ARTC

AUSTRALIAN RAIL TRACK CORPORATION LTD

Ref No:

30 April 2009

Mr. James Cox
Chief Executive Officer and Full Time Member
Independent Pricing and Regulatory Tribunal
PO Box Q290,
QVB Post Office NSW 1230

NEW SOUTH WALES RAIL ACCESS UNDERTAKING (NSWRAU)
Review of Rate of Return and Remaining Mine Life of Hunter Valley Mines

ARTC Response to New South Wales Minerals Council (NSWMC) Submission

Dear Mr Cox

ARTC welcomes the opportunity to provide a response to IPART in relation to a late submission provided by the NSWMC on IPART's Issues Paper regarding its review of Rate of Return to apply from 1 July 2009 to the Hunter Valley Coal Network in accordance with the NSW Rail Access Undertaking (NSWRAU). ARTC recognises the IPART's efforts to attempt to achieve a degree of procedural fairness in the consultation process given these circumstances.

In light of the timing of the NSWMC submission in relation to IPART's proposed date for making its Draft Decision, the comprehensive nature of the NSWMC submission, and the benefits for the industry by way of certainty arising from a prompt resolution of the matter by IPART, ARTC is only proposing at this time to respond to the NSWMC in broad terms based on the key themes that seem to be coming from the submission. While ARTC has a number of concerns with some of the arguments made in relation to the specific parameters, it is not proposed to address these in detail at this time, noting that some (but not all) of these issues have already been addressed in ARTC's own submissions. ARTC will also endeavour to rectify some of the assertions made for correctness.

ARTC wishes to emphasise therefore that any area in the NSWMC submission not addressed by ARTC in this response, should not be taken as an acceptance of the NSWMC position in relation to that area.

As stated in its April 9 submission, ARTC is somewhat surprised that the NSWMC has decided, in addition to responding to the issues raised by IPART, to propose a Rate of Return which lies substantially below the Rate of Return proposed by ARTC and which is substantially below the existing Rate of Return applicable under the NSWRAU. The NSWMC proposal has come at a very late stage in the consultation process set by IPART, and nearly five months after ARTC's original proposal was published for consultation by IPART. ARTC was advised by the NSWMC in August last year that coal producers recognised that the cost of capital has increased since it was last determined under the NSWRAU[1].

At that time (in a consultation document in relation to ARTC's proposed Hunter Valley Access Undertaking in July 2008), ARTC had previously made the NSWMC and other stakeholders aware of its initial position in relation to the Hunter Valley coal network rate of return, which proposed a return of 9.3% real pre-tax for existing assets and 9.6% real, pre-tax for new assets. The approach used by ARTC at that time was consistent with that used by IPART in 2004, and the NSWMC gave no indication at that time that it was concerned with this approach.

ARTC's proposed Rate of Return to IPART was 10% real, pre-tax; a figure that might be expected given deteriorating economic circumstances.

ARTC could not find anything in the NSWMC submission that provides cause for the NSWMC to have a substantially different view (upwards of 7.3% to 5.25%) from that of 9 months earlier, other than the opportunities that may have presented from the seemingly highly controversial draft position taken by the Australian Energy Regulator (AER) in relation to electricity transmission and distribution network service providers in December 2008.

In any event, ARTC is extremely concerned at the NSWMC submission that 5.25% real pre-tax represents a reasonable basis upon which ARTC could continue to provide access to, and substantially invest in, the Hunter Valley coal network. ARTC is unaware of any provider of infrastructure services that provides effective and efficient infrastructure services on a sustainable basis to support a strong and competitive end market with a rate of return near this level.

[1] Refer ARTC submission to IPART dated 9 April 2009.

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ARTC will address what would seem to be the key themes of the NSWMC submission as follows:

- impact of Rate of Return on ARTC's ability to obtain funding for its investment program;
- use of certain parts of the AER draft position;
- impact on Rate of Return on Hunter Valley coal producers;
- impact of setting Rate of Return too high as opposed to too low;
- use of a nominal, post tax framework or a real, pre-tax framework with an effective tax rate rather than a statutory tax rate;
- use of a point estimate for WACC; and
- asymmetric risks

Impact of Rate of Return on ARTC's ability to obtain funding for its investment program

The NSWMC notes that ARTC stated in its April 9 submission that it considered that the existing Rate of Return is too low and may result in ARTC not being able to attract sufficient funding for the substantial investment program being contemplated to deliver the capacity needed to meet current demand forecasts. As described earlier, and in also in the April 9 submission, ARTC was advised by the NSWMC in August last year that coal producers recognised that the cost of capital has increased since it was last determined under the NSWRAU. It would seem that the coal producers supported ARTC's position that the existing Rate of Return was too low in August last year.

