AUSTRALIAN RAIL TRACK CORPORATION LTD

10 July 2013

Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001

Capacity Expansion and Access Pricing for Rail and Ports

ARTC Response to the Authority's Discussion Paper

ARTC welcomes the opportunity to provide a response to the Authority in relation to its Discussion Paper relating to its review of access pricing for capacity expansion in rail and at ports. Due to timing and other priorities, ARTC has only had a limited opportunity to consider the issues raised in the Discussion Paper, and ARTC recognises that there are some complex efficiency and equity elements inherent in pricing for access to expanded or extended capacity delivered on rail and at the ports. As such, ARTC is only able to provide, at this time, a high level response. ARTC hopes to provide a more considered response if the opportunity is provided later in this review.

If you have any queries in relation to this submission please contact Glenn Edwards 08 8217 4292, gedwards@artc.com.au, or myself 08 8217 4239, kgallasch@artc.com.au.

Yours sincerely

Kylie Gallasch
Executive General Manager, Strategy & Growth (Actg)

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Introduction

ARTC currently operates the interstate rail network between Brisbane and Kalgoorlie connecting to ports in Sydney, Melbourne and Adelaide (but excluding metropolitan passenger commuter networks and that part of the interstate rail network between Sydney and Newcastle). ARTC also manages the Hunter Valley coal network to Newcastle ports, as well as several parts of regional rail networks in NSW and Victoria.

ARTC commenced a 60 year lease of the standard gauge rail line between the NSW/Queensland border and Acacia Ridge (around 100 km) in January 2010.

ARTC also has an agreement in place with the owners of those parts of the interstate network in WA (Brookfield) that provides for consistency in conditions of key elements of access and operations for interstate services between Kalgoorlie, Perth and the Port of Kwinana. ARTC has had similar arrangements in place in WA since 2000.

Almost all parts of the interstate rail network managed by ARTC are now covered by a voluntary access undertaking (ARTC Interstate Access Undertaking (IAU)) accepted by the Australian Competition and Consumer Commission (ACCC) in 2008.

As far as ARTC is aware, the leased network in Queensland is not covered by an access undertaking approved by the Queensland Competition Authority (QCA) and, to the extent of standard gauge interstate services operated on the leased network, has been excluded from Part 5 (Access to Services) of the QCA Act 1997 which provides for declaration of services in Queensland, and access arrangements to apply to declared services to be administered by the QCA.

Whilst subject to ARTC Board approval and any legal impediments, ARTC is planning to seek to extend coverage of the IAU to the leased network between the NSW/Queensland border and Acacia Ridge.

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The interstate rail network in WA continues to be covered by the Railways Access Code 2000 (Code) in that state.

The Aurizon Network Access Undertaking covers those parts of the rail network in Queensland used to support coal supply chains operating between inland mines and several coal ports. The commercial and operational circumstances surrounding these networks are similar to that which exists in relation to ARTC's Hunter Valley coal network in NSW. Regulatory considerations in relation to these networks in either NSW or Queensland can act to influence relevant outcomes with respect to both jurisdictions.

As such, the outcome of regulatory reviews in Queensland does not have any 'direct' implications for the network currently managed by ARTC but may have an 'indirect' impact on regulatory considerations with respect parts of the ARTC network by way of creating positions, introducing innovation and setting precedent.

For these reasons, ARTC has sought to actively participate in regulatory reviews conducted by the Authority.

ARTC has assumed that this review primarily relates to access pricing consideration in relation to those parts of the rail network in Queensland that support coal supply chains operating between inland mines and several coal ports and has focussed its consideration in relation to these supply chains. ARTC recognises that the rail network in Queensland also supports other supply chains that include port terminals such as grain and minerals, but considers that similar access pricing considerations in relation to other supply chains will not be substantively different.

Specifically, ARTC will seek to describe existing commercial and regulatory arrangements on the Hunter Valley coal network, and its experiences in relation to access pricing for rail capacity expansion in the Hunter Valley.

Relevant arrangements in the Hunter Valley Coal Network

ARTC's Hunter Valley Coal Network Access Undertaking (HVAU) was approved by the ACCC in June 2011. The HVAU contemplated a range of new commercial and operational arrangements in the Hunter Valley that were, in part, intended to

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address a number of inefficiencies inherent in historical arrangements. In broad terms, inefficiencies resulted from:

- access arrangements being between ARTC and rail operators, rather than coal producers capable of providing direct, long term commitments to utilisation of, and investment in, the rail network;

- a lack of certainty inherent in existing arrangements in relation to future access to the network for coal producers, and recovery of future investment for ARTC; and

- a lack of alignment between contracted capacity obligations between the rail network, above rail assets and the ports.

These inefficiencies manifested in a number of undesirable outcomes for the Hunter Valley coal industry including:

- lower incentives to invest in both rail network capacity and capacity in relation to other parts of the coal supply chain to meet growing demand;

- uncoordinated investment in capacity between different parts of the coal supply chain;

- the inability of the coal supply chain to meet contracted shipping requirements, resulting in extended shipping queues at Newcastle and demurrage costs for the industry; and

- a lack of accountability for performance in relation to both service providers and coal producers.

