INDEPENDENT PRICING AND REGULATORY TRIBUNAL

WORKSHOP ON REVIEW OF REMAINING MINE LIFE AND RATE OF RETURN

Tribunal Members

Dr Michael Keating - Chairman
Mr James Cox

Held at Meeting Room 2, Level 2
44 Market Street, Sydney NSW 2000

On Wednesday, 23 February 2005, at 9.20am

1 THE CHAIRMAN: My name is Michael Keating and I am
2 Chairman of IPART. I guess I am new to most of you, other
3 than the IPART staff.
4
5 As I think you all know, the tribunal is required to
6 determine the remaining mine life and rate of return from 1
7 July 2004 for a period of five years and this workshop is
8 part of the tribunal's consultation process.
9
10 I want to just say a few words about how we propose to
11 run this morning's discussions. Members of the tribunal's
12 secretariat will introduce each discussion topic as listed
13 on the agenda, and in the first session Booz Allen
14 Hamilton will also be making a presentation.
15
16 After the secretariat and Booz Allen Hamilton's
17 presentation, I will go round the table and ask
18 participants to present their position on the basis that we
19 will try to limit comments to about five minutes, so that
20 each presentation should be five minutes long, and I will
21 be fairly strict on that because we want to have time for
22 discussion. I would like that speakers are not interrupted
23 in their five-minute presentations, as we will have
24 questions and comments after the presentation.
25
26 We need to assist the transcribers in recording the
27 session, so I would like you to introduce yourselves at the
28 start of your presentation or when you have a comment or a
29 question. The transcript will be available on the
30 tribunal's web site by late next week.
31
32 I think it is probably useful if we ask those present,
33 at least at the table, to introduce themselves and the
34 organisation they represent.
35
36 MR TESSLER: Andrew Tessler, Booz Allen Hamilton.
37
38 MS RAPMUND: Sheridan Rapmund, IPART secretariat.
39
40 MR REID: Colin Reid, IPART secretariat.
41
42 MR SMART: Mike Smart, NECG, here helping Pacific
43 National.
44
45 MR BUGLER: Paul Bugler, Manager Business
46 Development, Pacific National.
47

1 MR FIKKERS: Andrew Fikkers, Barlow Jonker, assisting the
2 New South Wales Minerals Council.
3
4 MR CLACHER: Kenn Clacher, New South Wales Minerals
5 Council.
6
7 MR MARCHANT: David Marchant, CEO of ARTC.
8
9 MR EDWARDS: Glenn Edwards, Research & Planning
10 Manager, ARTC.
11
12 THE CHAIRMAN: Thank you. We will start with the
13 remaining mine life issues and, Andrew, perhaps you could
14 get us started.
15
16 MR TESSLER: I will keep this fairly short. Most of you
17 have read the report so it is pretty straightforward. We
18 were contracted by IPART to advise on the remaining mine
19 life remaining in the Hunter Valley coal mines and did so
20 by reference to the sectors detailed in schedule 6 of the
21 regime and looked at those in operation as at 1 July 2004.
22 We also expanded on that for prospect mines which we
23 believe may come into operation before the end of the
24 regulatory period.
25
26 We applied a number of methodologies to estimate mine
27 life, they being a simple unweighted approach, a production
28 weighted approach and an approach which allowed for some
29 productivity improvements, a full capacity production
30 approach, by proxy. These were employed to estimate the
31 mine life of existing mines and the prospects.
32
33 We received a request from IPART that we split up the
34 estimates according to sectors which used ARTC track and
a
35 subgroup which comprise mines utilising RailCorp track.
We
36 came up with a couple of recommendations, in the end one,
37 as to the best approach to be adopted, and that is what we
38 called option five, which was a weighted average approach
39 for prospect mines, the result being for the ARTC track
40 mines, if you like, 27.6 years of remaining life and the
41 mines utilising RailCorp track 26.7 years of remaining life
42 from 1 July 2004.
43
44 That was our basic recommendation in a nutshell. I
45 don't know if we can make more comment on that because I
46 believe you have read the report.
47

1 THE CHAIRMAN: I might ask ARTC to commence.
2
3 MR MARCHANT: Chairman, without taking up the time of
4 this workshop, we don't have any problem with basically the
5 previous IPART decision, which was 35 years. For the
6 purposes of this regulatory exercise, we don't have a
7 problem with the 40 years previously determined. That was
8 a regulatory assessment and therefore we don't have a
9 problem with the 35 years now, being cognisant of Booz
10 Allen's report. Short of a study of some magnitude, it is
11 better to just pick on something that everybody can be
12 certain about.
13
14 MR CLACHER: Our views are set out in our submission.
15 It seemed to us that taking an average for the remaining
16 mine life is not consistent with the whole purpose of the
17 exercise, which is to work out what depreciation rates
18 should be applied, and under the definition in the regime
19 it means depreciation of the asset base over the "useful
20 life" of the assets. I think the useful life extends
21 obviously beyond the average life of the assets and that,
22 especially when resources in the area served by the other
23 railway line are taken into account, that line will be used
24 to bring coal down to a port for a period of time way
25 beyond 35 years from now, but we are happy to stick with
26 the 35 years.
27
28 THE CHAIRMAN: Pacific National.
29
30 MR BUGLER: Chairman, I guess our view is a pragmatic
31 approach. 35 years makes good sense. We don't have any
32 particular expertise to bring to the table in terms of
33 these things. Our view is 35 years is a good outcome.
34
35 There is a particular issue that I think is worthy of
36 being addressed, which is whether or not it is appropriate
37 to use different mine lives for those assets that are on
38 spur lines, looking into the issue of stranded assets. Is
39 there a different risk asset profile than the average
40 assets? That is worthy of some consideration but, apart
41 from that, we agree with 35 years.
42
43 MR CUTBUSH: A useful purpose served by the Booz Allen
44 report was that it highlighted the large increases in
45 traffic that come from the Ulan line and down from
46 Gunnedah. Six years ago when discussing this topic here in
47 this room a great deal of concern was expressed about the

1 possibility of stranding on the Ulan line and other branch
2 lines - but the Ulan line was the major one - and I notice
3 from Booz Allen's report that compared to about 5 million
4 tonnes they are looking at 20 million tonnes coming down
5 that line.
6
7 THE CHAIRMAN: Secretariat?
8
9 MS RAPMUND: There seems to be a consensus that 35 years
10 would be acceptable to the stakeholders, but can I just
11 raise the question of the RailCorp sectors. Any views on
12 those areas?
13
14 MR CUTBUSH: That is the ones south?
15
16 MS RAPMUND: The five sectors.
17
18 MR MARCHANT: We have no view.
19
20 MR CLACHER: Whereas there may be some debate about
21 how much traffic will use the lines north from Newcastle up
22 to Ulan, in the far distant future when there is no coal, only
23 small amounts coming down that line, on the line south of
24 Newcastle I don't think there is any debate that it will be
25 in use for interstate traffic in the foreseeable future.
26
27 MR FIKKERS: The only development is the Wyong
28 deposit in that area. That can perceivably produce upwards
29 of 10 million tonnes, much of which would be destined for
30 the export market. The timing of that project is unclear.
31 The owners are doing exploration, so it could foreseeably
32 be in the next 15 years.
33
34 MS RAPMUND: 35 years remaining mine life, is that also
35 appropriate for those five sectors?
36
37 MR BUGLER: The question is of less importance because
38 mines on those lines are not paying at the ceiling, their
39 pricing is not constrained, so the importance of the
40 outcome is much less. I guess our view is, from a
41 pragmatic approach, 35 years is a reasonable outcome,
42 especially given the comments made by Kenn and Andrew,
43 that those lines will continue to be used presumably for
44 interstate traffic and for passenger traffic. So the
45 issues are somewhat different from the main Hunter
46 Valley network.
47

1 MS RAPMUND: I think that that has cleared that up.
2
3 MR SMART: If I may, there is one point I would like to
4 make about the spur line issue. The approach generally has
5 been to impose a single mine life across all of the assets
6 in category one. Thinking back to some experiences more
7 than five years ago when there was a project to try to get
8 a spur line built with private finance near Jerrys Plains,
9 one of the problems with the private financing proposal was
10 that it was a mine which had a 15-year expected life and in
11 order to make the project work financially it had to be
12 depreciated over the 15 years.
13
14 At the time the then 40-year mine life was rigidly
15 applied across every part of the network and that meant
16 that if depreciation was being recovered over 15 years that
17 put the spur line over the ceiling, even though the rate of
18 return on the spur line was actually in the permitted rate
19 of return. That was an unfortunate side effect of the way
20 the mine life was applied at the time.
21
22 I guess I am hoping that in this round IPART can
23 create some flexibility to cater for that type of
24 situation. Where you have an asset which is serving a
25 short-life mine, that if there were that flexibility to
26 have a different mine life for the purpose of setting the
27 ceiling then that would facilitate these types of projects
28 which might otherwise be stymied by the regulatory
29 framework.
30
31 THE CHAIRMAN: Just to clarify one thing for me, the
32 instance you gave was of, if you like, a new line to be
33 built for a new mine. What about if there was an existing
34 mine that had a short life but had a dedicated line which
35 is already there, do you extend your argument?
36
37 MR SMART: The same logic should apply, that unless that
38 new line serves a group of potential mines that might in
39 combination have a longer life, so some assessment would
40 have to be made on an individual case basis. All I am
41 suggesting is that by being able to alter the mine life for
42 these single business assets, that helps to mitigate the
43 risk profile without increasing the rate of return for such
44 projects. It is an alternative way to do that.
45
46 MR COX: Has work been done to identify lives for
47 individual sectors?