The contents of the NSWMC submission suggests that the NSWMC has reviewed ARTC's April 9 submission and has not disagreed with having provided this advice.

In its submission, the NSWMC has asserted that ARTC 'had not appeared to have put forward any specific evidence to support its position in relation to being able to obtain funding' and that 'although ARTC is projecting a substantial capital program for the HVCN, the NSWMC submits that ARTC should be able to fund the program', (presumably at the existing Rate of Return or lower).

The basis for the NSWMC assertions is that ARTC:

- has received a $580m equity injection from the Commonwealth Government for its planned investment of approximately $1000M in the HVCN;
- may have received other Commonwealth Government support in relation to borrowing;
- has a very low actual gearing;
- intends to require up-front long term, take-or-pay tonnage commitments by all coal users of the HVCN covering the capital costs of all its future investment in the Network as well as other fixed costs; and
- also intends to require up-front capital contributions by coal users where necessary to fund particular investments such as the $470m investment planned for the Muswellbrook to Narrabri line.

ARTC's response in relation to the NSWMC assertions, and the basis for those assertions, is as follows:

- ARTC made a number of statements in relation to the matters raised by the NSWMC in its 9 April submission. In fact statements were made in relation to capital contributions and the Australian Government equity injection in the Synergies report attached to the April 9 submission. ARTC adds the following:
  - ARTC initially sought to fund the $1bn investment program during 2008.
  - Financial institutions did not wish to provide funding for the entire program, and were only willing to make about 50% of required funds available.
  - ARTC sought from its shareholder equity support to enable it to obtain sufficient funds.
  - There is no reason to consider the Australian Government as any different from any other type of shareholder. The equity injection carries with it expectations of an appropriate return that reflects the risks involved, given the commercial nature of the Hunter Valley coal network.
  - The investment now required over the next 5 years to meet projected demand substantially exceeds $1bn and approaches $1.5bn. In an environment where credit is even harder to obtain than it was 12

months ago, ARTC sees no reason why obtaining debt (or equity) at the existing Rate of Return (or lower) will be less difficult than it has been in the past.

- The WACC analysis is done with reference to the 'efficient benchmark firm' and no consideration is made of Government ownership (including the ability to access funding from Government). A number of regulated businesses in Australia are Government owned and neither ARTC nor Synergies are aware that this has in any way influenced the decisions made by regulators in relation to rate of return. One of the key principles underpinning the National Competition Policy reforms implemented in the late 1990s was to ensure that the pricing of commercial activities reflected the full costs of providing those services, including generating an appropriate return on capital for the risks involved (given there is an opportunity cost in employing that capital). The rate of return proposed by ARTC (based on the report prepared by Synergies) is considered an appropriate, commercial risk-adjusted rate of return for this business activity **in the current market environment**. The rate of return proposed by NSWMC is considerably below this.

- ARTC can confirm that it has received no other shareholder support in relation to borrowing for the Hunter Valley investment program.

- The Hunter Valley coal industry operates on a clear commercial footing. There is an obligation to earn a commercial return on any equity invested in the Hunter Valley coal network.

- Lenders tend to focus on the future gearing level and liquidity if additional borrowings are undertaken. As a company, ARTC does not have a high level of gearing. ARTC commenced operations in 1998 and for most of the last 10 years has focussed on the development of the interstate network. IPART would be aware that at current pricing, ARTC does not make a commercial return on this asset base value as valued for regulatory purposes.

  As such, ARTC's investment in the interstate network has almost exclusively been funded internally, or through equity support and/or grants from its shareholder. Until recently, ARTC has not borrowed any significant amounts for investments. ARTC could only realistically obtain significant debt funding where the commercial nature of the business could support it.

  ARTC's gearing level will increase as a consequence of the investment program to be undertaken over the next 5 or so years. The NSWMC has suggested that because of ARTC's low level of gearing it should have no difficulties raising the necessary funds. This is not what ARTC has encountered in practice. As noted above, ARTC sought the additional equity support because financial institutions were only willing to fund about 50% of the capital program.

- The industry has for some time been contemplating access to the rail network being provided based on direct producer contracts with long term take-or-pay. No such contracts are currently in place. ARTC is submitting an access undertaking to the ACCC for approval, which incorporates <u>indicative</u> arrangements for coal contracting with a ten year initial term with five years notice thereafter. This does not mean that ARTC would not permit access to the network without this commitment. The NSWMC has indicated to ARTC that some producers are likely to seek contracts with shorter terms.

  Pricing under the indicative access agreement consists of a non take-or-pay component and a take-or-pay component. Given the relativity of fixed costs and new capital costs, it is expected that (where pricing is constrained) a large part of the price would be a take-or-pay component. This may not be the case where pricing is not constrained.

