Issues Paper

Valuation approach for the Interstate network

12 September 2019

Contents

1. Introduction

1.1. Valuation of the Interstate network

On 6 March 2018, the Australian Rail Track Corporation (**ARTC**) submitted the 2018 Interstate Access Undertaking (**IAU**) for assessment under Part IIIA of the *Competition and Consumer Act 2010* (Cth) (**the Act**). The 2018 IAU was intended to replace the 2008 IAU, originally accepted by the Australian Competition and Consumer Commission (**ACCC**) on 30 July 2008 for a 10-year term. On 20 December 2018, the ACCC released a draft decision to not accept the 2018 IAU, setting out a number of concerns with ARTC's proposal. ARTC withdrew the 2018 IAU from the ACCC's assessment on 25 January 2019.

Valuing the Regulated Asset Base in the replacement IAU

One of the ACCC's major concerns with ARTC's 2018 IAU application was ARTC's proposal to roll forward the Regulatory Asset Base (**RAB**) from $3.7 billion in the 2008 IAU to $10 billion in the 2018 IAU, without sufficient evidence and justification that expenditures incurred by ARTC over the term of the 2008 IAU were prudent and efficient. As a result, and as set out in the ACCC's draft decision on the 2018 IAU, the ACCC could not determine whether ARTC's proposed RAB roll forward was economically efficient.

In preparation for submitting the replacement IAU, ARTC is proposing to address the ACCC's concerns with ARTC's RAB roll forward in the 2018 IAU, by revaluing the Interstate network, using the Depreciated Optimised Replacement Cost (**DORC**) methodology.[1] However prior to formally submitting its replacement IAU application, ARTC is seeking views from the ACCC about whether the ACCC would consider a full DORC revaluation appropriate.

The ACCC is now considering, and seeking stakeholders' submissions on, the following two options for valuing the RAB on the Interstate network in the replacement IAU:

- rolling forward the RAB from the 2008 IAU RAB value
- undertaking a full network revaluation, using the DORC methodology (with the ACCC engaging a consultant).

Given the significance of the value of the RAB, the ACCC considers that, if a full DORC revaluation is undertaken, that the ACCC rather than ARTC, should manage the revaluation process. This would include the ACCC engaging a consultant with rail engineering and economics expertise.

Preliminary view

The ACCC is concerned that ARTC has not been able to provide the documentation necessary for the ACCC to progress with a RAB roll forward in the replacement IAU, in particular, documentation to demonstrate capital expenditure (**capex**) prudency. The ACCC is concerned that even with additional time ARTC may not be able to provide the information necessary for the ACCC to undertake a robust RAB roll forward. In the absence of this information, the ACCC is considering alternative approaches to determine what capex is and is not considered prudent under a RAB roll forward, such as calculating and applying a benchmark to determine what proportion of capex is included in the RAB. However, the ACCC considers this process will be very complex and will require the ACCC to make assumptions where there are information gaps.

[1] See ARTC, *ARTC proposal to ACCC re Methodology for Revaluation of the Interstate Network*, August 2019.

Additionally, the ACCC considers an efficient RAB roll forward should exclude all replacement expenditures incurred over the term of the 2008 IAU, given these expenditures should have been expensed, not capitalised, under the 2008 IAU perpetual RAB model.[2] However, this process will require the ACCC to apply complex adjustments to ARTC's proposed RAB roll forward in the 2018 IAU. At this stage, the ACCC is unsure what adjustments will need to be made to the RAB under a RAB roll forward, and what assumptions will need to be made to support those adjustments. The ACCC is concerned that, where there are information gaps, it will need to make a number of assumptions that may not be robust.

The ACCC considers that for the purpose of regulatory certainty and consistency, a RAB roll forward is the best approach to setting the opening RAB in a new regulatory period. However, given the extent of information required, the risk that the required information may not be available even within an extended time period and the assumptions and complex adjustments that the ACCC will need to make to roll forward the RAB, the ACCC has formed a preliminary view that a full DORC revaluation is likely to be a more appropriate option for valuing the RAB in the replacement IAU. The ACCC is seeking submissions from stakeholders on the ACCC's preliminary view.

Access Charges

ARTC is committing to set Access Charges in its replacement IAU application that are independent of the RAB valuation approach and RAB value, stating:[3]

> *Importantly, ARTC would like to reaffirm its public statements that irrespective of the outcome of the RAB valuation ARTC will not change its published standing offer pricing. This is consistent with the pricing implemented under the IAU where there is no direct link between the costs incurred in maintaining, operating and investing in the network and the price for access in any one year. For this reason, ARTC is happy to commit to the statement that its pricing is independent of the RAB methodology.*

The ACCC understands that the Access Charges in its replacement IAU application will reflect the Access Charges that it proposed in the 'standing offer', during the assessment of the 2018 IAU.[4] The ACCC will consult on ARTC's proposed Access Charges as part of the ACCC's formal assessment of the replacement IAU.

The RAB value is a key input in determining the Ceiling Limit of individual Segments under the IAU, and consequently determines the upper bound under which Access Charges must be set under the IAU. Consequently, while ARTC is committing to set Access Charges independent of the RAB valuation approach and RAB value in the replacement IAU, the RAB value could have an effect on Access Charges in future regulatory periods. As such, the ACCC considers that it is crucial that the valuation approach taken to setting the RAB in the replacement IAU is appropriate, and the valuation process is robust and transparent. See Box 1 for further explanation on how the RAB value can affect Access Charges.

Next steps

As ARTC has not yet formally submitted the replacement IAU application, the ACCC is consulting on this Issues Paper outside of the assessment process under the Act.

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2 ACCC, *Draft decision: Australian Rail Track Corporation's 2018 Interstate Access Undertaking*, 20 December 2019, pp. 86–8.

3 ARTC, *ARTC proposal to ACCC re Methodology for Revaluation of the Interstate Network*, August 2019, p. 4.

4 ARTC published the 'standing offer' in September 2018, setting out prices that it intended to apply from 1 July 2019. The standing offer prices were replaced with the Access Charges set out in the current 2008 IAU, as varied on 28 February 2019. Source: https://www.artc.com.au/uploads/2018-IAU-Standing-Offer.pdf, viewed 29 August 2019.

Consequently, the ACCC will not make any formal decision until ARTC submits, and the ACCC assesses, the replacement IAU application under the Act. However, following consideration of stakeholder submissions to this Issues Paper, the ACCC will publish its view on what the ACCC considers is the most appropriate method for valuing the RAB for the replacement IAU. The ACCC considers this will provide clarity and certainty to ARTC and stakeholders, and assist to progress the formal submission of ARTC's replacement IAU application.

Stakeholders will have a subsequent opportunity to make submissions on the value of the RAB as part of the ACCC's consultation process once ARTC formally submits the replacement IAU for ACCC assessment.

The ACCC considers engaging on the appropriate valuation approach to setting the RAB is an important step in ARTC progressing its replacement IAU application for submission. The ACCC welcomes ARTC engaging with the ACCC and stakeholders to resolve key issues of concern arising from the 2018 IAU assessment process, prior to ARTC formally submitting the replacement IAU. The ACCC considers this approach will reduce the number of unresolved issues in ARTC's replacement IAU application, and accelerate the formal assessment process.

The ACCC acknowledges there are a number of other outstanding issues raised in the draft decision on the 2018 IAU, including concerns and proposals raised by stakeholders during the assessment of the 2018 IAU. The purpose of this Issues Paper is to seek stakeholder views on the most appropriate method for valuing the RAB in the replacement IAU. However, the ACCC will consult on other outstanding issues once ARTC formally submits the replacement IAU application for ACCC assessment.

