

ARTC proposal to ACCC re Methodology for Revaluation of the Interstate Network

August 2019

ARTC



Table of Contents

ARTC proposal to ACCC re Methodology for Revaluation of the Interstate Network.....	1
August 2019	1
1 Overview	3
2 Historic RAB Model	4
3 Network upgrades	5
4 ACCC's 2018 Draft decision	6
5 Depreciation	6
6 Network Consistency	7
7 Regulatory and Accounting Consistency	7
8 Capital prudence	8
9 Conclusion	8

1 Overview

ARTC's proposed 2018 Interstate Access Undertaking (IAU) incorporated the methodology of determining the Regulatory Asset Base (RAB) that was defined in the 2008 IAU; namely a RAB based on a perpetual asset life that therefore did not incorporate depreciation of the network. This methodology was developed for the original 2002 IAU and reflected an assumption that the rail network would exist in perpetuity, therefore defining the network as having a perpetual economic life with no depreciation. The approach to developing the 2008 IAU was to provide as much continuity as possible, therefore the perpetual economic life assumption was maintained.

Given the substantial investments in the network throughout the term of the 2008 IAU, and the consequent changes to network capability and asset configuration, it is reasonable to question the accuracy of the perpetual network assumption. The ACCC's Draft Decision correctly identifies that, whilst the network may be perpetual (based on an assessment of current technology), the individual assets that make up the network are not and have defined lives.

ARTC consider that an accurate RAB model would therefore incorporate depreciation of these specific assets, as well as allowing for the replacement and disposal of these assets via corridor capital works. Such a model would therefore allow an accurate basis to allow the calculation of an economic ceiling based on the return on and of that capital against which ARTC's proposed pricing offers can be measured.

ARTC supports the inclusion of Depreciation in the future RAB model; however, believes for reasons outlined below, that the historical RAB model is incompatible with such an approach.

The period of the 2008 IAU was historic in respect of the investment undertaken to upgrade the interstate freight network. This investment, plus agreement with the Queensland State Government on a lease for the segment of the track from the Queensland Border to the intermodal terminal at Acacia Ridge, has resulted in a fundamental (and unique from an Australian infrastructure perspective) change to the scope and alignment of the Interstate Freight Network.

The ACCC's Draft Decision requested that new DORC calculations be undertaken in respect of the inclusion of the new segments. In addition, it has sought further information in respect of the prudence of the capital projects whilst proposing a definition of capital expenditure that only reflects explicit capacity expansions (such as loops and turn outs) with resleeper and rerailing projects classified as operating expenses given they reflect maintenance of the network.

ARTC is concerned that adoption of such recommendations would deliver a RAB model that inconsistently values segments across the network and one that applies inconsistent capital definitions across its two undertakings (and with formal accounting standards). Finally, the draft decision to expense network upgrades, despite their network standard and condition enhancing impacts, would ensure that the RAB model is inconsistent with the technical reality of the network.

The application of the ACCC's Draft Decision to the historic DORC model therefore creates inconsistencies between that historic model and the future requirements sought by the ACCC based upon:

- The ability to incorporate asset specific depreciation;
- A RAB model which reflects the specific assets on the ground;
- A consistent valuation approach across the entire interstate network; and

- A consistent regulatory RAB definition across ARTC's two regulated RAB networks.

For these reasons, ARTC believes that a DORC revaluation of the existing network, reflecting its current condition and based on a consistent methodology would ensure the accurate representation of the asset base and provide a consistent asset model approach across ARTC's regulated rail networks.

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.

2 Historic RAB Model

The basis for the current RAB model was defined in the original 2002 IAU; which methodology was adapted for the 2008 IAU with the inclusion of the NSW leased assets.

The theoretical basis for the RAB roll forward methodology was that there would always be a demand for the interstate rail network; that is, it possessed a perpetual economic life. Due to this perpetual economic life, the asset exists in perpetuity with a low risk of asset stranding or technical obsolescence. Therefore, the asset was not subject to economic decay nor replacement and so depreciation (aside from signals and communication assets) was not incorporated into the model.