Key elements introduced by the HVAU that intend to reduce or remove these inefficiencies (at least to the extent that an access undertaking in relation to a single service provider can) include:

- direct contracting for access rights with ARTC by producers;

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- long term contracting including obligations to provide capacity where funded through take or pay arrangements;

- limits on access to future network capacity if access to capacity at the port is not secured;

- in order to increase focus on coal chain efficiency, the mandated involvement of the Hunter Valley Coal Chain Coordinator in a range of commercial and operational processes including:

    - capacity analysis and allocation;
    - development of system assumptions;
    - management of capacity shortfalls;
    - management of capacity losses;
    - reporting of system performance;
    - maintenance planning;
    - capacity trading;
    - development of capacity plans, and
    - development of additional capacity;

- the introduction of financial penalties for non-performance in relation to meeting capacity entitlements;

- access pricing principles focussed around providing incentives for efficient utilisation of, and investment in, network capacity and coal chain capacity; and

- ex-ante approval of capital expenditure for inclusion in the regulated asset base following extensive industry consultation and approval mechanisms.

Development of network capacity expansions in the Hunter Valley

The HVAU prescribes a detailed process for the planning, development and endorsement of capacity expansion projects in the Hunter Valley. This process is detailed at Sections 7 to 11 of the HVAU.

Illustrative flowcharts describing the process are provided at Attachment A to this submission.

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In broad terms, the process provides for:

- a number of relevant parties to the Hunter Valley coal chain to initiate a project for ARTC initial investigation (Concept Assessment);

- the annual development, following relevant stakeholder input and consultation of a Hunter Valley corridor capacity strategy which includes options for capacity expansion, objectives, and high level costs and benefits;

- the development and implementation of projects through a staged consultative process for reporting and endorsement beginning with Concept Assessment, and incorporating Project Feasibility, Project Assessment and Project Implementation;

- the establishment and operation of an industry consultative forum (Rail Capacity Group (RCG)) involving coal producer representation (with prescribed voting rights), coal chain service providers and the HVCCC.

- RCG endorsement of each stage of development as a pre-requisite to proceeding to the next stage of development;

- project implementation through the development, endorsement and delivery of a project management plan with detailed budget;

- a consultative process for dealing with scope and cost variations, with expert resolution if needed;

- voting rights and rules constituting endorsement of each stage of project delivery;

- criteria under which ARTC may elect not to fund a project and a process for inviting user funding of projects where ARTC does not wish to fund a project itself;

- pricing principles with respect to capacity expansions that are user funded through a capital contribution;

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- automatic inclusion of capital expenditure that is endorsed through the RCG into the regulatory asset base; and

- penalties for late or over-budget delivery of capacity expansions.

To date, ARTC considers that this process has worked well and capital expenditure proposed by ARTC for inclusion in the regulatory asset base in annual compliance assessments has not been queried by stakeholders.

To date, there have been no instances where ARTC has elected not to fund a project.

Access Pricing with respect to network capacity expansions

Outside of capacity expansions that are user funded, there are no prescribed pricing rules in the HVAU that determine how a capacity expansion will be priced.

Under the HVAU, pricing objectives are prescribed (Section 4.13) to which ARTC will have regard in determining pricing. These objectives include full recovery of the capital charge associated with capacity expansions through a take-or-pay (TOP) component of pricing over the economic life of that expansion applied in an open and equitable manner.

In relation to capacity expansions funded by a capital contribution from a user or users, the specific pricing principles prescribed in the HVAU (Section 10) provide for a contributor to:

- fund a capacity expansion up front, reimbursing costs when incurred or as otherwise agreed with ARTC;

- recover the capital cost associated with the capacity expansion depending on whether the cost of the capacity expansion can be included in the regulatory asset base (through RCG endorsement above or ACCC endorsement);

- where the cost of the capacity expansion can be included in the regulatory asset base, ARTC will determine pricing for the relevant part of the network having regard to:

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  - maximising recovery of the fixed and capital cost associated with that part of the network in proportion to the relative consumption of the assets funded by ARTC and the contributor, and
  - maximising recovery of the capital cost associated with the capacity expansion based on its useful life and the regulatory rate of return in proportion to the relative consumption of the assets funded by ARTC and the contributor;

  and recovery of the capital cost associated with the capacity expansion will be such that the return obtained by the contributor will be the same as that obtained by ARTC for its investment in that part of the network – essentially the cost is socialised;

- where the cost of the capacity expansion cannot be included in the regulatory asset base, ARTC will determine pricing for the relevant part of the network having regard to:

  - maximising recovery of fixed operating expenditure associated with that part of the network in proportion to the relative consumption of the assets funded by ARTC and the contributor;
  - maximising recovery of the capital cost associated with that part of the network in proportion to the relative consumption of the assets funded by ARTC;
  - no recovery of the capital cost associated with the capacity expansion, except where a third party (non-contributor) utilises the capacity expansion, maximising recovery of the capital cost associated with the capacity expansion in proportion to that party's consumption of the capacity expansion; and
  - maximising recovery of the capital cost associated with the capacity expansion based on its useful life and the regulatory rate of return in proportion to the relative consumption of the assets funded by ARTC and the contributor;

  and recovery of the capital cost associated with the capacity expansion will only be such that the return obtained by the contributor will be the same as that obtained by ARTC for its investment in that part of the network – essentially the contributor pays but can recover cost from third party users.

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In any event, ARTC is to be economically no worse off as a result of a capacity expansion being funded through a capital contribution.

ARTC has provided some illustrative diagrams to the Authority on a confidential basis at Attachment B describing principles for cost recovery, equitable treatment and maintenance of a 'no worse off' position for ARTC in relation to capacity expansions funded by a capital contribution under a range of commercial scenarios.

Where ARTC funds a capacity expansion, the broader pricing principles under the HVAU apply. These pricing principles permit ARTC to:

- Have regard to the cost of a capacity expansion when differentiating pricing between different types of use (different coal train configurations) in the relevant part of the network;

- Fully recover the cost of a capacity expansion over the economic life of that capacity expansion where the market permits, through inclusion of the costs of the capacity expansion in the regulatory asset base. Where the relevant part of the network is constrained, the cost of the capacity expansion will be recovered through the TOP component of the charge from constrained network users each year through application of the ceiling test and unders & overs accounting. Where the relevant part of the network is not constrained, the cost of the capacity expansion will be recovered through the TOP component of the charge from un-constrained network users each year through under-writing arrangements in agreements or in the long run through the capitalisation of economic losses for recovery when the market permits.