Expiry of the 2008 IAU

The 2008 IAU is currently due to expire on 29 February 2020. On 29 July 2019, ARTC submitted an application to extend the 2008 IAU expiry date until 30 June 2020. In its application, ARTC states that:[5]

> *This extension is requested to ensure enough time for ARTC to resolve the outstanding asset valuation methodology issues with the ACCC and then [submit] a renewed IAU consistent with the issues raised by the ACCC in their Draft Decision on the withdrawn 2018 IAU published on 20 December 2018 and ensuring the renewal IAU is approved and commences from 1 July 2020.*

The ACCC is currently assessing this extension application.

[5] ARTC, *Australian Rail Track Corporation Ltd, RE: 2008 Interstate Access Undertaking Extension Application to the ACCC*, 29 July 2019, p. 1.

Box 1: The Regulatory Asset Base

What is the RAB?

The RAB is an accumulation of the value of capital investments that a service provider has made in its network.[6] On the Interstate network, this includes the value of the rail, sleepers, ballast, signal and communication assets that ARTC uses to provide below rail services.

When assets first become regulated, an initial calculation must be undertaken to determine the value of the RAB. Under the 2008 IAU, the opening RAB value was $3.7 billion (nominal) for the Interstate network.[7]

Initial calculation of the RAB

Several different valuation methodologies are taken across different regulated industries. Under the 2008 IAU, ARTC is required to value the opening RAB using the DORC valuation methodology.[8]

Under the DORC valuation methodology, regulated assets are valued by first calculating the cost of an 'optimised' Interstate network. This is determined based on the cost of constructing the Interstate network today using current technology, assuming the same service capability but adopting an optimised design. Second, the cost of an 'optimised' Interstate network is reduced to account for accumulated depreciation.

Value of the RAB over time

Over time, the RAB value needs to be updated from the initial value to reflect increases from capital investments that have expanded the Interstate network, and decreases as a result of depreciation. Typically, this is done by rolling forward the RAB to reflect new prudent capex, disposals and depreciation. Rolling forward the RAB at the start of each regulatory period is normal regulatory practice. This is the approach taken in several regulatory industries, including gas, electricity, telecommunications, and rail.

In the 2018 IAU, ARTC proposed to roll forward the RAB from $3.7 billion to an opening RAB value of $10 billion. However, in the draft decision on the 2018 IAU, the ACCC set out a number of concerns with ARTC's proposed RAB roll forward. To address the ACCC's concerns, ARTC is proposing to revalue the RAB in its entirety in the replacement IAU.

How does the RAB affect Access Charges?

The regulatory model in the IAU dictates that the revenue ARTC makes from Access Charges must be above a particular Floor Limit (unless agreed by ARTC) and below a particular Ceiling Limit.[9] As such, the Floor and Ceiling Limits determine the bounds within which Access Charges must ultimately be set.

The RAB is a critical input to determining the Ceiling Limit for individual Segments, and consequently the upper bound below which Access Charges must be set, in the IAU. However, on Segments where ARTC faces significant competition from alternative transport modes, such as road, ARTC may choose to set Access Charges well below the Ceiling Limit.

Under the 2008 IAU, the Ceiling Limit is set by calculating how much revenue is required for ARTC to recover the following:

- Depreciation, which allows ARTC to recover the RAB over the life of the assets on the Interstate network.
- A return on ARTC's investments, where the return is calculating by multiplying the RAB with the weighted average cost of capital (**WACC**).
- All operating and maintenance costs incurred by ARTC to provide services on the Interstate

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6 AER, *Why do we index the regulatory asset base?,* October 2017, p. 1.

7 Segments in WA, SA and Vic were initially valued using the DORC methodology in the 2002 IAU. In the 2008 IAU, the RAB value of existing Segments were rolled forward, and Segments in NSW that ARTC sought to incorporate into the IAU were valued using the DORC methodology.

8 Section 4.4(d)(i).

9 Section 4.4(a) of the 2008 IAU and proposed 2018 IAU.

network, acting efficiently and prudently.

Under the 2008 IAU, the Floor Limit is set by calculating how much revenue is required for ARTC to recover the incremental costs of maintaining the Interstate network. Incremental costs are made up of a subset of operating and maintenance costs.

ARTC has made a commitment that the RAB valuation approach and value of the RAB will not affect Access Charges during the term of the replacement IAU.[10]

However, ARTC may seek to change Access Charges in a future regulatory period. As the value of the RAB is a key input in determining the Ceiling Limit, the RAB value will affect the upper bound under which Access Charges in a future regulatory period must fall under. As such, the ACCC considers that it is crucial that the valuation approach taken to the RAB in the replacement IAU is appropriate, and the valuation process is robust and transparent, to ensure Access Charges cannot be set inefficiently high in future regulatory periods.

[10] ARTC, *ARTC proposal to ACCC re Methodology for Revaluation of the Interstate Network*, August 2019, p. 4.

1.2. Request for submissions

Given the significance of the valuation of the RAB, the ACCC is seeking submissions from stakeholders on the most appropriate valuation approach for setting the RAB in the replacement IAU.

The focus of this Issues Paper is on the valuation of the RAB, however the ACCC will undertake further consultation of other issues in ARTC's replacement IAU, after ARTC formally submits its application. This includes consulting on any remaining issues in ARTC's proposed 2018 IAU, and the ACCC's draft decision on the 2018 IAU.

Invitation to make a submission

Submissions should be addressed to:

Mr Matthew Schroder
General Manager
Infrastructure & Transport – Access & Pricing Branch
Australian Competition and Consumer Commission
GPO Box 520
Melbourne VIC 3001

Email: transport@accc.gov.au

The ACCC prefers to receive electronic copies of submissions, either in PDF or Microsoft Word format, which allows for the submission text to be searched.

Due date for submissions

Submissions on this Issues Paper are due by **5.00 pm (AEST) on 4 October 2019**.

The ACCC encourages stakeholders to make submissions as soon as possible and at the latest by **5.00pm (AEST) on 4 October 2019** to allow consideration by the ACCC and ARTC in the approach taken to value the RAB in the replacement IAU.

Confidentiality

The ACCC strongly encourages public submissions. Unless a submission, or part of a submission, is marked confidential, it will be published on the ACCC's website and may be made available to any person or organisation upon request. If stakeholders wish to provide a confidential submission, the ACCC asks that stakeholders provide a full copy of the document and a public version with the confidential information omitted, that will be published on the ACCC website.

Sections of submissions that are claimed to be confidential should be clearly identified. The ACCC will consider each claim of confidentiality on a case by case basis. If the ACCC refuses a request for confidentiality, the submitting party will be given the opportunity to withdraw the submission in whole or in part.

For further information about the collection, use and disclosure of information provided to the ACCC, please refer to the ACCC publication '*Australian Competition and Consumer Commission/ Australian Energy Regulatory Information Policy – the collection, use and disclosure of information'* available on the ACCC's website at the following link:

https://www.accc.gov.au/publications/accc-aer-information-policy-collection-and-disclosure-of-information

Further information

ARTC's letter setting out its proposed valuation approach of the RAB in the replacement IAU is available on the ACCC's website at the following link:

https://www.accc.gov.au/regulated-infrastructure/rail/artc-interstate-rail-access-undertaking/proposed-valuation-for-the-interstate-network

Public submissions made to this Issues Paper will also be published at this location.

