



AUSTRALIAN RAIL TRACK CORPORATION LTD

Ref No:



17 December 2004

Mr James P Cox
Acting Chairman
Independent Pricing and Regulatory Tribunal of NSW
PO Box Q290
QVB Post Office NSW 1230

Dear Mr. Cox

NSW RAIL ACCESS REGIME - REVIEW OF REMAINING MINE LIFE ARTC SUBMISSION

Thank you for the opportunity to provide comment with respect to your review of the remaining life of Hunter Valley coal mines in accordance with Section 3.2(c)(ii) of Schedule 3 of the NSW Rail Access Undertaking ("Undertaking").

In a previous submission to the Tribunal, ARTC provided an outline of the company's objectives, its role on the national interstate rail network, and the recent lease of the interstate and Hunter Valley rail networks in NSW.

The long term lease arrangement with the NSW Government, which commenced on the 5th September 2004, will effectively give ARTC the same control over the interstate and Hunter Valley rail networks in NSW as it has on its own network and deliver the same continuity of access management on the north-south corridors, as currently applies to the majority of the east-west corridors. The arrangement will also deliver to the interstate north-south corridors significant performance benefits designed to improve rail's competitiveness on these corridors and bring about substantial modal shift, through the investment of around \$540m in targeted improvements on these corridors. These improvements are designed to achieve the outcomes contemplated in the National Audit undertaken by ARTC on behalf of the Commonwealth Government in 2001. In addition, ARTC will invest a further \$165m in the Hunter Valley rail network, following consultation and endorsement by users, as well as \$170m elsewhere in NSW. ARTC will also be utilising a \$450m grant recently made available by the Australian Government, to further improve rail competitiveness on the important Sydney - Brisbane corridor, which will also benefit the Hunter Valley coal industry. Finally, the Australian Government has committed to investing a further \$550m in the national rail network as part of its AusLink program, with a substantial share of this investment on the eastern seaboard.

AUSTRALIAN RAIL TRACK CORPORATION LTD ACN: 081 455 754

Off Burbridge Road, Passenger Rail Terminal Rd, Mile End SA 5031; PO Box 10343, Gouger Street, Adelaide SA 5000

Tel: (08) 8217 4366 Fax: (08) 8217 4578 E-Mail: track@arcom.com.au

Access to the ARTC network outside of NSW is governed by ARTC's Access Undertaking approved by the Australian Competition and Consumer Commission (ACCC) in May 2002. The undertaking sets out the framework under which access to that network can be negotiated with ARTC in a fair and balanced way. The ACCC indicated that it saw ARTC's access undertaking as laying a foundation for the development of a consistent 'national' rail access regime in conjunction with other state based jurisdictions.

Under the terms of lease, ARTC will provide access to those parts of the NSW rail network included in the lease in accordance with the provisions of the Undertaking, until such time as access undertakings with respect to those parts of the NSW network are approved by the ACCC. ARTC expects to submit draft undertakings during the first year of the lease.

ARTC is defined as an access seeker in the Undertaking. The Undertaking amended the previous NSW Rail Access Regime to, among other things, recognise ARTC as the infrastructure owner with respect to the leased network, as well as an access seeker in NSW. The leased network includes significant parts of the Hunter Valley Coal Network, as defined in the Undertaking, and, in particular, all of those parts of the Hunter Valley Coal Network where access pricing is constrained by the application of the Undertaking. This is normally regarded as the rail network bounded by the ports of Pt. Waratah and Kooragang, and the mines at Dartbrook and Bengalla in the Hunter Valley.

As such, ARTC has a very significant stake in the outcome of this review with regard to its impact upon ARTC's potential investment on the Hunter Valley coal network.