Where the cost of a capacity expansion is endorsed (by the RCG or ACCC) as prudent, and can be included in the regulatory asset base, ARTC would normally set pricing for the relevant part of the network (pricing zone) so as to recover the cost of the capacity expansion from all coal users of that part of the network. In other words the cost of the capacity expansion is socialised amongst those coal users that utilise the part of the network (pricing zone) where capacity is expanded. In such circumstances, where there is an increasing cost of capacity (that is the average cost per, say, tonne of the capacity expansion is greater than the cost per tonne of existing capacity), pricing would be such that the cost differential would be averaged (socialised) over all users in the pricing zone.

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Under the HVAU, a pricing zone can include a number of segments (network links between coal load points). Under the HVAU, the ceiling test acts to ensure that any user (or combination of users) does not pay any more than the economic cost of the segments used by that user (or combination of users). This provides some flexibility in how revenue can be allocated to segments which can often be sufficient to enable the extent of socialisation as described above without breaching the ceiling limit for a single access holder or combination of access holders in that part of the network (pricing zone). In other words, the combinatorial nature of the ceiling test under the HVAU enables a degree of averaging of recovery of costs in parts of the network, but not to the extent that any user or combination of users would pay more than stand-alone cost.

It should be mentioned here that the RCG voting rules for endorsement of a capacity expansion in a pricing zone provide for a 50% threshold (on a GTK basis in that pricing zone) of support for endorsement, and a 70% threshold where the pricing in that pricing zone will increase by more than 10% as a result of the capacity expansion.

This means that substantial support from affected users for the capacity expansion is required, particularly where there will be a significant pricing impact.

The application of the combinatorial stand-alone ceiling test and the nature of the Hunter Valley network largely limit any averaging of the recovery of the cost of an expansion to within the relevant pricing zone. ARTC recognises the possibility that users in one part of the network (pricing zone) may benefit from the capacity expansion in another part of the network even if they do not directly utilise that capacity expansion itself. For example, a capacity expansion on a more distant (from port) pricing zone may be such that more volumes can utilise the closer pricing zone, reducing the average cost of access to that closer pricing zone for both the closer users and farther users. Also, the capacity expansion may result in operations in the closer pricing zone that increases the available capacity in that pricing zone for the closer users.

It could be argued that users of the closer pricing zone are deriving a benefit from the capacity expansion that is being paid for by users in the more distant pricing zone. The Discussion Paper suggests that this is not unreasonable and may

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represent compensation for existing users for bearing the risk of underwriting initial capacity or for previous contributions to excess capacity. ARTC considers that there could be arguments on both sides when considering equity and fairness.

Nevertheless, ARTC does not consider a degree of pricing flexibility to be unreasonable, where the ceiling test acts to ensure that any user (or combination of users) does not pay any more than the economic cost of the infrastructure used by that user (or combination of users). ARTC considers that the application of the combinatorial, stand-alone ceiling test under the HVAU permits some degree of balancing between efficiency and equity considerations in pricing capacity expansions in the Hunter Valley, largely within a pricing zone where a substantial level of support is required from the user 'community' for a capacity expansion to occur.

Normally a capacity expansion that is not endorsed (by the RCG or the ACCC) as prudent or underwritten by the relevant users, and so cannot be included in the regulatory asset base would not be funded by ARTC. In such circumstances the capacity expansion may be funded through a capital contribution from users, in which case the relevant pricing principles above would apply.

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ATTACHMENT A

HVAU INVESTMENT FRAMEWORK
ILLUSTRATIVE FLOWCHARTS

This document is intended to demonstrate the 'workings' of the Investment Framework by way of illustrative flow charts.

In this document, ARTC has incorporated against each element of the illustrative flow charts, references to the relevant sections in the Investment Framework at sections 7 to 11 of the HVAU.

The flow charts are intended as a general guide only and should not be relied upon. Nothing in the flow charts will be taken in any way to replace the provisions of the HVAU.

The terminology used is consistent with the HVAU.

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Diagram 1: HVAU Investment Process Overview

