SUBMISSION TO
THE NSW INDEPENDENT PRICING & REGULATORY TRIBUNAL

IN RESPECT OF THE DRAFT DECISION GAP TO TURRAWAN RAIL NETWORK 2012/13 FINANCIAL YEAR & JULY – DECEMBER 2013

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ARTC

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1 Executive Summary

This submission responds to the Draft Decision published by the NSW Independent Pricing And Regulatory Tribunal (**IPART**) regarding its review of ARTC's compliance with the NSW Rail Access Undertaking (**NSWRAU**) for the Gap to Turrawan (**Zone 4**) portion of ARTC's rail network for the periods of the 2012/13 financial year and the half year July to December 2013 (**2013H2**).

ARTC has reviewed the Draft Decision and has concerns as to the IPART analysis and conclusions. It appears that IPART may have questioned the appropriateness of ARTC's proposed costs, however, we will not provide comment on those views in this response. In order to advance the matter in a positive way ARTC has provided a modified analysis in this submission that takes into account that the portion of the network from Muswellbrook to Gap (**Zone 3**) that operates under the Hunter Valley Coal Network Access Undertaking (**HVAU**), administered by the Australian Competition & Consumer Commission (**ACCC**) is subject to the capitalisation of losses into the asset base.

The effect of this is that while capitalised losses apply, there is no effective Ceiling Limit to revenue in Zone 3. The application of this means that IPART's proposed 'max-out' method, used to determine the ceiling limits would not operate as it was originally proposed. ARTC has provided a modified max-out analysis which recognises a Full Economic Cost (**FEC**) of Zone 3 that includes the capitalised losses at the relevant point in time.

ARTC has adopted the cost assumptions contained in the Draft Decision notwithstanding that ARTC does not fully agree with the analysis underlying the Draft Decision. ARTC has also taken the minimum position with regard to the allocation of revenue between Muswellbrook and the port despite the recent ACCC draft determination that would allocate significantly higher revenues to Zone 1 to satisfy the Floor Limit. Thus, this combination represents the highest likely recovery of cost to Zone 4 with any movements in these values due to changes in regulatory decisions (ACCC or IPART) likely to result in a lower level of recovery.

The result of the modified max-out analysis is a Zone 4 recovery in 2012/13 of 64.3% and 2013H2 of 56.4%, both substantially below 80%. ARTC concludes that on the basis of this modified analysis and contrary to the Draft Decision, it would be reasonable for IPART to find that the recovery in Zone 4 in both periods is less than 80% and that NSWRAU Schedule 3 sub-clause 5(f) should apply.

ARTC reserves the right to fully argue its case should IPART determine that NSWRAU Schedule 3 sub-clause 5(f) does not apply.

2 Introduction

2.1 Purpose

This document provides ARTC's response to the Draft Decision published by the IPART on 14 October 2015 regarding its review of ARTC's compliance with sub-clause 5(f) of Schedule 3 of the NSWRAU Zone 4 portion of ARTC's rail network for the periods of the 2012/13 financial year and 2013H2.

2.2 Background

The HVAU, administered by the ACCC, commenced in July 2011. Also in July of 2011 but separately to the commencement of the HVAU, ARTC exercised an option to lease the section of track from Gap to Boggabilla which until that time was under the control of the Country Rail Infrastructure Authority of NSW. Notwithstanding the transfer of effective control, the portion of the network between Gap and Boggabilla remained subject to the NSWRAU, administered by IPART. Zone 4 is a subset of that part of the network, and carries coal traffic to the port of Newcastle. Due to the relatively higher revenues earned in Zone 4, a separate compliance assessment has been carried out each financial year to ensure that the Ceiling Test and the NSWRAU has been complied with. Up to 2012/13, the recovery of FEC has been below 80% and NSWRAU Schedule 3 sub-clause 5(f) has applied. This sub-clause relieves the track owner from a number of obligations under the NSWRAU, including the need to apply the unders and overs provisions that are designed to recover any revenue shortfall below FEC or to reimburse any recovery over FEC.

