pacific national

ACCC Issues Paper

'The most appropriate method for valuing ARTC's Regulated Asset Base for the Defined Interstate Rail Network?'

Pacific National Submission

14 October 2019

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1. Executive Summary

Pacific National is strongly of the opinion that it is not appropriate for the ACCC to undertake a revaluation of ARTC's Defined Interstate Network. A 2019 revaluation of the Interstate Network using a DORC methodology would:

1. result in a significant windfall gain to ARTC as the current replacement cost would be materially higher than that calculated in 2001 (and escalated to 2006) due to material increases in construction costs over this period
2. allow ARTC to include the value of assets which were grant funded by the Australian Government and/or justified based on benefits to non-freight users
3. allow ARTC to include the value of investments made since 2008, which would increase the value of the RAB, despite no economic justification of these investments being made available and as required by the 2008 access undertaking.

2. Background and Context

Pacific National (PN) is a rail operator and is a major user of the ARTC rail network, which is currently regulated under the 2008 Interstate Access Undertaking (2008 IAU), the subject of the proposed 2018 Interstate Access Undertaking (2018 IAU) (now withdrawn). PN operates in numerous freight supply chains which rely on access to the ARTC Interstate Network to move coal, mineral products, steel, grain, construction products, waste and containerised products. On the Interstate Network, PN competes primarily with the heavy vehicle freight industry (trucks, including A and B Doubles as well as Super B Doubles), but also to some extent with sea.

2.1. The National Freight Task

As the monopoly provider of access to the Interstate Rail Network, ARTC has a significant role to play in ensuring that rail freight transport supply chains are efficient, cost-effective and productive so that rail can compete with the other market-based modal alternatives such as road and sea. Improved service coordination, integration, reliability and performance will facilitate efficient freight outcomes for existing customers and grow the freight business by attracting new customers to move their freight by rail. An efficient and nationally harmonised rail freight transport supply chain will enable the rail industry to compete on a level playing field with the trucking industry to grow its share of the national freight task.

2.2. National Freight and Supply Chain Strategy

On 2 August 2019, the Transport and Infrastructure Council endorsed the National Freight and Supply Chain Strategy and National Action Plan to position Australia to meet its emerging freight and supply chain challenges over the next 20 years and beyond. The Strategy and National Action Plan set an agenda for integrated national action across all freight modes. Developed by all Australian governments, with extensive input from industry, the Strategy commits to national action in four critical areas:

- smarter and targeted infrastructure.
- enable improved supply chain efficiency.
- better planning, coordination and regulation.

- better freight location and performance data.

ARTC, as a Commonwealth Government body, should be fully cognisant of what is required by the Australian Governments to ensure Australia is able to meet its emerging freight and supply chain challenges.

Recognising the Commonwealth Government has made the important "nation-building" step to fund ARTC's construction of Inland Rail should not mean that the regulatory reform of ARTC's business goes into a holding pattern until Inland Rail is commissioned. There remains significant work for ARTC to do within the next 5 years to progress the four critical areas identified above. Accordingly, rather than focusing solely on revaluing its interstate RAB, we believe ARTC's focus would be better directed if they were to consult with stakeholders on how the Replacement IAU will drive the Commonwealth Government's freight and supply chain challenges over the term of the next regulatory period, including how it will:

- promote an increasingly dynamic and commercially sustainable rail freight sector to underpin sustainable economic growth across Australia.
- strengthen economic incentives for the increased use of the interstate network, and more cost-effective government investment (both Commonwealth and state government) in the use of the network for the movement of the National Freight Task.
- secure value for money for governments, rail freight operators, freight forwarders, end-customers, and the community, in terms of supporting sustainable economic growth and a balanced trade-off between both the rail and road freight sectors required to deliver the National Freight Task.
- support a better service for rail customers with better freight location and performance data to enable the freight industry to hold ARTC to account for performance and standards of service across its network.
- promote innovation and efficient long-term investment across the rail industry, including in complementary above-rail rollingstock and freight terminals, through the appropriate development of a regulatory framework aligned to the National Freight and Supply Chain Strategy.
- promote improved policy awareness of the efficiency, safety and sustainability of a nationally integrated approach to the consideration of rail and road freight supply chains for the benefit of all rail and road users and the public, through increased transparency and robust advice on the opportunities to further freight supply chain integration and deliver an increased share of freight volume growth for the rail industry.

2.3. Regulatory Processes under Part IIIA

2.3.1. ACCC's 2018 Draft Decision

PN endorses the ACCC's 2018 Draft Decision on ARTC's 2018 Interstate Access Undertaking (2018 IAU), particularly with respect to its concerns on the:

- excessive WACC proposed.
- lack of documentation provided to detail the roll forward of the RAB to 2018–19.
- lack of DORC valuations for the Metropolitan Freight Network (MFN) and Southern Sydney Freight Line (SSFL).
- robustness of the financial model.
- prudency of capex proposed.
- inclusion of $3.8 billion of replacement expenditure on track assets into the RAB when track assets are treated as perpetual assets.
- inclusion of $580 million of capex funded by government grants.
- application of (CPI) indexation without a corresponding reduction in the annual allowable revenue.
- lack of accounting for asset disposals.

