AUSTRALIAN RAIL TRACK CORPORATION LTD

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INDEPENDENT PRICING & REGULATORY TRIBUNAL

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 RATE OF RETURN
ARTC SUBMISSION

Thank you for the opportunity to provide a further submission with respect to your review of the rate of return in accordance with Section 2.1 of Schedule 3 of the NSW Rail Access Regime ("Regime").

ARTC has previously provided a submission to the Tribunal dated 30 September 2004 that sought to address several issues raised, being:

- Is the capital asset pricing model the most appropriate methodology to determine the rate of return?
- Are the parameters the Tribunal used in 1999 reflective of prevailing market conditions and more specifically:
    - Does the equity beta appropriately reflect the systematic risks faced by the rail infrastructure owner, and
    - What unsystematic risks warrant a move above the mid-point of the feasible WACC range?
- Any other matters interested parties consider might be relevant to an analysis of an appropriate rate of return applicable to rail infrastructure assets.

By and large, ARTC supported the approach taken by IPART with respect to many of the WACC parameters and saw little reason to adjust values for these parameters from the previous rate of return assessment. ARTC also considers that, where suggestions were made in the submission with regard to IPART's consideration of some parameters and of asymmetric risk, ARTC considers that the combined impact of any resulting adjustments would be unlikely to result in any compelling reason to adjust the maximum rate of return.

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ARTC considers that the assessment undertaken was fair and reasonable, adequately considered submissions made by industry participants, and that the maximum rate of return of 8% real, pre-tax represented a fair balance of the interests of the infrastructure owner, network users, and the wider community. Efficiency improvements in both above and below rail in the Hunter Valley has reduced transport costs, improved coordination and lead to improvement in coal throughput and supply chain competitiveness in international markets.

ARTC noted from submissions arguments calling for a significant reduction in asset beta relating to the Hunter Valley coal assets. The previous IPART assessment resulted in a wide range in asset beta (0.29-0.55) which reflected significant uncertainty in the measurement of this parameter. There are a number of approaches that can be used to estimate a company's asset beta including comparison with a range of similar entities in the same industry or operating under similar regulation, as well as consideration of the relative stability of a company's financial performance against market norm. Such approaches are often based upon a significant degree of assumption, limited information, and are often limited in coverage of pertinent factors making any conclusion difficult. ARTC considers that the above range remains a reasonable reflection of the of asset beta that might apply to the Hunter Valley coal assets, given the balance of circumstances that may have changed since 1999. Given the assumptions made and uncertainty surrounding the arguments made in submissions, there does not appear to be conclusive evidence suggesting that the above range is no longer reasonable.

With regard to IPART's previous assessment of asymmetric risks facing the track owner, ARTC considers that there is little change in this regard since 1999. ARTC has indicated in the past that it saw the Hunter Valley as providing strategic option in NSW for the movement of interstate freight in the longer term. The role of the Hunter Valley in this regard is by no means certain and will depend on longer-term interstate market and operational requirements as well as other strategic investments in NSW rail infrastructure such as the proposed Inland Route. In any event, ARTC sees the Hunter Valley network as, first and foremost, part of a coal supply chain. Without coal, the infrastructure configuration, operating and commercial framework in the Hunter Valley will be very different (probably not much different than that which might exist to service existing non-coal business in the long term without coal). It would be most unlikely that non-coal business would ever recover the economic cost of infrastructure provision on a stand-alone basis. For the purpose of the existing network and future investment, the risk of asset standing remains largely unaltered.

In making its 1999 rate of return assessment, incorporating asymmetric risks, IPART recognised and recommended the use of an unders and overs account, as well as permitting a rate of return above the mid-point determined by the CAPM framework in order to take account of the partial truncation of return to the track owner due to the combinatorial test, rather than allowing a fixed uplift factor above WACC. This would imply that IPART's 1999 assessment of an appropriate rate of return incorporated the impact of using of an unders and overs account to manage deviations about the maximum rate of return.

In submissions, ARTC noted documentation arguing that truncation of returns should not be considered as an asymmetric risk on the basis that the combinatorial nature of the ceiling test permits 'averaging' if returns over the network. Whilst, technically, the combinatorial test does not prevent a range of prices that can be charged to particular mines (when considered in the context of pricing with regard to other mines), the pricing on some sectors is limited to what the relevant mines using that sector can afford to pay, when relative competitiveness with other mines is taken into consideration. Pricing under the regime is negotiated within a floor ceiling band and, where revenue in such cases is insufficient to meet the full economic cost for a particular sector, the track owner is unable to achieve the overall maximum rate of return. ARTC supports IPART's 1999 approach in this regard.

As part of its lease of the Hunter Valley rail network, ARTC has proposed to invest around $165m in a range of projects designed to improve coal throughput from around 85mtpa to 100mtpa. Strong demand over the last couple of years and the current trend in the performance of the Hunter Valley coal chain would strongly suggest the need for this investment. ARTC has been consulting the Hunter Valley coal network with respect to this investment program and ARTC believes that there is also strong support for the investment in the industry.

The investment program has been developed as part of ARTC's business case for the Hunter Valley coal network. ARTC business case and this investment are predicated upon the existing maximum rate of return of 8% real, pre-tax. A lower return would clearly prompt reconsideration of the investment by ARTC.

Regulation of infrastructure in Australia to date, particularly on highly utilised facilities, has not generally provided a strong incentive for investment by the infrastructure owner. This is largely because the availability of benefits of capacity augmentation investment to the infrastructure owner is often limited through some form of revenue capping. Benefits are generally directed more so to the users of the network (through yield improvements and improved competitiveness) and ultimately to end users and the wider community.

The Productivity Commission, in its current review of National Competition Policy Reforms, has proposed that this is in area where 'Australia's competition and regulatory architecture can be further improved'.

'More should be done to ensure that pricing regimes for regulated infrastructure services give appropriate incentives to providers to properly maintain facilities and to enhance and augment networks[1]'

In conclusion, ARTC recognises and supports the needs of Hunter Valley coal network users to increase network capacity and supply chain competitiveness in order to meet global customer demand. ARTC has based its Hunter Valley coal network business case

[1] Productivity Commission, Review of National Competition Policy Reforms – Discussion Draft, Overview, pXXXI

and investment program on a maximum regulatory rate of return of 8% real, pre-tax. Given the current business risks and economic environment, ARTC considers that this still represents a fair balance of the interests of the infrastructure owner, network users, and the wider community and sees no compelling reason for moving away from the existing maximum regulatory rate of return of 8% real, pre-tax required for its business case and investment program.

ARTC will be proposing a rate of return that supports its business case and investment program as part of the draft access undertaking it is required to submit to the ACCC during the first twelve months following commencement, as required under the NSW lease arrangements.

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).

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