1
2 MR SMART: Not that I am aware of, but usually there is a
3 reasonable feel for what an expected life is for a mine
4 that might sit at the end of a spur line by itself.
5
6 MR MARCHANT: We agree with the conceptual framework.
7 We are unaware of IPART's previous decisions about mine
8 life. Other than the stuff I have read, I have not been
9 involved in those decisions on rail, I have only been
10 involved in the last five years. It is abundantly clear that
11 there is to be an application to the ACCC about these
12 corridors in the next 12 to 18 months and obviously that will
13 take a different form with regard to proposals for adding to
14 or extending lines that are connected to the ARTC lines.
15 Normally that would provide flexibility to put an amended,
16 or varied application, to the ACCC, which I would expect in
17 the event that there has been a material change of some
18 form or a change in the way the assets are used which would
19 change the economics of the projects.
20
21 What we would normally do for our part, I am aware of
22 previous applications that may have been made. If it
23 materially affects it, we would come back to IPART for a
24 variation through a hearing process and do it on its
25 merits, rather than have a generic outcome. I would think
26 my colleagues would be concerned with a variation outcome
27 because they might think that inadvertently we would
28 exploit that - not that we would, but they might think
29 that. I would not want to add to that perception of
30 potential rape and pillage.
31
32 We have not looked at spurs in this process. We are
33 actually looking at this process as a temporary process so
34 we can get on with the investment that the mining industry
35 has said should be made. I would not like to get diverted
36 into other things that could be dealt with in an
37 application on its own merits. I am sure IPART would not
38 preclude those applications depending on financial or other
39 circumstances. We would be the first to come back to
40 assist private investment to add to throughput. We are not
41 a company that wants to handle it all ourselves. Anybody
42 who would like to help with overall input, we would be
43 behind them. We would not be adverse to coming back for a
44 variation if it was justified.
45
46 I am basically saying that for a window of 12 to 14
47 months we want to roll through and get on with investment,

1 but provide flexibility over time to allow other
2 investments to take place so there is not just our
3 investment on the line, or surrogate government investment.
4 We would certainly be happy to come back with amendments
5 or variations for spurs or other things that may not be
6 captured in this decision.
7
8 MR CLACHER: The Minerals Council has for a long time, in
9 several forms, said that if investments are proposed that
10 require different depreciation rates to be applied because
11 of the nature of the investment, we are happy to talk to
12 people about that, the builder or the infrastructure owner.
13
14 THE CHAIRMAN: I think we have a situation where each
15 of the stakeholders agrees on the principal issue, the
16 average mine life, and we also seem to have some agreement
17 on the need for flexibility on how it could be introduced, so I
18 think it might be useful if we move on from mine life,
19 given the degree of consensus amongst the stakeholders, and
20 turn to rate of return issues.
21
22 On this there is rather more of an issue. I think
23 there is a considerable divergence of views on the
24 value of the equity beta and rate of return. The
25 purpose of this second part is to give stakeholders the
26 opportunity to put forward their views on those two issues
27 and verbally comment on the views of the other
28 stakeholders.
29
30 We will have a period in the workshop where we have
31 time for general issues to be raised. A bit like
32 previously, we will have the secretariat give a short
33 presentation about the issue as we see it, and then we will
34 allow each stakeholder about five minutes to present their
35 views on the issue and then we will have a period of
36 discussion and questions. Again, as I have said, this is
37 being transcribed so could you speak clearly and identify
38 yourself before you speak.
39
40 There are two members of the tribunal secretariat
41 responsible for these issues, Adrian Kemp and Alex Oeser,
42 and Alex will give a brief overview of the issues
43 associated with this.
44
45 MR OESER: Good morning, I am Alex Oeser, I am an
46 analyst with the tribunal on the policy development team,
47 and my team is providing assistance to the tribunal on the

1 rate of return issues.
2
3 The purpose of today's workshop is to allow
4 stakeholders to respond to the issues raised in the
5 submissions to the tribunal. The tribunal has two areas,
6 the equity beta and the rate of return. At the end of the
7 workshop you will have an opportunity to raise any further
8 issues you are concerned with.
9
10 Just as an aside, the tribunal's process was to set a
11 rate of return in two steps. First, the tribunal
12 determines an industry benchmark rate of return range -
13 this is where the equity beta would have an impact - and,
14 secondly, the tribunal chooses an appropriate rate of
15 return from within that range.
16
17 I just want to give you some background relating to
18 the review. In 1999 the tribunal conducted a review of the
19 rate of return allowable for rail access charges under the
20 then NSW rail access regime and the key outcome was a rate
21 of return range from 5.3 to 8.8 per cent and a maximum rate
22 of return of 8 per cent, which is the mid point and which
23 was basically done in recognition of the truncation of
24 returns. Since the 1999 review, a number of changes have
25 occurred which impact on the allowable rate of return, and
26 they include a drop in real interest rates, a drop in the
27 statutory tax rate, and also a change in the risk profile
28 of the owner.
29
30 While the impact of the first two points is clear,
31 namely a reduction in the rate of return, the impact of
32 the changed risk profile is far less clear, and we expect
33 that today's discussion will permit the tribunal to form a
34 better view on these issues.
35
36 Just to quickly summarise the submissions the tribunal
37 has received on the equity beta and rate of return, as you
38 can see from the graph, equity beta values submitted by
39 stakeholders varied considerably. I have indicated a
40 mid-range of the values submitted. I want to remind you
41 that the equity beta represents the relative riskiness of a
42 security in terms of market wide risks and that it does not
43 take into account any business specific risk. We would
44 like to explore today if any of the changes in the
45 operational or regulatory environment that have been
46 mentioned in the submissions are in effect market or
47 business risks.

The tribunal has also received submissions that the rate of return range from 5 to 8 per cent, and I guess that the main reason for this wide range was that stakeholders have different perceptions about whether any business specific risk should be taken into account when choosing a rate of return.

Just quickly introducing the topics, the first part of the workshop focuses on the equity beta. While ARTC submitted that the changes that have occurred since 1999 may justify a higher equity beta than in the 1999 decision, Pacific National and the Minerals Council argued for a lower equity beta. What we really have to understand is whether any of those changes contributed to market risk or whether they are business specific and can be diversified away.

What we would in particular like to hear your views on today is the points mentioned in the submissions, the first being the change in ownership structure referring to ARTC's lease of the rail tracks; changes in the regulatory environment, for example, the unders and overs account; and operational changes such as consolidation of mine ownership in the Hunter Valley. If any of those changes do have an impact on the equity beta, we would like to find out if that is a positive or a negative impact.

I guess we stop the presentation there and go to comments.

THE CHAIRMAN: If I might start again with ARTC.

MR MARCHANT: With the equity beta issues, effectively to put it into context, the investment proposed for the Hunter Valley is not covered by government grant. There has to be a return on borrowing in the marketplace. Effectively when a decision is made on these issues we have to determine our ability to borrow, our ability to leverage the pent-up frustrated demand for capital improvement in the Hunter Valley demonstrated by the views of the mining industry, PNL and operators, and that view has been exacerbated by frustration that that has not taken place.

We are not dealing here with an esoteric exercise where somehow we can go back to the shareholders and say, "you provide this", because our investment in the Hunter

Valley is based on an equity investment, not a Commonwealth grant. An equity investment, having $1 shares or whatever, forms the basis for our leverage to help our balance sheet so we can go to the banks to finance areas such as the Hunter Valley.

Our business case in New South Wales, our presentation to stakeholders over the last few years, envisaged a rate of return similar to what IPART had provided in the past, recognising there are some adjustments that do need to be made. We do not dispute those. We didn't want to go into a wholesale recount, even if we go to the ACCC in 14 months time, which everybody will be involved in.

On the equity beta, the unders and overs accounts were actually recognised in the 1999 decision. There is nothing new about those in this decision. The arguments being put now have the same arguments as advanced then. Effectively if a readjustment is now based on those arguments, the risk framework, if you don’t have the unders and overs in five years you discount them back out again and readjust the equity beta rate based on that so you have a new risk, a systematic risk then.

The unders and overs account appears to have worked reasonably well in the last few years but the reality is there has not been a large investment strategy in the Hunter in the last five years so therefore there are arguments put forward such as it has been reasonably flat with regard to cash flow and that the systematic risk has gone. We don't get access to that material in due diligence so I can't comment on cash flow, except my experience is cash flow is not flat and it seems to have averaged in the market. I cannot comment on the cash flow. It is irrelevant to us because we have a bumpy cash flow because of our investment strategy. Our investment strategy is at least $150m, it is likely to be more than that in the next few years, especially given the states are also putting out proposals for expanding coal investment.

The consolidation of mine ownership has not in fact reduced the beta risk. In fact, it may have raised it, because consolidation has gone basically to two international coal companies who arbitrage between themselves in the coal market and the rest of the world. It effectively raises the risk rather than lessening it. In a equity beta sense effectively it is captive of

1 decisions made by others and not us with regard to sources
2 of coal worldwide. They have actually consolidated and
3 that produces inadvertently a greater risk because in fact
4 they are not domestic suppliers, they are world suppliers
5 and make a lot of decisions outside which changes the risk
6 profile in a different way.
7
8 The consultation process, although that was an
9 interesting proposal put forward by IPART and others five
10 years ago, there has not been any major capital investment
11 consulted about, so the second part of it is that there are
12 in fact more than two people to consult. It is not just
13 PNL and the Mining Council, there are a number of
14 individual mine owners, all of which have a requirement for
15 consultation, so that process is completely untested and,
16 quite frankly, may in fact be flawed because you could have
17 a couple who decide to hold out for different reasons. I
18 am not sure the consultation process has helped, hindered
19 or varied this issue other than to cause a bureaucratic
20 process.
21
22 The shorter depreciation life issue has been raised on
23 the equity beta stuff and I think even on the evidence from
24 Booz Allen there is a myriad of views of "life" in a mining
25 depreciation framework. Effectively everybody has agreed
26 to an artificial level for the purpose of getting a
27 formula. Nobody has done it on an informed basis.
28
29 The next argument being put forward is that ARTC will
30 adopt any such measures to the detriment of users, that
31 there will not be tonnes of interstate trains actually
32 running through the Hunter Valley going to wherever, I
33 don't know, Werris Creek, and there is not a lot of demand
34 there. The reason for integrating is that it is an
35 integration of management systems to help underlying
36 economies. It is true integration provides a bonus that in
37 the event Sydney becomes stranded at one point, a disaster
38 or otherwise, which is not unknown, the reality is it gives
39 us an opportunity to move Brisbane trains around Sydney,
40 because it is the only standard gauge connection north of
41 Sydney in Australia. Each of those issues I don't think
42 materially affected the equity beta in a structural sense
43 because in fact the changes in those positions actually
44 makes it slightly worse.
45
46 The other part is that in fact the customer we are
47 dealing with directly is no longer the government. The

1 government as a customer is the least predominant, whereas
2 they were the most dominant, and by that there was a moral
3 and underlying rate with regard to their commitment. I can
4 assure you PNL's commitment to certain lines depends on its
5 commitment about the return. You only have to live in
6 Portland, Victoria to realise that, where services changed
7 a month ago. There is quite a lot of risk.
8
9 All I am getting at is that the dimensions of the
10 customer base and the system are in fact getting less
11 predictable. There are new operators coming on and new
12 coal companies coming on, some consolidation, and, lastly,
13 the coal industry has turned upside down since 1999.
14 Long-term contracts, gone; they are now in a spot market
15 framework, they are now looking for capped investment to
16 deal with surges, and surges by their nature mean you can
17 build a capital asset to deal with a surge and in the next
18 year someone makes a decision to build a different coal
19 loader which actually two years later will limit that surge
20 down to become more reliable, so you have a capacity
21 framework that may have been good for the market at one
22 point but is now at risk, and the next application to the
23 Regulator will discount that capital investment because of
24 surplus. And every five years there is that process.
25
26 When you systemically go through it without going to
27 the other calculations on the finance side, dealing with
28 the systematic equity risks, the dimensions of change have
29 probably made it more volatile than less, and I think the
30 biggest is partly the consolidation but also the world coal
31 changes, let alone what may have come through in other
32 changes worldwide.
33
34 We have not sought to make the risk higher, we are not
35 arguing to make it higher - although it might be a
36 plausible argument. And we are certainly not arguing it
37 has been eased. In many ways it has actually become
38 multi-dimensional, this framework, and it is hard to see
39 the mitigating things that have been put forward are real
40 as distinct to plastic.
41
42 In summary form, our view is that the risk is probably
43 higher, but we are not arguing that issue.
44
45 THE CHAIRMAN: The Minerals Council?
46
47 MR CLACHER: I will just deal with a couple of the items

that David mentioned and get Greg to deal with the others.

