INDEPENDENT PRICING AND REGULATORY TRIBUNAL OF NEW SOUTH WALES

Statement of reasons for IPART's Final Decision on compliance of Australian Rail Track Corporation (ARTC) with the New South Wales Rail Access Undertaking (NSWRAU) for 2012-13 and for the six months to 31 December 2013 in respect of the Gap to Turrawan sector.

Final Decisions

2012-13

ARTC has demonstrated to IPART's reasonable satisfaction that access revenue of the Gap to Turrawan sector was no more than 80% of the Access Revenue likely to be derived by application of the Ceiling Test under clause 5(f) of the NSWRAU for the 2012-13 compliance year.

2013-14 (six months to 31 December 2013)

ARTC has demonstrated to IPART's reasonable satisfaction that access revenue of the Gap to Turrawan sector is no more than 80% of the Access Revenue likely to be derived by application of the Ceiling Test under clause 5(f) of the NSWRAU for the six months to 31 December 2013.

In making this final decision, we have undertaken further consultation with the relevant stakeholders to ensure ARTC and relevant access users had a reasonable opportunity to make submissions to IPART on relevant matters. We received submissions from ARTC and two access users with mining operations in the Gap to Turrawan sector.

REASONS FOR DECISIONS

During 2014 ARTC found that it had inadvertently omitted access revenue in its Ceiling Test submitted to IPART for the compliance year 2012-13. For the 2013-14 compliance year, ARTC changed its approach in demonstrating compliance of the Gap to Turrawan sector from the 'proxy assessment' approach (used for 2011-12 and 2012-13 compliance years) to a 'direct assessment' approach.

Prior to 2013-14, ARTC used the 'proxy assessment' approach to conduct the Ceiling Test for the Gap to Turrawan sector under the NSWRAU because it did not have a robust means of allocating revenue between the two networks. IPART agreed with this approach.

In its compliance submission for 2013-14, ARTC restated its 2012-13 Ceiling Test using the 'direct assessment' approach. This approach has the advantage of excluding from the Ceiling Test the Gap to Muswellbrook sector which is regulated by the ACCC. Applying this approach, ARTC concluded that the Access revenue of the Gap to Turrawan sector was less than 80% of Full Economic Cost of the sector. Our assessment of ARTC's proposal, including the change in methodology, is summarised below.

IPART Draft Decision on ARTC's proposed 'direct assessment' approach to allocate access revenue

In October 2015 we released a Draft Decision on ARTC's compliance for further consultation with relevant stakeholders. The Draft Decision found that ARTC had not complied with clause 5(f) of Schedule 3 of the NSWRAU for 2012-13 and for the six months to 31 December 2013.

Under the 'direct assessment' approach, ARTC allocated Access revenue from coal mines located in the Gap to Turrawan sector between the Gap to Turrawan sector and the Muswellbrook to the Gap sector (Pricing Zone 3 (**PZ3**) under the *Hunter Valley Access Undertaking* (HVAU)). The Ceiling Test then compared:

- the access revenues from coal mines located between Turrawan and the Gap (after subtracting the portion that was allocated to the the Gap to Muswellbrook sector and the direct cost for that traffic to use the Muswellbrook to Port tracks)

to:

- the Full Economic Cost of the Gap to Turrawan sector (after adjusting for the direct costs of other traffic that uses it).

Our assessment, which was based on a '*maximum out-allocation"* method, found that ARTC had over-allocated access revenue to the Muswellbrook to the Gap sector. The Ceiling Test when applied to that sector would have been violated if such a large revenue allocation had been made (ie, access revenue exceeded the Full Economic Costs of the sector).

Further, while we did accept the capital related costs (depreciation and rate of return) proposed by ARTC, we considered that costs relating to some derailment incidents should not be included in the Full Economic Cost of the Gap to Turrawan sector.

Stakeholder submissions to IPART's Draft Decision

We received three submissions from stakeholders in response to our Draft Decision – one from ARTC and two from access users (confidential) using the Hunter Valley Coal Network (**HVCN**).

ARTC is concerned that the Draft Decision did not take into account loss capitalisation within the Muswellbrook to the Gap sector (**PZ3**)) provided for by the HVAU administered by the Australian Competition and Consumer Commission (**ACCC**). The mechanism is designed to allow ARTC to invest in the network to provide for capacity growth. Loss capitalisation allows ARTC to recover its investment during periods of low traffic volumes. ARTC submits that information on capitalised losses for PZ3 is well documented in ARTC's public submissions to the ACCC and subject to the ACCC's assessment as part of the 2013 annual compliance review.