ARTC's proposed 2018 IAU and related material, including stakeholder submissions, ACCC information requests, ARTC's responses, and the ACCC's draft decision are available on the ACCC's website at the following link:

https://www.accc.gov.au/regulated-infrastructure/rail/artc-interstate-rail-access-undertaking/interstate-rail-access-undertaking-2018

The current 2008 IAU, and related material, is available on the ACCC's website at:

https://www.accc.gov.au/public-registers/access-to-services-registers/s-44zzc2-access-undertaking-%E2%80%93-australian-rail-track-corporation-variation-of-12-december-2018-variation

For queries about any matters raised in this Issues Paper, please contact:

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2. Background

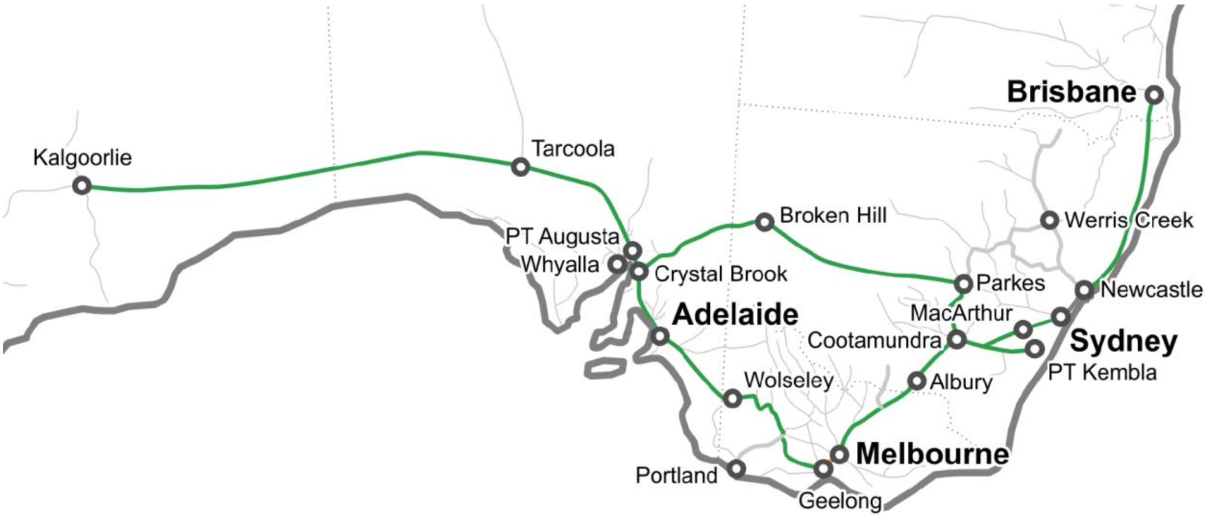
2.1. Industry context

ARTC began operations on 1 July 1998, the result of an Inter-Governmental Agreement among the Australian, NSW, Victoria, Queensland, South Australia and Western Australia Governments.[11]

ARTC was established as a consolidated rail track owner and operator to create a single avenue for all operators seeking access to the national interstate rail network, consistent with the National Rail Summit Heads of Agreement and the Competition Principles Agreement.[12]

The track managed by ARTC on the Interstate network extends for around 8 500 km from Western Australia to Queensland, through South Australia, Victoria and NSW (Figure 1).

Figure 1: ARTC's Interstate Network



Source: ARTC, *Defined interstate rail network*, https://www.artc.com.au/customers/standards/route/access/defined-interstate/, viewed 29 August 2019.

ARTC has a monopoly over the below-rail infrastructure used to transport bulk freight, intermodal freight and passengers over the Interstate network. While ARTC and the Australian rail industry face competition from road (especially for shorter non-bulk freight movements) and sea (for bulk freight), the ACCC recognises that all above-rail operators providing intermodal, bulk and passenger services on the Interstate network rely on ARTC to supply an important business input.

2.2. 2008 IAU

On 30 July 2008, the ACCC accepted the 2008 IAU under Part IIIA of the *Trades Practices Act 1974* (Cth). The 2008 IAU sets out the terms and conditions by which above rail operators can access the standard gauge tracks on the Interstate network.

The 2008 IAU was originally due to expire on 21 August 2018. ARTC has since varied the 2008 IAU to extend the expiry date to 29 February 2020. On 29 July 2019, ARTC submitted

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11 ARTC, *2018 Interstate Network Access Undertaking – Explanatory Guide*, 6 March 2018, p. 8.

12 National Competition Council, *National Competition Policy: Major areas for reform*, viewed 6 September 2019, ncp.ncc.gov.au/pages/reform.

an application to vary the 2008 IAU to extend the expiry date to 30 June 2020. The ACCC is currently assessing this application.[13]

In the original 2008 IAU, ARTC disaggregated the Interstate network into 10 Segments for applying Access Charges. In 2013, ARTC varied the 2008 IAU to include a new Segment– the Southern Sydney Freight Network (**SSFL**).

2.3. Variations to the 2008 IAU

Since the 2008 IAU has been in effect, ARTC has submitted six applications to the ACCC to vary the 2008 IAU, and conducted a five year review of its operation, summarised in Table 1.[14]

Table 1: Variations to the 2008 IAU

Matter	Finalisation Date	Status
Indicative access agreement variation 2008	9 October 2008	Withdrawn
Forecast expenditure variation 2012	18 April 2012	Approved
Southern Sydney Freight Line 2013	10 April 2013	Approved
Five year review of undertaking	9 May 2014	Finalised
Extension of term to 21 December 2018	25 July 2018	Approved
Extension of term to 28 February 2019	12 December 2018	Approved
Extension of term to 29 February 2020, increase in Access Charges[15] and new reconciliation mechanism	22 February 2019	Withdrawn[16]
Extension of term to 29 February 2020	28 February 2019	Approved
Extension of term to 30 June 2020	-	Under assessment

2.4. 2018 IAU application

On 6 March 2018, ARTC submitted the 2018 IAU to the ACCC for assessment under the Act. The 2018 IAU was intended to replace the 2008 IAU.

In the 2018 IAU, ARTC proposed to roll forward the RAB from $3.7 billion (in 2006–07) to $10 billion (in 2017–18).

In the 2018 IAU, ARTC sought to include two new Segments into the IAU:

- Metropolitan Freight Network (**MFN**) in Sydney
- Queensland Border to Acacia Ridge.

As noted above, ARTC previously varied the 2008 IAU to include the SSFL into the IAU.

13 See ACCC website: Extension of the 2008 Interstate Access Undertaking (to 30 June 2020).

14 As required under section 2.4(d) of the 2008 IAU.

15 ARTC proposed to increase Access Charges by CPI + 2 per cent on the Adelaide to Kalgoorlie Segments, and CPI on all other Segments (in line with the existing escalator in the 2008 IAU).

16 Following stakeholder submissions that raised a number of concerns, particularly regarding the reconciliation mechanism, and discussions with the ACCC, ARTC withdrew its initial application and submitted a revised application.

In the 2018 IAU, ARTC include the cost of the MFN, Queensland Border to Acacia Ridge and SSFL into the RAB–a total value of $1.25 billion.

ACCC information requests

During the assessment of the 2018 IAU, the ACCC formed the view that ARTC had not provided sufficient information in its application to assess the 2018 IAU against the statutory criteria set out in section 44ZZA(3) of the Act. Consequently, the ACCC made two formal information requests to ARTC, in May and September 2018.

The information requests required ARTC to provide on a Segment basis (as defined in the 2018 IAU), the following:

- access revenue, Ceiling Limits and Floor Limits
- actual and forecast maintenance and operating expenditure (**opex**)
- actual capex
- RAB value for Segments ARTC sought to roll into the RAB
- supporting documentation of the prudency of capex undertaken over the term of the 2008 IAU.