IPART REVIEW OF REMAINING MINE LIFE

The adequacy of Hunter Valley revenues and investment returns is critical to the commerciality of ARTC's operations in NSW and to ARTC generally. It is also important to both the users of the network, the Hunter Valley coal industry, and the wider NSW and national community. ARTC's strategy is to increase Hunter Valley network capacity to a level that is both efficient and sustainable, through improved management practices and selected investments endorsed by the industry. ARTC shares the industry's desire to improve the competitiveness of the Hunter Valley coal industry. ARTC sees its role in achieving this is to:

- ❑ assist, in whichever way is most effective, to optimise the supply chain so that the lowest overall cost of coal production and delivery can be achieved, and,
- ❑ encourage efficient competition for rail services.

ARTC is intending to improve the open-ness and equity in network management and access pricing.

ARTC's objectives with respect to access pricing in the Hunter Valley (and the wider NSW lease network) are to seek a practical balance between the ARTC's legitimate business interests, the interests of operators and end users wishing to have access to the services

provided by ARTC and the interests of the wider community.

Access pricing should be designed so as to:

- ❑ Recover reasonable costs incurred by ARTC in providing access and a fair and reasonable return on investment that reflects the risks involved,
- ❑ Promote efficient use and investment in the network, and,
- ❑ Stimulate customer confidence and growth in the rail industry.

Of vital importance to the users of the Hunter Valley coal network is the availability of sufficient supply chain capacity to meet growth in international demand for coal.

ARTC has reviewed the draft report prepared by the IPART's consultants, Booz Allen Hamilton, 'Review of remaining mine life under NSW Rail Access Regime'.

The review by Booz Allen Hamilton has been largely conducted along the same lines as an equivalent review carried out by the same consultants in 2000. The review provides a broad comparison of the estimated mine life under certain measurement scenarios against the equivalent estimate in 1999.

The report recommends IPART adopt a remaining life of mines served by the Hunter Valley coal network of 27.5 years after 1 July 2004. This compared to a remaining mine life of 33 years after 1 July 1999 estimated in the previous review. Both estimates are based on a level of production weighted average approach of existing mines served by the Hunter Valley coal network as well as prospective mines due to come on stream in the 5 year period following 1 July 2004 (or 1999 as appropriate). ARTC notes that the consultants point out that the previous study was based on only the remaining lives of Category 1 and Category 2 mines (those paying around maximum rate of return), as defined at the time in the NSW Rail Access Regime. The Undertaking no longer uses this terminology and the consultant's brief (and approach taken) covers all Hunter Valley coal mines that utilise the coal network (including previously defined Category 3 mines that were considered at the time to be paying at around floor levels).

ARTC notes that the consultant's estimate in 1999 bore little resemblance to the remaining mine life prescribed for the Regime by IPART (40 years).

USE OF REMAINING MINE LIFE AS A BASIS OF DEPRECIATION

ARTC supports the use of the remaining economic life of the Hunter Valley coal mines as a basis for determining an appropriate depreciation charge for the Hunter Valley coal network. ARTC has stated in previous submissions to regulators, and in its application to the ACCC, that where the business underpinning the service potential of, and investment in, the assets has an indefinite life, it is reasonable to assume that the assets could be maintained at this level indefinitely through an ongoing MPM program. To the

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extent that an MPM/renewals program can hold the service potential (or condition) of the asset constant, depreciation is not applicable. However, regardless of the condition or potential to which the asset is maintained, where the underlying business has a limited life, or the asset life is limited for some other reason such as technical obsolescence, then this life should become a basis for depreciation.

It is clear that the Hunter Valley rail network essentially exists to provide a transport service to the Hunter Valley coal industry. The assets are configured in order to meet service requirements of Hunter Valley coal users, and investment is designed to increase capacity throughput of the Hunter Valley coal supply chain.

The Hunter Valley rail network carries general freight and passenger traffic as well as coal. When all coal resources in the Hunter Valley are depleted, it is possible that some parts of the Hunter Valley coal network could remain open to service these traffics. The configuration and standard of the network will, however, be very different to that required to meet the service potential of the existing network. Further, it is unlikely that any of these traffics will be capable of meeting any more than direct or incremental costs as is the case now. Depreciation and a return on assets are not likely to be recoverable.

