DORC valuation of ARTC's Interstate network

ACCC supplementary paper to GHD's valuation report

21 October 2021

1. Purpose

This paper provides a conclusion to the ACCC's Depreciated Optimised Replacement Cost (DORC) valuation of the Australian Rail Track Corporation's (ARTC) Interstate network, which commenced in April 2020. The paper summarises stakeholders' views on GHD Advisory's (GHD) draft report on the DORC valuation.

2. Background

2.1. The uncertain role of a regulatory asset base in the regulatory framework for ARTC's Interstate network

On 25 August 2021, the ACCC released an Issues Paper seeking stakeholders' views on the competitive environment the Interstate network faces – now and in the future; the specific need for regulation of the Interstate network; and where it is required, the most appropriate regulatory approach.

The ACCC is seeking stakeholders' views on the regulatory framework due to concerns that the DORC methodology may be unsuitable for the Interstate network. The ACCC has formed this view given our preliminary analysis of the valuation indicated the ceiling limits that would be established using the DORC are high compared to the revenue ARTC is likely to earn.

We are concerned the high ceiling limits may allow ARTC to significantly increase prices in the future and earn a return on historical non-commercial assets (assets that an efficient commercial operator would not have invested in).

At this stage, it is unclear whether the regulatory framework for the Interstate network will continue to use a regulatory asset base (RAB) (whether derived from a DORC or another method) and thus whether GHD's DORC valuation is required.

2.2. The original rationale for revaluing ARTC's Interstate network

On 6 March 2018, ARTC submitted its 2018 Interstate Access Undertaking (IAU) application intended to replace the 2008 IAU.[1] Following its assessment, the ACCC released a draft decision to not accept the replacement undertaking under Part IIIA of the *Competition and Consumer Act 2010* (Cth), setting out a number of concerns with ARTC's proposal.

Under the current undertaking, the RAB is a key input to the calculation of ceiling limits.[2] However, the ACCC was unable to determine the prudency of ARTC's capital expenditure nor whether the proposed RAB roll forward was appropriate.[3]

On 25 January 2019, ARTC withdrew its 2018 IAU application from the ACCC's consideration and subsequently proposed to address some of the ACCC's concerns by revaluing the Interstate network, using the DORC methodology.[4]

On 8 November 2019, the ACCC published its Statement of Approach stating the ACCC would appoint a consultant to undertake a DORC valuation of the Interstate network to

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

2 ARTC's 2008 IAU calculates the ceiling limits in accordance with clause 4.4(c) and 4.4(d) by determining how much revenue is required for ARTC to recover the Economic Cost of one or a group of its Segments.

3 The Australian Energy Regulator in its 2017 paper "Why do we index the regulatory asset base?" describe the RAB as the accumulated value of prudent capital investments that an infrastructure provider has made in its network.

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

determine the RAB value.[5] On 23 April 2020, the ACCC engaged GHD to conduct the DORC valuation.

2.3. GHD's Depreciated Optimised Replacement Cost valuation

On 15 June 2021, the ACCC published GHD's draft valuation report seeking stakeholders' views with an accompanying consultation paper that noted our concerns about the DORC methodology. The stakeholder submissions received during consultation are available on the ACCC's website.[6]

2.4. Further information

For queries about any matters raised in this supplementary paper, please contact:

Greg Mckay
Acting Director
Regulated Access and Pricing
Infrastructure & Transport – Access & Pricing Branch
Phone: 08 8456 3541

Email: greg.mckay@accc.gov.au

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5 Available here: www.accc.gov.au/regulated-infrastructure/rail/artc-interstate-access-undertaking/proposed-valuation-for-the-interstate-network/statement-of-approach.

6 Available here: www.accc.gov.au/regulated-infrastructure/rail/dorc-valuation-of-the-interstate-network.

3. Consultation responses and the ACCC's approach to GHD's valuation report

3.1. Consultation responses

In response to its consultation paper, the ACCC received stakeholder submissions from ARTC, Pacific National, Yancoal Australia (Gloucester Coal Ltd) and the Hunter Rail Access Task Force (HRATF).