ACCC draft decision

On 20 December 2018, the ACCC released a draft decision to not accept the 2018 IAU. The ACCC set out a number of concerns with ARTC's application, including that ARTC's proposal to roll forward the RAB to an opening value of $10 billion for 2017–18 was not appropriate. In respect of the RAB roll forward, the ACCC had significant concerns with ARTC's approach to the treatment of the following:[17]

- **Initial RAB values for new Segments –** ARTC sought to include the cost of the MFN, Queensland Border to Acacia Ridge and SSFL into the RAB, at a value of $1.25 billion. However, ARTC did not include DORC assessments for MFN and SSFL, a requirement under the 2008 and 2018 IAU.[18] Further, the ACCC had a number of concerns with ARTC's submitted DORC assessment for the Queensland Border to Acacia Ridge Segment.
- **Prudency of capex –** Under the 2008 IAU, ARTC was required to seek the ACCC's approval to increase capex exceeding 20 per cent of that forecast capex for projects set out in Schedule H of the 2008 IAU.[19] Although there were a number of instances where ARTC's actual capex for those projects was more than 20 per cent higher than forecast, or not forecast for, ARTC did not seek the ACCC's approval. ARTC's response to the ACCC's information requests did not provide sufficient supporting documentation for the ACCC to undertake a prudency assessment of the 104 capex projects, at a cost of $2.8 billion, that ARTC sought to roll into the RAB for the 2018 IAU.
- **Capex funded by Government grants –** ARTC sought to include $581 million of capex funded through grants (or gifted funds) into the RAB, which would allow ARTC to earn a return on capital and depreciation. However, ARTC's response to the ACCC's information requests did not indicate that ARTC was required to generate a return to government for this grant funding.

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[17] ACCC, *Draft decision: Australian Rail Track Corporation's 2018 Interstate Access Undertaking*, 20 December 2019, pp. 39–98.

[18] Section 4.4(d)(i).

[19] Section 4.4(e) of the 2008 IAU.

- **Replacement expenditure –** ARTC sought to include expenditure on track assets into the RAB where under the 2008 IAU financial model, track assets on the Interstate network are assumed to exist in perpetuity, with assets maintained at a 'steady state' through Major Periodic Maintenance (**MPM**) expenditure. The ACCC considered that a number of these projects, such as those involving rerailing and resleepering, should be considered replacement expenditure and consequently not included in the RAB. Based on ACCC analysis, replacement expenditure accounted for approximately $1.5 billion of expenditure that ARTC sought to roll into the RAB. Similarly, ARTC sought to roll in $340.5 million of corridor capital into the RAB, which the ACCC considered should also be considered replacement expenditure and not rolled into the RAB.
- **Capex allocation to asset types –** The ACCC noted concerns with ARTC's allocation of capex between track (considered perpetual and not subject to depreciation) and signalling and communication (considered to have a finite life and subject to depreciation). In particular, ARTC allocated a number of capex projects as track assets, which the ACCC considered should be allocated as signalling and communication assets.
- **Asset disposals –** ARTC did not propose to include any disposals in the RAB roll forward for the 2018 IAU. However, the ACCC considered there were a number of projects undertaken by ARTC that necessitated the disposal of assets, such as rerailing and resleepering.
- **Financial models –** ARTC's financial model included instances of negative capex and capex on Segments not part of the Interstate network, which the ACCC considered was inappropriate.
- **Indexation –** ARTC proposed to apply indexation to the RAB from 2006–07 when the ACCC considered it should have been applied from the date of the opening RAB, 2007–08. Additionally, the ACCC considered ARTC applied the wrong inflation rate.

ARTC proposed no changes to its RAB annual roll forward equation in the 2018 IAU. In its draft decision, the ACCC considered the RAB annual roll forward equation remained appropriate.[20]

On 25 January 2019, following discussions with the ACCC, ARTC withdrew the 2018 IAU from the ACCC's assessment.[21]

20 ACCC, *Draft decision: Australian Rail Track Corporation's 2018 Interstate Access Undertaking*, 20 December 2019, p. 40.

21 ARTC, *2018 IAU – Withdrawal letter*, 25 January 2019.

3. Options for valuing the RAB

To address the ACCC's concerns with ARTC's proposed RAB roll forward in the 2018 IAU, ARTC is proposing to undertake a full revaluation of the Interstate network, using the DORC methodology, to set the opening RAB in the replacement IAU. However, prior to submitting its replacement IAU application, ARTC is seeking views from the ACCC about whether the ACCC would consider a full DORC revaluation appropriate.

Therefore, the ACCC is now seeking submissions from stakeholders on the most appropriate approach for valuing the opening RAB in the replacement IAU, between the following two options:

- rolling forward the RAB from the 2008 IAU RAB value
- undertaking a full network revaluation, using the DORC methodology (with the ACCC engaging a consultant).

Whichever valuation approach is applied to determine the opening RAB in the replacement IAU, the ACCC understands that ARTC does not propose any changes to the RAB annual roll forward equation in the replacement IAU. As noted above, in the 2018 IAU draft decision, the ACCC considered the RAB annual roll forward equation remained appropriate. This means, that following the valuation of the opening RAB for the replacement IAU, the ACCC understands that the RAB will be consequently rolled forward on an annual basis.

Section 4.4(d)(ii) of the 2008 IAU states that the RAB is annually rolled forward based on the following:

$$RAB_{t,\ start} = RAB_{t-1,\ end} = (1+CPI_{t-1}) \times RAB_{t-1,\ start} + Net\ Capex_{t-1} - Depreciation_{t-1}$$

where

$RAB_{t,\ start}$ is the RAB at the start of the relevant year (t) (which, for the first year following the Commencement Date, would be the Initial RAB).

$RAB_{t-1,end}$ is the RAB at the end of the preceding year (t–1) as applicable.

$RAB_{t-1,\ start}$ is the RAB at the start of the preceding year (t–1) as applicable.

CPI_{t-1} is the inflation rate for the preceding year (t–1), determined by reference to the All Groups Consumer Price Index Statistics published for the March quarter of that year.

$Net\ Capex_{t-1}$ is the net additions to the RAB in year t–1 (that is out-turn Capital Expenditure by ARTC less any disposals during period t–1) on a prudent basis.

$Depreciation_{t-1}$ is the Depreciation applicable to the RAB in year t–1.[22]

3.1. RAB roll forward valuation approach

Under the RAB roll forward valuation approach, the opening RAB in the replacement IAU would be calculated by rolling forward the RAB in the 2008 IAU, as per the RAB annual roll forward equation under section 4.4(d)(ii) of the 2008 IAU.

22 Under the 2008 IAU, track assets were assumed to exist in perpetuity and not depreciated, and signalling, train control and communications assets were assumed to have an economic life of 30 years.

As noted above, the ACCC had significant concerns with ARTC's proposed RAB roll forward in the 2018 IAU. Namely, that ARTC proposed an opening RAB value of $10 billion, without sufficient evidence and justification that expenditures incurred by ARTC over the term of the 2008 IAU were prudent and efficient. Given these significant concerns, the ACCC considers that the following adjustments to ARTC's proposed 2018 IAU RAB roll forward need to be made to calculate an economically efficient opening RAB in the replacement IAU:

- Any replacement expenditure that ARTC incurred over the term of the 2008 IAU would be removed from the proposed 2018 IAU RAB, as these expenditures should have been expensed rather than capitalised under the perpetual RAB model in the 2008 IAU.
- Consistent with section 4.4 of the 2008 IAU, any capex above that forecast in Schedule H of the 2008 IAU, plus 20 per cent, needs to be subject to a prudency assessment where only prudent capex is included in the opening RAB in the replacement IAU.
- Any capex not forecast in Schedule H needs to be subject to a prudency assessment where only prudent capex is included in the opening RAB in the replacement IAU.
- Any capex funded by government grants must be first subject to an assessment of the grant funding covenant. If the funding covenant did not require ARTC to earn a commercial return (such that the capital need not be recovered), then capex should be excluded from the RAB. If ARTC was required to earn a commercial return on the grant-funded capex then it must provide supporting documentation of the covenant in place. On provision of supporting documentation, the grant-funded capex is then subject to a prudency assessment outlined above.