One thing David did not mention was the issue of the optimisation of assets and also he mentioned unders and overs, which is already recognised in the 1999 regime. I just need to go back on a bit of history.

In 1999 there was an amendment to the Transport (Administration) Act which provided that the conclusions of the review carried out by IPART in 1999 and expressed in the 28 April report were automatically incorporated into the New South Wales Rail Access Regime. The two outcomes of the report were: One was a list of recommendations of the review, and there were 16 of those, but then it was apparent that the recommendations were not in an appropriate format for automatic incorporation into the Rail Access Regime, so on page 84 of that report, section 2.3, there was a page headed "amendments" made by the report, and there were some very specific amendments made by the report.

One of those was the definition of depreciation and rate of return. It was made quite clear that the asset value would be reviewed after five years and the intention of that was to re-optimise the assets of the network after five years. When Booz Allen Hamilton were engaged by IPART in 2000, or late 1999, to determine what the DORC of the network was, or of the constrained network, they proceeded, and IPART understood, that this would be done on the basis that after five years there would be a re-optimisation of the asset value.

The Rail Access Corporation, as it then was, and the Minerals Council both disagreed with that. They both recognised that this was an obvious disincentive to investment and that the owner could make an investment to have that optimised out of asset base some years down the line, and so both RAC and the Minerals Council strongly encouraged IPART not to provide for an asset that they recognised was a disincentive and appropriately included in the DORC for it to be optimised out at some later stage, and that was indeed done I think in the 28 March 2003 version of the Rail Access Regime, so that clearly at the time of these amendments being made to the regime in 1999 it was done on the clear understanding, and expressed actually in the regime, that there would be a re-optimisation of the asset value every five years with

the possibility that assets paid for by the infrastructure owner could be later optimised out.

The other issue about unders and overs which David and the NECG in their second submission to the tribunal have said were clearly included in the regime in 1999 is that it is not mentioned in the specific amendments made to the regime. It was certainly included as one of the recommendations of the report but it is clear from a reading of the recommendations that it was not automatically included in the regime and the unders and overs were only included in the 2003 version.

Let me also add that the NECG claim that the analysis they did which looked at monthly receipts for access reflected the effect of the unders and overs, not so, I am afraid, because, as I said, there wasn't even an unders and overs policy until 2003. As far as I am aware there has been no adjustments at all to access charges arising from the unders and overs policy to this day.

MR CUTBUSH: I will now address some of the other points that Mr Marchant has made. On the consultation question it seems to me these matters are always questions involving some judgment, but it is just as valid to say, is it not, that these larger firms that now dominate the industry are also less subject to the whims of local conditions when they do plan their activities, so it seems to me we ought to hear something from representatives that are not here today on the subject. I can think of a handful of arguments that are working in the opposite direction than those that Mr Marchant mentioned.

Secondly, again of course ARTC is best placed to comment on its own plans, I suppose, relative to others, but integration of the Hunter Valley with the rest of the business I would have thought is an automatically stabilising feature for its business. We would need a little bit more explanation of why it is anything else.

It seems to me diversification is in fact underway and that is the very thing that ARTC is pursuing with its policy. On mine life, as my colleague mentioned during the first part of this morning's session, as a matter of fact there is every reason to think that 35 years is the very least for our long list of assets. There can be no suggestion that the 35 that people have agreed to for

practical purposes is anything but arbitrary. I would simply suggest that most of the evidence would point to a much longer period rather than a shorter period, notwithstanding the analysis Booz Allen has done, and again I refer to the earlier discussion on that subject.

Government customers, there is a fair point there, I guess, the proportion of customers who are government owned has diminished. There is no doubt that this changes its pattern of exposure to some degree but I am not sure that I understood Mr Marchant's earlier mention of the role of Commonwealth equity holding in the ARTC and how that may effect the equity beta. It seems to me we still have to accept that it is a reality. What was the Commonwealth doing investing in it if it was not to effect the beta, you might ask, and maybe we could get a little more discussion on that later on.

MR CLACHER: David mentioned the fact that whereas ten years ago virtually all of the coal sold on international markets was under long-term contract, now about 50 per cent or more is sold under spot contracts. That may be so but I think examination of the so-called long-term contracts would have shown that they could be cancelled, say, on a yearly basis, tonnages and prices were reviewed every year and, if people didn't agree, the long-term contract was not really such a long-term contract. To say that because these contracts, well, even if that were true, why do people buy coal? They buy it to put in power stations and steelworks and you can't say that power stations or steelworks will look at their plans year-by-year and say, will I produce this year and shut down next year or not. They have all sorts of commitments to customers to keep on supplying indefinitely, so the demand will be there, but the question David raises is will demand switch around between Australia or New South Wales or the Hunter and other places - Queensland, China, USA, Japan, and in response to that you can only look at what has happened in the past five years and ask, "Will it be much different in the next 20 or 30 year", and my guess would be, no.

MR CUTBUSH: The commitment is not anything less capital intensive, it is the reverse on the part of both the operators of power stations and tracks. That is a small indicator of the greater specificity and greater commitment, I agree.

MR BUGLER: I will perhaps make some general comments and ask Mike Smart to make some more comments on the technical matters. I guess our general view is that the risks are substantially the same as drove the decision in 1999 from IPART. While clearly there are changes in various aspects, those changes have not materially affected the risk profile now.

Just raising a couple of issues, or responding to a couple of matters raised, with respect to the change in ownership away from the government sector to the private sector, of course that is absolutely right. However, I do raise the question as to quite how that effects the risk profile. In particular if one looks at the industry we are in, rail is divided into the above and below components, and the below component is ARTC. The above rail component, the rail operators, are in a competitive market, and in the Hunter Valley example we have PN and QR operating and who knows what operators might be there in the future, so is it particularly relevant or changing the risk profile that they are in government or private ownership? Given that it is a competitive market, it is hard to see quite how that works out.

With regard to the optimisation, as I think Kenn Clacher articulated, there is a process been put in place in the regime which mitigates against optimising out investments that have been agreed by the stakeholders. That is a process that we strongly endorse and certainly we would have no interest in seeing an arrangement that put an investment at risk once it had been committed. Given that the process is a consultative one, it takes into account stakeholder views, I will not say we agree with it, but it should not be reason why they can walk away from such investment. That is in place in the current regime and we don't see any risk to that process. Nobody is asking for it to be removed.

In terms of volatility, which to some extent is wrapped up in the decision about the consolidation of ownership, there are several aspects to that, some which are industry related and some which are specific to the current business model that is in place. Looking at the business model that is in place, the pricing arrangements for the Hunter Valley for the constrained network, those mines that are paying at the ceiling, which is I guess the most germane point of this discussion, there is a mechanism

1 whereby the prices are set through what we call a cusp
2 mechanism whereby the prices are set on the basis of around
3 about 75 to 80 per cent of the tonnage for a year. Once
4 that target has been hit, the price is then reduced to the
5 marginal rate because the pre-cusp tonnage generates
6 the full return to the structure owner.
7
8 I would suggest that that substantially mitigates the
9 volume risk that ARTC, or the infrastructure owner, has.
10 If you compare that to the risks faced by other parties in
11 the coal chain I think you will find that substantially it
12 reduces the volume of risk far more so than any other
13 mechanisms that are in place. That is backed up by the
14 overs and unders account, which certainly in PN's thinking
15 and understanding has always been the intention that has
16 been in place, it has been in place through that period, it
17 has been in operation and obviously pricing to date has not
18 been transparent in the public domain and therefore it is
19 perhaps not open to stakeholders to necessarily see the
20 operation of that, but it certainly has been in place, and
21 our understanding was that the 1999 decision by IPART was
22 taken on the basis that it would be in place, so we see no
23 change in that environment.
24
25 The other side of the volatility I guess in looking at
26 market risk is while it clearly is open to multinational
27 firms to divert their sourcing of production and so on, it
28 is also clear that those firms are making very large
29 investments in mines in specific locations and have a very
30 strong incentive to produce from those locations, so it is
31 hard to imagine that they would switch the bulk of their
32 production, for example, out of the Hunter Valley into
33 Indonesia or some other location, albeit that I accept that
34 certainly it affects those investment decisions being
35 taken.
36
37 MR SMART: Perhaps to amplify on Paul's comments, the
38 centre piece of our analysis on the question of beta has
39 been a piece of empirical work which is described in our
40 attachment to Pacific National's first submission. From
41 Mr Marchant's comments it seems there may be some
42 misunderstanding about exactly what we have done in that
43 analysis. I would like to take this opportunity to clarify
44 a few key points.
45
46 Just by way of introduction to that, though, certainly
47 regulators frequently face the difficult task of trying to

1 calculate an appropriate beta for a regulated firm and
2 normally there is not much guidance in the way of empirical
3 material. We have a unique opportunity now in that RIC has
4 been operating for four years, sorry, five years, under
5 this new rail access regime. We actually have some
6 history. We can look at the actual returns that RIC has
7 earned and look at the co-variance of those with the stock
8 market and calculate, at least based on accounting figures,
9 a beta figure. That is the exercise on which we embarked.
10 We felt that this type of direct empirical evidence would
11 be far more meaningful and useful than I guess a lot of
12 hand-waving discussion about how some development in
13 the industry might have this effect or that effect. That is
14 what we set out to do and you have seen the results of that
15 in our submission.
16
17 On to some of these questions: the first one was, how
18 do we know what RIC's revenues were for the category one
19 coal system, and the simple answer to that is that over the
20 period that we looked at, which is July 2000 to August
21 2004, Pacific National and its precursor, FreightCorp, were
22 the only coal haulers in the Hunter Valley. Therefore
23 RIC's revenues are exactly equal to the invoices that
24 Pacific National and FreightCorp paid over that period, and
25 we have access to that information. So there is no doubt
26 about what the precise revenues were, we have got the bills
27 to demonstrate it.
28
29 The second question was whether we have averaged these
30 calculated returns for RIC or not. The answer to that is
31 we looked at two scenarios. The first scenario was we
32 looked at the actual monthly revenues paid to RIC in each
33 month and in that scenario there was no averaging
34 whatsoever, these were based on the actual tonnes of coal
35 shipped times the actual access price, and that is the
36 actual revenue that RIC received.
37
38 In the second case there was some degree of averaging,
39 and that was as noted in our report, simply to take account
40 of the fact that there is this operation of the cusp
41 tonnage and that the revenues post-cusp dropped sharply,
42 but our conclusions were virtually the same in both cases.
43 So in no way does the averaging affect the conclusion.
44
45 Perhaps working a bit further afield from the direct
46 empirical work, there has been discussion about whether the
47 consolidation of mine ownership in the Hunter Valley has

affected the systematic risk faced by the infrastructure owner and I guess that is perhaps a difficult question, but I would have thought on the face of it that the consolidation of mines, whilst it certainly affects risks, I would not have thought it had much systematic dimension to it. I would have thought it would have altered the firm's specific risks, but I don't see how it would flow through to the systematic risks, particularly as the risk is based on how volatile the coal is from the whole Hunter Valley and, as Mr Clacher said, that is ultimately driven by demand overseas by power stations and steel mills, and apart from the increasing trend in China, those demand levels are really quite predictable and quite stable.