ARTC stated that as its 'pricing is independent of an economic ceiling calculated based on the traditional building block approach… it is therefore likely that the actual value of the DORC as calculated by GHD has no role to play in future IAU regulation'.[7]

ARTC expressed its belief that there is little benefit of stakeholders engaging in a detailed rebuttal of GHD's valuation report. Despite this, ARTC considered it important to express its concerns with the valuation, so they can be revisited if necessary.[8]

Pacific National said that GHD's valuation report 'should not be relevant in determining Network Access Charges for ARTC'. Pacific National said it would not 'spend time on critiquing the DORC valuation outcome in detail but rather highlight the major concerns and issues in the Report'.[9]

Gloucester Coal and the Hunter Rail Access Taskforce's submissions did not comment directly on GHD's valuation report. Rather, both Gloucester Coal[10] and the Hunter Rail Access Taskforce[11] expressed a desire to participate in the ACCC's consideration of changes to the regulatory framework for ARTC's Interstate network.

3.2. ACCC approach to GHD's valuation report

As discussed above, on 25 August 2021, the ACCC released an Issues Paper seeking stakeholders' views on a future regulatory framework. While the continued use of a DORC-derived RAB in the regulatory framework is an option set out in that paper, we also note that we have concerns that the DORC methodology may be unsuitable for the Interstate network.

The submissions on GHD's draft valuation report indicate stakeholders' reluctance to expend time and resources in responding to the consultation, given the role of the RAB in the regulatory framework is uncertain.

In light of this, the ACCC and GHD have taken the approach of summarising, rather than responding to, stakeholders' views on the draft valuation report. The ACCC recognises that further consideration of stakeholder issues and concerns (and potentially further consultation) would likely be required to finalise GHD's valuation if it were to be used in future.

GHD's report summarises, in table form, stakeholders' comments on the assumptions and technical processes undertaken by GHD to value ARTC's Interstate network. These stakeholder submissions relate to the replacement cost of required assets, selecting modern

7 ARTC, *PUBLIC ARTC Response to ACCC IAU DORC and Framework Consultation*, July 2021, p 6.

8 ARTC, *PUBLIC ARTC Response to ACCC IAU DORC and Framework Consultation*, July 2021, p 6.

9 Pacific National, *RE: DORC valuation of ARTC's Interstate network*, 2 August 2021, p 1.

10 Yancoal (Gloucester Coal Ltd), *Submission on DORC valuation of ARTC's Interstate network – ACCC consultation paper*, 28 July 2021.

11 Hunter Rail Access Taskforce, *Submission on DORC valuation of ARTC's Interstate network – ACCC consultation paper*, 28 July 2021, p 1.

equivalent assets, optimising the network, calculating the cost of interest during construction, and depreciation. A copy of GHD's concluding valuation report is available on the ACCC's website.[12] In section 4, we summarise stakeholder submissions on the matters we raised in our consultation paper on the DORC valuation.

4. Stakeholder submissions on the issues raised in our consultation paper

In the ACCC's terms of reference, we stated we would provide GHD with certain inputs to use in the valuation. This includes the Weighted Average Cost of Capital (WACC) used to calculate operating cost savings and the cost of interest during construction. The ACCC also provided GHD with a list of government grant-funded assets to exclude from the RAB following the DORC calculation. The ACCC also set out how the RAB value should be calculated and maintained. This section summarises the views expressed by ARTC and Pacific National on these matters.

4.1. Weighted Average Cost of Capital

The ACCC provided GHD with a pre-tax real rate of 4.37% for use as both the rate for calculating the cost of interest and the rate for discounting operating expenditure savings to the valuation date. The ACCC based this on the WACC calculated in the ACCC's draft decision on ARTC's 2018 IAU application, and updated the risk-free rate, debt risk premium and inflation expectations. In taking the approach to update only these WACC parameters, the ACCC had regard to the resourcing and time required of all stakeholders if it fully updated and consulted on all WACC parameters and the resulting WACC value.

See chapter 7 of GHD's draft valuation for further discussion on how GHD calculated interest during construction, and chapter 10 for a discussion of the operating cost savings process.

4.1.1. Stakeholder submissions

ARTC highlighted significant concerns with the ACCC WACC assessment used to calculate the value of operating cost savings, including:

- market parameters – ARTC argued that the ACCC's approach appeared inconsistent as it assumes an investor takes a long-term view of inflation and market risk parameters, and a short-term view of the risk-free rate
- asset Beta – ARTC challenged the ACCC's use of Class 1 Railroads as comparators for ARTC's asset risk, and its assessment of asset risk in 2018 given the statement that revenue risk is low in a perpetual model
- national inconsistency – ARTC noted a disparity of 160 basis points between the ACCC's assessed efficient rate of return for the Hunter Valley Coal network and the Economic Regulation Authority Western Australia's assessed efficient return applicable on the segment of the Interstate network owned by Arc Infrastructure (between Kalgoorlie and Perth).