The ACCC considers there are a number of practical issues with implementing the above adjustments to the 2018 IAU RAB, discussed further in chapter 4.

3.2. Full DORC revaluation approach

Alternatively, the opening RAB in the replacement IAU can be set by undertaking a full DORC revaluation. This includes revaluations for the Segments under the existing 2008 IAU and new valuations for:

- MFN
- Queensland Border to Acacia Ridge
- SSFL.

Under a full DORC revaluation, the Interstate network RAB would be revalued as follows:[23]

- Determine the 'optimised' Interstate network, within the constraints of the existing dimensions of the Interstate network:
  - determine the optimal configuration, size and scope of the Interstate network to meet current or expected demand
  - determine the optimal design of the system components and optimal modern technologies used to construct the system components.
- Calculate the Optimised Replacement Cost (**ORC**) of the Interstate network, where the 'optimised' Interstate network is determined above. The ORC should adjust for:
  - over-design, over-capacity and redundant assets

[23] This description is based on a previous review undertaken by Marsden Jacob Associates, engaged by the ACCC to review ARTC's proposed DORC valuation for the Gap to Turrawan Segment on the Hunter Valley rail network. See Marsden Jacob Associations, *Final Report: Review of Australian Rail Track Corporation's valuation for the Gap to Turrawan Segment of the Hunter Valley rail network: Report prepared for the Australian Competition and Consumer Commissioner*, 30 November 2013.

    - differences in operating costs.

- Calculate cumulative depreciation–which requires a calculation of the life consumed of the existing assets on the Interstate network. Existing assets are further depreciated to reflect the lower capital costs of modern equivalent replacement assets if their lives exceed that of existing assets when new.
- Calculate the DORC–equal to the ORC less cumulative depreciation.

This is consistent with the definition under section 4.4(d) of the 2008 IAU, which states that the ORC is 'the cost of replacement by commercially efficient application of the best known currently available technology based on existing capacity and performance characteristics of the asset.' Depreciation is then applied to the ORC to determine a DORC value.

ARTC previously engaged Booz Allen Hamilton (**BAH**) to undertake a DORC valuation of the Interstate network, in preparation of the 2008 IAU.[24] In this valuation, BAH applied optimisation principles based on a Modern Equivalent Form (**MEF**) of assets.

During the assessment of the 2008 IAU, the ACCC engaged PricewaterhouseCoopers (**PWC**) to review the BAH's DORC assessment. PWC defined the MEF as 'a modern set of standards that would be used today as the construction standard' for rail construction in Australia.[25]

Additionally, PWC described optimisation as an important step in the DORC process, stating:[26]

> *…it is important that assets included in the valuation are appropriately optimised and do not represent a 'gold plated' asset and takes appropriate consideration of those assets which have been made redundant due to technological changes (an example of these assets in rail is the updates in communication/signalling technologies).*

Adjustments for optimisation means that a DORC valuation is not necessarily representative of the assets currently used in the network. In particular, the optimisation adjustment relates to both the assets used in the network and the configuration of the network:

- **assets used in the network –** a DORC valuation utilises the MEF, irrespective of whether this reflects the assets currently in use. For example, BAH's DORC valuation for the 2008 IAU used an optimisation of concrete sleepers and 60kg rail throughout the Interstate network, when large parts of the network contained timber sleepers and 47kg rail.
- **configuration of the network –** a DORC valuation optimises the entire network, removing inefficient assets and ensuring the asset base is the minimum requirement to meet the demand of present and future traffic. Typical optimisation of rail networks such as the DORC valuation undertaken by BAH for the 2008 IAU includes the removal of additional tracks and sidings off the mainline.[27]

Following optimisation, depreciation of network assets is determined through condition assessment of the physical network, determination of asset economic life and remaining economic life.

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24 Booz Allen Hamilton, *Final Report: ARTC Standard Gauge Network DORC: Australian Rail Track Corporation Ltd*, January 2007.

25 PricewaterhouseCoopers, *ACCC: Review of ARTC DORC Valuation, Assessment of the reasonableness of the proposed valuation for the 10 year access undertaking*, March 2008, p. 19.

26 PricewaterhouseCoopers, *ACCC: Review of ARTC DORC Valuation, Assessment of the reasonableness of the proposed valuation for the 10 year access undertaking*, March 2008, p. 12.

27 Booz Allen Hamilton, *Final Report: ARTC Standard Gauge Network DORC: Australian Rail Track Corporation Ltd*, January 2007, p. 10.

Engaging a consultant

The value of the RAB will be a key issue in the replacement IAU and future IAU applications, affecting the Floor and Ceiling Limits, and consequently Access Charges.

Given the significance of the value of the RAB, the ACCC considers that if a full DORC revaluation is undertaken, that the ACCC, rather than ARTC, should manage the process, including engaging a consultant with rail engineering and economics expertise. If a full DORC revaluation is undertaken, the ACCC will publish the consultant's draft valuation report, and seek stakeholder submissions on the draft report.

4. Assessment of issues

Below, the ACCC sets out what it considers are the advantages and disadvantages of both approaches to valuing the RAB for the replacement IAU, in reference to the concerns outlined in the ACCC's draft decision on the 2018 IAU, specifically:

- prudency of capex
- depreciation
- replacement expenditure and disposals
- timing
- RAB value.

4.1. Prudency of capex

Under a RAB roll forward, the ACCC must be satisfied that capex incurred over the term of the 2008 IAU was incurred on a prudent basis, in order for ARTC to roll it into the opening RAB for the replacement IAU.[28]

The 2018 IAU draft decision set out the ACCC's concerns with ARTC's proposal to roll in capex relating to 104 projects, at a cost of $2.8 billion, into the RAB for the 2018 IAU, without sufficient supporting documentation demonstrating that capex was incurred on a prudent basis.[29]

Similarly, ARTC sought to roll in $581 million of capex funded from government grants (or gifted funds) into the RAB, without sufficient evidence demonstrating that ARTC was required to generate a return to government for this grant funding.

The ACCC sought information to demonstrate capex prudency in the information requests issued to ARTC during the assessment of the 2018 IAU, in May and September 2018 respectively. This included, for each project, documents demonstrating:

- decision documents for each project delivery phase, approved by ARTC's Business and Investment Committee and Board
- actual capex incurred
- cost-benefit analyses
- evidence of customer endorsement.

While ARTC provided some capex project documentation, the ACCC considered the information was insufficient to undertake a prudency assessment for all capex ARTC was seeking to roll into the RAB for the 2018 IAU. The ACCC understands that there were a number of reasons why ARTC did not provide sufficient information, including that ARTC did not have the data requested by the ACCC because 'there was no requirement within the IAU for the ACCC to assess cost efficiency or capital prudency on an annual basis.'[30]

Since May 2019, the ACCC has been working with ARTC to identify additional targeted documentation that would satisfy the ACCC's requirements while also ensuring the regulatory burden on ARTC is appropriate. In response, ARTC has provided some capex

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28 This is a requirement under section 4.4(d)(ii) of the 2008 IAU, and will ensure the opening RAB in the replacement IAU is economically efficient.

29 ACCC, *Draft decision: Australian Rail Track Corporation's 2018 Interstate Access Undertaking*, 20 December 2019, pp. 72–83.