As to the fourth point, there has been some discussion about the over and under account and what effect that might have on systematic risk. It may be true that the over and under account was perhaps only formally recognised relatively recently, but it has certainly been on the books for quite some time. When it was first brought in, by its nature it has a retrospective character and so taking into account whatever date the over and under account initially started, the effect that it had really began in the prior year because it is an adjustment for past over or under recoveries. I am assuming that effectively it was in place over this whole period that we have looked at.

If you look at systematic risk and you look at the way that might influence coal railings from one year to the next, if there is a market downturn and there is low coal railings in one year and then there is a subsequent upturn in the following year, then the over and under account essentially permits the infrastructure owner to make up the shortfall in the prior year by recovering above the ceiling in the subsequent year. That capability must reduce the level of systematic risk, so I think if there is an effect on systematic risk it must be to reduce it, not to increase it.

One further small point: Mr Marchant also mentioned that whilst returns earned by RIC have been very flat over this four-year period that we have looked at, that over that period there was no investment in the Hunter Valley, I think that is not quite right. There has been ongoing incremental investment in main line enhancement. There has been a steady ongoing stream of investment. Taking all that into account, a co-variance analysis of the return to

RIC shows it to have been extremely low with respect to cover of market returns.

The final point: there has been some discussion - Mr Cutbush raised this - about whether the change in ownership of the train operating companies has increased other systematic risk faced by ARTC. It is conceivable that that might have had such an effect, I agree with that, but I would point out that over two of the four years that we looked at in our empirical study, Pacific National in private ownership was the freight haulier, so half of the period we looked at contemplated a phase of private ownership of the primary rail carrier; the other half contemplated government ownership. There is no obvious change in the beta calculation we have done if you look at the first and second halves of that period. That concludes my comments.

THE CHAIRMAN: Thank you.

MR KEMP: There is probably an area that no-one has touched on in as much detail as we would like to explore. That is the issue of the leasing arrangements for ARTC and ownership of the assets. The Minerals Council has obviously raised in their submission the issue that, under the leasing arrangements, there is effectively no or at least a greatly reduced asset stranding risk associated with this. I am interested in getting a better understanding as to what some of the details are of the leasing arrangements and whether, indeed, this is true. So that is probably to the ARTC.

In contrast to that, I suppose there is a question regarding new investment and how new investment is incorporated into the regime and whether there are asset stranding risks associated with possibly new investment and, therefore, that is perhaps back to the New South Wales Minerals Council to say whether they agree or disagree, in the context of new investment, there may be some asset stranding risk there.

MR CLACHER: I will address that. In our submission on the mine life we demonstrated reasonably clearly that there is every probability that the main line and the Ulan-Werris Creek branch will be in use for all the coal at a level such that they can pay the bills that will arise from that well into the future. We have said that the minerals

industry is happy to consider shorter depreciation periods on specific investments if there is a clear indication that these particular investments will not have such a long life.

MR MARCHANT: I think in the foreseeable period Ulan may get to that point but this debate is not really about this. This debate is between the midpoint in the WACC and 0.2 per cent allowed for truncating. I haven't got to that yet Ulan truncation will be in the five years after and we will wait and see. Effectively, if that happens, that will actually still bring the thing within the ceiling framework and so you take more when you combine them together. It comes to the difference between the midpoint and what was allowed in 1999 for the purpose of truncating. That issue will become more focused by the ACCC. I am not sure that is going to be solved in the next 15 months.

The lease arrangements: effectively, the lease is for 60 years of the defined assets. The 60 years are the interstate main lines from Newcastle to Albury through to Sydney and subsidiary freight line we are building plus the Hunter Valley lines and the lines across to Parkes and to Broken Hill, et cetera. The lease has within it conditions with regard to key performance indicators which must be met on all the lines. There can be a situation where effectively a failure on one can lead to a failure on all.

From a banker's perspective you have to keep it up to standard regardless of the volume or you lose everything. You don't lose a segment or a part, you lose everything, so it's a take-all exercise with regard to the NSW lease framework of which the Hunter Valley is a part. You can be successful in the Hunter Valley but if the rest of the area doesn't come up to the standard, everything is put at risk. That is a big risk to the company and obviously a big risk to our financiers, especially debt financiers.

The new investment within the Hunter Valley, I mean the reality is that none of these investments will be project finance. We are dealing with a corridor. Effectively, the value of the increment is the value of the total corridor, not the individual parts. The problem with the parts being valued in project terms is that no financier will finance it. The income stream relies on all the elements of the conveyor belt working in harmony and the rest is dictated off the conveyor belt, just as you

wouldn't get project finance for a mine extractor without looking at the total project of the mine because the extractor is totally relying on the product going through it. You can't deal with increments of new investment, whether it be an overpass at Kooragang or otherwise. That kind of project finance on its own has to be taken within a total framework.

That gives a bit of the picture. We are treating the Hunter as one corridor. It is likely that we may come back after consultation with the industry and move more transparently with the pricing framework. The unders and overs have been used but we haven't been given any documentation. I don't blame anybody for not giving any records to us. We are just saying we haven't got the information to look at, so because we haven't looked at the income stream. For two years the Mining Council have been telling me there is no investment in any capacity; everyone feels they are being stiffed and want something to happen. Effectively, we have to do the investment. Demand from the mines for the coal for this 12 months is surging dramatically from month to month. Going through it month by month, it is not a consistent flow pattern.

If you are aware of the port, the port cannot deal with surges for any long periods of time because it has little land space so the infrastructure owner is in fact having to build infrastructure to deal with surges. That comes back to the mine ownership and its arbitrage between one mine and another. We have to build capital for the surge. The surge does not reflect the market; it reflects the lack of capacity to hold at the outlet at the port. That therefore means that the infrastructure owner has to actually build over capacity against the average mean to actually deal with the surges and deal with the spot framework and the issue about market and what happens in the steel industry - the equity beta is being discussed here – ARTC's, not RIC's or not PNL's, not the guys who have other contracts, their consultation on investment is brilliant except in two years times the person who takes their place might take a different view. The equity beta means for us that the surges against certain expectation which may change because of other frameworks, the participants in that may in fact not stand by that in four or five years time and the persons who dictated the advent of the surge are not related to the local market.

1
2 The equity beta looked at here is ours. The point
3 with regard to the point of consolidation with overseas
4 companies and companies coming in spreads both ways -
5 some bigger guys, some smaller guys and BHP somewhere in
6 between. I am not decrying that, it is market spread.
7 What that does for my equity beta is actually they do not
8 dictate their decisions based on our economy, they dictate
9 them by their arbitrage, the hot beds in London between
10 the supplier to the steelworks in China, et cetera, and
11 they will move those according to best arbitrage. So they
12 should.
13
14 The difference is long-term contracts and again I think
15 we are out to show you the tonnage going through Port
16 Waratah over the last decade which reflects long-term plans
17 is smooth - not many cancelled yearly but I would prefer to
18 have a yearly contract cancelled rather than a 21-day spot
19 contract. From our agreed beta perspective, although the
20 steel mills wants it, China wants it, we are not the only
21 party there to supply it. Part of it is that on the supply side
22 there is a range of choices of supply which could change
23 the co-variance price over the period of time depending on
24 the next development.
25
26 This equity beta is not dealing with the coal
27 industry, it is not dealing with PNL, it is dealing with
28 the mug with infrastructure not worth much later in the
29 event when they make decisions to bring demand down
30 by 10 or 15 per cent.
31
32 MR BUGLER: Could I respond to a couple of points. David
33 showed a couple of graphs there which were absolutely
34 right, quite factual. There is much volatility in the
35 movement of tonnages through the Hunter Valley system. I
36 think relevant to the point, though, is the access charges
37 based typically on annual forecasts which, as Mike
38 mentioned before, have yielded results to the
39 infrastructure owner which have been rock solid and that is
40 in no small part due to the pricing mechanism which we
41 discussed before and which in fact gives the return to the
42 infrastructure owner on something less than 80 per cent of
43 the volumes that are predicted to go through. From the
44 infrastructure owner's perspective a 5 or 10 per cent
45 variation in volumes is of no consequence to the returns
46 that you will get.
47

1 I think it is important to keep that in mind, even
2 though there are certainly swings from month to month. In
3 terms of the capacity that's put in to take account of the
4 volatility, absolutely right again, that there is more
5 infrastructure in place than you would need if you had a
6 flat task and, in fact, if you look at each service
7 provider in the coal chain they provide greater capacity
8 than you would need; PN has more trains than you would
9 need if you had an absolutely flat task; ARTC has more
10 track; the port probably has more capacity than if you had an
11 absolutely flat task, although that is probably closer to
12 what Mike said. But in terms of the infrastructure, the
13 cost of providing that infrastructure is built into the
14 access charges and so the infrastructure owner has
15 compensated for that overcapacity to the extent that it is
16 there.
17
18 We then look at the discussion about the potential for
19 someone at a later point in time to overturn an agreement
20 to inclusion of a piece of infrastructure and optimise it
21 out. My understanding of the mechanism currently in place
22 is that the consent, if you like, of stakeholders is made
23 at a point in time and the infrastructure owner is
24 therefore able to rely on that consent into the future. It
25 is not a case if a different railway comes along in five
26 years time and it says, "We didn't like that PN said yes to
27 that piece of infrastructure, so we'll ask for it to be
28 out." My understanding of the mechanism is that is not the
29 case. If stakeholders consent, then that consent is good
30 for any future decision before IPART regarding
31 optimisation.
32
33 MR MARCHANT: Somewhere between 5 and 8. When we
34 get to the substance of the final figures, one set of
35 submissions is lower than the market would give the
36 investor in the bank tomorrow. The industry's view about
37 demand and consent, that in fact is a graph of what in fact
38 coal demand is based on - all the coal supplies in the
39 Hunter Valley for export in those years. The bottom graph
40 is a replication of what the port can do. We are talking
41 about oversupply in Australia. There is a gap between
42 those two points at this point in time.
43
44 There is a range of issues being attempted by the
45 State to resolve that. All that is in the market right now,
46 being assessed right now and somewhere between now and
47 June it will be resolved. It requires a surge of capital