In June 2014, the ACCC accepted an amendment to the HVAU to include Zone 4 with effect as of 1 January 2014. Under the *Transport Administration Act 1988* (NSW) this triggered a transfer of the economic regulation of this part of the network from the NSWRAU to the HVAU. It is for this reason that one element of the Draft Decision relates to July to December 2013 rather than for the full 2013/14 financial year as this was the last period that Zone 4 was operated under the NSWRAU.

The amalgamation of Zone 4 into ARTC's network and contemporaneous splitting of economic regulation of the coal traffic between two regulatory jurisdictions in July 2011 introduced a degree of complexity in the evaluation of ARTC's compliance with the NSWRAU. The two regulatory regimes apply a similar concept to determine the maximum permitted revenue that could be recovered from the relevant parts of the network. That concept involves the determination of a revenue "Ceiling" which is the sum of the economic costs of owning and operating the network, including a return on the asset. The determination of the revenue that is compared against the Ceiling occurs through the aggregation of a combination of different traffics using the network (the Combinatorial model), taking into account that some traffics also travel on other parts of the network and that revenues may be allocated to those other parts as well as the portion of network being tested, provided that a minimum "Floor" revenue is assigned to each part of the network to reflect the Direct Costs incurred.

However, while the two regulatory instruments share this common approach, they also differ in several important respects. These differences include:

- Periodicity: the HVAU operates on calendar years, the NSWRAU operates on financial years.
- The rate of return allowed.
- The assumed remaining economic life of the mines from which coal is hauled which determines depreciation rates and the closing value for each segment of the network.
- Under the HVAU, two asset valuations apply to Zone 3 such that when the regulatory asset base (**RAB**) is higher than the "RAB Floor Limit", the Ceiling Test does not apply – essentially there is no upper revenue limit in operation while that condition is met.[1]
- The HVAU provides for the capitalisation of losses into the RAB in Zone 3.[2] While the RAB exceeds the RAB Floor Limit, i.e. while there are losses capitalised into the asset

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1 HVAU section 4.3(b)

2 HVAU section 4.4(a)

base, revenues may exceed the full economic costs (**FEC**) of the relevant segments of the network. In this way, prior losses may be recovered.

- The RAB under the HVAU is different from the RAB under the NSWRAU. The NSWRAU RAB is more akin to the RAB Floor Limit under the HVAU as neither contain capitalised losses.
- The NSWRAU provides for a "cut-off" for the recovery of FEC by effectively excluding the operation of the "Unders & Overs Account" provisions where revenues recover less than 80% of FEC. There is no corresponding provision within the HVAU.

2.3 Confidentiality

This document is a public version of the formal ARTC response to IPART which excludes the confidential appendix provided to IPART. This document may be published at IPART's discretion.

3 Modified Analysis

The Draft Decision reflects IPART's modified analysis, termed in this submission the 'max-out' method. The purpose of the max-out method is to overcome the problems arising through the perceived need to evaluate the outcome for Zone 4 by taking into account the revenue allocated to Zones 1 and 3.

ARTC considers that there are alternate methods to for IPART to form a reasonable view regarding the recovery of the economic cost of Zone 4 which may be more appropriate. In this submission, however, ARTC is presenting a modification to the max-out method that will in part address the disparity in regulatory treatment between the NSWRAU and HVAU.

Notwithstanding ARTC's acceptance of a modified max-out method in this submission for the purpose of providing additional insight to IPART, ARTC reserves the right to argue its case against any reliance on the cost outcomes in other regulatory jurisdictions at a later date should it remain necessary to provide IPART with a sufficient understanding of the relevant issues to form a reasonable view that recovery in Zone 4 is less than 80% in both of the relevant periods.

ARTC's proposal in this submission is to recognise the capitalised losses contained in the HVAU Zone 3 RAB. ARTC is of the view that by doing so it would be reasonable for IPART to find that the recovery under this modified test is below 80% and would therefore satisfy NSWRAU Schedule 3 sub-clause 5(f).

3.1 The Max-Out Method

The max-out method as described in the Draft Decision seeks to address the problem that revenue for coal traffics applies to the whole journey, not to individual components of the journey. ARTC agrees with this in concept. In prior compliance submissions ARTC proposed, and IPART accepted, a solution that evaluated the recovery of Zone 4 by using an analysis of the entire journey and then calculating the recovery against a combined Zone 3 and 4.[3] This served as a useful proxy at the time, noting that by the nature of the test it was highly likely that recovery less than 80% would mean that recovery for Zone 4 in isolation would also be less than 80%.