30 ARTC, *ARTC Public Response to ACCC information request dated 20 September 2018*, 30 October 2018, p. 2.

information to the ACCC but has indicated that more time is needed to locate and provide additional relevant documentation. Moreover, the ACCC understands that some of this information may not exist, given ARTC's statement noted above that it did not maintain records due to there being no requirement in the 2008 IAU to provide data to the ACCC on an annual basis to assess cost efficient or capital prudency.[31]

If ARTC is unable to provide substantially more information on its historical capex projects, the ACCC will need to consider alternative approaches to determine what capex is included in the RAB under a RAB roll forward. For example, a possible alternative approach would be to calculate and apply a benchmark to all capex projects that the ACCC has insufficient information on, to determine what proportion of capex is considered prudent and can be included in the opening RAB for the replacement IAU. Such a benchmark could be calculated based on a weighted average of cost-benefit analyses in respect of particular capex projects, which ARTC provided to the ACCC during the assessment of the 2018 IAU. However, the ACCC considers that such a process is likely to be complex and may require the ACCC to make assumptions where there are information gaps. At this stage, the ACCC is unsure what adjustments will need to be made and what assumptions will need to be made to support those adjustments. The ACCC is concerned that where there are information gaps, it will need to make a number of assumptions that may not be robust.

As such, the ACCC considers that even with more time for ARTC to locate and provide additional capex documentation, it may still not be sufficient for the ACCC to undertake a robust RAB roll forward.

If the RAB is valued by undertaking a full DORC revaluation, assets are valued as they stand today, without any prudency assessment of capex incurred over the term of the 2008 IAU. This means that in undertaking a full DORC revaluation, the RAB can be valued without requiring ARTC to locate and provide documentation relating to capex incurred over the term of the 2008 IAU. This allows the ACCC to engage a consultant immediately, and start the process of valuing the RAB. Additionally, it removes the possibility of having to consider alternative approaches to assess prudency, in the absence of sufficient information.

However, under a full DORC revaluation, historic expenditure will not be assessed for prudency. ARTC has undertaken a large program of capex over the term of the 2008 IAU, which the ACCC has been unable to determine is prudent due to a lack of information provided by ARTC. A full DORC revaluation is likely to include a large proportion of this capex in the opening RAB for the replacement IAU. Although, a DORC revaluation will make adjustments for depreciation and optimisation, including adjusting for any redundant assets, over-design and over-capacity, capex that could be assessed as imprudent under a RAB roll forward with full information, could be assessed as prudent under a full DORC revaluation, and valued at its full replacement cost, as long as those assets are utilised to some degree.

4.2. Depreciation

Under the 2008 IAU financial model, track assets on the Interstate network are assumed to exist in perpetuity, with assets maintained at a 'steady state' through MPM expenditure. In the draft decision on the 2018 IAU, the ACCC considered that ARTC's proposal to continue applying a perpetual life to track assets was not appropriate. While the ACCC accepted this proposal in the 2008 IAU, it took a different view after learning how ARTC was treating perpetually lived assets in its financial model.[32]

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31 ARTC, *ARTC Public Response to ACCC information request dated 20 September 2018*, 30 October 2018, p. 2.

32 ACCC, *Draft decision: Australian Rail Track Corporation's 2018 Interstate Access Undertaking*, 20 December 2019, pp. 114–20.

To address the ACCC's concerns in the draft decision, ARTC states that it intends to remove the perpetual RAB model in the replacement IAU and instead introduce depreciation on all assets on the Interstate network.[33] However, ARTC states that 'updated asset specific valuations are required to allow depreciation profiles to be added into the RAB model'.[34]

ARTC states that under the current RAB model undertaken by BAH in 2006, which formed part of the 2008 IAU, remaining lives were assigned to aggregated line segments, rather than specific assets. This means that under the current RAB model, individual assets are aggregated into asset classes. For example, the value of rail, sleepers and ballast are aggregated under the asset class 'track.' The life expired component of track assets is calculated based on the following constant proportions:[35]

- ballast–32 per cent
- rail–33 per cent
- sleepers–35 per cent.

ARTC states that introducing depreciation to all assets in the current RAB will require:[36]

> *…both the deconstruction of line segment assessments to an individual asset basis and the assumed allocation of an aggregated value down to that level.*

Under the RAB roll forward, the ACCC considers that depreciation would be applied by depreciating the RAB value according to the remaining life of assets currently in the Interstate network, rather than the assets in place when the RAB was first valued by BAH in 2006. As part of this process, the RAB value will need to be assigned to each individual asset. Given the way assets are currently aggregated in the RAB, the ACCC acknowledges that it may be difficult to assign proportions to individual assets.

Under a full DORC revaluation, the value of the RAB can be assigned to each individual asset class based on appropriate proportions as determined by the DORC consultant.

4.3. Replacement expenditure and disposals

In its 2018 IAU application, ARTC sought to roll in expenditure on track assets associated with major resleepering and rerailing projects into the RAB. Based on ACCC analysis, replacement expenditure accounted for approximately $1.5 billion of expenditure that ARTC sought to roll into the RAB. Similarly, ARTC sought to roll in $340.5 million into the RAB associated with corridor capital. The ACCC considered that under the 2008 IAU perpetual RAB model, ARTC received MPM allowances, likened to 'depreciation' cash amounts, to replace, refurbish and maintain assets as necessary to keep track assets in a steady state. Consequently, the ACCC considered that replacement expenditure on track assets, and corridor capital, should have been expensed rather than capitalised.[37] In contrast the ACCC considered that, under the steady state assumption, expenditure that physically expands the IAU asset base, such as the addition of passing loops, should be classified as expansion capex and if prudent, be rolled into the RAB.[38]

Additionally, in the 2018 IAU, ARTC did not propose to reduce the value of the replacement expenditure by the value of any disposals as a result of replacing assets. In the draft

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[33] ARTC, *ARTC proposal to ACCC re Methodology for Revaluation of the Interstate Network*, August 2019, p. 6.

[34] ARTC, *ARTC proposal to ACCC re Methodology for Revaluation of the Interstate Network*, August 2019, p. 8.

[35] ARTC, *ARTC proposal to ACCC re Methodology for Revaluation of the Interstate Network*, August 2019, p. 4.

[36] ARTC, *ARTC proposal to ACCC re Methodology for Revaluation of the Interstate Network*, August 2019, p. 6.

[37] ACCC, *Draft decision: Australian Rail Track Corporation's 2018 Interstate Access Undertaking*, 20 December 2019, pp. 86–8.

[38] ACCC, *Draft decision: Australian Rail Track Corporation's 2018 Interstate Access Undertaking*, 20 December 2019, p. 86.

decision on the 2018 IAU, the ACCC considered that the extent of replacement work undertaken over the term of the 2008 IAU, such as rerailing and resleepering necessitated the disposal of assets.[39]

Under a RAB roll forward, the ACCC considers all replacement expenditures incurred over the term of the 2008 IAU, which ARTC sought to roll into the 2018 IAU RAB, should be removed. Excluding all replacement expenditures in the opening RAB in the replacement IAU also removes the need to calculate the value of disposals.

However, in practice this involves making complex adjustments to ARTC's financial model to identify and remove all replacement expenditures. This is particularly complicated where projects involved some costs related to expansion and some costs that should be considered replacement expenditure. The ACCC is concerned such a process is likely to be complex and may require the ACCC to make assumptions where there are information gaps. At this stage, the ACCC is unsure what adjustments will need to be made and what assumptions will need to be made to support those adjustments. The ACCC is concerned that where there are information gaps, it will need to make a number of assumptions that may not be robust.