1 investment by the track owner and some investment by
2 whoever is going to do the port investment. That surge in
3 capital investment is to deal with the much higher level
4 than in fact has been in the past, recognising there are
5 major fluctuations now taking place compared to what used
6 to take place because of the quantity market for coal has
7 changed. The consent process, I am not decrying it, but
8 no-one has seen it effectively work yet after five years.
9 There has been one letter of consent RIC gave me for an
10 initial investment of $30m some while back to do some
11 studies. The reality is that the consent process requires
12 agreement of all stakeholders. The reality is two or three
13 stakeholders hold that back, 90 per cent agree. IPART or
14 its successor will leave open that five-year basis to
15 re-optimise the asset base, but nobody can invest while the
16 asset bases are up in the air.
17
18 The point I am trying to make is in asset investments
19 we have agreed generally a 40-year life, now a 35-year
20 life - that's for the depreciation part - five years
21 resetting. A five-year reset does enable optimisation to
22 take place. The person making the assessment is making it
23 on an economic base for 40 or 30 years. On the finance
24 base it is doing it for 35 years plus as distinct from the
25 economic basis and the reality is that people who consent
26 at those stages could easily not be there at any one of
27 these retrigger points in five years, but the sunken assets
28 are being amortised in finance terms.
29
30 It is like the 35-year life mentioned earlier. As I
31 understand the 35-year life is there for the purposes of
32 creating a DORC model for the purposes of giving a
33 framework. It is obviously nonsense but economists and
34 accountants need it because they have to give final account
35 of what is a sunken asset, what gets renewed over a curve
36 in time so that it doesn't fall over in five years. The
37 resetting of the optimisation is actually aimed at a
38 readjustment not coming down to zero. That does include
39 the situation where the asset is reoptimised in certain
40 circumstances.
41
42 So we are dealing with a method or concept. Everyone
43 is arguing return here now, in today's circumstances.
44 But it is not here and now for me to borrow
45 on a 35-year cycle knowing that asset reset will take place
46 because no-one is going to go to 35 years and then
47 because with new mines someone is going to have to build

1 the additional investment for new mines. The old track
2 will come out of the asset base in real economic terms. We
3 are dealing with a mathematical process that enables
4 investment to take place but not in a rambunctious way for a
5 monopolist to attempt to extract monopoly rent. We are
6 trying to get a calculation here which enables investment,
7 enables a financial return to take place. The people looking at
8 these sign-offs look at them as if they are set in
9 concrete. In five years times the representative may not
10 argue the same way. It is a process.
11
12 From an economic point of view I have to go and argue
13 with the banks. I have a piece of
14 paper signed by PNL for three years. At the end of three
15 years they may not be there. They may be signed by Anglo,
16 Rio or Xstrata and not signed by the small companies - all
17 the stakeholders, but at least there is generally consent
18 about that. It is a cautionary thing, not a mining thing.
19 I am cautious about overplaying them. It is to show the
20 regulator there is a general goodwill about this investment
21 at this point in time. That's fine, but I can't take that
22 to the banks and say, "Look they have signed off for 35
23 years." They will laugh at me, unfortunately. I am used to
24 that you but I actually need the money.
25
26 The balance of those things, I'm cautioning here
27 between the bureaucratic process of consents which is not
28 binding and the economic framework of bringing things
29 together to get financed and the issues around that. So
30 the equity beta issue is really about what we are exposed
31 to and what we have to justify to our banks. That isn't
32 just focused on five years but 30-plus years and the equity
33 figure is exposed. If you have two or three gorillas,
34 banks then look at what the gorillas do in the market. The
35 reality is they are at risk. They are a different risk.
36 They are a different risk now than when the market was
37 much more long-term contracted. The commodity process
38 has changed.
39
40 I am not arguing for a higher equity beta. When you
41 look at the calculation five years ago and the equity beta
42 calculation now, they probably think it is right but it's
43 just a different reason to be right, that's all.
44
45 THE CHAIRMAN: Do you have any further questions?
46
47 MR KEMP: Going back to the leasing issue, what I am

1 taking away from your comments, David, is that in your
2 opinion the leasing arrangements haven't actually had any
3 impact in terms of risk.
4
5 MR MARCHANT: There is an increase in the risk in the
6 sense that if I am not able to meet standards in one part of
7 the network, the rest of the asset is lost. When you put the
8 leased assets together, they cost the State of New South Wales
9 $205m. That's how much it is when you put Hunter Valley in.
10 They lost more when you take Hunter Valley out. You are
11 starting off going to the bankers saying, "I have a beautiful
12 dog here, part of it is in the Hunter Valley, but collectively
13 it loses $205m."You don't start from a strong position that
14 way. Your beta arrangements, with risk low, and unders and
15 overs. Some guy has a 50-year contract, you look at the
16 lease and it looks a real dog. You are left with the banking
17 financial risk. Effectively that's to you and to us as a
18 company, so in a equity beta sense it puts the equity slightly
19 more at risk because it is Russian roulette. Do I think it is
20 a dramatic risk? No, beta is probably right. It is a dramatic
21 risk to the State of New South Wales.
22
23 MR KEMP: One thing I wanted to pick up with your
24 comments is that you were indicating in your view, based
25 on average asset lives, that effectively you weren't expecting
26 any of the mines to fall over in the next five-year period,
27 so the likelihood of asset stranding risk is, if I can could
28 put words into your mouth, almost as equal as it was five
29 years ago. Is that a fair comment?
30
31 MR CLACHER: I was talking about asset stranding in
32 relation to the reality line, not in relation to mines.
33 Mines by their very nature come and go.
34
35 MR KEMP: In relation to the railway line, though.
36
37 MR CLACHER: I think it has been clarified that the Ulan
38 line certainly has a much more assured future than was
39 apparent five years ago. Five years ago there were
40 questions about greenhouse - is the greenhouse issue going
41 to mean that oil demand will dwindle - and all the evidence
42 is that the coal industry is in good shape, strong. Mines
43 have closed, new mines will open, as they do. It's the
44 nature of the beast.
45
46 MR COX: At the risk of having a discussion on equity
47 beta, I would like to ask this question: you have done

1 your co-variance analysis, thank you for doing that, and
2 what you have done is looked at the accounting return to
3 RIC over the last four years compared to the market, the
4 co-variance has been found to be low, and we have seen
5 other conclusions. The problem with that is that it is a
6 fairly short data series, there may be areas that are
7 variables, there may be particular events that affect the
8 correlation, so you don't want to put too much into that.
9 You yourselves at the end of the day do not put too much
10 reliance on it because this is really a low number, it is
11 not reasonable to impose this on the ARTC, we will adjust
12 it up. Can you explain to me how you have adjusted it
13 upwards and why you would not have adjusted it upwards
14 further, say, to the range we had last time?
15
16 MR SMART: Certainly we do recognise the limitations of
17 using this short-period accounting return calculation. I
18 think we identified some of the shortcomings in our
19 submission. The genesis for that type of analysis was
20 simply a concern about the way these beta discussions often
21 go, which is often quite qualitative, and we thought, given
22 there was actually some quantitative data available, we
23 should see what that suggests, and if you took the numbers
24 on a straight reading, if you believed that the assumptions
25 underpinning it were correct, really you should see the
26 data pretty close to zero.
27
28 We didn't advocate that, we felt that was an extreme
29 and probably risky step to take, because undoubtedly there
30 are risks, there are some institutional changes taking
31 place and we felt that we didn't want to take a risk with
32 investment because we agree with everybody that
33 investment is very much needed in the Hunter Valley
34 system. In terms of where we wound up as a number, we
35 advocated point 3 for the asset beta. I don't pretend that
36 there is a lot of science behind that number.
37
38 We felt that IPART's original figure of point 4 for
39 the asset beta was projected in an atmosphere of some
40 uncertainty about how the regime would operate in practice.
41 At that point there had been no practical experience at all
42 and I guess we were all there at the time and it was very
43 clear how things would work and how it would pan out in
44 practice. My feeling is that the point 4 asset beta was
45 based on an expectation of a reasonably high degree of
46 uncertainty. Looking at what has actually happened it has
47 not been uncertain at all, the returns have been rock

solid, very, very solid, and although four years is not a long time, four years is not an extremely short time either, over that period quite a lot has happened in the economy, a great deal has happened to the rail and coal industries, yet these rock solid returns have been continuing.

I guess the feeling was that point 4 was probably too high and the figure should come down somewhat from point 4, but on a precautionary principle we didn't recommend the radical reduction.

MR CUTBUSH: One point that should not need to be laboured is simply that Mr Marchant referred again to the consolidation question, what influence that might have had on the beta. In that sense he raised an issue we should have mentioned ourselves, which is the theatre of ARTC presenting to the banker. I guess it seems to me that if you have got PN suggesting that it has a certain amount of traffic that will be forthcoming and it has Rio's signature on it and it has Anglo Coal, BHP Billiton's signature on it, it looks a pretty credible kind of a prospect, a more credible one than would hitherto be the case with a series of rats and mice type operations, with all due apologies to those involved, written on the promise sheet. That is one thing.

The second thing is that just as a matter of logic I would have thought that for these large firms their powers to exercise arbitrage from a desk in London are not aided much one way or the other, are they, by a decision to consolidate a series of mines in the Hunter. What I think the consolidation of a series of mines in the Hunter implies is that the likes of Rio can exercise its power of consolidation to that degree on that scene, so it is a question of asking yourself, for this particular review, this particular workshop, where we are concerning ourselves with Hunter, that consolidation that has occurred in that particular theatre is one that must I would have thought as a matter of logic have been something that reduced the overriding risk and that there is a pressure downwards on the beta.

MR MARCHANT: The difficulty in this discussion is looking at the Hunter as if it is an island. This equity beta is ours in this country. If a large international company consolidates in an environment, consolidates to get

economies of scale in that environment, it could also consolidate to get economies of scale world wide for its commodities. Quite frankly, it could be a risk the other way round, they actually close a slightly lesser efficient mine in the Valley. All that behaviour is quite rational, I am not suggesting they should not do that, but by the same token what has been suggested is that - they have not signed contracts with BP that I am aware of that guarantees an absolute tonnage for every mine. If that was the case, I would be feeling much better.

I have looked at the way it works and it does not work that way, it actually does vary, and it varies between mines, including those mines where they do commit to a daily run. They sometimes don't deliver, therefore you get an undersupply in any month. The last three months gives good examples. I am not sure. In our area their behaviour is quite rational, I agree with that behaviour. Having worked for an energy company looking at commodity trades, quite frankly that is a rational thing to do.