  A substantial part of the investment is on the ARTC network north of Muswellbrook, which is currently unconstrained. Given the size of the investment needed, it is unlikely that this part of the network will become constrained in the short to medium term, and it is not certain that it will become constrained in the long term. Whilst the new access undertaking incorporates provisions to permit recovery of early losses in later years, there is no certainty this will be approved by the ACCC and no certainty that longer term volumes will be sufficient to enable recovery in the long term.

  The arrangements being proposed by ARTC to the ACCC are not fully supported by the industry and, as such, it is not certain that the arrangements as described will be approved by the ACCC or will eventuate at all. For example, the coal industry has proposed that access contracts should provide for a producer to relinquish up to 25% of contracted capacity with one year's notice after the initial ten year period, and all contracted capacity with three years' notice.

  Take-or-pay contracts could provide ARTC with certainty for as little as ten years, noting that the protection provided by take-or-pay is only as strong as the underlying creditworthiness of the counterparty (as noted in the Synergies report). For the purpose of setting the rate of return, ARTC's risk profile needs to be assessed as it currently stands. There is considerable uncertainty remaining regarding the future contractual arrangements. In any case, the term of any protection afforded by take-or-pay, if and when implemented, will still be considerably less than the lives of the assets that are being put in place on the network.

- The existing NSWRAU and ARTC's new access undertaking provide for capital contributions to be made by an access seeker. This is intended to provide an alternative to the access seeker to bring about investment. Another alternative is to pay through access charges. Under the NSWRAU or ARTC's new access undertaking, there is no conferral of any right for ARTC to require a capital contribution be made by an access seeker.

  To date, ARTC has never sought, nor has it received, a capital contribution in relation to an investment on the Hunter Valley network. It is not ARTC's intention to require capital contributions for any future investment as asserted by the NSWMC, including in relation to the $470 million investment planned for the Muswellbrook to Narrabri line. The existing and proposed regulatory arrangements offer an alternative. ARTC is not aware of any offer of a capital contribution being made by Hunter Valley producers or operators. In fact, given the circumstance where the cost of capital of producers and operators is likely to be substantially higher than ARTC's cost of capital (upon which it would base its access charges), it is difficult for ARTC to envisage a situation where a producer or operator would see a capital contribution as a viable alternative to paying access charges. ARTC expects that this has inhibited such a practice in the past.

  It is therefore inappropriate to assess the risk profile of ARTC's Hunter Valley coal network on the assumption that capital contributions will be sought and obtained.

As such, ARTC does not see the circumstances asserted by the NSWMC as providing an adequate basis for arguing that ARTC's rate of return should be reduced and funding would be readily available. As suggested above, in the current credit environment ARTC has experienced significant difficulty in securing funding for the proposed investment program at the existing rate or return, and would see this continuing as more funding is needed. This has given rise to ARTC seeking equity support from its shareholder. More importantly, the key issue is the extent to whether these factors should be considered in assessing ARTC's risk profile and if so, how. This has already been considered in detail in the submissions prepared by ARTC and the report prepared by Synergies.

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Use of certain parts of the AER draft position

ARTC became aware that the NSWMC was intending to take the opportunity to pursue more favourable approaches to determining certain WACC parameters (from a users' perspective) offered by the recent draft AER Statement of Regulatory Intent at the April 1 Public Hearing. ARTC (through Synergies) have commented on this NSWMC strategy in its April 9 submission.

In summary, the AER Statement relates to a different industry, and is currently only a draft statement. It is highly controversial and has led to a reaction in both the financial markets and stakeholders that has been unprecedented. In the April 9 submission, Synergies quoted several examples of submissions made to the AER by independent investment market participants.

The draft Statement introduces a number of views that are quite different from traditional regulatory settings in most industries, and particularly rail. These views are unprecedented and the impact is untested. The NSW Minerals Council have asserted that the AER undertook the review 'in conjunction with' the ACCC. ARTC does not believe this to be the case.

For example, the NSWMC has adopted the AER's proposal to shorten the term of the risk-free rate to match the term of the regulatory period on the basis that a long-term rate over-compensates ARTC. First, and based on the reasoning applied by the AER, this assumes that ARTC secures all of its funding for a five year term. This is not the case, because ARTC is funding long-term assets. Such a strategy also presents significant refinancing risks as it assumes that all of the debt is refinanced at the end of each regulatory period.

Second, and more importantly, a fundamental tenet underpinning the theoretical and practical determination of the Weighted Average Cost of Capital (including the CAPM, which is used to determine the cost of equity), is that investors are taking a long-term forward-looking view when setting their expectations in relation to the rate of return. In setting the WACC the term of the risk free rate should be based on the investor's horizon, not that of the regulator. It is for this reason that the typical proxy used for the risk-free rate is the longest liquid sovereign government bond in the relevant market, which in Australia is the ten year Commonwealth Government bond.