- application of a 10% margin on operating and maintenance costs.
- efficiency of the operating and maintenance costs.

Throughout the ACCC's 2018 regulatory process, PN predominately focused on the overarching strategic themes we considered to be most relevant to the ACCC's consideration of the scope of the next access undertaking to replace the 2008 IAU (Replacement IAU).

Economic development - and the strategic importance of:

- facilitating the growth in interstate and intra-state rail freight movements, taking account of all the varied end-to-end freight supply chains underpinning the National Freight Task.
- national harmonisation of road and rail access charges underpinning or rail and national road freight networks.
- modal shift incentives to facilitate an optimal utilisation of our rail and national road freight networks through regional communities, and in the freight transport traffic mix delivering the national freight task to Australia's metropolitan and capital cities.
- rail and road network investments to deliver the required transport infrastructure required to underpin the country's expected and forecast population growth in the next five, ten and twenty years.
- delivering national transport networks which improve the environmental and road safety outcomes for people living in regional Australia, as well as those living in Australia's metropolitan and capital cities.

Economic efficiency – and the need for national consistency in delivering

- all publicly-funded transport infrastructure projects (e.g. the interstate rail and national road highway networks), including the allocation of costs to the socio-economic benefits these national transport networks have been designed to deliver
- capital investments in rail and road networks to efficiently deliver the required freight transport infrastructure assets required to underpin Australia's expected and forecast population growth over the next five, ten and twenty years
- key rail freight service performance measures to enable governments, rail operators, freight forwarders and rail freight end-customers to monitor the performance and productivity of the government-owned rail network assets
- a competitive level playing field between rail operators, trucking companies and freight forwarders to ensure the national freight task is delivered safely and efficiently, while also minimising the environmental impacts involved in the delivery of the National Freight Task
- a long term declining average cost in operating and maintaining publicly-funded transport infrastructure cost over the long term.

Balanced negotiation framework – and the need for an effective negotiation framework which:

- appropriately balances the interests of access seekers, access holders, and the legitimate business interests of ARTC in operating and managing the interstate rail network.
- promotes efficient operation of, use of and investment in the interstate rail network.
- delivers economic and competitive outcomes that are in the public interest, including the public interest in having competition in the competitive markets upstream and downstream from the interstate rail network.
- delivers a standard-form access agreement which requires ARTC to provide access to all information necessary for access seekers and/or access holders to understand the nature, scope and standard of their contractual rights, and provide an ability for ARTC to be held accountable in delivering those rights.

- access to a dispute resolution process to remove any inappropriate discretionary powers that may reside in ARTC's favour due to drafting ambiguity in the 2011 standard access agreement.
- greater transparency in ARTC's operational framework (planning, scheduling and day of operations) so ARTC can be held accountable in delivering train paths consistent with contractual obligations.

2.3.2. ARTC's withdrawal of the 2018 IAU

The 2018 IAU regulatory process ended on 25 January 2019, when ARTC withdrew its proposed undertaking for the interstate rail network from the ACCC's consideration.

2.3.3. ARTC's application to extend the 2008 IAU

On 28 February 2019, the ACCC consented to ARTC's revised variation application extending the term of the current 2008 IAU to 29 February 2020. ARTC was required to give its intention to the ACCC to submit a Replacement IAU (or further extend the 2008 IAU) by 29 August 2019.

On 26 September 2019, the ACCC consented to ARTC's revised four-month variation application extending the term of the current 2008 IAU to 30 June 2020. This is the fourth time the ACCC agreed to a variation. The 2008 IAU was originally due to expire on 21 August 2018.

ARTC's regulatory access undertaking process is a voluntary process under Part IIIA of the CCA. The only regulatory timeframe that rail freight stakeholders can be reliant on in the future is the fact that ARTC must advise the ACCC by 30 December 2019 of whether it intends to submit a Replacement IAU or seek a further extension of the 2008 IAU.

2.3.4. ARTC lodgement of a 2019 IAU with the ACCC

ARTC has not lodged a Replacement IAU with the ACCC for consideration and approval under Part IIIA of the Competition and Consumer Act (CCA). ARTC has not formally undertaken a public consultation process with its key stakeholders to understand the key issues of importance to:

- interstate rail freight operators and freight forwarders who are reliant on access to ARTC's interstate network and the respective state-based rail networks in order to haul the National Freight task both inter- and intra-state within Australia.
- freight customers, with a direct interest in moving their product by rail or road to the destination end-market, both domestic and globally (import and exported freight).
- local businesses and household consumers, with a direct interest in receiving their goods and services in the most economically efficient manner, taking account of all economic externalities involved in the movement of the National Freight Task by both the rail and road sectors.
- state governments, including on how ARTC's management of, and investment in, the interstate network will align to, and complement, each state governments' strategic policy' objectives for the freight sector (both road and rail freight policy objectives) as well as to meet the strong growth demands of its metropolitan and country-based passenger services.
- the Commonwealth Government, including how ARTC's management of, and investment in, the interstate network aligns to, and complements, the 'National Freight and Supply Chain Strategy'.