With all respect to my colleague, we did it, because that is how we made money, by moving gas from one place to another, arbitrage, even though we owned both places. I am not suggesting that is bad behaviour. I am talking about our equity beta. The reason I raised the banks is that our average weighted cost of capital is published, everybody knows what we have to get as an averaged weighted cost of capital. Hunter competes for that with the rest of the interstate line in New South Wales. If the average weighted cost of capital is too low from a regulatory basis we would put something into place to get a better gain from that.

The reality is that this is a discussion about what is the best package. It is a discussion about what is bankable without ripping anybody off. That is the reality of this discussion. It is not esoteric about who has got the best beta. NECG had something for a more diverse sort of business in Western Australia. A point 4 beta in that case was for iron ore, aluminium, grain and coal. Companies that actually do alumina mining, Australia does not buy too much from there, we go overseas, so these things are interesting but in the end the bottom line is what does the calculation come out at and is it a fair balance for all the risk involved.

I am just cautious that with equity beta, debt beta,

1 in the end you have to come to the bottom calculation and
2 look at it, is it too hard, too soft, will it enable
3 investment? I am trying to look at bottom line figures and
4 say, does that get me across the line with what I am trying
5 to do. I will obviously later discuss about company tax.
6 And interest rate changes, I have to have some framework
7 for that, nominal and real rates, but I am looking at it quite
8 frankly from the basis of coming out with a number that is
9 rational, that allows investment and is not monopolistic.
10 That is unfortunately the balance of the debate.
11
12 THE CHAIRMAN: I propose we have take a short break,
13 then we will come back and look at the bottom line, which
14 is the rate of return.
15
16 SHORT ADJOURNMENT
17
18 THE CHAIRMAN: We will recommence. The final item
19 is what David Marchant was inviting us to focus on,
20 which is the bottom line - that is, the rate of return. Alex,
21 are you going to start off again. .
22
23 MR OESER: I am just quickly going to introduce what we
24 were talking about just now, rate of return. I think one
25 of the main points I want to mention is the 1999 decision
26 when the Tribunal took some specific risk into account
27 when setting rate of return. There were diverging views on
28 rate of return that should be applied. The ARTC submitted
29 that there should be no change in rate of return. Pacific
30 National and the New South Wales Mineral Council called
31 for a reduction. The main argument for supporting a
32 submission for reduction is that unders and overs allows
33 the ARTC to always earn the maximum rate of return.
34 Another item was that if the Tribunal is to take into account
35 systematic risk when setting the rate of return, those risks
36 should in fact lower the rate of return below the midpoint,
37 rather than increasing it.
38
39 What we would like to find out today is whether
40 systematic risks should be taken into account in the rate
41 of return and, if so, what impact would these risks have in
42 a positive way or negative way.
43
44 MR KEMP: Could I just add one thing. I think coming out
45 of our earlier discussion there is also the further point
46 worth exploring in terms of your specific response and that
47 is this question of the investment stream so, effectively,

1 everyone talking about future investments required in the
2 area. We are interested in what the implications are of
3 different rates of return given that some of the external
4 factors indicate the rates of returns are lower; what the
5 rates of return will be for that investment when,
6 importantly from the both sides of fence and ARTC's
7 aspects, the businesses would like to utilise that
8 investment.
9
10 MR MARCHANT: It might make it easier if I go first.
11 Systematic risk was discussed in the last session in
12 relation to the setting of equity beta which effectively
13 becomes part of the risk and debt. Regulators tend to look
14 to equity beta and then recalculate it according to the way
15 you mix it. I am not saying it is not a good thing to do.
16 The process tends to rebalance it through. I think the
17 systematic issue is in the sense our economist would look
18 at the equity beta. I didn't
19 want to touch too much on that.
20
21 There are three points. One is there is a gap at the moment
22 between the nominal rate of return and the real risk
23 rate. Probably it is the biggest gap I have seen in a decade
24 of regulatory frameworks and I am actually cautious
25 about the setting of that rate at this point in time.
26 Since 1998 there has been some migration but the real rate
27 has actually been reasonably flat and the nominal rate has
28 moved around a bit. But the gap between the nominal and
29 real rate now is the biggest gap in a decade and I am
30 cautious that when you look at the nominal versus real rate
31 you may go to a strike rate based on the 20-day frequency
32 of time. That's an aberration. I don't fully understand
33 why the market is in its present form because the nominal
34 framework is actually reasonably flat over the time but the
35 real rate has actually really gone down. I can't
36 understand that aberration, which has certainly been the
37 case the last couple of months. The Reserve Bank and
38 others are obviously talking up the likely real rate in
39 interest changes. The market doesn't seem to have moved
40 with that just yet, but the nominal market has actually
41 held; the gap has spread between them.
42
43 My first point is that I am cautious about taking a
44 real rate based on a 20-day framework. It will come out
45 with an aberration at this point in time. I think a better
46 result would be to do the average in the last five years
47 - five years as distinct from four

1 weeks. In summary form, I am saying I want you to think
2 about moving away from striking a 20-day real because the
3 20-day real in my view - I am not trying to double-guess
4 the market - when you look at the market at the time it
5 seems unreal and not likely to sustain itself. It is better
6 to look at that over an average of five years given the
7 investment scenario and look at the gap spread and
8 therefore in 4 weeks we are suggesting the real rate
9 should be 2.8 or a variation of that. The average figures
10 come in at about 3.35 depending on how you average it.
11
12 I am cautious and I suggest not taking a real rate based
13 on 20-day strike. The spread at this point is very abnormal.
14 It is a mathematical caution I have because when you look
15 at the discussion in the documents coming out on those
16 things there is a consensus, including by us, that we would
17 like to strike it around the real rate, but I want to qualify
18 the consensus to make it more real than this because it is
19 abnormal and unusual and in a form I have never seen in
20 the last decade. That's my first point.
21
22 The second point is that obviously we have argued for
23 the present statutory rate but recognising some technical
24 reasons why it needs to be adjusted. Firstly, the
25 technical rate was done on the basis of an income tax
26 factor with companies at 36 and it should be adjusted down
27 to 30, which is blatantly obvious. Secondly, and this is
28 more a technical issue than a real one, it is done to a
29 60/40 debt/equity framework. I don't think in real terms
30 the finance market will support that in New South Wales
31 because of the massive difference between the performance
32 of New South Wales and its potential, and although they
33 look at us with glowing eyes to think we can turn it around
34 from a $205m loss, they are cautious.
35
36 So a debt to equity ratio of 60/40 is unlikely to be
37 achieved, and more likely is 50/50. 55 wouldn't worry me
38 but if it went higher that would be unrealistic.
39 Mathematically it means 0.2 per cent between 40, 50 and 60
40 but I am cautioning in real terms it is not likely to be
41 60/40 but 50/50, or around that framework. That does
42 doesn't make an impact. I think it is highly unlikely to
43 be 60.
44
45 The third part of the framework on that is that I
46 didn't want to get into the gamma discussion because I
47 thought that was more humorist than economist. So

1 effectively our present forecast is to spend $160m over the
2 next three to four years. I envisage it will be higher. We
3 are in consultation at the moment on what that spending
4 should be. In fact, there is a draft discussion paper on
5 the website. It is quite entertaining, the consultation
6 process. That could go on for four to five weeks and then we
7 go to the industry as a whole soon after that.
8
9 It is quite clear to us that what was envisaged over
10 five years is probably going to be reduced to less than
11 three because of the graph I showed you earlier. With
12 demand and with the new equation there's likely to be a
13 movement by the coal owner earlier than later. The state
14 simply determined to come to a decision by June or July of
15 this year and wants to get something committed and under
16 way in the next two years so the capacity is to move faster
17 than that. That actually requires additional investment by us
18 because each of the proponents have proposals requiring
19 further rail development to connect up other facilities
20 over and above the 160.
21
22 So the bottom line for all those things to work is that we
23 have to borrow the money to get there. Our present
24 rate of return from shareholders' requirements is about 7.3
25 to 7.4 real. Our calculations come out somewhere between
26 7.1 and 7.5 once you take the capex, and resulting debt
27 structuring framework and the corporate tax framework out,
28 but that is based on a 45 per cent debt. In reality
29 regulators would go to 50 per cent, or 55. That changes it
30 by 0.2 per cent. We are obviously looking at a situation
31 where the return comes out somewhere around the real rate
32 of 7.1 to 7.5 because at that point we have enough to be
33 able to actually get the capital and move forward with the
34 bankers taking a risk framework around that.
35
36 That's just a realistic answer to the framework. How we
37 calculated that is we actually were concerned between
38 nominal and real interest rate because we thought we would
39 get an abnormal result which would not be bankable because
40 the spread is much higher than it normally is. The market
41 risk premium is around the 7 framework but that's mainly
42 because of the changes in the structural exercises we have
43 gone through, the way banks look at that rather than we look
44 at it. Banks would look at it as much more risky. The debt
45 margin and equity rating we have gone through, effectively,
46 the bottom line is that's the sort of margin we are looking
47 at for a $160m to probably $200m spend, not in five years

1 but probably in less than five years, say in three years.
2
3 Now, why do I say that? I am hoping people will say that
4 this is normal marketing to try to get a good return. We
5 have an opportunity cost of doing it there or putting it into
6 the main lines with potentially greater growth. That is so
7 that we get 20 per cent volume growth and get some money
8 out, which would be quite surprising. The difficulty also
9 with us is that we do have to go to the ACCC some time in
10 the next two years. That is a risk to the bankers; it is a
11 regulatory risk. We go through one process here and then
12 borrow money on the move and then you have to go to the
13 ACCC where the optimised asset base will come back in,
14 et cetera. That is a catch-22 for us and that risk is
15 something that we have to run if we are going to get the
16 assets in place, but the reality is these guys are getting
17 another go. With regulatory framework and ups and downs
18 and all that, you have to put yourself in the ballpark to
19 make yourself attractive. That's the honest answer.
20
21 MR CLACHER: I will start off by talking about the risk of
22 underinvestment. Obviously it is of considerable
23 importance to the New South Wales coal industry that these
24 investments are made and it just so happens that this
25 review has come out at the same time as ARTC is faced with
26 some decisions about investment. Now, our submission
27 came out with a fairly below normal standard bottom line.
28 We got to that by first of all thinking about the question:
29 Is the CAPM the right way to go about determining
30 suitable rate of return. I think we have heard certainly
31 from ARTC that they are not happy with the way that the
32 answer comes out when you take the 8 per cent that we have
33 previously and apply what we thought were some reasonable
34 adjustments, taking into account changes in risks as we
35 perceived those changes, changes in interest rates and
36 taxation rates and so on, and correcting what we saw as an
37 incorrect application of the so-called truncation caused by
38 the combinatorial pricing arrangements. When we worked
39 through that we came out with the answer and it's much
40 more a technical view or technical process - it certainly
41 wasn't a political process - and the industry is concerned
42 about underinvestment and wish to see capacity of that
43 railway line brought up to current demand.
44
45 David has been talking a lot about banks and so on and
46 he mentioned return to shareholders. What he didn't
47 mention is that returns on investment in the Hunter through