There are a number of other significant concerns with the approach the AER has taken to particular parameters. However, ARTC is not of the view that this is the time and place for that debate.

The NSWMC references the draft decision as if it is the sole authoritative source for the value of some of the WACC parameters. The AER position is not binding on IPART or any other regulated industry. The NSWMC and their consultants provide no analysis themselves. They reference parameter values that result in an extraordinarily low WACC for ARTC.

Even if its draft Statement is ratified, ARTC therefore believes that no weighting should be given to it.

Further, ARTC believes that a review of Rate of Return in the Hunter Valley is not the appropriate forum for the substantial, time consuming and wider debate that is likely to arise around the positions in the AER's Statement. It is not ARTC's intention to engage in the wider debate through this forum.

Impact on Rate of Return on Hunter Valley coal producers

In its covering letter, the NSWMC claimed that ARTC's proposal *'would have a significant negative financial impact on Hunter coal producers'*[2].

Whilst it is not ARTC's intention to place the profitability or sustainability of the coal industry in any sort of jeopardy as a result of this review, ARTC considers it reasonable and consistent with efficient markets for it to be permitted to earn a fair and reasonable rate of return reflecting the risks faced. ARTC would consider this important in facilitating efficient investment in capacity expansion of the Network.

ARTC would argue that the impact of any regulatory review of rate of return would be positive as long as the rate of return was set at a fair and reasonable level and encouraged efficient investment.

ARTC would also argue that the impact of any change of rate of return should only be contemplated as an outcome of the regulatory decision rather than a determinant of that decision. To do otherwise may lead to sub-optimal outcomes for the industry.

Without wishing to give credence to the NSWMC position, the statement made above would seem to be inconsistent with the position put forward in other parts of the NSWMC submission. For example the NSWMC states that *'rail transport costs are a*

[2] NSWMC, Rate of Return and Remaining Mine Life Relating to the Hunter Valley Coal Network, 23 April 2009, Covering Letter.

relatively small proportion of FOB costs'[3] and *'there is scope for Hunter mines to take a considerable price decrease before mine closures would be contemplated'*[4].

With current coal pricing of around $70/tonne, and average access pricing at around $1/tonne, ARTC would expect that a moderate increase in rate of return is unlikely to significantly impact a coal producer. Based on an existing RAB of around $500m, an increase of 1% in the Rate of Return would increase the revenue ceiling by around $5m. Spread over 100mTpa, this would result in a 5c/tonne impact on the coal producer.

On the other hand, a 1% decrease in Rate of Return would reduce ARTC's revenue by $5m (around 5% of revenue).

In any case, the key issue for the regulatory review is what constitutes a fair and reasonable rate of return based on the risks involved. If the industry ended up in a situation of financial hardship, this will be a commercial issue between ARTC and producers within the contractual framework. It does not warrant selective adjustment to one or more of the building blocks that form part of ARTC's annual revenue requirement.

Impact of setting Rate of Return too high as opposed to too low

ARTC note that the NSWMC has submitted that the costs of setting the WACC too low are not greater than the costs of setting it too high, notwithstanding ARTC's capital program. It also suggests that selecting an estimate above the mid-point of an overall WACC range is not justified on the basis of asymmetric consequences of regulatory error.

The NSWMC used as a basis for it position a quote from NERA to the ESC:

'... both under-investment and over-investment are costly, and it is not at all clear which is preferable. If over-investment gives rise to capacity that will not be utilised by reasonably anticipated future demand, the resources dedicated to overbuilding the asset could presumably have been better utilised elsewhere, eg in the provision of alternative infrastructure services for which the consumer welfare associated with the provision may be equal or greater.'[5]

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[3] NSWMC, Rate of Return and Remaining Mine Life Relating to the Hunter Valley Coal Network, 23 April 2009, p13.

[4] NSWMC, Ibid.

[5] NSWMC, Ibid, p15

The NSWMC also argues a position that there is little risk of under-investment in the Hunter Valley coal network, submitting that ARTC should be able to fund its substantial investment program for a number of reasons. ARTC has already commented on this earlier in this response.

ARTC does not contest that there are costs associated with both under-investment and over-investment, but maintains a position that the cost of under-investment would normally be higher. This would seem to be supported by NERA in another regulatory forum where it asserted:

'Importantly for regulatory practice both IPART and ICRC [Independent Competition and Regulatory Commission of the ACT] display a significant degree of regulatory caution as they consistently set rates of return within the top half of the feasible [WACC] range. In our opinion this represents good regulatory practice and implicitly acknowledges the asymmetric costs of setting regulatory rates of return slightly too higher compared to setting rates slightly too low.'[6]

In any event, the likelihood and cost of impact should be considered in the circumstances.