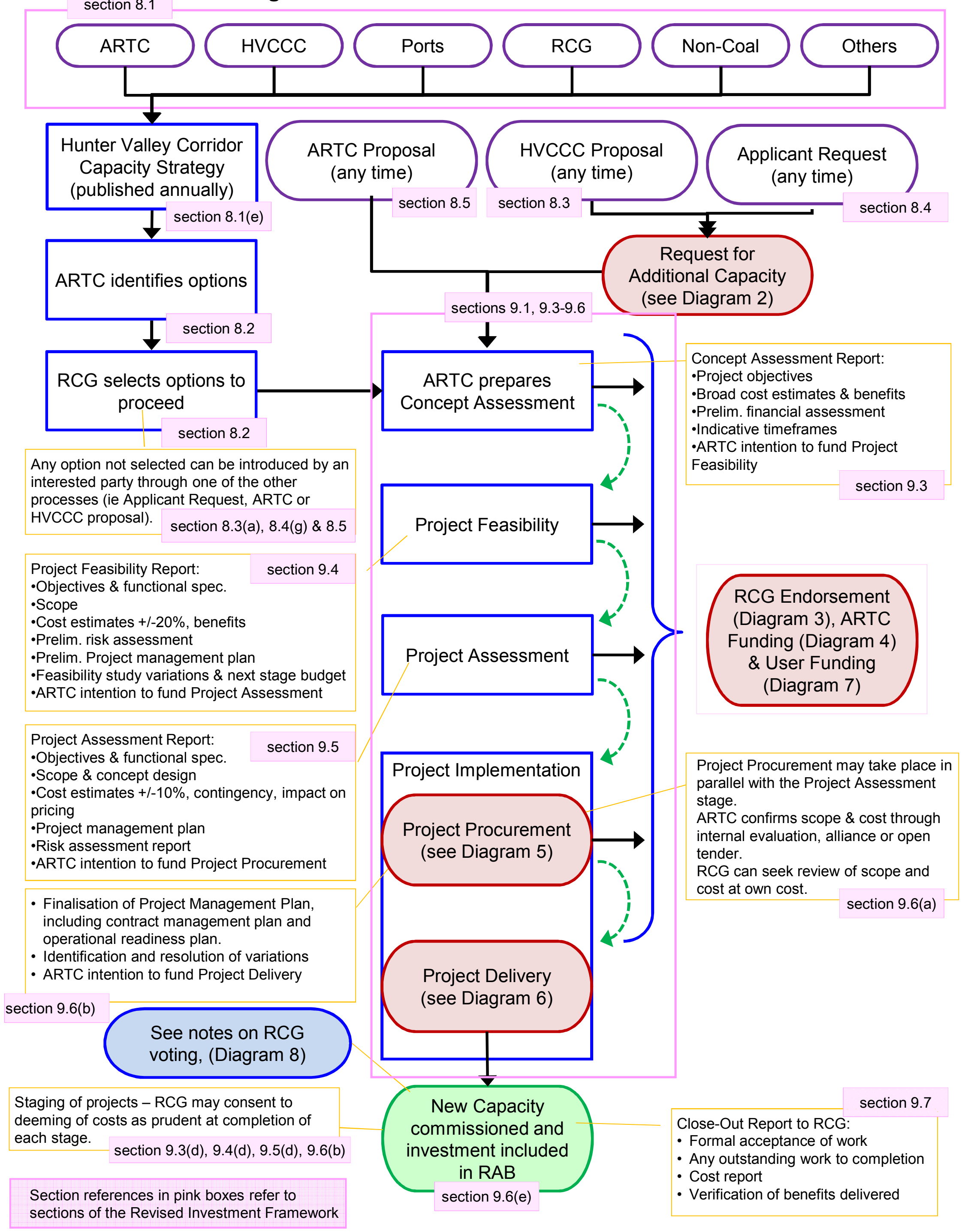

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Diagram 2: Applicant/HVCCC Request For Additional Capacity