1 ARTC isn't the only return the shareholder will make. It
2 will make a considerable return through company tax if more
3 coal is sold overseas. New South Wales Government will
4 make a considerable return for no investment at all.
5
6 David also mentioned that he was talking about going
7 to his bankers with a proposal of 60/40 debt/equity ratio
8 based on the whole of New South Wales. When the previous
9 exercise was done setting the rate of return for the Hunter
10 rail network it was my understanding that it was based on
a
11 sort of ring-fencing of the Hunter railway network in
12 isolation, because the Hunter then is, and still is, the only
13 part of New South Wales rail network that was making
14 any return at all on capital. I believe that is still the
15 case. So when the rate of return is being looked at it
16 shouldn't be looked at in New South Wales as a whole but
17 just for the Hunter.
18
19 The issue of truncation was briefly mentioned. In
20 its previous finding IPART adjusted or chose the final rate
21 of return to apply very much at the top of the range that
22 it had identified and this was, it was said, based on
23 so-called truncation of returns which arise because of
24 combinatorial pricing. At the time we didn't consider
25 there was any such truncation. In fact, the fact of the
26 combinatorial pricing principles was to enable the
27 structure owner to charge more on some sectors than it
28 would have been able to if the combinatorial pricing
29 principles didn't apply. Truncation can be deemed to occur
30 but only if you come from your basic premise that users of
31 one asset should pay for or should compensate the owner of
32 a different asset who is making less than the amount he
33 would like on that different asset. But if you come from
34 the premise that users of infrastructure or services
35 shouldn't have to pay for assets that they don't use, then
36 combinatorial pricing principles in fact act to enhance the
37 returns of the infrastructure owner on that part of the
38 infrastructure, but not on the other bits of infrastructure
39 that people don't use. In our submission, we attached a
40 couple of letters which are trying to demonstrate that.
41
42 MR CUTBUSH: I have been asked by my colleagues to
43 comment on the final slide that our presenter put up
44 concerning systematic risks. We have talked about
45 systematic risks this morning already in a section of this
46 workshop. I want to talk more about unsystematic risks and
47 the difficulty there is in knowing exactly what they are and
whether they

1 are relevant. When we prepared the submission by the
2 Minerals Council for 30 September last year we had a close
3 look at the 1999 report or the determination by IPART and
4 felt the Tribunal hadn't been as clear as it might have
5 been on exactly what it had done and why in that regard.
6
7 It seems to me there is no doubt about it,
8 unsystematic and systematic risks, and understanding what
9 they are is the most difficult thing in WACC calculations.
10 It would be foolish of me to pretend that I am an expert
11 yet in this area, but as a matter of principle, specific
12 risks are not considered in estimating the WACC. That's
13 the general capital model, because they could be minimised
14 by holding a diversifiable portfolio so diversifiable
15 things are out. The trouble is that, in practice, there
16 can be room for opinion about whether a certain risk is to
17 be classified as systematic or unsystematic. It is not
18 exactly straightforward.
19
20 I recommend for a discussion of this subject a paper
21 prepared by the Queensland Competition Authority. At this
22 stage I have only ever seen a draft, but it was on their
23 web site, in summary form, and I think raises the issue in
24 a very engaging way.
25
26 It asks the question: what do you do about outlining
27 an extraordinary risk. What we are talking about in the
28 current era is what do you do about, in Hunter's case,
29 let's say a terrorist risk? Is that for the community to
30 bear or is that something that should be part and parcel of
31 the commercial environment which coal freight would take?
32 Since "9/11", as they say, these matters are coming into
33 focus a bit more than they did earlier.
34
35 It seems to me of course, as you would expect, the
36 Mineral Council's position on this is that the community
37 has to pick the tab up for some class of risks that are
38 everybody's business. It seems to me that that is where
39 one can start peeling away at the onion to determine what
40 it is that is the residual risk that you deal with when
41 talking about the betas and rate of return in this kind of
42 forum.
43
44 My plea would be, I think I can trust that the
45 tribunal will do this exercise well, but it would be very
46 important for all of us I think if that were done
47 explicitly next time round and that we were a little less

1 left to guess how it had been handled. In our own
2 submission on the 30th we have given an outline of our
3 concern and suggested a few thoughts, made a few
4 suggestions, about what is in and what is out and so forth.
5 There is no point going through it here in any depth.
6 Could I just leave with you that request. The point is we
7 have no elaboration on our own points at this stage.
8
9 MR BUGLER: I will ask Mike to address the systematic risk
10 issues of a more technical nature, but our view is that
11 from a general perspective the risk framework is generally
12 the same as it has been over the last five years, which
13 would lead us to a view that radical change in the rate of
14 return is not appropriate. We have conducted, NECG on our
15 behalf, an exercise of going through the detailed analysis
16 and came up with a rate of around 6.5 per cent, which was
17 in our last submission to the tribunal.
18
19 To our thinking, clearly investment in the rail
20 infrastructure in the Hunter Valley is of paramount
21 importance to every stakeholder. I don't think anybody is
22 dissenting from that, and that would lead PN to the
23 conclusion that where there is an element of doubt, perhaps
24 that should go to the infrastructure owner. We certainly
25 are not keen on an outcome that would inhibit investment
26 and the sort of range that David mentioned before of 7.1 to
27 7.5 per cent certainly would not be something that we would
28 complain about.
29
30 Our view is that, as I say, there is in the current
31 environment reason to give benefit of the doubt to the
32 infrastructure owner and ensure the investment takes place
33 rather than put that investment in jeopardy. Mike might
34 comment.
35
36 MR SMART: Just a few things. First, can I just ask
37 Mr Marchant a clarifying question. You mentioned a 7.1 to
38 7.5 per cent target rate of return. I gather that is real.
39 Is that pre-tax or post-tax?
40
41 MR MARCHANT: It is pre-tax.
42
43 MR SMART: The first thing to say is that the Mineral
44 Council's headline maximum rate of return strikes me as
45 extreme and low and probably risky in terms of ability to
46 bank new projects. That needs to be said.
47

1 Talking about some of the more detailed WACC
2 parameters that ARTC has referred to, there was a
3 suggestion that the risk free rate be determined by a
4 five-year average. That strikes me as a fairly significant
5 departure from current regulatory practice and I would be
6 concerned about such a departure given that regulatory
7 practice has evolved over many years now over a wide
8 range of industries. I think there is a pretty settled view on
9 most of these things and I would have thought estimating
10 the rate of return is one of the more settled aspects of
11 it. I would not be keen on any radical departure from
12 normal regulatory practice.
13
14 On the gearing question, I guess it is a bit
15 hypothetical because the current actual gearing of ARTC
16 will be different from what is ultimately considered in the
17 WACC calculation. There is a bit of a judgment as to what
18 would be a hypothetically optimal level of gearing for an
19 ideal firm in ARTC's situation. We have suggested sticking
20 with something between 60 per cent and 50 per cent debt,
21 which is I think consistent with regulatory convention.
22 Obviously there is some leeway for interpretation there,
23 but I do make the point that we are talking about a maximum
24 rate of return for the Central Hunter Valley, category one.
25 This is the least risky part of the whole Hunter Valley.
26
27 Mr Marchant himself said that he intends to finance
28 investments there through debt, so clearly there is an
29 ability to gear up for this particular part of the asset base.
30 It should not be taken at face value that some
31 particularly low debt capital structure be proposed because
32 over time one can well imagine that the gearing will rise
33 to a level which is consistent with the overall risk
34 profile and that may be closer to 60 per cent.
35
36 I guess there was another discussion Mr Marchant
37 mentioned, that the capital that is earmarked for the
38 Hunter does not necessarily have to be spent there.
39 Certainly nobody would dispute there is a pressing need for
40 investment in other parts of ARTC's network to facilitate
41 growth in its inter-modal business. Certainly it is
42 important in terms of national priorities. That is an
43 important balancing act that you have to make and the
44 company has to be involved in. But if the proposition is
45 that an insufficient rate of return on the Hunter Valley
46 might lead to some of that being reallocated to the
47 interstate network, I would find that hard to understand

1 because in financial terms it is difficult to see that that
2 investment would earn a higher rate of return than a
3 certain percentage on the interstate network. If there is
4 a reallocation, it would be done for reasons other than
5 financial comparison between the Hunter valley and the rest
6 of the network.
7
8 MR MARCHANT: I am happy to deal with that because that
9 is a misunderstanding.
10
11 MR SMART: Just a very final point before turning over to
12 Mr Marchant. Mr Clacher talked about the combinatorial
13 ceiling model and how that did not involve any truncation
14 of returns. I would just like to clarify what might be some
15 misunderstanding about how the combinatorial model
16 operates. It is fair to say that there will be some truncation
17 of upside returns from the way the combinatorial
18 ceiling model operates. It is certainly not the case that a
19 cross-subsidy between one part of the network and another
20 takes place within the combinatorial model. That is the
21 very thing that the model is designed to prevent, so I
22 guess the simple answer is that there is some degree of
23 truncation which takes place as a result of the
24 combinatorial model. The truncation premium that was
25 allowed in 1999 was a legitimate claim at the time and
26 there is really no cross-subsidy if the combinatorial model
27 is applied correctly.
28
29 MR MARCHANT: If I can query that last bit, it is a
30 misunderstanding of the pricing and constraint mechanism.
31 The tribunal's decision, not being aware of it at the time
32 but now looking at it, how it is priced, is probably a
33 misunderstanding of the the cross-subsidy, because
34 the marginal cost is paid on the way through. The 0.2
35 variation made last time is a correct variation in the
36 circumstances of how the value presently operates, and that
37 was taken into the decision. That will change because Ulan
38 will change, but the Ulan mine is part of category 2 now
39 and if that point 2 is not put up on the framework it would
40 lead to a situation where the pricing would need to be
41 rejigged for all the mines.
42
43 I am not sure that the track owner could do that
44 because effectively the pricing framework for the mines was
45 settled with the train operators and it would in fact
46 create a new pricing model for every mine in the Hunter
47 because you can never get over the ceiling. The reality is

that that is the way it has been calibrated - Mike may have been involved - to actually make sure it did not go over the ceiling of the framework, some people call it an uplift, but there was an adjustment made to the median point by the tribunal five years ago to recognise that the intent of picking it up could not be matched with the reality of how you do it without actually squeezing everybody in the exercise.

That is a misunderstanding. That will be solved in a later ACCC application when we look at pricing and there is more transparent pricing, keeping the ceiling in place, when you can calibrate how to do that with the industry, but it is a misunderstanding to think there is a cross subsidy. I am sure the tribunal has been through the calculations more than I have, but the 7.1 to 7.5 assumed the Ulan framework, but not as an uplift.