[3] Recovery against Zone 1 is satisfied through the application of the Floor Limit as the relevant parts of Zone 1 are constrained under the HVAU.

For the restated 2012/13 and 2013H2 evaluations, ARTC found that the proxy approach was no longer sufficiently reliable to be useful in determining the recovery of Zone 4 and proposed an alternative evaluation based on the prior recognition of revenues in submissions to the ACCC relating to the HVAU network. Under that method, recovery of Zone 4 did not rely on an evaluation of costs in another jurisdiction. Instead it relied on an apportionment of revenue between the HVAU and NSWRAU jurisdictions on the premise that IPART could have confidence that all revenue had been accounted for through reporting to the relevant regulator.

The Draft Decision appears to have proposed the max-out method. The max-out method works as follows:

Zone 4 coal revenue = Total coal revenue from Zone 4 traffics – Zone 1 Floor Limit – Zone 3 FEC

Zone 4 Recovery = FEC Zone 4 – Zone 4 coal revenue – Zone 4 non-coal Floor Limit revenue[4]

The method assigns as much revenue as possible out of Zone 4 to other parts of the network not under test (hence 'max-out'). In order to do this, a key requirement is the calculation of FEC for Zone 3.

In the Draft Decision, ARTC understands that FEC has been calculated, more or less, according to the RAB Floor Limit as would apply to Zone 3. In calculating the FEC, IPART has discounted certain costs claimed by ARTC that IPART believes were not efficient, notwithstanding any decision by the ACCC to the contrary.

3.2 Modified Max-Out Method

As stated, ARTC is proposing an alternate method to address a key deficiency in the IPART analysis being that the method fails to take into account the application of loss capitalisation to Zone 3 under the HVAU. Loss capitalisation was designed to allow ARTC to invest in the network to cater for planned future volumes so that the capacity is in place when required. This has been crucial in facilitating the growth in Zone 4 coal volumes over the past few years. Without loss capitalisation, ARTC would not be able to recover its investment in periods where traffic volumes were not capable of sustaining the additional cost. There is no analogous mechanism under the NSWRAU and loss capitalisation only applies to Zone 3 under the HVAU.

For the period 2012/13 and 2013H2, losses had been capitalised into the RAB in Zone 3. As a way forward, ARTC has provided in this submission a modification to the max-out method to recognise the losses capitalised into the asset base as reported to the ACCC in submissions on compliance for the relevant periods.

3.3 Value Of Capitalised Losses

The adjustment to the max-out method proposed by ARTC is simply to increase the FEC by the value of the then outstanding capitalised losses. This value is able to be derived from ARTC's public submissions and ACCC decisions as RAB – RAB Floor Limit.

As ARTC's calculation of the RAB and the RAB Floor Limit is conducted on a calendar year basis, it is necessary for the 2012/13 financial year to take an average value of the closing 2012 and 2013 values. For 2013H2, the closing value for December 2013 can be used as provided to the ACCC. It is noted that in late October the ACCC published a Draft Determination that included a much higher

4 No non-coal traffics travel only within Zone 4 and therefore the Floor Limit only is relevant for these traffics.

value for Zone 3 capitalised losses; this is discussed further below. The relevant values are set out in Table 1.

Table 1: Values For Capitalised Losses

Period	RAB $m	RAB Floor Limit $m	Capitalised Loss $m
Closing value 2012[#1]	286.02	275.58	10.44
ARTC Submission Closing Value 2013[#2]	288.25	279.45	8.80
Draft Decision Closing Value 2013[#3]			20.89
Average value 2012/13[#4]			9.62

#1 ACCC 24 March 2014 "Determination, Australian Rail Track Corporation's compliance with the financial model and pricing principles in the Hunter Valley Coal Network Access Undertaking for January – December 2012" p.27

#2 ARTC May 2014, "1 January To 31 December 2013 Submission To Australian Competition & Consumer Commission In Respect Of Hunter Valley Access Undertaking Roll Forward Asset Base Ceiling Test Unders And Overs Account" p.13

#3 ACCC 30 October 2015 , "Draft Determination Australian Rail Track Corporation's compliance with the Hunter Valley Coal Network Access Undertaking financial model for the 2013 calendar year" p.41

#4 Simple average of 2012 and ARTC 2013 values.