The current RAB modelling was undertaken by Booz Allen Hamilton in 2006 (building on the 2002 model), and was reviewed and accepted by Price Waterhouse Coopers as part of the ACCC's Draft and Final Decisions on the 2008 IAU. The accepted model calculated the DORC by:

- Assessing the Optimized Replacement Cost (ORC) based on the Modern Engineering Equivalent Rail Assessment (MEERA) of concrete sleepers and 60kg rail;
- Assessing the asset condition by way of an assessment of the remaining asset life when compared to the MEERA;
 - This assessment is undertaken at an aggregated line segment level. That is, it is not based on an individual asset register, reflecting the absence of a requirement for depreciation profiles;
- The DORC is equal to the ORC multiplied by the remaining life of the asset
- ORC is calculated for "Track" which is equal to Rail plus Sleepers plus Ballast
- The life expired component for Track is calculated based on constant defined proportions being:
 - Ballast: 32%
 - Rail: 33%
 - Sleepers: 35%

The DORC values therefore reflect both aggregated values and aggregated assets which are not reflective of the individual asset descriptions required for depreciation.

3 Network upgrades

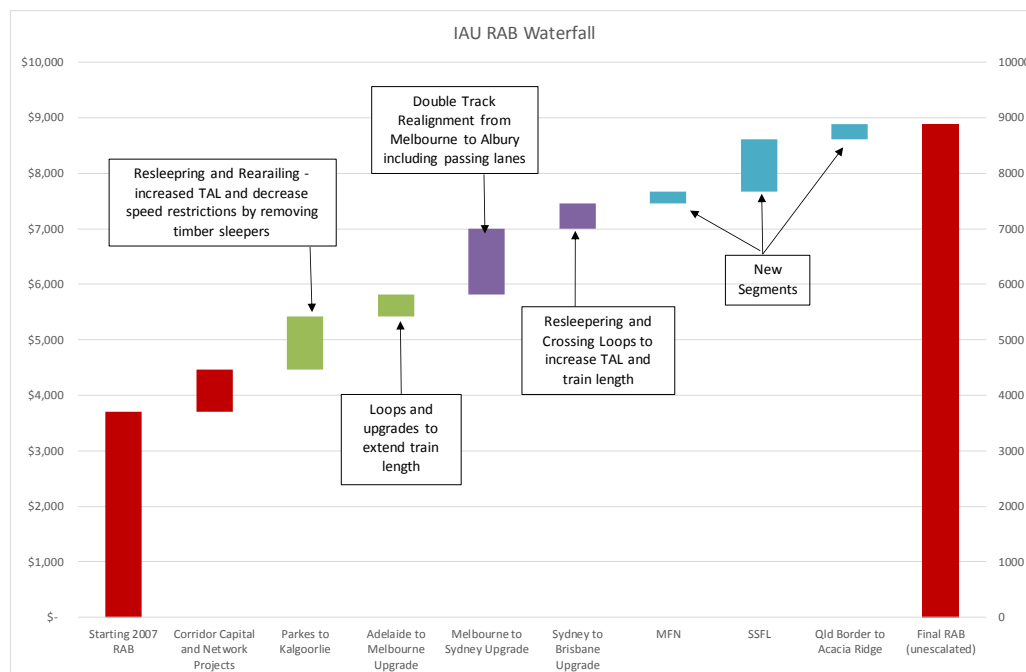
Throughout the term of the 2008 IAU, ARTC invested heavily to substantially improve the productivity of the Interstate Network to enable the operation of more efficient trains by:

- upgrading its condition,
- extending its life,
- improving its performance and productivity based on:
 - increased axle loads;
 - Longer trains; and
 - increased speeds; and
- expanding its capacity through investments in:
 - double track realignments;
 - loops; and
 - turnouts

In addition, ARTC has expanded the scope of the network through the inclusion of three new segments:

- Queensland Border to Acacia Ridge;
- Sydney Metropolitan Freight Network (MFN)
- Southern Sydney Freight Line (SSFL)

The impact of these investments and inclusions on the proposed RAB is demonstrated in the chart below:



4 ACCC's 2018 Draft decision

The ACCC's Draft Decision focussed on the following key issues in respect of the valuation of the Interstate Asset:

- Provision of a DORC valuation for the 3 new segments (MFN, SSFL and Queensland Border to Acacia Ridge);
- Build in a depreciation profile to reflect a reality that the asset does depreciate;
- ARTC to provide further detailed information in support of the 104 projects undertaken over the 2008 IAU term;
- Change the definition of capital that can be rolled into the RAB under the IAU given that it is not depreciated;
- Make allowance for the impact of disposals on the network; and
- Ensure inflation is accounted for appropriately.

The ability to accommodate the ACCC's requests for a future RAB model with depreciation are problematic with the status of the historic RAB model. This model reflected the state of the Interstate Network at the time, in particular the preponderance of timber sleepers across NSW and a single-track alignment from Melbourne to Junee.

The fundamental changes to the network therefore impact on the adequacy of the RAB model in an environment where individual asset condition is a critical consideration to allow for the introduction of asset depreciation

5 Depreciation

The historic perpetual RAB roll forward model reflected the view that the demand for the rail network would exist in perpetuity since rail infrastructure is not subject to economic decay and does not need replacing; therefore, the RAB should exist in perpetuity and not depreciate. Whilst this is true from the overall network's perspective, this is not true from an individual asset's perspective – where each asset has a useful life which needs to be reflected in a depreciation profile for that asset. This also underestimates the extent of the improvement in network capability and the changed asset configuration that arose from the capital programme undertaken across the 2008 IAU. The ACCC has, therefore, rightly requested this change in asset modelling; which change ARTC is happy to implement. However, the historical perpetual model was not defined to accommodate depreciation as the valuation is provided on an aggregated basis as outlined above.

Reformatting this model to one which accommodates depreciation would therefore require both the deconstruction of line segment assessments to an individual asset basis and the assumed allocation of an aggregated value down to that level. This means that the individual asset values determined for depreciation are disconnected from the actual individual asset values and condition and do not provide an accurate basis for determining the depreciated asset values across the network.

Therefore, updated asset specific valuations are required to allow depreciation profiles to be added into the RAB model.

The revaluation approach also incorporates the net effect of depreciation of the existing asset with maintenance and corridor capital. In this fashion, revaluation of the asset not only ensures that the model is appropriate for the future application of depreciation in the RAB model, but also incorporates the impact of historic depreciation on the network. Revaluation of the network therefore is the only manner in which there can be consistent treatment of asset depreciation in transitioning to the new model requested by the ACCC.

6 Network Consistency

The depreciation discussion above raises a further issue with the status of the historic model – that it reflects the status of the network when the initial modelling was undertaken in 2006. The substantial investments made by ARTC to upgrade the Interstate Network (discussed below) are therefore not taken into account. This includes replacement of timber sleepers and 47kg rail in the extensive resleepering and rerailing program undertaken by ARTC across NSW in particular – projects that ARTC notes were defined as non-capital or expensed projects in the ACCC's Draft Decision.

Application of this Draft Decision would therefore deliver a RAB model that depreciates Timber Sleepers which do not exist, whilst the concrete sleepers installed on the ground have been expensed.

In addition, ARTC notes that the ACCC has requested ARTC to undertake DORC assessments for the three new segments to be rolled into the IAU:

Undertaking of these DORC assessments would therefore create an inconsistent DORC valuation basis and model between the historic assets and the new assets; reinforcing the issues with the historic valuation basis identified above.

7 Regulatory and Accounting Consistency

Discussions with the ACCC have highlighted the importance of the consistency of capitalization rules across ARTC's regulatory undertakings. The application of the Draft Decision's capitalization ruling would deliver an outcome rule that is not only inconsistent with those applying under the HVAU, but also with the Accounting standards under which ARTC must prepare its accounts.