Pacific National expressed the view that the 10-year (Commonwealth Government) bond rate is a more appropriate proxy for the WACC, given federal and state governments typically fund ARTC's assets.

12 Available here: www.accc.gov.au/regulated-infrastructure/rail/dorc-valuation-of-the-interstate-network/concluding-report.

4.2. Treatment of government grants in the regulatory asset base

In the 2018 IAU, ARTC sought to include $581 million of capital expenditure funded by government grants between 2007–08 and 2017–18 in the RAB. ARTC did not provide any documentary evidence demonstrating it was required to generate a commercial return to government on this grant funding. Additionally, the cost-benefit analysis undertaken by ARTC for its capital expenditure projects, including those funded by grants, showed ARTC applied non-financial benefits (for example, environmental impacts) to justify the expenditure. In its 2018 IAU draft decision, the ACCC did not consider it appropriate for ARTC to include grant-funded assets in the RAB.

Following consultation on the appropriate approach to valuing the RAB, the ACCC reiterated its position in the Statement of Approach noting:

> *The ACCC considers that as a general principle, assets funded by government grants should be excluded from the RAB, unless ARTC can provide supporting documentation demonstrating that ARTC was required to earn a commercial return on that funding. The ACCC considers it inappropriate to include capex into the RAB that was intended by government to achieve non-commercial objectives, such as funding intended to address externalities.*[13]

During the valuation process, ARTC provided the ACCC with an itemised list of capitalised costs funded by government grants. In turn, the ACCC provided the list to GHD to exclude the value of the assets funded by government grants from the RAB following the DORC calculation.

GHD excluded $447 million of assets funded by government grant from the RAB, following the DORC valuation. See chapter 11 of GHD's draft valuation for further discussion on the process.

4.2.1. Stakeholder submissions

ARTC expressed the following views:

- It is expected to earn a commercial return on grant-funded assets given shareholders do not differentiate dividend expectations between grant and equity funding.
- The ACCC, in removing the grant funded assets:
  - ignored shareholder's verbal confirmation to the ACCC that ARTC is required to earn a commercial return on Commonwealth grant funding
  - applied a test which neither ARTC nor its shareholders were aware had to be met, if funding documentation did not specifically mention the funding had a commercial purpose.
- If the RAB excludes government grant assets, ARTC is not compensated for operational risk in contracting and managing these assets.
- ARTC has been working with its shareholders on wording to include in future grant-funding documents to ensure this issue is resolved going forward.

Pacific National expressed the following views:

- It supports the notion of removing grant funding from the asset calculation.

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[13] ACCC, *Statement of Approach: Valuation of the Interstate network*, 8 November 2019, p 11.

- The ARTC network contains legacy assets established with government spending.
- The recognition and removal of $447 million (of government grant-funded assets) is low compared to GHD's network replacement cost of $19 billion.

4.3. Calculation and maintenance of the RAB

In the event that ARTC uses the DORC valuation (as of 1 July 2019) as a basis for the RAB in a future undertaking, it would need to be updated to set the opening RAB in the replacement IAU from the date it commences. In the consultation paper accompanying GHD's draft valuation report, the ACCC stated that the updated RAB would need to incorporate prudent and efficient capital expenditure, indexation, recalculation of the present value of operational expenditure savings, disposal of assets and depreciation.

4.3.1. Stakeholder submissions

ARTC expressed the following views:

- It is committed to transparency of its performance, including provision of information to enable a prudency review of capital projects.
- It is committed to engaging with customers, stakeholders and the ACCC to develop its proposed framework.
- Until there is clarity on what the framework will be, and if a RAB is used, committing resources and incurring costs to meeting prudency requirements (collating and maintaining records) made since the valuation date is not an efficient use of resources.

Pacific National expressed an alternative approach to rolling forward the RAB using the Consumer Price Index.

5. Next steps

Stakeholder submissions on the Issues Paper closes on 22 October 2021. These submissions will be published at: www.accc.gov.au/regulated-infrastructure/rail/artc-interstate-access-undertaking/the-regulatory-framework-for-artcs-interstate-network/issues-paper-and-submissions.

If the regulatory framework continues to use a RAB and a DORC valuation is required, the ACCC may re-evaluate GHD's DORC valuation and stakeholder submissions, and subsequent submissions in response to any further consultation, as part of that process.