The values from Table 1 are explained further below.

Closing value 2012

This is the value contained in the ACCC's final determination for 2012.

ARTC Submission Closing Value 2013

At the time of writing, the ACCC has not made a final determination of ARTC's compliance with the HVAU in 2013. The values in Table 1 in this row are the values submitted by ARTC to the ACCC.

Draft Determination Closing Value 2013

On 30 October 2015, the ACCC released a draft determination regarding 2013 compliance with the HVAU. The value of $20.89m reflects the finding in the draft determination that the amount of revenue from Zone 4 coal traffics applied to Zone 1 to comply with the Zone 1 Floor Limit should have been approximately $12m higher in calendar 2013 than ARTC's submission. This finding is driven by a number of matters, the most significant of which is an ACCC view that ARTC should have included incremental capital costs in the determination of the Floor Limit. ARTC has yet to respond to the findings of the Draft Decision. However, given the position expressed in the Draft Determination, it is reasonable to conclude that the final value for capitalised losses in December 2013 will be at least $8.8m as per ARTC's submission.

Average value 2012/13

This is the simple average of the capitalised losses arising from the 2012 and 2013 (ARTC submission) closing values. ARTC is of the view that for the purposes of this analysis in relation to the 2012/13 financial year this would be a sufficiently close approximation of the 'true' value, noting that such a mid-year value would not ordinarily exist under the HVAU.

3.4 Application Of Values To Modified Max-Out Method

For the purpose of this submission, ARTC has used the values of $9.62 for capitalised losses for 2012/13 and $8.80 for 2013H2 as additions to the FEC in the modified max-out method for each period. The detailed results of the modified max-out method were provided in a confidential appendix to the confidential submission.

Table 2 provides a summary of the key parameters, reflecting the FEC that resulted in the revenue allocations in the Draft Decision, the capitalised losses and resulting modified FEC. The max-out method is then applied to this modified FEC. This delivers a recovery in Zone 4 of 64.3%.

Table 2: Summary Of Calculation Of Recovery Under Modified Max-Out Method 2012/13

	Zone 1 $m	Zone 3 $m	Zone 4 $m	Total $m
Total Revenue				**99.17**
IPART Full Economic Cost Calculation	**2.01**	**53.08**	**53.65**	**108.74**
Capitalised Losses		9.62	-	9.62
Modified Full Economic Cost With Loss Cap.	**2.01**	**62.69**	**53.65**	**118.35**
Modified Max-Out Revenue Allocation	2.01	62.69	34.47	99.17
% Recovery		100.0%	**64.3%**	83.8%

Table 3 provides a similar summary for the 2013H2 period, resulting in a recovery of 56.4%.

Table 3: Summary Of Calculation Of Recovery Under Modified Max-Out Method 2013H2

	Zone 1 $m	Zone 3 $m	Zone 4 $m	Total $m
Total Revenue				**54.38**
IPART Full Economic Cost Calculation	**1.10**	**29.65**	**26.31**	**57.06**
Capitalised Losses		8.79	-	8.79
Modified Full Economic Cost With Loss Cap.	**1.10**	**38.44**	**26.31**	**65.85**
Modified Max-Out Revenue Allocation	1.10	38.44	14.84	54.38
% Recovery		100.0%	**56.4%**	82.6%

4 Conclusion

The costs used in the analysis in this submission for both 2012/13 and 2013H2 include the changes applied by IPART in the Draft Decision. The inclusion here should not be understood as ARTC accepting those changes. However, as the analysis uses the highest recovery outcome, i.e. including 'efficiency discount' applied by IPART and the lowest allocation of revenue to Zone 1, ARTC believes that any other values that might reasonably be substituted would further reduce the recovery.

Given these results, ARTC firmly believes that the Tribunal could reasonably conclude that recovery in Zone 4 is less than 80% in both periods.