

## REVIEW OF NSW RAIL ACCESS UNDERTAKING

# Review of the rate of return and remaining mine life relating to the Hunter Valley Coal Network

This fact sheet explains IPART's review of the rate of return and remaining mine life under the *NSW Rail Access Undertaking* (Undertaking) relating to the Hunter Valley Coal Network and the proposals that IPART has received from the infrastructure owners of the network.

### What the review covers

The *NSW Rail Access Undertaking* (Undertaking) requires IPART to review specific aspects of the Undertaking.

The rail infrastructure covered by the Undertaking is the Hunter Valley Coal Network. The network comprises 37 track sectors with 32 sectors leased to Australian Rail Track Corporation (ARTC) on a 60-year lease from 5 September 2004. RailCorp retains ownership of the remaining 5 sectors.

IPART is currently conducting a review of the remaining mine life of the Hunter Valley coal mines serviced by the relevant rail network.<sup>1</sup>

The Undertaking provides that the depreciation of the regulatory asset base (RAB) of the rail infrastructure is to be calculated using a straight-line methodology and the estimate of the remaining useful life of the rail assets. The Undertaking further provides that the useful life of the relevant rail infrastructure be determined by reference to the remaining mine life of the mines using the rail network. The revised remaining mine life is to be applied to estimate the depreciation of the Hunter Valley coal network from 1 July 2009.

IPART is also required by the Undertaking to review the rate of return every five years.<sup>2</sup>

Rate of return means a rate of return in percentage terms approved by IPART for a period of five years to be applied to the average of the opening and closing regulatory asset base.

<sup>1</sup> Section 3.2(c)(iv) of Schedule 3 (Pricing Principles) of the *NSW Rail Access Undertaking* requires a review of remaining mine life every five years by IPART.

<sup>2</sup> Section 2.1 of Schedule 3, *NSW Rail Access Undertaking*.

The revised rate of return is to be applied to the regulatory asset base to yield a return on the rail infrastructure assets for five years commencing 1 July 2009.

### Process for the 2009 review

IPART commenced the review process in November by requesting proposals from the infrastructure owners, RailCorp and ARTC. The proposals are available from IPART's website ([www.ipart.nsw.gov.au](http://www.ipart.nsw.gov.au)).

IPART is now seeking submissions from stakeholders to inform its decisions. Submissions are due by the close of business on **30 January 2009** (Friday).

In February, IPART will hold a workshop to discuss issues raised by access holders and access seekers. IPART will provide details of the workshop closer to the date of the workshop.

IPART will release its draft decisions in March 2009. IPART will request submissions on the draft report before finalising its report in May 2009.

**Table 1 Timetable for the review**

<b>Process</b>	<b>Date</b>
Invite public submissions on infrastructure owners' proposed rate of return and remaining mine life	Dec 2008
Stakeholders' Submissions due	30 Jan 2009
Hold public workshop of stakeholders and infrastructure owners	Feb 2009
Release draft report by the IPART for comments	March 2009
Release final report on mine life and rate of return	May 2009
Apply new depreciation rate and rate of return	1 Jul 2009

### IPART invites submissions

IPART invites submissions on the rate of return and remaining mine life (used to estimate the depreciation of the Hunter Valley Coal Network) proposed by the infrastructure owners.

It is useful if submissions refer to the ARTC proposal and address issues relating to the rate of return and remaining mine life. Please also consult IPART publication 'How to make a submission' which is available in IPART's website.

## Current rate of return and remaining mine life

The rate of return and remaining mine life approved by IPART for the regulatory period commencing 1 July 2004 was 7.3 per cent (real pre-tax) and 35 years respectively. The rate of return of 7.3 per cent is in the 75<sup>th</sup> percentile of the range 5.5 per cent to 8 per cent determined by IPART. Table 2 sets out the weighted average cost of capital (WACC) parameters used in the 1999 and 2004 IPART decisions.

**Table 2 WACC parameter value in the 1999 and 2004 Decision**

Parameter	1999 Decision	2004 Decision
	Value	Value
Nominal risk free rate	5.4%	5.5%
Real risk free rate	3.5%	2.7%
Inflation	1.8%	2.7%
Market risk premium	5.0 to 6.0	5.5 to 6.5
Debt margin	1%	1.13% to 1.23%
Equity beta	0.7 to 1.0	0.7 to 1.0
Asset beta	0.29 to 0.55	0.32 to 0.46
Debt beta	0.10 to 0.08	zero
Debt to total assets	60% to 50%	60% to 50%
Gamma	0.5 to 0.3	0.5 to 0.3
Tax rate	36%	30%
Cost of equity (nominal post tax)	8.9% to 11.39%	9.4% to 12.0%
Real pre-tax WACC	5.3% to 8.8% <sup>a</sup>	5.5% to 8.0% <sup>b</sup>
Decision	8%	7.3%

<sup>a</sup> Based on both market and reversed transformation.

