INDEPENDENT PRICING AND REGULATORY TRIBUNAL OF NEW SOUTH WALES

Statement of reasons for draft decisions on the compliance of Australian Rail Track Corporation (ARTC) with the New South Wales Rail Access Undertaking (NSWRAU) for 2012-13 and 2013-14 for the Gap to Turrawan sector.

Draft Decisions

2012-13

ARTC has not demonstrated to IPART's reasonable satisfaction that the 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.

2013-14

ARTC has not demonstrated to IPART's reasonable satisfaction that the 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).

Reasons for Draft Decisions

For 2011-12 and 2012-13, ARTC demonstrated compliance with clause 5(f) of the NSWRAU with respect to the Gap to Turrawan sector by performing a Ceiling Test on the combined Gap to Turrawan and Muswellbrook to Gap sectors. In essence, the 'proxy demonstration' approach tested coal revenue from mines located between Turrawan and Muswellbrook against the Full Economic Costs (FEC) of the combined networks.

ARTC considered this approach reasonable in conducting the Ceiling Test for the Gap to Turrawan under the NSWRAU in the absence of a robust means of allocating Access revenue between the two networks.

Given that coal traffic originating from Gap to Turrawan is destined for export and therefore needs to use the Muswellbrook to the Gap network on its journey to the Newcastle Port, ARTC took a pragmatic approach to perform the Ceiling Test on the combined sectors (Muswellbrook to the Gap and Gap to Turrawan). As the sector between Gap and Turrawan was (and remains) less utilised than that between Muswellbrook to the Gap (most coal is only carried part way in the Gap to Turrawan sector), ARTC considered it highly likely that cost recovery in Gap to Turrawan sector would be less than that for Muswellbrook to the Gap sector, and so less than the combined cost recovery for the combined Muswellbrook to Turrawan sectors. IPART agreed with this approach.

During 2014, ARTC found that it had inadvertently omitted Access revenue in its Ceiling Test submission provided to IPART for 2012-13. In its compliance submission for 2013-14 ARTC restated its 2012-13 ceiling test using a revised revenue allocation methodology, the 'direct assessment' approach, and concluded that its Access revenue was less than 80% of FEC. For 2013-14, ARTC proposed its revised Access revenue allocation methodology to demonstrate compliance of the Gap to Turrawan sector.

We made further information requests to ARTC in light of the re-stated Ceiling Test information and proposed methodology changes. These questions were answered.

This is the last year that IPART will be assessing compliance for the Gap to Turrawan sector, as in June 2014 the ACCC approved ARTC's application to incorporate Gap to Turrawan in their Hunter Valley Access Undertaking (HVAC) from 1 January 2014 (meaning IPART is only required to assess the six-month period ending 31 December 2013). In making our draft decision we have reviewed the ARTC submitted Ceiling Test information on the Gap to Turrawan sector for the 2013-14 (covering operation for six months to 31 December 2013) and also its re-stated ceiling test for 2012-13.

We note that ARTC submits that the information it provided in response to our requests does not form part of their submission, and it would not be reasonable for IPART to form a view under the NSWRAU on the basis of a test that incorporates parts of the network not covered by the NSWRAU. In our view, IPART has a duty to consider all relevant information. We consider that the information provided regarding the combined Muswellbrook to Turrawan Access revenue and FEC are relevant and we have had regard to them in making our draft decisions. Prior to publishing this decision, we provided ARTC with an opportunity to demonstrate how it may be detrimentally affected if we relied upon and published the information. We did not receive a substantive response to this request. In the absence of any substantive response from ARTC, we have been unable to identify any reason not to rely on, or publish, the information provided.

ARTC proposed 'direct assessment' approach to allocate access revenue

ARTC submits that their proposed 'direct assessment' approach avoids the use of 'proxy demonstration'. Under this approach, Access revenue from coal mines located along the Gap to Turrawan sector is allocated between the Gap to Turrawan sector and Muswellbrook to the Gap sector (Pricing Zone 3 under HVAU). The Ceiling Test then compares:

- the Access revenue from coal mines located between Turrawan and the Gap sector

- less the portion that was allocated to the Gap to Muswellbrook sector
- less the direct cost for that traffic to use the Muswellbrook to Port sector

to:

- the Full Economic Cost of the Gap to Turrawan sector
- apart from the direct costs of other traffic that uses it.