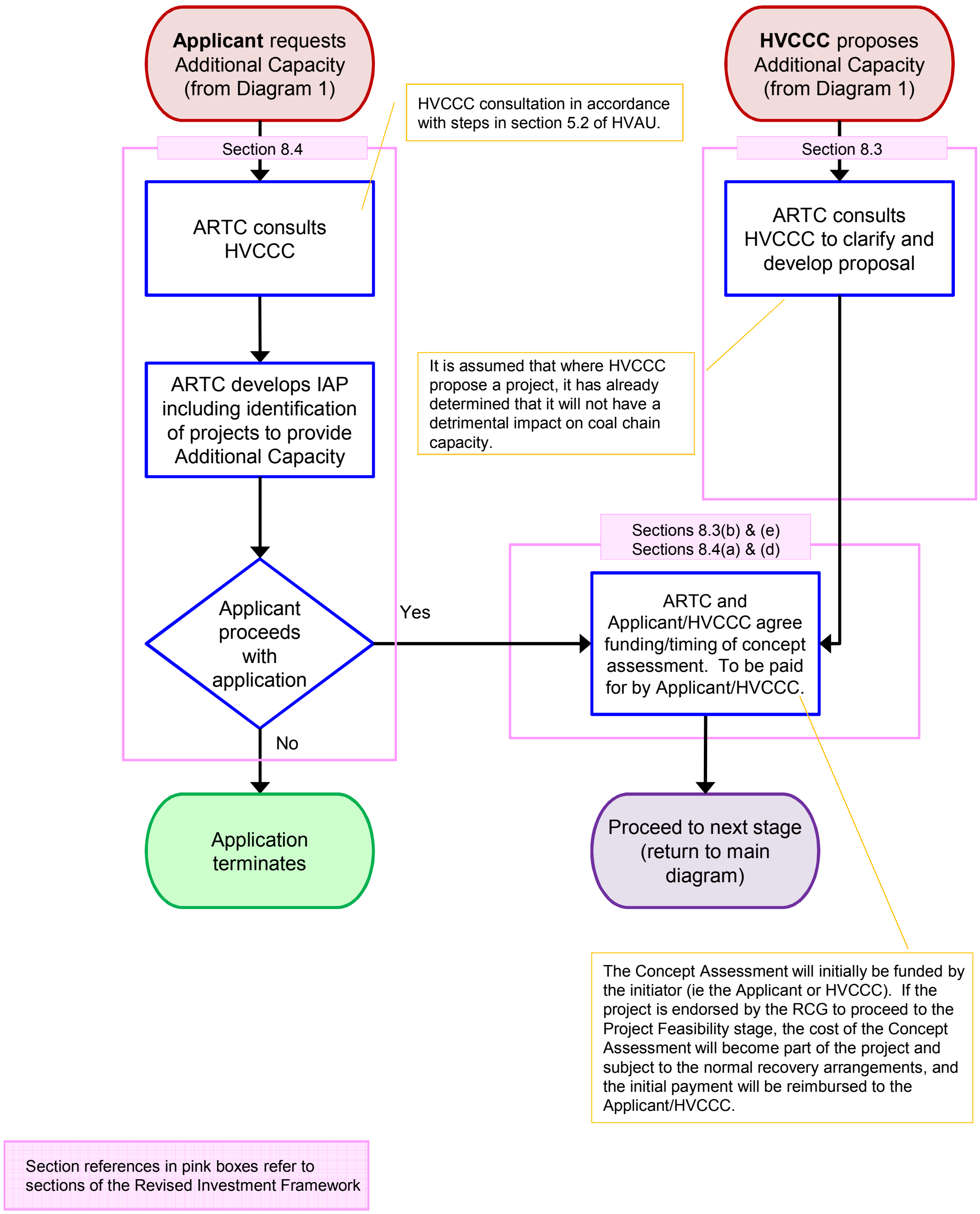

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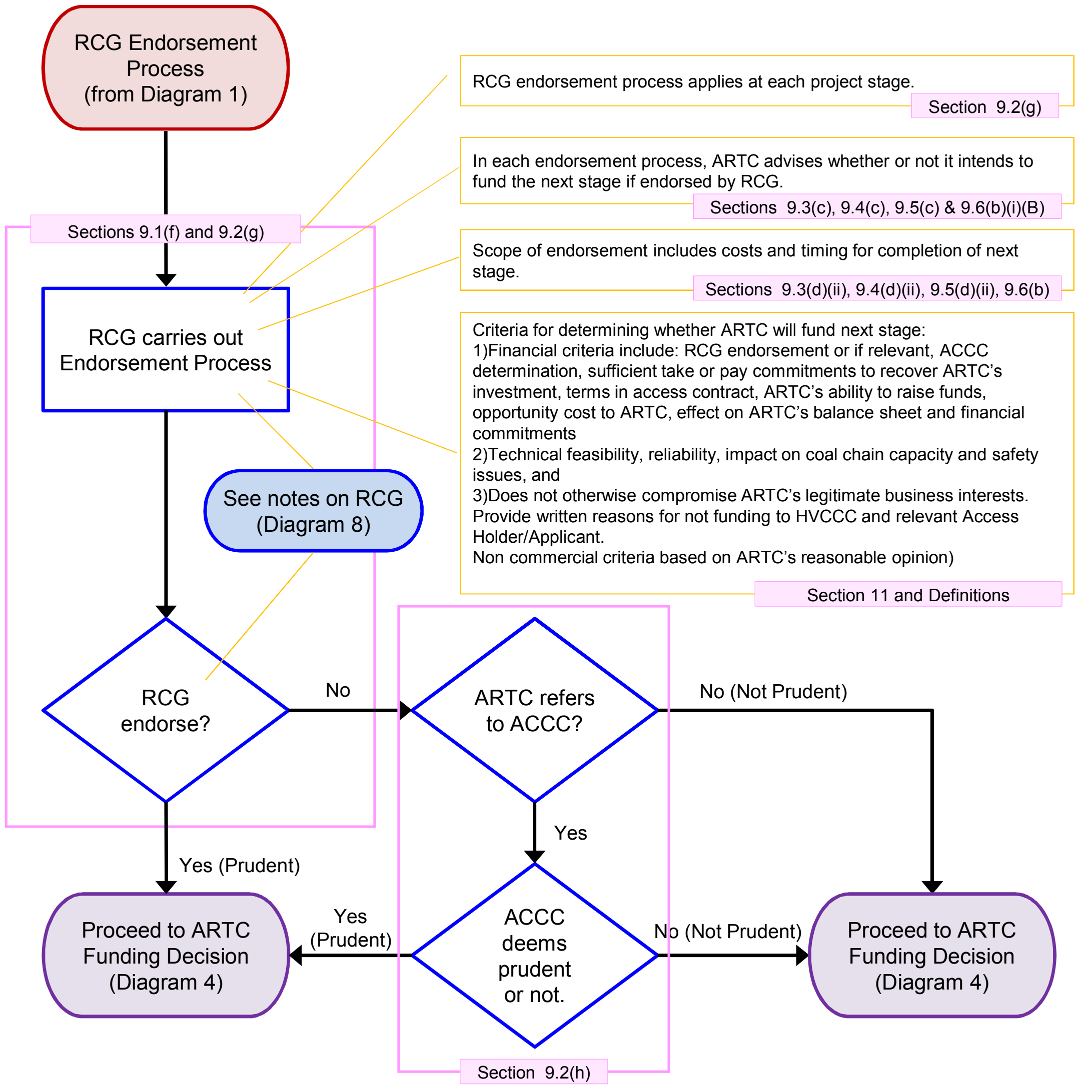
Diagram 3: RCG Endorsement Process Outcomes



Section references in pink boxes refer to sections of the Revised Investment Framework

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Diagram 4: Outcomes Of ARTC Funding Decision

