

22 February 2017

Mr Grant Kari
Regulated Access – Rail
Australian Competition and Consumer ACCC
GPO Box 520
MELBOURNE VIC 3001

By email: grant.kari@accc.gov.au

Dear Grant

RE: WACC Responses

ARTC welcomes the opportunity to provide more detail supporting its WACC submission reflecting responses to HRATF's position in its stakeholder submission.

Inflation

ARTC firmly believes that the critical priorities for inflation forecasting are that it should be:

- Accurate: and
- Consistent with the underlying methodology used for all market parameters being market based calculations reflecting rates at the time of lodgement; particularly the risk free bond rate.

ARTC's proposed methodology continues the current WACC calculation and Building block methodologies by providing for the RAB to inflate annually based on actual inflation. The proposed change is only to ensure the market based methodology for determining WACC parameters is consistent across all parameters and delivers the most accurate assessment of future inflation at the time.

Market outcomes are, in the view of ARTC, the most objective form of data available. Market rates of the nominal bond (used in setting both debt and equity returns) reflect the inflation expectations of the market over the investment horizon. It is therefore entirely appropriate to align the market's view of inflation with the nominal bond rate, given the critical nature of that bond rate in the WACC determination. If the inflation expectation is subjective, then the bond rate must be subjective, and an alternative, objective, measure used for estimating the risk free rate. ARTC therefore strongly rejects the HRATF argument that the calculation of inflation expectations in investment decisions based on market data is subjective.

HRATF's submission implies that the accuracy of the inflation forecast is immaterial to the outcome, such that its accuracy should not be of concern to the ACCC; merely that it is consistent with previous methodologies (even if such methodologies are inaccurate). This statement only holds provided the same number is used in the WACC calculation and RAB escalation. Agreeing the forward escalation of the RAB is a substantial change from the existing methodology and reflects a methodology that has not been publicly submitted by either HRATF or ARTC.

This position also ignores the more relevant factor that the market inflation expectations are built into the risk free rate. Therefore, accepting the market determined risk free rate, being at historical lows due to the unique low inflation environment, whilst using an inaccurately high inflation forecast

penalizes ARTC in respect of WACC whilst exposing it to low inflation outcomes on RAB escalation. ARTC has currently been exposed to the spread between actual inflation and implied inflation in the WACC calculation under the existing HVAU which, in the current low inflation environment, has been to the benefit of customers.

ARTC is not proposing to amend the underpinning methodology of the building block model and the interaction of WACC and inflation through the creation of some fixed escalator as per the HRATF proposal. ARTC is merely proposing an adjustment in the method of forecasting inflation to provide greater accuracy and, more importantly, to reflect the market expectations built into the historically low bond rate which underpins the WACC calculation. This is critical given the explicit link between these bond rates, and the inflation expectation built into them, as highlighted in HRATF's own quote of the AER from its final Ausnet determination, which quote is reproduced below (highlights by ARTC), :

*It is both internally consistent and necessary to use a 10 year inflation expectation to convert a nominal return on debt with a 10 year term to a real return on debt with a 10 year term. Debt contracts are based on prices investors are willing to pay. **These prices reflect investor expectations of the risk free rate, debt risk premium and inflation over their investment horizon** at the time they raise this debt. Service providers, including JEN agree that this horizon (or term) for the return on debt is 10 years. Therefore, while debt contracts may fix the nominal cost of debt, **this cost incorporates investor expectations of inflation** over the next 10 years*

ARTC reiterates the objective nature of market based determinations and highlights the need for consistency in assessing all parameters on the same methodology to ensure that the linkages between the parameters are effectively managed. Using the inflation expectations embedded in the market's determination of the risk free rate is therefore the only objective methodology which provides consistency across the calculation of all WACC parameters.

ARTC therefore rejects HRATF's position that the market is subjective and that a fundamental change in the application of the building block model is a rational response merely because the objectively determined WACC outcome is inconsistent with HRATF's demand for a lower WACC.

GAMMA

ARTC would highlight that the ACCC did not make a determination on WACC in the 2011 HVAU approval. Therefore the statement that the ACCC approved a gamma of 0.45 is factually incorrect.

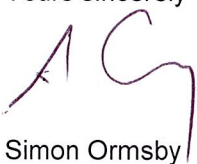
ARTC reinforces its view that gamma of 0.25 reflects market based assessments of the value of gamma, thereby ensuring a consistency of methodology across all WACC parameters.

MARKET RISK PREMIUM

ARTC notes that the MRP result in the final AER determination quoted by HRATF was 6.50%. HRATF's proposed upper range of 6.0% is therefore inconstant with the AER determination.

For further information regarding this information, please don't hesitate to contact Jonathan Teubner on (08) 8217 4248 or by email jteubner@artc.com.au.

Yours sincerely



Simon Ormsby

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