The second part is that the reality is we targeted where we would spend money. Our submissions to PNL, QR and the Mining Council for the last two years on our investment was presented on the basis that there would be a rollover of the rate. To be frank with you we were concerned to get into this debate about 5% or 6%, but we are going to invest, you all want it, but we expect some sort of rollover of the rate. We don't mind going into this market with it excluding adjustments for corporate tax rates and things like that but not overall adjustments.

To be frank, our business case was presented having gone through two and a half years of negotiation in New South Wales and assuming those rates would be carried through how it was done. To come into this debate on these figures is interesting, but it was consulted previously. Don't be surprised what our weighted cost of capital would be if we invested slightly more in various part of the interstate route because they are options to trade off to get different outcomes. Our weighted average cost of capital is actually higher than what would be proposed out of this. Secondly, because of the under-utilisation of those assets, the upturn in cash flow would be less constrained because we are well under the ceiling framework. We could get a better return, especially in New South Wales, and a better cash flow. It would be faster. That's a commercial decision. We are not suggesting we are making that decision, but if you set the number at a point where it becomes irrational against your cash flow and framework, you expect people to act accordingly.

The second part of that, and it is just a reality thing, is that if I could get a higher return to the cash flow, you go to the place with the higher rate of return. The issue where the Government should be worried is the social implication. A company has to make returns to shareholders. The 143 provided was as equity, not as a grant. They bought shares and expect a return out of those shares. We are not borrowing 50/50 against New South Wales. We won't do that. If we are borrowing 60/40 it is in fact a Hunter Valley issue. I don't mind if it comes out 60/40, but I am trying to get across the regulatory system for track owners of assuming a utility rate of 60/40. We went to the ACCC on that and have subsequently come through a process to realise that the track owners will never get a 60/40 ratio for a whole range of reasons, including parent company guarantees. You can expect it to be closer to 55, not 60/40. I very much doubt that Freight Australia's track is on a 60/40 basis without a parent guarantee behind it.

No bank would bank it on a 60/40 basis. No bank would bank New South Wales on 60/40. Who is going to risk 60/40 when you give projections on the basis of what you might do. It is closer to 55 in the Hunter. That's not New South Wales. In the rest of New South Wales we are doing it out of our balance sheet and cash reserves and a whole range of other things. In the Hunter Valley we are obviously locking in a more bankable framework. We sell the Hunter Valley as a bankable thing on its own with that balance sheet and equity behind it. The money invested in the Hunter Valley is not debt. We are putting equity in. It will end up being a blend of equity and debt.

I am cautious that the coal industry pays taxes to Commonwealth and New South Wales Governments, which is interesting but unrelated to ARTC. If I were a beneficiary of the taxes I would welcome it. The social good issues with regard to security and structural stuff, if a terrorist hits my track, unfortunately I have to fix it up. I do take protective terrorist insurance because every company has to, but it is not a social obligation, just as any accident on our track is in fact a litigious matter now, as PNL and ourselves work out very regularly.

1 I can't understand where those issues come from. I
2 don't have a government guarantee. I don't have the
3 Commonwealth's balance sheet behind us. That's the
4 explicit way we are set up. Those sort of intrinsic issues
5 are public good issues and are not before this Tribunal.
6 If we get to that, we get into passive subsidies and the
7 rest of it. Heaven help me. The economics of the industry
8 would be distorted even further.
9
10 THE CHAIRMAN: Are there any others questions?
11
12 MR KEMP: There is something, picking up on the
13 discussions coming out of ARTC and Pacific National to the
14 Minerals Council. I am trying to get a better
15 understanding of what the implications are of rates of
16 return in the order of magnitude that the ARTC is
17 discussing at 7.1 to 7.5 on, effectively, your members.
18
19 MR CLACHER: When we put in our submission that
20 identified a range of things, 4 to 5 and up to 6 and a bit, it
21 won't come as a surprise to anyone in this room that we
22 didn't expect that IPART would deliver a judgment at the
23 lower end of that range. Similarly, ARTC in their first
24 submission seemed to think it should be above 8 per cent.
25 I doubt whether IPART thought that was perhaps justified.
26 As Paul said, there's no doubt that all players in this issue
27 have a vital interest in investment happening and the
28 council members in particular are the most affected by
29 investment, or lack of it, in this Hunter Valley rail network
30 so that the council's members are keen to get a result that
31 all the players are happy with.
32
33 At the end the Tribunal has to come to a judgment
34 based on all the arguments that have been put to it and the
35 information that's been put to it. In our submission, we
36 tried to point out in as straightforward manner as we could
37 what we saw as being issues and what had changed and
38 hadn't changed since the last rate was set. In the end the
39 tribunal has to come to a decision based on that
40 information given to it and, as I say, we obviously want a
41 result that will be such that ARTC is happy to go ahead and
42 invest but we also want to see the Tribunal come to the
43 right answer for the right reasons.
44
45 MR CUTBUSH: Could I add something to that. Just by way
46 of general perspective, it seems to me that if one reflects
47 about what some people have been saying concerning the

1 decisions that ARTC has to make on investment in the next
2 little while, let's pause for a moment and ask ourselves
3 what would you expect them to say? It seems to me this
4 Tribunal's involvement with this industry and involvement
5 with rail track cost models and costing and pricing has to
6 do with the fact that the rail owner, in this case
7 leaseholder, long-term leaseholder, is a natural
8 monopolist. That says something about where the owners
9 ought to be when it comes to deciding what it be allowed to
10 do and what it not be allowed to do. I don't think it
11 needs to be said much more than that. Really, the point is
12 the whole rationale for the involvement of this forum in
13 this question has to do with the fact that, in the ordinary
14 course of events, the owner of an asset of this type has
15 every incentive to withdraw supply and change its price.
16 That's what the supervision of its activities is intended
17 to prevent.
18
19 MR MARCHANT: This is confusing. Are you actually
20 suggesting that the difference between a 4 and 8 would be
21 the difference between a monopoly supply drawdown? I
22 really find that difficult because in the end, it really is
23 an assessment about what is a real return against what
24 needs to be financed and how finance works in the real
25 world. It is a surrogate for a marketplace test. The
26 catch-22 is that you may get the lowest number you want
27 and, having got the lowest number you want, you may
28 have to live with the consequences of that.
29
30 MR CUTBUSH: There are many, many components of this
31 but I'm saying to you, and I am sure you don't disagree, that
32 it is not unreasonable for society to have an oversight of
33 your kind of activity and the question is why? That is
34 where the Minerals Council starts its consideration of
35 these sorts of questions and it is appropriate, in closing
36 our contribution to this, that that be mentioned.
37
38 MR BIDDULPH: I am Tom Biddulph from Rio Tinto, and
39 I am new to the detailed discussion of today. I have come
40 along more as an observer, but it is relevant to actually
41 underscore some of the comments made this morning, that
42 there is a keenness, and I actually believe an expectation,
43 that investment occurs without delay in the Hunter Valley
44 and that there is a stark reality that this year the tonnes
45 of coal that we would like to shift through the Hunter
46 Valley essentially from our mines on to the vessels that
47 are waiting off Newcastle is not as great as we would like.

1
2 We are operating under a capacity distribution scheme
3 in the Hunter Valley at the moment which allocates the
4 available capacity, which is coal chain capacity. It is
5 constrained, and there is a keenness, and I dare say an
6 expectation, that all of the stakeholders act immediately
7 to ensure that capacity is made available.
8
9 In that context, the IPART and its work is there to
10 make sure that there is a proper balance between the
11 interests of the access seekers and the access providers.
12 I suppose as well, as far as the industry goes, I am aware
13 the industry is prepared to work through and discuss all
14 matters relating to this and also subsequent ACCC issues in
15 how it all comes together to make sure the interests of
16 both the access seekers and providers are effectively met.
17
18 THE CHAIRMAN: Are there any other comments, questions?
19
20 MR KEMP: I have one further issue that I have been asked
21 to raise with the stakeholders. I don't know whether it is
22 appropriate to ask it now if there are no other questions
23 on the other matter.
24
25 THE CHAIRMAN: Do it quickly.
26
27 MR KEMP: The Tribunal has received an advice that
28 indicates that it needs to consider two rates of return as
29 part of this, one for ARTC and one for RailCorp, in terms
30 of the five segments to the south of Newcastle. We are
31 just interested in a very quick, admittedly, comment as to
32 whether there are any factors that may indicate why the
33 rate of return should be different for RailCorp or the
34 ARTC. It is just very quick. Is there any difference
35 there that suggests the rates of return should be
36 different?
37
38 MR CLACHER: This was thought about six years ago when
39 we were going through this exercise and it was put in the
40 too-hard basket then, and it is in the too-hard basket now.
41 Certainly the changes that have occurred raised this
42 question again and it needs to be thought about, but it may
43 be relevant with more coal, say, coming down to Vales Point
44 and Eraring power stations. Certainly when the Wyong
45 mine starts up, something will need to be in place.
46
47 MR MARCHANT: From an ARTC perspective - we are cautious

1 to talk about someone else's expectation except in some
2 context that our history in these things is not to come along
3 with ballpark measures and come to a compromise – we tend
4 to try to stick to about what we get close to and get on with
5 business, so we haven't tried to ballpark that. I am not sure
6 what RailCorp's risk profile would be or otherwise. Wyong
7 mine depends on economics. If and when that happened,
8 maybe we run on the one system which might be a
9 separate application in time.
10
11 MR BUGLER: I guess my view is that in the current
12 environment it is of perhaps academic interest rather than
13 practical interest if existing rates of return are
14 constrained or at the ceiling. The risk profiles are
15 probably different because they are fundamentally different
16 traffic sets that are involved and I would think it is a
17 whole different discussion that might enter into if it had the
18 relevance, but PN's view is that there is no obvious need
19 to put in place an alternative set of rates in the current
20 environment. We will address it when it is needed.
21
22 THE CHAIRMAN: Thank you all for very much, especially
23 on behalf of myself as a new member of the tribunal, as
24 today's session has been very productive. I think we have
25 a better understanding now of where you are coming from
26 than I could get from reading the submissions, so it has
27 been very helpful to us.
28
29 Just to add one word, that having had some experience in a
30 former job, being a shareholder of ARTC, or having
31 represented a shareholder as once the head of the
32 Department of Finance, I can tell you that ARTC is expected
33 to operate commercially, so the notion that there be any
34 sort of taxpayer subsidy does not come into it and the
35 tribunal has to, for its part, accept that ARTC is required
36 to operate commercially. Also one of the reasons why, as
37 has been said already, ARTC is regulated in terms of its
38 pricing, is so that it does not seek monopoly rents, but it
39 is then expected that it will invest to meet demand
40 consistent with that price. The question is to get the
41 price right.
42
43 Thank you all very much.
44
45 THE WORKSHOP CONCLUDED AT 12.20PM
46
47