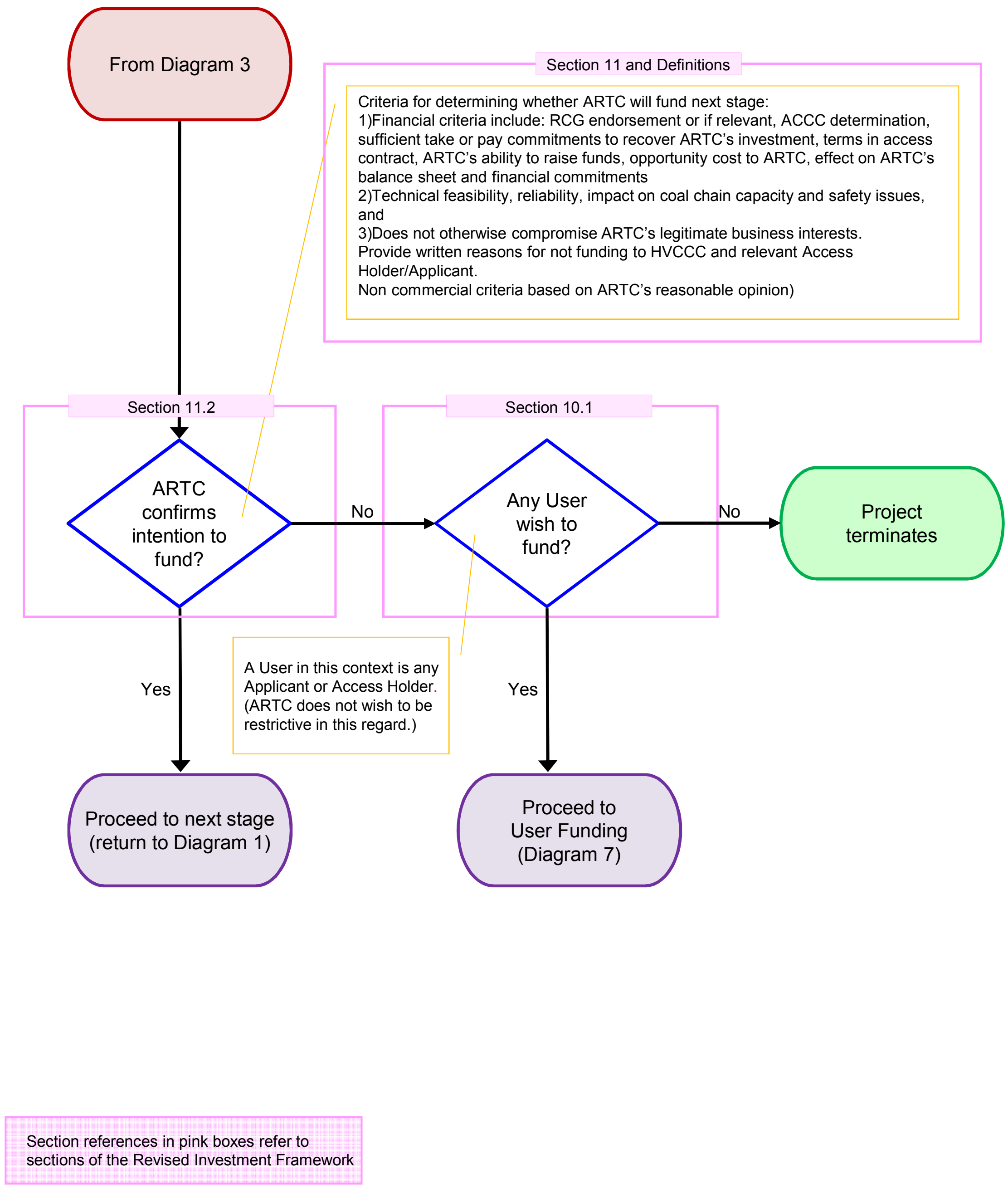

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Diagram 5: Project Procurement