In contrast, under a full DORC revaluation, expenditures incurred over the term of the 2008 IAU are not reviewed and ARTC's financial model does not need to be adjusted. Rather, under a full DORC revaluation, assets are valued as they stand today, without any assessment or categorisation of expenditures incurred over the term of the 2008 IAU. Under a full DORC revaluation, any assets that should have been disposed of are not included in the new valuation.

While a full DORC revaluation will optimise and depreciate the assets as they stand today the extensive replacement expenditure program undertaken by ARTC over the term of the 2008 IAU is likely to be included in the RAB valuation and as a result, increase the remaining life of some track assets. Additionally, as noted above, under the 2008 IAU perpetual RAB model, ARTC received MPM allowances, likened to 'depreciation' cash amounts, to replace, refurbish and maintain assets as necessary to keep track assets in a steady state. As a result, under a full DORC revaluation, ARTC may recover a value for depreciation on assets in the term of the replacement IAU and beyond that it has already recovered with these MPM allowances during the term of the 2008 IAU.

In contrast, under a RAB roll forward, the ACCC considers that no replacement expenditure incurred over the term of the 2008 IAU should be included in the RAB for the replacement IAU.

4.4. Timing

As noted above, the ability to do a robust RAB roll forward is dependent on ARTC locating and providing sufficient information to demonstrate prudency of capex incurred during the term of the 2008 IAU. As such, the timeframe for this is unknown. Additionally, there is a risk that in postponing the assessment of the replacement IAU so that ARTC has additional time to locate and provide this information may still result in an outcome where any additional information provided is still not sufficient for a robust RAB roll forward to be undertaken. In particular, the ACCC understands that some of this information may not exist, given ARTC's states that it did not maintain records due to there being no requirement in the 2008 IAU to provide data to the ACCC on an annual basis to assess cost efficient or capital prudency.[40]

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[39] ACCC, *Draft decision: Australian Rail Track Corporation's 2018 Interstate Access Undertaking*, 20 December 2019, pp. 94–5.

[40] ARTC, *ARTC Public Response to ACCC information request dated 20 September 2018*, 30 October 2018, p. 2.

ARTC previously engaged consultants to undertake a DORC valuation of four new Segments on the Hunter Valley network, the Gap to Turrawan Segments, to include in the Hunter Valley Access Undertaking and to roll in their value into the RAB.[41] The ACCC understands this valuation took approximately 3 months for ARTC's consultants to complete. The Gap to Turrawan Segments are approximately 130 km.

The valuation of the entire Interstate network will be a substantially bigger project. Including new Segments, the Interstate network is approximately 8 500 km. Considering the magnitude of the task of valuing the entire Interstate network, the ACCC considers a full DORC revaluation will take at least 6 months from commencement.

4.5. RAB value

In the 2018 IAU, ARTC sought to roll forward the RAB from $3.7 billion to $10 billion.

In the replacement IAU, under either valuation approach, the ACCC considers the RAB value is likely to be higher than the 2008 IAU RAB value due to any new Segments that ARTC seeks to include in the replacement IAU. However, the value of the RAB, under either valuation approach, is unknown.

Under a RAB roll forward, adjustments to the RAB value proposed in the 2018 IAU would be made for the following:

- Replacement expenditures would be removed (approximately $1.9 billion[42] in the 2018 IAU RAB)
- The following capex would be subject to a prudency assessment for consideration of inclusion in the RAB:
    - All capex above that forecast under Schedule H of the 2008 plus 20 per cent
    - Any capex not forecast, which is expansionary capex and not replacement expenditure
    - Any capex funded by government grants (approximately $582 million in the 2018 IAU RAB), for which ARTC provides sufficient supporting documentation that ARTC was required to earn a commercial return on that expenditure.

Under a full DORC revaluation, there may be some differences in the capex included in the RAB. For example, there may be some capex incurred over the term of the 2008 IAU that is considered prudent under a DORC valuation, but considered imprudent under a RAB roll forward with full information. Additionally, replacement capital incurred over the term of the 2008 IAU will likely increase the remaining lives of some track assets. However as noted above, under a full DORC revaluation, the RAB will be optimised for redundant assets, over-design and over-capacity.

5. Preliminary view

The ACCC's preliminary view is that it is preferable to undertake a full DORC revaluation of the Interstate network to set the opening RAB in the replacement IAU, with the ACCC engaging a consultant and managing the revaluation process.

The ACCC considers both options to value the RAB have their advantages and disadvantages. Additionally, while the value of the RAB is likely to increase from the 2008

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41 See Evans & Peck, *Australian Rail Track Corporation, Depreciated Optimised Replacement Cost Calculation for additional segments of the ARTC network, Gap to Turrawan Valuation Report*, 28 June 2013.

42 Including corridor capital.

IAU RAB value under both approaches, the ultimate RAB value in the replacement IAU is, at this stage, unknown under either valuation approach. However, the ACCC considers that undertaking a full DORC revaluation is the more practical option.

ARTC has not previously provided sufficient evidence in respect of capex projects incurred over the term of the 2008 IAU for the ACCC to be able to undertake a prudency assessment for inclusion of capex in the RAB. The ACCC is concerned that even providing ARTC additional time to locate and provide relevant capex information, the ACCC may still not have enough detail to undertake a robust RAB roll forward, and as a result of this delay, the assessment of the replacement IAU will be postponed.

If the ACCC were to progress with a RAB roll forward, the ACCC would consider an alternative approach to assessing the prudency of capex, for example calculating and applying a benchmark to determine what proportion of capex is and is not included in the RAB. However, the ACCC considers this process is likely to be complex and may require the ACCC to make assumptions where there are information gaps. At this stage, the ACCC is unsure what adjustments will need to be made and what assumptions will need to be made to support those adjustments. Further, the ACCC considers that such adjustments may not be robust.

Additionally, under a RAB roll forward, the ACCC considers all replacement expenditures incurred over the term of the 2008 IAU should be excluded from the opening RAB in the replacement IAU. However, in practice this involves the ACCC making complex adjustments to ARTCs 2018 IAU RAB model to identify and remove all replacement expenditures. Similarly, this process is likely to be complex and may require the ACCC to make assumptions where there are information gaps. As noted above, at this stage, the ACCC is unsure what adjustments will need to be made, and what assumptions will need to be made to support those adjustments.

The ACCC considers that a full DORC revaluation:

- avoids the need to undertake an assessment of the prudency of historical capex
- avoids the need to identify and remove replacement expenditure incurred over the term of the 2008 IAU
- allows for specific and individual depreciation profiles to be applied at the asset level
- provides for the ACCC to engage a consultant immediately to start revaluing the RAB for the replacement IAU.

The ACCC acknowledges that a RAB roll forward is preferable to maintain regulatory consistency. In the ACCC's final decision on the 2008 IAU, the ACCC stated that:[43]

> *…[T]he ACCC considers that revaluation should not normally be allowed under a DORC framework, because it creates unnecessary uncertainty, may encourage gaming and increases regulatory costs.*

The ACCC accepted the RAB revaluation as part of the 2008 IAU because it was anticipated in the 2002 IAU. However, ARTC committed to locking in the value of the Interstate network assets going forward.[44] As such, undertaking a full DORC to set the opening RAB in the replacement IAU is inconsistent with ARTC's commitment in the 2008 IAU.

The ACCC maintains its view that, ordinarily, RAB revaluations should not be allowed. However, the given lack of capex prudency information, and that a RAB roll forward will

[43] ACCC, *Final decision: Australian Rail Track Corporation, Access Undertaking – Interstate Rail network*, July 2008, p. xvii.