Our assessment of ARTC's compliance is based on the pricing principle that the Ceiling Test of the NSWRAU must be met (Schedule 3, clause 1(l) of the NSWRAU). In particular, the Access revenue must not exceed the Full Economic Cost on a stand-alone basis for any group of access seekers.

ARTC's proposed cost allocation methodology transfers revenue from the Gap to Turrawan sector to the Muswellbrook to Gap sector. This proposed allocation would result in the Ceiling revenue being exceeded for the Muswellbrook to Gap sector. In our view, that level of Access revenue re-allocation is not consistent with the NSWRAU because the Ceiling revenue would be exceeded for some combination of access seekers. We have considered what would be the maximum amount of the Gap to Turrawan Access revenue that could be allocated to the Muswellbrook to Gap sector without exceeding the Ceiling revenue for that sector. In making our draft decision we have used the '*maximum out-allocation method*' to determine that amount of re-allocated revenue.

The maximum out-allocation method is a method to determine an amount that would equate FEC of the Muswellbrook to Gap sector to the sum of:

- Access revenue from Gap to Muswellbrook mines less direct costs from Muswellbrook to Port); and
- The allocation of Access revenue from Turrawan to Gap mines (less direct costs from Muswellbrook to Port).

Access revenue

Table 1 presents our draft decision on the Access revenue to be allocated to the Gap to Turrawan sector that complies with the NSWRAU.

Table 1 Gap to Turrawan access revenue ($m)

Access revenue	2012-13 (12 months) ($m)	2013-14 (6 months) $m
IPART draft decision	44.1	23.6
ARTC proposal	39.7	19.3

Full Economic 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)).

ARTC submits that the total operating costs of the Gap to Turrawan sector are efficient in comparison with comparable inter-state coal networks and notes that on a unit cost basis:

- The unit maintenance cost of the Gap to Turrawan sector compares favourably with the Central Queensland Coal Network (Moura and Newlands). ARTC notes that the lower variable and fixed maintenance unit cost largely reflected the lower than normal activities over the 6 month period.[1]
- The unit operating cost ($'000 Gtk) (network control and corporate overheads) is significantly lower than the CQCN networks.

However, ARTC notes that meaningful comparison is difficult to make for the following reasons:

- Costs are driven by different activities in different periods. Variable and fixed maintenance costs fluctuate from year to year, in particular major periodic maintenance (MPM). The volatility is more apparent for a smaller network than a large network like the CQCN or the whole HVCN which is relatively more stable over time.
- Gap to Turrawan sector is a small sector (132.5 track km) relative to the comparator sectors, and the short time frame of the 6-month period tends to emphasise differences on activity levels and the incidence of special and non-recurring events which would normally be smoothed out over a larger network over a longer timeframe. In comparison, the CQCN unit costs represent averages over a 4-year period and the network comprises 3,200 km of tracks.

Our assessment of Gap to Turrawan costs

We assessed the Gap to Turrawan operating and maintenance costs against the benchmark cost rates that we used to assess RailCorp's compliance with the NSWRAU for its 5-sector of HVCN.

ARTC noted in their 2012-13 submission provided in May 2014, the higher operating expenditure in 2012-13 includes significant maintenance costs

1 ARTC submission for 2013/14 for Gap to Turrawan, February 2015, p 54.

associated with derailments in Breeza and Coxs Creek Bridge.[2] However, ARTC advised that costs relating to some derailment incidents should not be included in the full economic cost and ARTC agreed to remove those costs. Once we exclude the full derailment costs ARTC's proposed full economic costs are reasonably consistent with our benchmark costs.

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

Our draft decision is that for both 2012-13 and 2013-14 ARTC has not 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.

Regulatory assets valuation based on Depreciated Optimised Replacement Cost methodology

ARTC proposed that we accept the DORC valuation approved by the ACCC. We agree that the use of the DORC valuation of the Gap to Turrawan sector approved by the ACCC is reasonable for the purpose of demonstrating compliance with the NSWRAU under clause 5(f).

In compliance with clause 5(f) of Schedule 3 of the NSWRAU, ARTC has provided an "indicative Regulatory Assets valuation based on Depreciated Optimised Replacement Cost (DORC) methodology" or Gap to Turrawan sector.

Overall assessment of compliance under 5(f) for 2012-13 and 2013-14

Overall, we are not 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 for 2012-13 and 2013-14 (6 months to December 2013) under clause 5(f) of Schedule 3 of the NSWRAU. It will therefore be necessary to conduct a compliance check under clause 5(b) in respect of each period.

October 2015

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