In the case of the Hunter Valley coal network, ARTC contends that the cost of under-investment is high. This is consistent by the position that the NSWMC took in its submission to Infrastructure Australia (and included in ARTC's April 9 submission) as follows:

'Despite these large planned investments in rail and port capacity, the system remains constrained, with an estimated 5-10Mt shortfall in 2007 representing more than $400 million in lost exports. There remains significant uncertainty about entitlement to coal chain capacity, both in the short term to 2010 and in the longer term.

The costs include:

- Lost export revenue, estimated at more than $2 billion between 2005 and 2010
- Additional costs, with demurrage estimated at more than $300 million per annum
- Decreased customer confidence and loss of export markets / market share
- Lost employment opportunities
- Future investments in new mining export infrastructure and growth at risk.

[6] NERA Economic Consulting, Review of ACG's Assessment of Queensland Rail's WACC, 22 August 2005, Appendix (forming part of QR Submission re 2005 Draft Undertaking Draft Decision (Aug 05)

In the light of predictions of strong, long-term demand for NSW coal resources, and the opportunity available to Australia through the required growth in global coal production to meet forecast demand, the costs to NSW and Australia are immense.'[7]

A reasonable conclusion from this is that the costs of under-investment are considered to be very high. On the other hand, ARTC would contend that given the cost relativity of access to the network compared to the overall cost of coal industry output, the impact over any over-investment is relatively low.

ARTC has already contested the NSWMC assertion that the likelihood of under-investment is low, and further contends that the provisions of the NSWRAU serve to ensure that the likelihood of over-investment is low.

In particular, the NSWRAU provides for IPART to consider the outcomes of a prescribed consultation process with access seekers to be taken into consideration in assessing whether to include an investment in the RAB. Certainty of inclusion would normally require the endorsement of access seekers. As such, access seekers are in a position to satisfy themselves that any investment is necessary for future demand, is efficient, and ensure that over-investment does not occur. ARTC is not aware of any concerns held by the Hunter Valley coal industry in relation to the effectiveness of current consultation processes. ARTC's proposed Hunter Valley access undertaking provides for even greater level of consultation and control of investment occurring on the network.

ARTC has also submitted that the risk of optimisation provides a significant disincentive on a regulated business to not over-invest. A key risk facing all regulated businesses is that if there is a significant and permanent deterioration in demand for its service, all or part of its asset base could become stranded. Certain arguments made by ACIL Tasman that refute this (which are relied upon by the NSWMC in supporting its position) confuse regulators' positions on asset revaluation with optimisation. This is considered further under the discussion on stranding risk below.

In summary, ARTC contends that in the context of the Hunter Valley coal network, the cost of under-investment is far more likely to be higher than the cost of over-investment, given the relative likelihood and impacts involved.

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[7] NSW Minerals Council Ltd (2008), Submission to Infrastructure Australia: Australia's Future Infrastructure Requirements, p.12.

Use of a nominal, post tax framework or a real, pre-tax framework with an effective tax rate rather than a statutory tax rate

A real, pre-tax framework has been used in the Hunter Valley since the commencement of regulatory scrutiny in 1999. ARTC and its predecessor have been undertaking annual regulatory compliance testing for many years and have established systems and processes to underpin this framework. ARTC is not aware of substantive concerns being raised by any Hunter Valley stakeholder in relation to the use of a real, pre-tax framework and a statutory tax rate in the past. The reasons for the change of position are not clear to ARTC.

For the above reason, and others, ARTC sees substantial benefits in providing for a consistent regulatory framework on the network over time. The Hunter Valley requires investment, often lumpy over time, in long life assets requiring long term returns. In this environment, consistent regulatory treatment is important. A continually changing regulatory framework that deals with certain points in the life cycle of an investment or business serves to create uncertainty and may constrain optimal long term decision making.

ARTC is aware that the ACCC favours a nominal, post-tax approach. ARTC was required to develop business modelling as part of the approval process for its Interstate Access Undertaking using a nominal, post-tax framework, and the ACCC approved a regulatory rate of return on a nominal, post-tax basis. Given that there was unlikely to be any practical application of the rate of return on the interstate network (such as annual compliance review of pricing) ARTC had no strong concern with meeting the ACCC requirements in this case.

Nevertheless, ARTC considers it more important to maintain a consistent framework over time than to ensure the same framework is used over parts of the ARTC network, as was suggested by the NSWMC. Given that the Hunter Valley network is likely to be the only part of the wider ARTC network where pricing is constrained, ARTC does not see any imperative that the Hunter Valley and interstate networks both operate on a nominal, post-tax basis. Different frameworks have existed on different parts of the rail network for some time with any practical difficulties.