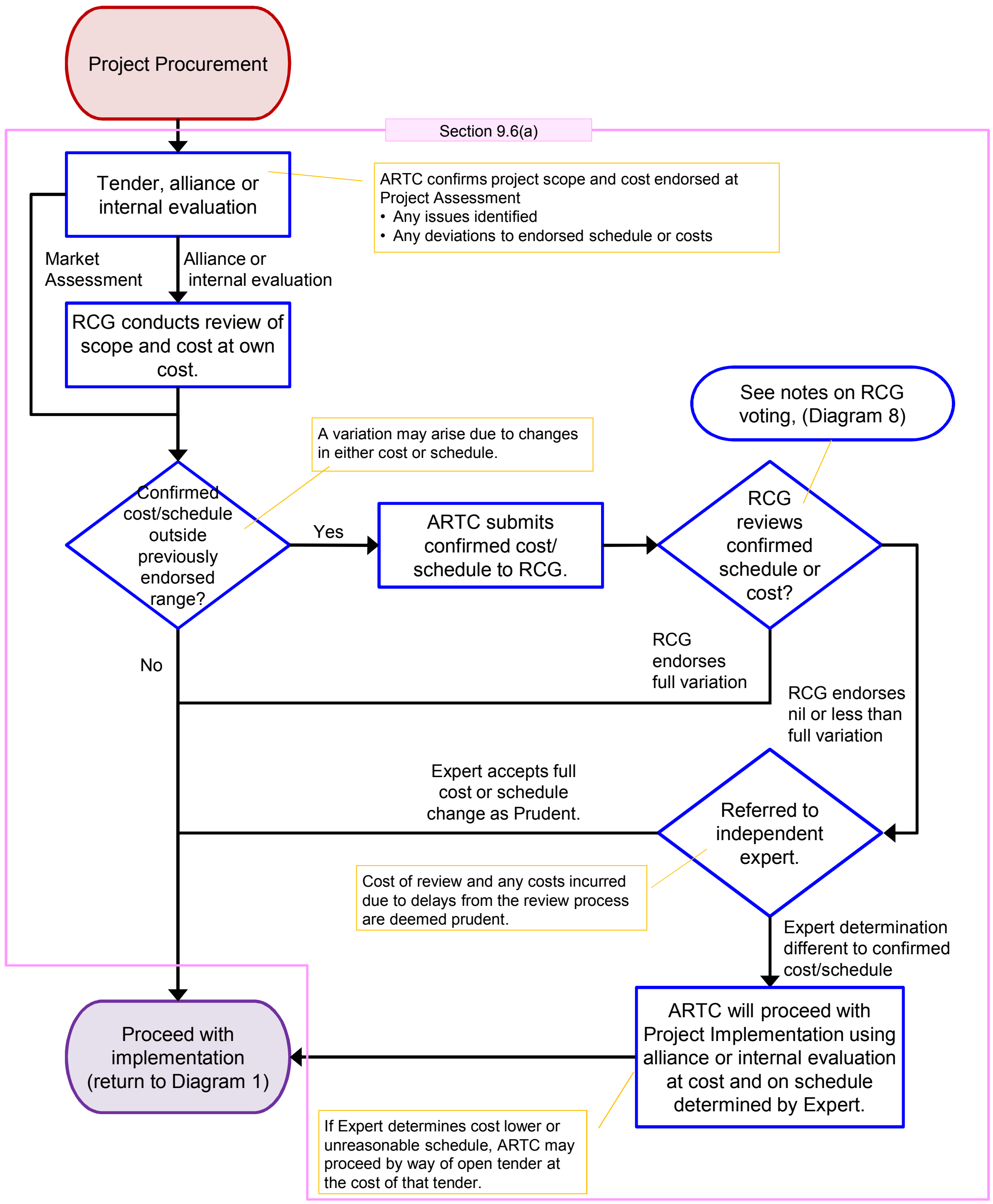

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Diagram 6: Project Delivery

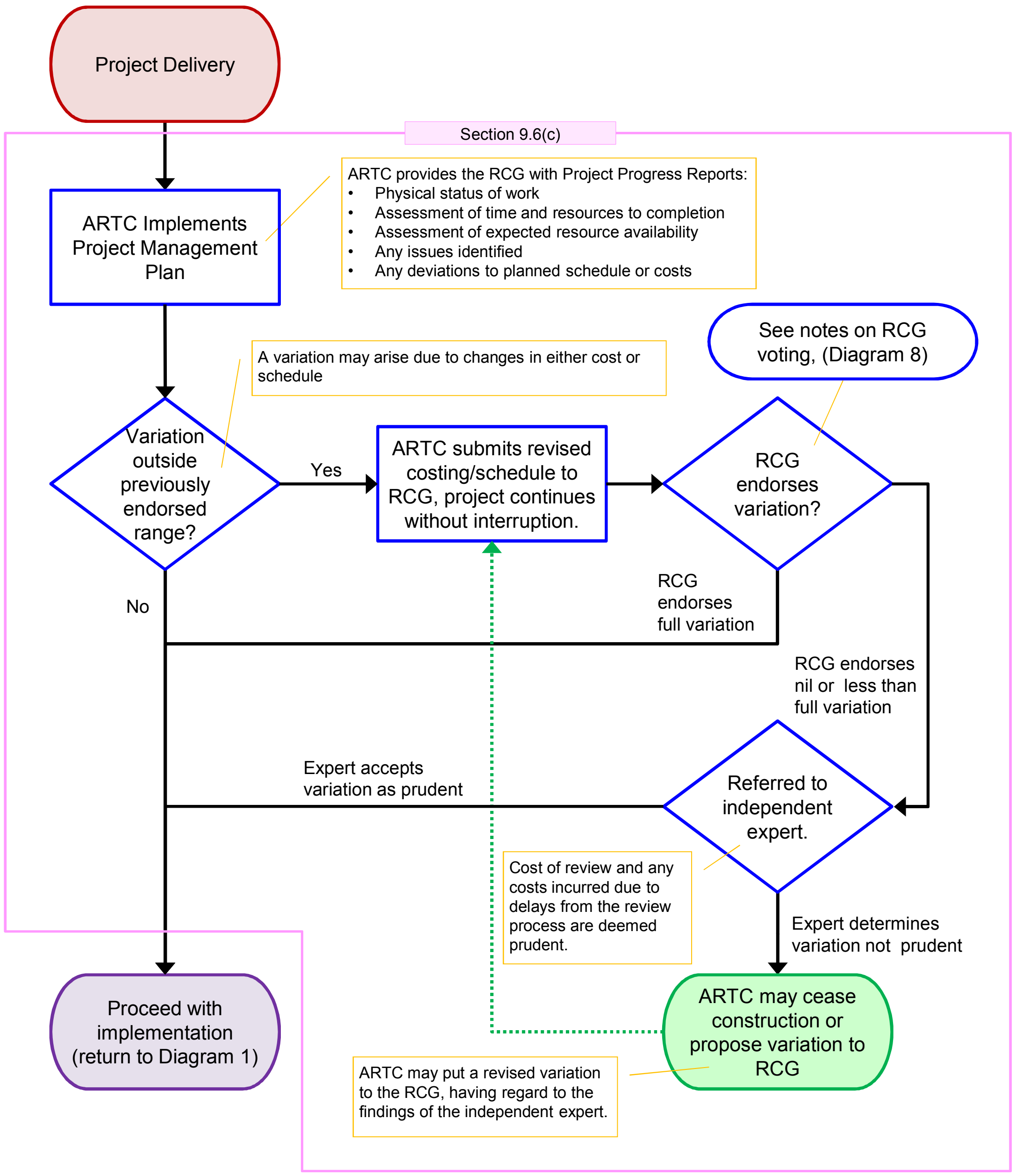

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Diagram 7: User Funding Arrangements

