Response to the ACCC Issues Paper - Valuation approach for the ARTC Interstate Network

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1 Introduction

Arc Infrastructure Pty Ltd (**Arc**) welcomes the opportunity to respond to the *Valuation Approach for the Interstate Network Issues Paper* as published by the ACCC on 12 September 2019 (**Issues Paper).**

Arc is the rail infrastructure manager for Western Australia's rail freight network. Arc manages approximately 5,500km of standard, narrow and dual gauge rail infrastructure within Western Australia, with connections to ports at Kwinana, Fremantle, Bunbury, Geraldton, Albany and Esperance, freight terminals at Forrestfield/Kewdale, Kalgoorlie, Picton and Avon Yard, and a connection to the eastern states rail network via the ARTC operated EGR. The Arc network is primarily used for the transportation of mining and agricultural inputs and outputs, fuel, and containerised freight. Passenger services such as the TransWA Prospector, Australian and Avon Link, and the Indian Pacific also traverse the Arc Network.

The following submission is structured to address the questions raised by the ACCC in the Issues Paper, in considering whether it is appropriate to revalue the ARTC rail network. Where a term in this submission is capitalised it should be read as having the meaning ascribed in the Issues Paper.

2 Arc's Response to Questions for Stakeholders

2.1 Do stakeholders prefer a RAB roll forward or a full DORC revaluation?

Arc supports a full DORC revaluation of the ARTC network in preference to an adjusted RAB roll forward. Arc is of the view that where information regarding the prudency and efficiency of historical capital expenditure made in respect of the ARTC network is unavailable, it is unlikely that an adjusted RAB roll forward will be sufficiently accurate and there is a risk that inaccuracies will be compounded in future RAB roll forwards.

2.2 Do stakeholders have any comments on the use of a RAB roll forward for setting the RAB for the replacement IAU?

Arc notes the ACCC's concerns in conducting a RAB roll forward as expressed at part 4 of the Issues Paper and agrees with the ACCC's position. Arc supports a full DORC revaluation to set the RAB for the replacement IAU in preference to a RAB roll forward.

2.3 Do stakeholders have any comments on the use of a full DORC revaluation for setting the RAB for the replacement IAU?

It is preferable that the RAB for the replacement IAU is set based on a full DORC revaluation. A full DORC revaluation resolves the issues that have arisen in relation to determining prudency of capital expenditure, amending the valuation model to allow for depreciation, and including new valuations for MFN, Queensland Border – Acacia Ridge and the SSFL under one regulatory regime.

Arc also notes ARTC's concerns regarding the inconsistent regulatory treatment of various assets comprising the ARTC interstate network. Arc does not propose to comment in a detailed manner on the regulatory framework ARTC operates under, however Arc is of the view that consistency in regulation should be supported wherever possible.

Prudency of Capex

Arc notes that the 2008 IAU did not require ARTC to retain data to enable the ACCC to assess cost efficiency or capital prudency on an annual basis. A full DORC revaluation would resolve this issue on the basis that the value of historical capex spends are largely irrelevant, as the network will be valued based on its optimised replacement cost. A DORC valuation inherently requires an assessment of what is 'optimal' in respect of the network, inefficient over investments are therefore excluded when determining the value of the network.

Depreciation

A full DORC revaluation provides the opportunity to modify the valuation model to incorporate depreciation. It is inappropriate to apply depreciation to the existing historic cost model. The historic cost model assumes the network exists in perpetuity, therefore requiring the capital expenditure incurred to keep the network in its 'steady state' to be expensed rather than rolled into the RAB – ie the network in effect has a static value save and except for capex that expands network capacity. Depreciation assumes that the network has a limited life and degrades over time, capital expenditure is therefore required to renew the network as various components of the network come to the end of their life.

Arc agrees that where depreciation is to be applied, it is inappropriate to aggregate all assets comprising a line into a single value which is then depreciated. Assets comprising a line will have various physical remaining lives and those assets will require replacement (capex) at various times. Undertaking a revaluation of the assets in situ and determining the remaining asset life for various asset classes allows depreciation to be applied in a manner which will result in the DORC of the asset closely reflecting the physical state of the asset. Future capital expenditure can then be depreciated with regard to the physical life of the respective asset classes.

Replacement and Expansion Expenditure

The distinction between replacement and expansion expenditure that existed in the 2008 IAU was necessary as a result of the assumption that the network existed in perpetuity, i.e. a 'steady state' asset. Based on that assumption, it is logical that expenditure incurred to keep the asset in 'steady state' was expensed, whereas expenditure that expanded the capacity of the network was rolled into the RAB, causing an appropriate increase in the value of the network.

In practice it is often difficult to clearly delineate between replacement expenditure and expansion expenditure. Some expenditure, for example the construction of new line segments, is clearly expansion expenditure. Other expenditure, such as the replacement of failed sleepers in a like for like resleepering program, is clearly replacement expenditure.

Frequently, capital projects undertaken for the purpose of replacing assets that are at the end of their life also have the effect of expanding the operational capacity of the network. Where an existing asset (such as a timber sleeper) can be replaced with a modern equivalent asset (such as a concrete sleeper) at similar cost but significant benefit, it is prudent and efficient to choose a modern asset over a like for like replacement asset. As such, in practical terms, the capital expenditure incurred in such projects is likely to comprise both replacement and expansion expenditure.

Moving away from a DORC based on historical values goes some way to resolving this issue. Whilst the ACCC will still be required to assess expenditure and determine if it was incurred prudently and efficiently, it should be unnecessary to distinguish between the treatment of replacement and expansion expenditure.

2.4 Do stakeholders have any comments on the effect of the valuation of the RAB in setting Access Charges in future IAU applications?

Arc notes that ARTC have undertaken to leave access prices unchanged whilst the valuation issue is being determined, and during the DORC revaluation process in the event the DORC revaluation proceeds. This is an appropriate position which provides certainty in access pricing in the short term to ARTC's customers. In the mid to long term, Arc believes that the future RAB based on the DORC revaluation should inform access pricing.

Where a full DORC revaluation is undertaken, and depreciation is accounted for, the RAB should closely reflect the physical condition of the network. Linking the access charges to the RAB means that the charges should be reflective of the quality of the asset a customer has access to. Where capital expenditure is reasonably and prudently expended on the network, it is appropriate that access charges reflect that additional capital expenditure. Government subsidies, capital grants, or extensions or expansions funded by a customer should not be rolled into the RAB unless otherwise agreed by the funding party and approved by the ACCC.

2.5 Do stakeholders have any comments on the suitability of the ACCC engaging a consultant to undertake the valuation?

Arc suggests that it would be prudent for ARTC and the ACCC to confer and select a suitably qualified and independent consultant to undertake the valuation. Arc agrees that the setting of the RAB is significant, and as such ARTC and the ACCC should facilitate the process jointly. Submissions in response to the valuation should be accepted from ARTC and stakeholders.