The Hunter Valley is specific in respect of what actions are considered capital and what are considered expenses; which definitions are consistent with ARTC's financial practices and the application of accounting standards. In particular, this results in the determination that consideration of resleepering and rerailing activities over a certain length is considered capital. This reflects the reality that, the replacement of (in the extreme), a single sleeper or a single piece of rail cannot impact on the capacity of the network (via increased axle loads or increased speeds). However, replacement of segments of track do have this impact – where the need to upgrade the rail and sleepers to improve the performance of the network was identified at the creation of ARTC. The importance of these projects to network efficiency underpinned submissions to Infrastructure Australia which have been provided to the ACCC.

Major resleepering and rerailing projects are therefore treated as capital within ARTC's financial systems and would be treated as capital under the HVAU. Therefore, any forward RAB model, consistent with rail regulation practice, would need to reflect this definition, so application of a historic definition that is different from the future definition is inappropriate.

Revaluing of the network based on its existing condition therefore avoids the need for determining which projects were capital and which were expense projects; as the net effect on the asset condition and remaining life is determined as part of the asset revaluation. This therefore avoids any requirement for historic definition of projects and allows the future definition consistent with Accounting Standards and the HVAU to be applied.

8 Capital prudence

The revaluation approach also ensures that the prudence of all projects is assessed as the valuation is based purely on the existing network condition reflecting efficient unit costs of optimized asset construction. That is, the current RAB roll forward mechanism would require an approved value to equal the existing RAB value plus the prudent project value; where the project is considered capital due to its impact on enhancing the condition and improving the capacity of the network.

The RAB revaluation therefore incorporates a specific outcome-based prudence assessment on all projects undertaken on the Interstate Network. That is, the optimization and condition assessment of the entire network ensures that the valuation of the network reflects the net effect of the depreciation of the historic network plus the impact of maintenance, corridor capital and other projects. The prudence and efficiency of historic expenditure is therefore explicitly incorporated in the revaluation approach; ensuring that there is consistency in the transition to the future model requested by the ACCC and accepted by ARTC.

Revaluation of the asset base therefore incorporates a network wide prudence test rather than the sum of the individual project tests. ARTC firmly believes that given the network altering impacts of the projects undertaken, such a network wide approach is the optimal way of assessing the efficiency of its capital works programme.

9 Conclusion

ARTC therefore believes that the most efficient method to provide an accurate DORC calculation of the Interstate Network RAB is to revalue the entire Network on a consistent methodology at an asset specific level. This will ensure:

- Consistent valuation methodologies are applied across the network
- The network to be depreciated reflects the assets on the ground and their current condition
- The historic depreciation of the network (and impact of corridor capital) is accounted for based on the determination of that asset condition;
- The RAB model reflects the upgraded and realigned network

The change to the network and alignment is a critical issue as it ensures that this network re-valuation approach does not set a regulatory precedent for other industries as no other infrastructure network has undertaken such a radical transformation between regulatory periods; nor has one been required to fundamentally change the asset depreciation and valuation profile.

The requirement to transition to a new model, therefore requires the change in approach given the inability of the current model to meet the future needs of a RAB model as requested by the ACCC and agreed to by ARTC.

ARTC believes that the most efficient method of dealing with all these issues is to revalue the DORC as this approach:

- Provides the DORC valuation for the 3 new segments on a consistent basis with the balance of the network;
- Ensures that the value addresses the impact of the depreciation of the existing 2008 RAB as part of the holistic optimization, therefore allowing that asset base to be depreciated consistently moving forward as requested by the ACCC;
- Ensures that the valuation reflects the optimized impact of all the projects conducted on the Interstate Network such that the RAB is reflective of the optimized impact of the sum of the projects;
- Ensures capital is defined and treated consistently across the HVAU and IAU going forward;
- Ensures the impact of disposals is accounted for by only valuing the assets in place; and
- Is consistent with stakeholder requests to establish the value of the RAB based on its remaining useful life compared to the MEERA.