In its Hunter Valley access undertaking, ARTC has proposed to the ACCC to continue use of the real, pre-tax framework in the Hunter Valley for the reasons above. As such, IPART should not consider ARTC's new undertaking as an imperative to change from a real, pre-tax framework. ARTC would not support this.

The NSWMC has submitted:

'Given accelerated tax depreciation schedules, use of the statutory tax rate will over-estimate the tax burden in the presence of a significant capital expenditure program. Given the size of the capital expenditure program foreshadowed by ARTC, its effective tax rate is likely to be significantly lower than 30%.'

ARTC is not aware of any specific or preferential taxation treatment in relation to the investment program in the Hunter Valley. ARTC expects to depreciate its investment in accordance with normal ATO requirements. As such, ARTC can only presume that the NSWMC are referring to timing differences that may arise as a result of different methods of depreciation (such a diminishing value or prime cost (straight line)). ARTC would consider that even with the size of the capital program proposed by ARTC, ARTC's effective tax rate (as a result of these timing differences) may reduce for a period of time possibly to below 30%, but would not expect its tax rate to move significantly lower than 30%. It is unclear as to the basis for the NSWMC assumption the ARTC's effective tax rate would be 10%. In any event, any timing differences could be expected to balance out in the long term. In the long term, a company's effective tax rate should equate to the statutory tax rate. ARTC understands that it is for this reason that regulators have consistently favoured the use of a statutory rate rather than an effective rate.

As stated earlier, ARTC understands that Hunter Valley stakeholders have either proposed or supported IPART's use of a statutory tax rate over the past 10 years. In 2004, the NSWMC submission (as a reason for supporting the use of a real pre-tax rate of return rather than a post tax rate of return) suggested:

'the considerable period of time that has elapsed since much of the investment in the Hunter rail network was undertaken, so that much of the network would be fully depreciated for tax purposes and the actual tax payable relatively high'[8]

The NSWMC recognised in 2004 that the nature of the Hunter Valley assets were such, that, the effective tax rate was high. As there was a fairly long period without substantial investment in the Hunter Valley covering the latter half of the 1990s and the first half of this decade, ARTC contends that the effective tax rate for below rail assets in the Hunter Valley may well have been higher than the statutory tax rate. Investment in the network has gradually built up over the last few years suggesting that the effective tax rate may have reduced, possibly to below the statutory tax rate.

It could therefore be said that the adoption of a statutory tax rate may have under-compensated the track manager for the last decade and a half. Given that the timing

[8] NSW Minerals Council, Submission to IPART, Review of Rate of Return in the NSW Rail Access Regime IN THE

differences arising from tax depreciation treatments are intended to balance out such that an entity would pay the statutory rate over the long term, it would seem inappropriate for the NSWMC to now seek to convert to using an effective tax rate following the use of the statutory rate for the last ten years.

Further, ARTC prefers the use of a statutory tax rate where investment over time can be lumpy, because it can bring about greater stability in access prices over time. If, for example, ARTC's effective rate was to be substantially below the statutory tax rate for the period around the investment, this would be followed by a period where the effective rate was substantially higher than the statutory rate. Resulting variations in the regulated return may result in price instability as well as equity concerns in relation to cost of access over time.

Given the above, it is not clear as to what benefit would arise from changing to a nominal post-tax framework or adopting an effective tax rate would have. ARTC would urge IPART to continue use of the current real pre-tax framework using a statutory tax rate as has been the case since 1999.

Use of a point estimate for WACC

In its Discussion Paper, IPART did not explicitly seek any comment in relation to its use of a feasible range for WACC, a practice it had applied in the assessment in both 1999 and 2004, and consistent with applications in other regulated industries. To this end, ARTC saw no reason to comment on this issue.

ARTC notes that the NSWMC has submitted that a single point estimate is more appropriate, and if a WACC range is used, a single point estimate should be used in the case of many parameters.

ARTC sees no reason why IPART should deviate from its previous practice on the basis that some other regulators have elected to take a single point position on some of the parameters despite substantial debate still occurring in economic circles.

In 1999, IPART *'stressed that there is no single precise value for the component parameters of the WACC. However the parameters provide a useful guide for establishing a reasonable range for the cost of capital within the CAPM approach.'*[9] The substantial debate in regulatory circles that still remains around many of the parameters suggests there is no clear guidance to regulators in a number of areas. In this situation, the use of a feasible range for these parameters is reasonable. As

[9] IPART, Aspects of the NSW Rail Access Regime, Final Report, 28 April 1999, p50.

such, ARTC would support IPART's current approach until there is a substantial degree of certainty around the CAPM parameters (if this ever occurs).