ARTC has indicated in the past that it sees some potential for parts of the Hunter Valley coal network to be used to provide a route for interstate traffic (as occurs to a limited extent now). Whether this eventuates or not will depend on a range of factors such as the future needs of interstate logistics markets at the time, investment in capacity in the existing interstate network, the outcome of investigations into alternative north-south routes (eg an inland route). In any event, it is also unlikely that any traffic in this regard will be capable of meeting depreciation and a rate of return, as currently occurs on the north-south interstate network.

As such, ARTC sees no reason to deviate from the existing approach to depreciation that is designed to address the dominant usage and financing of the network by the coal industry, and the fact that the network is configured, maintained and enhanced to provide the service potential required by this industry.

SCOPE OF THE ASSESSMENT

With regard to the inclusion of all mines using the Hunter Valley coal network (as opposed to only previously defined Category 1 and 2 mines), ARTC notes that the Undertaking makes no reference to different mine categories. On this basis, it would seem appropriate that all mines be included in the assessment.

On the other hand, there is an argument that only Category 1 and Category 2 mines should be included on the basis that it is only from these mines that the access provider can recover depreciation charges. ARTC understands that pricing of Category 3 mines is only based on recovery of variable cost with respect to the constrained network, whilst the constrained group of mines effectively pay for all fixed cost, depreciation and return. Basing recovery of depreciation on all mines may lead to under-recovery in a circumstance

(although unlikely) where all Category 1 and 2 mines reserves were depleted and only Category 3 mines remained. The track owner may be unable to recover depreciation following closure of Category 1 and 2 mines.

ARTC notes from the consultant's report that the Category 3 mines included contribute 0.9 years to the weighted average remaining life including prospects. If they were removed it is possible that the resultant re-weighting of remaining mines may increase life to compensate. The Tribunal needs to confirm that the impact of including these mines is minimal. Should this be the case, ARTC accepts the inclusion of these mines in the assessment despite there being some argument against the appropriateness of this.

CONSULTANT'S APPROACH TO DETERMINING REMAINING MINE LIFE

The consultant has used similar information sources and recommended approach to determining remaining mine life to that used in 1999. In principle, ARTC would prefer consistency in application over time.

Alternative proposed approaches include:

- ❑ Option 1 - Simple (unweighted) average of existing mines as at 1 July 2004
- ❑ Option 2 - Average weighted on existing (2002-03) production of existing mines as at 1 Jul 2004
- ❑ Option 3 - Average weighted on full capacity production of existing mines as at 1 July 2004
- ❑ Option 4 - Simple (unweighted) average of existing mines as at 1 July 2004 plus likely prospects to 30 June 2009
- ❑ Option 5 - Average weighted on existing (2002-03) production of existing mines as at 1 Jul 2004 plus likely prospects to 30 June 2009
- ❑ Option 6 - Average weighted on full capacity production of existing mines as at 1 July 2004 plus likely prospects to 30 June 2009

The consultant recommended the approach adopted under Options 2 and 5 namely, average mine life weighted by 2002-03 production, and further recommended inclusion of likely prospects to 2009 (Option 5). Remaining life of individual mines was calculated as the marketable reserves divided by 2002-03 production. This approach was also recommended in the 1999 assessment.

ARTC agrees with the consultants that estimation of remaining mine life is impacted by a number of internal and external factors that are difficult to predict including coal pricing, capacity and productivity, and environmental legislation. As such, any estimation based on information and assumptions available at a given point in time is likely to be approximate at best. The approach recommended by the consultant is probably the best that can be applied given the information currently available. Particular concerns that ARTC has with the approach, many of which are also recognised by the consultant, include:

- **Information sources** - the consultant has gathered information about existing production levels, reserves and prospects from a range of fairly normal sources. ARTC has no better information available to it in this regard. Having said this, ARTC notes from the report that there are some very wide fluctuations between information upon which the 2004 assessment is based and that shown in the 1999 report. Of particular concern is the change in quoted marketable reserves for many mines in 2004 compared to 1999. Whilst some variations are explained through combining some mines together there remain some surprising changes. Whilst ARTC would expect a reduction in marketable reserves through consumption over the last 5 years and increases as a result of reserves becoming marketable as a result of strong current markets, there are a number of quite significant decreases that appear surprising, with examples being Cumnock, Dartbrook, United and Wambo mines. It would help if some explanation as to the reasons for these variations were provided.