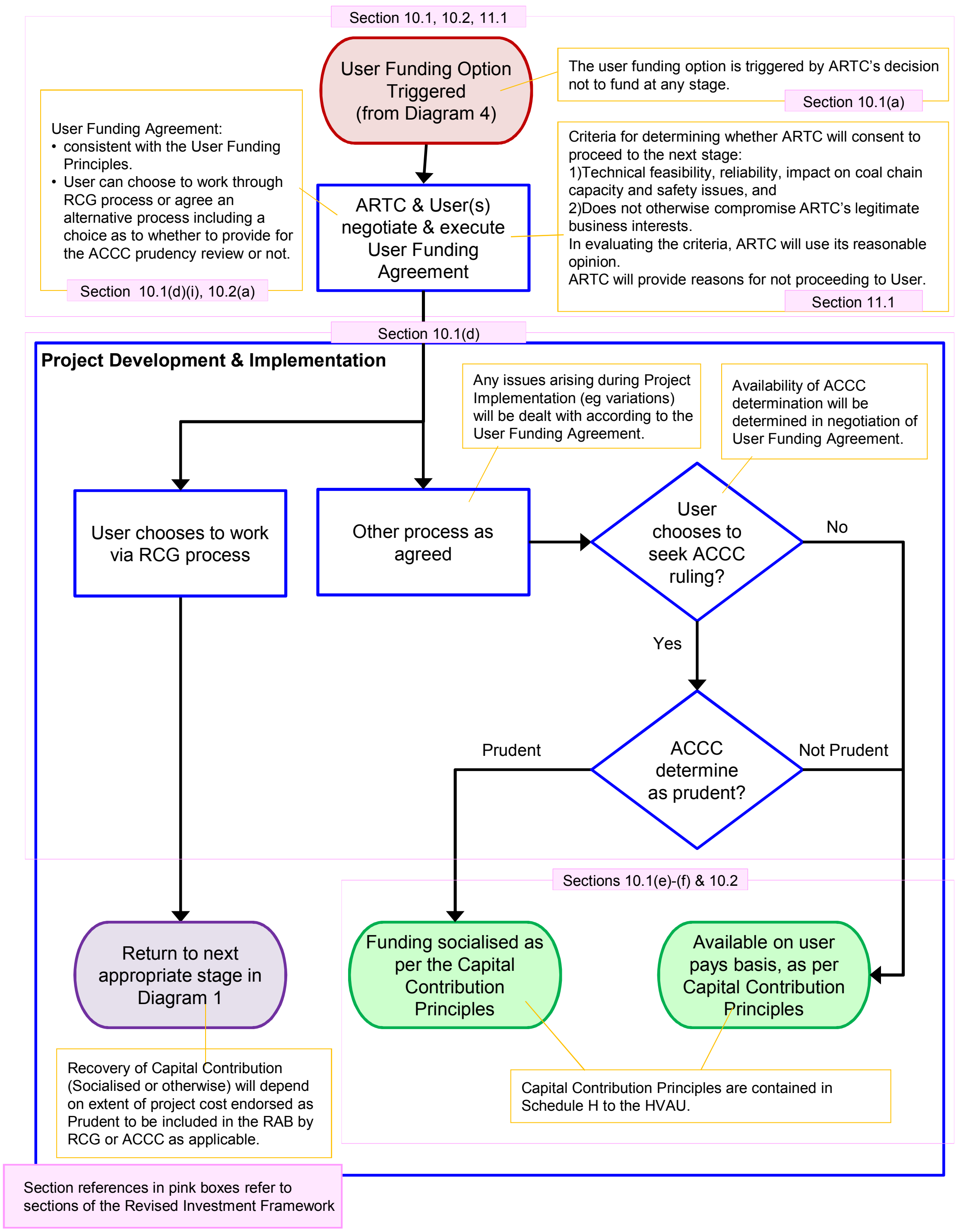

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Diagram 8: Notes On Operation Of RCG, Voting Etc

RCG Membership

Section 9.2(b) & (c)

Initially, the RCG will comprise one representative from each:

a) Access Holder who holds the largest volume of contracted coal GTK in each Pricing Zone;

b) any other Access Holder with more than 7% of contracted coal GTK on the Network

c) all Access Holders with less than 7% of contracted coal GTK on the Network

d) each Operator, in its capacity as an Operator, with more than 10% of contracted coal GTK on the Network (not already covered above), in a non-voting capacity

e) the HVCCC in a non-voting capacity.

The composition of the RCG may change from time to time as agreed by ARTC and the RCG. RCG members may or may not be participants in the HVCCC.

How RCG Votes Are Cast And Counted

Section 9.2(d), (e) & (f)

- Each RCG member will vote in accordance with the wishes of the underlying coal producer that is represented. A representative of multiple coal producers may split its vote according to the % of contracted coal GTK held by each represented coal producer.
- Voting will be weighted on the basis of contracted coal GTK for the current calendar year and the next nine calendar years, in the Pricing Zone in which a project is proposed to occur.
- ARTC may include any coal GTK in the Pricing Zone which it reasonably expects will become contracted coal GTK, for the current calendar year or for any of the following nine calendar years, immediately following the completion of the proposed project.

RCG Voting To Endorse Additional Capacity

Section 9.8

- For any vote in relation to a project in a particular Pricing Zone, endorsement occurs where votes representing over 50% of contracted coal GTK in that Pricing Zone endorse the matter.
- Where the Additional Capacity being voted upon is provided results in an increase in the Indicative Access Charge for that Pricing Zone by more than 10%, the endorsement requires over 70% of contracted coal GTK in that Pricing Zone.
- Where the 70% of contracted coal GTK has not been achieved, but sufficient endorsement votes for 50% is reached, ARTC may continue on the basis of that lower endorsement where the Applicant is willing to fund the excess above the 10% increase in Indicative Access Charges (without ARTC earning a return on the excess funded amount).

Section references in pink boxes refer to sections of the Revised Investment Framework

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ATTACHMENT B

CONFIDENTIAL

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