[44] ACCC, *Final decision: Australian Rail Track Corporation, Access Undertaking – Interstate Rail network*, July 2008, p. xvii.

require complex adjustments to ARTC's financial model, the ACCC's preliminary view is that it is preferable to undertake a full DORC revaluation in this instance.

If the ACCC engages a consultant to undertake a full DORC revaluation, the ACCC expects ARTC to work cooperatively with the ACCC's consultant to progress the assessment as quickly as possible.

ACCC expectations for the replacement IAU

The reasons that the ACCC considers a robust RAB roll forward is not currently possible is due to:

- ARTC not maintaining adequate records of its expenditure incurred over the term of the 2008 IAU
- ARTC not having clear and transparent capitalisation rules that are consistent with its 2008 IAU financial model.

As noted above, the ACCC generally considers that the revaluation of the RAB is less desirable compared to a RAB roll forward. While in this instance, the ACCC's preliminary view is that a full DORC revaluation is the preferred option, the ACCC expects that in the replacement IAU, and future IAU applications, the RAB will be rolled forward.

To ensure that ARTC maintains accurate and detailed records of its expenditure and complies with its financial model, the ACCC expects that the replacement IAU should clearly set out the process for the annual RAB roll forward, including what sorts of information ARTC will provide to the ACCC on an annual basis, in order for the ACCC to undertake a prudency assessment for inclusion of capex in the RAB, and assess ARTC's annual RAB roll forward. The ACCC considers this is essential for promoting transparency and accountability in the process, and ensuring ARTC maintains records of all relevant projects over the term of the replacement IAU.

To facilitate an annual assessment, the ACCC considers ARTC should provide, at a minimum, information sufficient for the ACCC to assess:

- prudency, efficiency and classification of expenditures
- depreciation and disposal of assets in the RAB.

Additionally, the ACCC expects that the replacement IAU should set out clear and transparent capitalisation rules in respect of what expenditures will be treated as capital and consequently rolled into the RAB, and what expenditures will be expensed.

6. Questions for stakeholders

The ACCC is seeking submissions from stakeholders on which valuation approach is most appropriate for setting the RAB in the replacement IAU. The ACCC is seeking responses from stakeholders on the questions in Table 2.

The ACCC will undertake further consultation on the value of the RAB and other issues in the replacement IAU, including outstanding issues from the assessment of the 2018 IAU, once ARTC formally submits its replacement IAU application.

Table 2: Questions for stakeholders

1)	Do stakeholders prefer a RAB roll forward or a full DORC revaluation?
2)	Do stakeholders have comments on the use of a RAB roll forward for setting the RAB for the replacement IAU?
3)	Do stakeholders have comments on the use of a full DORC revaluation for setting the RAB for the replacement IAU?
4)	Do stakeholders have comments on the effect of the valuation of the RAB in setting Access Charges in future IAU applications?
5)	If a full DORC valuation was undertaken, do stakeholders have comments on the suitability of the ACCC engaging a consultant to undertake the valuation?
6)	Do stakeholders have any other comments on the approach to valuing the RAB?

7. Next steps

As ARTC has not yet submitted the replacement IAU to the ACCC for assessment, the ACCC is consulting on this Issues Paper outside of the formal assessment process under Part IIIA of the Act. As such, the ACCC is not making a formal decision. However, following consideration of submissions to this Issues Paper, the ACCC will publish its view on what the ACCC considers is the most appropriate method for valuing the RAB for the replacement IAU. The ACCC considers this will provide clarity and certainty to ARTC and stakeholders, and assist to progress the formal submission of ARTC's replacement IAU application.

7.1. Expiry of the 2008 IAU

The 2008 IAU is currently due to expire on 29 February 2020.[45]

On 29 July 2019, ARTC submitted an application to extend the 2008 IAU expiry date until 30 June 2020. ARTC states that:[46]

> *This extension is requested to ensure enough time for ARTC to resolve the outstanding asset valuation methodology issues with the ACCC and then [submit] a renewed IAU consistent with the issues raised by the ACCC in their Draft Decision on the withdrawn 2018 IAU published on 20 December 2018 and ensuring the renewal IAU is approved and commences from 1 July 2020.*

The ACCC is currently assessing ARTC's extension application.

7.2. Replacement IAU

Following the ACCC publishing its view on what the ACCC considers is the most appropriate method for valuing the RAB for the replacement IAU, the ACCC expects that ARTC will adopt the valuation approach that the ACCC considers is most appropriate, and once calculated, the RAB value, in its replacement IAU application. The ACCC notes that stakeholders will have the opportunity to make submissions on the value of the RAB as part of the ACCC's formal consultation process once ARTC submits the replacement IAU.

There are a number of other outstanding issues raised by the ACCC and stakeholders during the assessment of the 2018 IAU. The ACCC expects ARTC will address these issues during consultation with stakeholders and the ACCC in preparation for submitting the replacement IAU for ACCC assessment.

The timeframe for finalising the assessment of the replacement IAU is extremely tight. However, the ACCC considers that ARTC can progress the development of the replacement IAU, and concurrently progress with the valuation of the RAB. Additionally, the ACCC considers the ability to progress the assessment of the replacement IAU in a timely manner is highly dependent on the level of engagement from ARTC and stakeholders to resolve the outstanding matters raised by stakeholders and the ACCC in the 2018 IAU draft decision.

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[45] On 28 February 2019, the ACCC consented to ARTC's 22 February 2019 application to vary the 2008 IAU to extend the term of the 2008 IAU until 29 February 2020, and extend the notice period that ARTC must give to the ACCC of its intention to submit a replacement IAU.

[46] ARTC, *Australian Rail Track Corporation Ltd, RE: 2008 Interstate Access Undertaking Extension Application to the ACCC*, 29 July 2019, p. 1.

8. Legal framework

The ACCC is seeking submissions on the most appropriate approach to valuing the RAB for the replacement IAU. As ARTC has not yet formally submitted the replacement IAU to the ACCC for assessment under section 44ZZA(1) of the Act, the ACCC is undertaking consultation outside of the formal assessment process under section 44ZZBD of the Act. However, the approach taken to value the RAB will be a key input in ARTC's replacement IAU application. Moreover, the ACCC will likely have regard to submissions in response to this Issues Paper in the formal assessment process. As such, in considering submissions to this Issues Paper, the ACCC will have regard to the matters set out in section 44ZZA(3) of the Act, as it would in assessing a formal application under section 44ZZA(1) of the Act.

Section 44ZZA(3) of the Act provides that the ACCC may accept an access undertaking if it thinks it appropriate to do so, having regard to the following matters:

- the objects of Part IIIA of the Act, which are to:
  - promote the economically efficient operation of, use of and investment in the infrastructure by which the services are provided, thereby promoting effective competition in upstream and downstream markets, and
  - provide a framework and guiding principles to encourage a consistent approach to access regulation in each industry
- the pricing principles specified in section 44ZZCA of the Act (see further below)
- the legitimate business interests of the provider of the service
- the public interest, including the public interest in having competition in markets (whether or not in Australia)
- the interests of persons who might want access to the service
- whether the undertaking is in accordance with an access code that applies to the service, and
- any other matters that the ACCC thinks are relevant.

In relation to the pricing principles, section 44ZZCA of the Act provides that:

- regulated access prices should:
  - be set so as to generate expected revenue for a regulated service that is at least sufficient to meet the efficient costs of providing access to the regulated service or services, and
  - include a return on investment commensurate with the regulatory and commercial risks involved
- access price structures should:
  - allow multi-part pricing and price discrimination when it aids efficiency, and
  - not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operations is higher, and
- access pricing regimes should provide incentives to reduce costs or otherwise improve productivity.