- **System productivity and capacity improvement** - The consultant identified a range of factors that may increase mine productivity and production, which may shorten mine life, including better technology and flexible labour arrangements as well as increased rail network efficiency and capacity. The corollary to this was that the same productivity improvements and improved competitiveness would also assist in the discovery and exploitation of new sources of marketable reserves. ARTC is intending to invest around \$160m in the Hunter Valley, following consultation and support from users, which together with further improvements in operating practices, is expected to increase capacity from the present 85mTpa to approximately 120mTpa over the next 5 years. The realisation of increased supply chain capacity will, of course, be contingent upon complementary capacity improvements in rail operations and at the port. The realisation of increased production and throughput will depend on prevailing market conditions, including competition, and legislative impacts, such as Kyoto. Improved asset utilisation will, however, significantly improve competitiveness, and marketability of resources, and increased exploration.

ARTC agrees with the consultant that productivity improvements and other factors will increase production where capacity permits, and is also likely to increase available marketable reserves in the longer term. The consultant, however, seems to make no allowance for either factor in estimating mine life, seemingly on the basis that the life reducing impacts of improved productivity and capacity may largely be offset by life increasing impacts of further identification of marketable reserves. This is a significant assumption that, in ARTC's view, creates further uncertainty about the estimate. This risk may be mitigated, however, by regular review of mine life.

- **Use of 2002-03 production levels and marketable reserves to determine mine life** - The impact is that effectively the consultants have estimated mine life as at 2002-03 and taken this as a proxy for life remaining as at 1 July 2004 for mines existing as at 2002-03. Additional mines in 2003-04 have then been incorporated, together

with prospects, using estimates of production and reserves. ARTC would prefer the use of the most up-to-date estimates of production levels and marketable reserves if this can be achieved. Mine production information for 2003-04 should be available, and could be used for the purposes of weighting mine life, as well as estimating marketable reserves as at 1 July 2004.

ARTC broadly supports the approach recommended by the consultant and, in the absence of any better information available to it, ARTC is not able to improve on the assessment. Nevertheless, because of the above concerns, ARTC would propose that IPART should consider the estimate proposed by the consultant as a broad indicator as to the remaining mine life, unless it is able to obtain better information to improve the assessment.

IPART PRESCRIPTION OF REMAINING MINE LIFE

ARTC notes that in the 1999 assessment, IPART adopted a remaining mine life to be applied over the period from 1999-2004 of 40 years, following the consultant's assessment of 33 years. Reasons given by IPART for taking this view were not clear, apart from recognising the separate views of participants and noting that this was similar to the average useful life (engineering assessment) of Hunter Valley assets at the time as provided by Rail Access Corporation.

ARTC has stated that the estimate provided by the consultant should only be considered as a broad indicator in the absence of better available information, and considers that there are a range of factors applying that could mean the estimate overstates or understates 'reality', possibly to an extent supporting IPART's deviation from the consultant's estimate in 1999. ARTC does not believe that there is a strong imbalance in the upwards or downwards pressure that these factors may place on the true economic life of the Hunter Valley coal mines. Nevertheless, given the degree of uncertainty surrounding the estimate and the lack of better information, ARTC recognises that a degree of pragmatism may be warranted in order to move forward with investment and growth in the Hunter Valley and, thus, would not object to prescription of a higher remaining mine life up to 35 years.

There is no information in this letter that ARTC would consider commercial-in-confidence. For further information regarding the preparation of this submission, could you please contact Mr. Glenn Edwards, (08)82174292 (Ph), (08)82174578 (Fax), gedwards@artc.com.au (Email).



David Marchant

Chief Executive Officer