<sup>b</sup> Based on market transformation.

**Source:** IPART, *Report on the Determination of Remaining Mine Life and Rate of Return from 1 July 2004, NSW Rail Access Undertaking*, Determ 3/2005, pp 12 & 13.

## Infrastructure owners' proposals

For the regulatory period starting from 1 July 2009 the infrastructure owners' proposals are as follows:

### RailCorp's proposal

RailCorp owns five sectors of the Hunter Valley Coal Network. It did not propose any specific rate of return and remaining mine life to be applied from 1 July 2009. Rather, it is prepared to accept IPART's decision.

## ARTC's proposal

### *Rate of return*

ARTC proposes a rate of return of at least **10 percent** (real pre-tax) to apply to the regulatory asset base from 1 July 2009. This is in the 75<sup>th</sup> percentile in the range of 8.84 per cent to 10.53 per cent as proposed by ARTC (see Table 2).

The rate of return is based on the weighted average cost of capital which comprises debt and equity. ARTC determines the cost of debt by calculating a margin over the risk free rate, and the cost of equity by using the Capital Asset Pricing Model (CAPM).

**Table 3 WACC parameter value proposed by ARTC**

<b>Parameter</b>	<b>Lower bound</b>	<b>Upper bound</b>
Nominal risk free rate <sup>a</sup>	4.95%	4.95%
Debt to total value	50%	55%
Equity to total value	50%	45%
Debt margin <sup>b</sup>	3%	3%
Debt raising costs	0.125%	0.125%
Market risk premium	6%	7%
Gamma	zero	zero
Tax rate	30%	30%
Asset beta	0.5	0.6
Debt beta	zero	zero
Equity beta <sup>c</sup>	0.99	1.32
Cost of equity	10.88%	14.17%
Cost of debt	8.08%	8.08%
Inflation	2.73%	2.73%
Post tax nominal WACC	9.48%	10.82%
Pre tax real WACC <sup>d</sup>	8.84%	10.53%

<sup>a</sup> Based on a 20 day average for the period ending 28 November 2008.

<sup>b</sup> Based on a 20 day average for 8 year BBB bonds plus the margin between an A-rated 8 and 10 year bond for period ending 28 November 2008 and before debt-raising costs..

<sup>c</sup> Based on the Monkhouse formula.

<sup>d</sup> Based on market transformation method.

**Source:** ARTC proposal for the 2008 Review under the NSWRU, p 8.

ARTC submits that the proposed rate of return takes into account the following risks faced by the business:

- ▼ risks arising from the uncertainty of the current global financial and economic conditions which at least warrant a rate of return at the 75<sup>th</sup> percentile in the range suggested by ARTC (see Table 2)
- ▼ stranding risk due to magnitude of investment program to be undertaken in the next five years to deliver capacity to enable marginal volumes in the upper to be realised, and
- ▼ the unsettled nature of the commercial and operation arrangements on the Hunter Valley Coal Network in the new regulatory period.

### *Remaining mine life*

Also, ARTC proposes an average mine life of **22.8 years** to apply from 1 July 2009. The proposed average life is based on the constrained production of all mines currently in production and through to 2014. ARTC considers that this estimate is more reliable and realistic than the estimates prepared in the 2004 review.

### **Other current developments**

#### 1. ARTC's Undertaking with ACCC

ARTC advises that it is currently consulting with the industry stakeholders in relation to the development of its 2008 Hunter Valley Access Undertaking (HVAU) and will apply to the Australian Competition and Consumer Commission (ACCC) for its approval in 2009. ARTC is targeting the new undertaking to become effective from 1 July 2009. It is therefore possible that the HVAU may supersede the rate of return and remaining mine life determined by IPART to apply from 1 July 2009.

However, it is still necessary for IPART to undertake the review for the five sectors owned by RailCorp and given the possibility that ARTC's HVAU may not be approved by ACCC prior to 30 June 2009.

#### 2. ARTC's application to vary the current NSW Rail Undertaking

ARTC further submits that it is seeking an approval from the NSW Transport Minister to vary the current rate of return to be applied from 1 July 2008 to 30 June 2009. If the variation is approved by the Minister (and concurred by the Premier) IPART will need to undertake further review and public consultation on an interim rate of return.

If either development occurs, IPART will consider amending its consultation process for the 2008 review of the rate of return and remaining mine life to reduce uncertainty and streamline stakeholders' participation in the 2009 review.

The infrastructure owners' proposals are available from IPART's website.