In its proposal, ARTC has proposed a single point estimate of a number of parameters where there is reasonable certainty due to the parameters arising from a market assessment or from legislation. This includes the risk free rate, debt margin and tax rate. ARTC has also proposed a single point estimate for gamma representing its view as to an appropriate treatment.

In light of existing uncertainty surrounding the appropriate treatments for other parameters, ARTC considers it is reasonable to determine a feasible range. This includes gearing, market risk premium and asset beta. For gearing and asset beta, the NSWMC has merely chosen a point within a feasible range in any event.

Asymmetric Risks

ARTC has provided a substantial explanation in its proposal supporting its position that stranding risk has increased in the Hunter Valley. ARTC has stated that this arises from the substantial investment that ARTC, and the industry, expect to undertake in the outer Hunter Valley, and largely to increase capacity north of Muswellbrook to support prospective developments of Werris Creek.

This part of the Hunter Valley only carries relatively small quantities of coal currently, and is unconstrained, with revenue falling well below full economic cost, based on a depreciated optimised replacement valuation of the network of $140m as at 1 July 2008[10].

ARTC is intending to propose further investment of around $500m on this part of the network to meet producers' forecasted production relevant to this part of the network. This does not include any investments on the non-ARTC network north of The Gap.

Due to the size of this investment over the next five years, and the fact that the current prospective developments are currently in various stages of exploration and feasibility assessment, should they come to fruition with current expectations of reserves, they are not expected to commence production until after the next five years, and not achieve full ramp up until some years after that.

As such, ARTC considers it unlikely that that part of the Hunter Valley coal network north of Muswellbrook will become constrained over the next ten years.

[10] ARTC has undertaken a DORC valuation of Dartbrook to the Gap in support of its new Hunter Valley access undertaking.

This, and the fact that the Ulan line has been unconstrained up until 2007-08 (assumed ARTC's regulatory compliance is approved by IPART), would suggest that the outer mines are unable to pay any more for access. If this were not the case, then these lines would have been constrained, or would have at least recovered closer to full economic cost in the past.

This evidence does not seem to support the NSWMC position that the outer mines and developments pose low stranding risk and that on these parts of the network, access revenue lost as a result of a mine closure could be easily recovered from the remaining mines. Unlike the central Hunter Valley, both the Ulan line and the line north of Muswellbrook are supported, or are expected to be supported, by a few larger mines. The effect of a closure of any one mine could be substantial and as noted above, there is no guarantee that ARTC will simply be able to increase prices to achieve full cost recovery. ARTC has estimated that around only 63% of the Hunter Valley coal network RAB will be constrained in 2013-14, which assumes that the Ulan line will remain constrained after 2007-08.

ARTC does not consider that there will be any less stranding risk over the next ten years than has been the case over the last ten years, and given the focus of the upcoming investment, such risks could be higher. The cost of investments proposed for the Hunter Valley coal network could not be expected to be recovered through non-coal access revenue in the absence of coal revenue.

The NSWMC has pointed to expectations of long term take or pay arrangements with producers being in place that will heavily mitigate or remove stranding risk. ARTC agrees that it has been working with the industry to develop such arrangements, and that ARTC's new Hunter Valley access undertaking contemplates such arrangements.

However there are no such arrangements currently in place and the exact nature of the terms and conditions that will apply are still to be assessed by the ACCC, as is the term of the undertaking itself. The NSWMC has indicated during consultations with ARTC that it does not support many aspects of the arrangements contemplated by ARTC, including the longevity of commitment to be made by producers in the contract.

Investments in the Hunter Valley coal network are long term. ARTC has proposed a remaining mine life of around 23 years for the Hunter Valley, which is well in excess of the proposed time frame for contractual commitment, and there is no certainty that the proposed commitments will be accepted by the ACCC. Beyond such commitments, ARTC is still exposed to stranding risk.

ARTC has commented previously in relation to the NSWMC assertion that requiring capital contributions from mines requesting extensions to the network could be used to mitigate stranding risk.

As stated earlier, it is likely that substantial components of the Hunter Valley RAB will continue to be constrained for the next 10 years. The application of the combinatorial test (also proposed under the new access undertaking) will continue to prevent ARTC from earning the Rate of Return for its investment in the Hunter Valley. Irrespective of the existence of take-or-pay contracts, ARTC revenue may continue to be limited to full economic cost. As such, returns will be truncated if and when all parts of the network can afford to pay the full cost of the network, meaning that long term economic cost recovery is unachievable.

In its April 9 submission, ARTC indicated that it was intending to propose in its new undertaking a mitigation measure to deal with the impact of revenue truncation on achievement of long term economic cost recovery, however it is not certain that this will be accepted by the ACCC.

