Apart from the QCA issue, the Position Paper does not identify any change in ARTC's 2010 undertaking that reduces its risks compared to the Draft Decision. In fact, ARTC considers that the substantial changes to the HVAU and IAHA since the March Draft Decision has resulted in an increase in ARTC risk profile in the Hunter Valley. Such changes include greater prescription around business and investment processes in order to meet industry requirements for greater control and certainty and increased transparency and flexibility; as well as increased accountability for performance. It is therefore of great concern that the ACCC would seemingly lightly change its view on an important parameter, with the apparent sole reason being a precedent set by another regulatory body that had clearly distinguished its decision from applying to the Hunter Valley.

3 RISK IN ADOPTING A LOW VALUE

The ACCC decision on the rate of return will potentially impact directly on ARTC's:

(a) willingness to invest; and

(b) ability to obtain funding to invest.

It is ARTC's intention to develop the Hunter Valley network to meet export coal transport requirements where all of the forecasts see volumes doubling over the next few years. ARTC's 2009 Corridor Strategy sets out projects totalling $1.4 b to 2014 with a further $600 m up to 2019 to support this growth. An additional $300 m is required for projects in the network currently owned by the Country Rail Infrastructure Authority, to be transferred shortly to ARTC. ARTC will therefore be continuing to invest substantially in the network in order to meet the requirements of rapidly growing demand to transport export coal to Newcastle. This is in addition to an existing network asset base valued at around $940m.

ARTC will have concerns about approving these major investments where there is a perception that returns are "too fine" when all risks are considered, particularly as there is no 'upside' given the regulated maximum returns.

ARTC also has significant concerns that setting a maximum return too low will jeopardise its ability to secure financing for these projects. While it is certainly the case that ARTC intends to secure these investments by long term contracts with a high level of take-or-pay, this does not fully cover ARTCs risks.

[2] Queensland Competition Authority, "Draft Decision QR Network's 2010 DAU - Tariffs and Schedule F", June 2010, p 49

In particular, the HVAU increases ARTC's commercial risk position compared to the current contractual position under the NSW Rail Access Undertaking.

4 CONSEQUENCES OF ADOPTING TOO LOW A RETURN

The debate about rates of return often engenders an emotional response, and this can obscure the key issues:

(a) Industry needs ARTC to invest heavily over the next few years to provide the increased network capacity to support the doubling of volumes.

(b) Regardless of who its shareholder is, ARTC is a commercial organisation with a Board that is required to invest prudently, and too low a return will make it more difficult to attract funds and approve investments.

(c) The cost to coal producers from a modest increase in the rate of return is a tiny fraction of the loss of revenue that would occur if coal cannot get to port.

(d) Those industry participants who will ultimately meet the cost of investment have not raised any substantive objection in relation to the asset beta proposed in the Draft Decision.

The following 'ball-park' estimate illustrates the relative cost of supporting an increase in ARTC's rate of return such that ARTC has an unambiguous incentive to invest:

Revenue per tonne, Newcastle thermal coal - say $AU100 per tonne.[3]

Weighted average access charge = say $1.50.[4]

Asset base June 2010, say $1,000 m

Total coal volumes in 2010 Indicative Access Pricing (includes export and domestic) = $125 mt

Increase in access charge from 0.53% increase rate of return (asset beta 0.5) = $5.3 m = $0.04 per tonne

From these figures, it is clear that the cost to a coal producer of securing investment certainty of around 4 cents per tonne is insignificant to the potential loss of revenue of $100. It would be difficult to imagine that any business person would risk putting revenue earning capacity of that order at risk for sake of a 4 cent cost increase. Again the scale is telling, to place this discussion in context we are looking at an increase of around 125 mt of coal exports or additional export earnings (using a very conservative coal price) of in excess of $12.5 b per annum at a potential incremental cost of $17 m (based on an asset base of $3.2 b).

Even if the above cost was doubled to take into account the imprecision of the example, the cost is trivial compared to the offsetting benefit. It is ARTC's view that the cost of uncertainty regarding investment is out of all proportion to the cost of encouraging ARTC to invest by taking a more appropriate view of asset and equity beta in the context of the benefits that will arise.

5 ARTC REVISED PROPOSAL

In the Draft Decision and Position Paper the ACCC determined values for most parameters that fell short of ARTC's proposals. ARTC considers that there are strong arguments supporting its claims in relation to many of these parameters such as market risk premium and gamma. However, ARTC has elected not to

[3] Reported as $US123 in Business Spectator, 5 April 2011 with prices for metallurgical coal above $US300.

[4] From modelling of 2010 Interim Indicative Access Charges.

pursue better outcomes for itself in these cases, choosing to allow the regulatory process to set appropriate levels. This has occurred in relation to gamma.

In the case of beta however, ARTC believes that setting of 0.45 (and an equity beta of less than 1.0) is not appropriate in the circumstances and inconsistent with the ACCC's inclination in both the Draft Decision and Position Paper to adopt a conservative position in relation to setting the Rate of Return.

Consistent with the above considerations, where ARTC accepts all of the positions put forward by the ACCC in the December 2010 Position Paper, but for a revised gamma of 0.45 and a revised asset beta of 0.5, ARTC proposes the following revision to the Rate of Return proposed in the 2010 HVAU.

	ARTC 2010 HVAU (Sept 2010)	**ACCC 2010 Position Paper (Dec 2010)**	**ARTC 2011 Revised HVAU (Apr 2011)**
Rf (nominal)[1]	4.97%	5.36%	5.43%
Debt	52.5%	52.5%	52.5%
Equity	47.5%	47.5%	47.5%
D/E	1.11	1.11	1.11
BBB bond rate (nominal)	9.30%	9.69%	9.76%
Debt margin (nominal)[2]	4.33%	4.33%	4.33%
Debt raising costs	0.095%	0.095%	0.095%
Cost of debt (Nominal)	9.40%	9.79%	9.89%
MRP	0.065	0.06	0.060
Gamma	0.50	0.50	0.45
Inflation	2.50%	2.50%	2.50%
Tax rate	30%	30%	30%
Asset beta	**0.55**	**0.45**	**0.50**
Debt beta	0.00	0.00	0.00
Equity beta	1.15	0.94	1.04
ke	12.45%	11.00%	11.70%
kd	9.40%	9.79%	9.86%
Vanilla WACC	**10.84%**	**10.36%**	**10.73%**
Pre-tax real[4] WACC	**9.16%**	**8.57%**	**9.10%**