ARTC submitted a 'maximum out-allocation' calculation that takes into account the capitalised losses of PZ3 as provided for under the HVAC. The updated calculation demonstrates that the cost recovery of the Gap to Turrawan sector is well below the 80% specified in clause 5(f) of Schedule 3 of the NSWRAU. On this basis, ARTC considers that it has complied with clause 5(f) of Schedule 3 for the Gap to Turrawan sector. ARTC also considers that its calculation is likely to be conservative as the capitalised losses determined by the ACCC in its Draft Determination of 30 October 2015 are much higher than that proposed by ARTC to the ACCC.

ARTC's submission to our Draft Decision is supported by two access users with mining operations in the Gap to Turrawan sector. They both consider that it is reasonable to take into account the capitalised losses of PZ3 allowed for under the HVAU (administered by the ACCC) in the maximum out-allocation calculation. They also point out that the ACCC Draft Determination released in October 2015 significantly increases the revenue allocated to Pricing Zone 1 (PZ1) (to cover increased incremental costs). This further increases the capitalised losses of PZ3 and would reduce the cost recovery rate of the Gap to Turrawan sector to levels much lower than the under-recovery submitted by the ARTC.

The two access users who submitted also supported ARTC's submission that costs relating to the derailment incidents (at Breeza and Coxs Creek Bridge) should be included. They submitted that derailment costs are known and accepted cost of the rail transport industry as they occur intermittently on all rail networks and are unavoidable.

Final Decision – assessment of ARTC's compliance

Our assessment of the Gap to Turrawan sector costs

The NSWRAU defines Full Economic Costs as "Sector specific costs including a permitted Rate of Return and Depreciation and an allocation of non-Sector specific costs such as train control and overheads including a Rate of Return and Depreciation on non-Sector specific assets. All included items are to be assessed on a standalone basis" (Schedule 3, clause 2.1). Specifically, "the assessment of costs on a standalone basis requires calculation based on the optimal configuration of rail infrastructure in order to serve all Access Seekers operating in a common end market" (Schedule 3, clause 2.2(c)).

We assessed the Gap to Turrawan sector operating and maintenance costs against the following benchmark unit costs:

- the benchmark cost rates that we used to assess RailCorp's compliance with the NSWRAU for its 5-sectors of the HVCN; and
- the coal network benchmark unit cost used by Transport for NSW (**TfNSW**) in its 2013 Principles and Guidelines for Economic Appraisal of Transport Investment and Initiatives.[1]

We concluded that the submitted operating and maintenance costs were higher than the benchmark cost principally due to the significant maintenance costs associated with derailments in Breeza and Cox Bridge that ARTC included in the operating and maintenance costs of the sector.[2]

Our Draft Decision was to exclude derailment costs. Without these costs, we found that ARTC's proposed Full Economic Costs were reasonably consistent with our benchmark costs for the NSWRU.

Following our Draft Decision, we have considered the issue of derailment costs further. Our final decision is that they should be included. In making this decision, we note that the submissions of the two access users supported their inclusion on the basis that derailment costs are known and accepted costs of the rail transport industry and that it would be unreasonable to exclude them from the Full Economic Cost. We agree with this proposition.

Our final decision is that ARTC's proposed operating costs are reasonable.

Regulatory asset valuation of the Gap to Turrawan sector

ARTC proposed using the Depreciated Optimised Replacement Cost (DORC) valuation of the Gap to Turrawan sector that was approved by the ACCC. We agree that the use of the DORC valuation approved by the ACCC is reasonable for the purpose of demonstrating compliance with the NSWRAU and in compliance with clause 5(f) of Schedule 3 of the NSWRAU.

We have reviewed capital related costs (depreciation and rate of return) and agree that these costs comply with the NSWRAU.

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1 TfNSW, *Principles and Guidelines for Economic Appraisal of Transport Investment and Initiatives*, March 2013, p 259 (Table 38).

2 ARTC, *2012/13 submission to IPART on the Gap to Turrawan sector compliance with the NSWRAU*, p 21.

Overall assessment of compliance under clause 5(f) of Schedule 3 of the NSWRAU

Overall, we are reasonably satisfied that ARTC has demonstrated that Access revenue of the Gap to Turrawan sector was no more than 80% of the Access revenue likely to be derived by application of the Ceiling Test under clause 5(f) of Schedule 3 of the NSWRAU for 2012-13 and the six months to 31 December 2013. In making this final decision, we have had regard to the Regulatory Assets valuation, based on DORC methodology, as provided by ARTC.

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