IPART has previously indicated that it has dealt with the issue of partial truncation of returns due to the combinatorial test *'by allowing an unders and overs account system and permitting a maximum rate of return above the mid point determined by the CAPM framework.'*[11]

ARTC does not consider that circumstances in the Hunter Valley have changed over the last 10 years to warrant movement from this approach.

There are other external factors in relation to the Hunter Valley coal network that will also work to increasing stranding risk in the longer term, not the least of which is the long term effects on the coal industry of climate change, carbon trading and alternative clean base load energy technologies.

ARTC assumes that the NSWMC would accept that these represent long term risks to the sustainability of the Hunter Valley coal network. In a media release responding to the Carbon Pollution Reduction Scheme recently put forward in draft legislation, the NSWMC indicated that such a scheme did not provide *'certainty for coal industry jobs'*[12] and;

'The Federal Government's failure to address the inequity in the allocation of permits to EITE [Emissions Intensive Trade Exposed] industries has left the NSW coal sector

[11] IPART, Aspects of the NSW Rail Access Regime, Final Report, 28 April 1999, p74.
[12] NSWMC, Media Release 10 March 2009, 'No Security for Coal Jobs under CPRS'

isolated and vulnerable against trade competitors which would not be subject to emissions targets for the foreseeable future.

In the past seven years we have seen a 15% reduction in market share of the export thermal coal market to Indonesia, mainly as a result of infrastructure bottlenecks. This illustrates the ultra-competitive nature of international coal markets.

We are now faced with a scheme which will impose crippling costs and drive investment out of Australia. It will undermine Australian coal producers which compete with Indonesia, China, Columbia and South Africa'[13]

These statements by the NSWMC would seem to suggest that the coal industry sees its long term sustainability as being highly sensitive to how the national and global response to climate change plays out.

The statements also seem to be inconsistent will many of the arguments submitted by the NSWMC about the strength and sustainability of the Hunter Valley coal industry intended to support assertions made in relation to ARTC's exposure to stranding risk and its ability to obtain investment funding in the Hunter Valley.

As outlined above, ACIL Tasman has assumed that because regulators are reluctant to re-open the RAB, it will not optimise assets out of the asset base (and hence there is no stranding risk for ARTC). All regulators have clearly expressed a reluctance to re-open the RAB, once set, however that relates to revisiting the dollar value of the assets that are in that RAB. It does not mean that assets cannot be subsequently optimised out of the asset base if there is no demand for them (just as new investments will be added to that asset base once approved).

Even if this wasn't the case, ACIL Tasman proposes that if there was "a future diminution in coal freight" that ARTC would simply raise prices to its remaining customers. Particularly if the contraction in the customer base was material, ARTC questions how it could be confident that it will be able to recover the full return on, and return of, capital that it has invested from those remaining customers. First, both customers and the regulator are likely to reject such a significant increase in prices on commercial and equity grounds. Second, if there has been a downturn in demand, it is highly unlikely that the remaining customers would be able to absorb a significant price increase.

ACIL Tasman cite examples from the WA regime in relation to stranding risk, which are of no relevance here. In ARTC's case, as noted above, certainty in relation to the

[13] NSWMC, Ibid

initial inclusion of assets in the RAB is based on customer endorsement. Hence an excessive return is unlikely to attract over-investment by ARTC if there is a real risk under the NSWRAU of exclusion from, or optimisation out of, the RAB where the investment is not endorsed by the industry.

However, when considering stranding risk the issue is a longer term one. That is, once the investment has been undertaken and approved, will ARTC be able to recover the full return on, and return of, capital on that investment. As noted above, if, in the future, demand ever contracted to such a point where mines began to close, the key issue is whether or not ARTC is likely to be able to continue to recover a return on, and return of, the capital it has invested, irrespective of whether that investment had been endorsed by industry or not. Even if it had been endorsed by industry, if some of the participants are no longer operating mines, they will not be paying access charges. There is therefore no guarantee that ARTC will always be able to recover the full return of, and return on, capital over the life of the assets unless they were fully funded upfront.

Finally, ACIL Tasman notes that a self-insurance allowance is likely to be better approach for providing compensation for asymmetric risk. This in turn suggests that it supports the concept of compensation for asymmetric risk. As outlined in previous submission, ARTC agrees that a cash flow allowance is the optimal way to deal with asymmetric risk. However, there is no such compensation currently provided for this. It was therefore submitted that if no cash flow allowance is provided, an adjustment to the rate of return is warranted.
ARTC trusts that IPART will consider its original proposals and submission, as well as this response in coming to its draft determination.

If you have any queries in relation to the submission or reports please contact me on 0882174314, sormsby@artc.com.au or Glenn Edwards 0882174292, gedwards@artc.com.au.

Yours sincerely

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