2.4. ARTC processes since February 2019

Since February 2019, ARTC has been working with the ACCC to focus on developing a stronger asset valuation business case to reinforce its 2018 IAU position that the Interstate Network should be valued at nearly $10 billion dollars. It is following the ACCC Draft Decision on the 2018 IAU that ARTC has developed its proposal to re-value the Interstate Network's Regulated Asset Base (RAB) as part of its development of its proposed Replacement IAU.

However, rather than incorporate its revaluation proposal into a comprehensive Replacement IAU, ARTC have completely separated the revaluation of the interstate asset base from the Replacement IAU. In proceeding down this pathway, ARTC did so in isolation of any engagement with Pacific National on the nature and scope of its asset revaluation proposal, and how this proposal might fit within the context of the forthcoming Replacement IAU.

It would be unprecedented for the ACCC to approve a regulatory valuation proposal without any context of the regulatory framework within which the proposed valuation model would be given effect and we understand that it is not proposed that the ACCC approve the revaluation application as part of this process. However, we consider that the ACCC should not proceed to consider the revaluation application on a standalone basis and publish its view as is proposed as it is pre-emptive and prejudicial to the proposed Replacement IAU process and any formal decision that may be made in that forum. Rather than continue with the ARTC's revaluation application, we recommend that instead, the ACCC encourage ARTC to incorporate its revaluation proposal in the proposed Replacement IAU.

3. ACCC Issues Paper - Valuation of the Interstate Network

3.1. ARTC's Revaluation Application

As ARTC's application is made in isolation of any formal regulatory application (under Part IIIA of the CCA) to the ACCC and does not form part of an ARTC application for the ACCC to approve a replacement Interstate Access Undertaking (Replacement IAU), Pacific National queries the basis for the ACCC's consideration of this matter. Under Part IIIA, the ACCC is only empowered to consider an ARTC Replacement IAU, having regard to the access criteria listed under Clause 44ZZA of the CCA.

Part IIIA of the CCA
The relevant object of Part IIIA is defined at 44AA (a): To "promote the economically efficient operation of, use of and investment in the infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets." 44ZZAA (c) lists the relevant matters the ACCC is to consider: "The Commission may accept the undertaking, if it thinks it appropriate to do so having regard to the following matters: (aa) the objects of this Part; (ab) the pricing principles specified in section 44ZZCA; (a) the legitimate business interests of the provider; (b) the public interest, including the public interest in having competition in markets (whether or not in Australia); (c) the interests of persons who might want access to the service; (da) whether the undertaking is in accordance with an access code that applies to the service."

We submit that the ACCC's consideration of ARTC's valuation of the Interstate Network in isolation of any access undertaking is not appropriate, having regard to the centrality of the ARTC valuation to the access undertaking and the access criteria that the ACCC will apply when considering whether to approve or not approve ARTC's Replacement IAU. We note that the ACCC has indicated in its Issues Paper that the ACCC will not make any formal decision until ARTC submits, and the ACCC assesses, the Replacement IAU application under the CCA and that stakeholders like Pacific National 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.

However, we are most concerned that this pre-assessment process is outside of the Replacement IAU assessment process and will have a prejudicial impact on the assessment of the RAB when it comes to be considered inside the Replacement IAU process given the ACCC's position on these matters will be pre-determined and published through this process (noting that it won't be a final decision).

This is particularly because the ACCC has also noted that it considers that this Issues Paper process will:

- provide clarity and certainty to ARTC and stakeholders on the most appropriate method for calculating the RAB for the Replacement IAU;
- assist to progress the formal submission of ARTC's Replacement IAU application; and
- reduce the number of unresolved issues in ARTC's Replacement IAU application.

This leaves Pacific National to conclude that the outcomes of this process are in effect designed to be incorporated into the IAU as a default position, notwithstanding that it is being considered in isolation and will be, and should be, intimately connected with the overall consideration of the Replacement IAU application in accordance with the principles set out in section 44ZZAA.

On that basis, Pacific National considers that the ACCC should not be considering this application through this process and should instead delay this consideration until such time as the ARTC submits, and the ACCC assesses, the Replacement IAU application. Only in this way can the ACCC consider the appropriateness of all of the issues that will be generated by the ARTC's lodgement of a 2019 or 2020 IAU for approval by the ACCC, having regard to all relevant component issues that will be raised by all stakeholders and appropriately be considered by the ACCC in accordance with clause 44ZZA of the CCA.[1]

If the ACCC does publish its view on what the ACCC considers is the most appropriate method for valuing the RAB for the Replacement IAU as proposed, then Pacific National requests that the ACCC make it abundantly clear that this view is subject to its consideration of the Replacement RAB under clause 44ZZA of the CCA and that it give sufficient and adequate time in the consultation process for stakeholders to make submissions on the value of the RAB.

3.2. Significant Issues with the ARTC Revaluation Application

We are of the opinion that it is not appropriate for the ACCC to undertake a revaluation of the Defined Interstate Network.

Firstly, a 2019 revaluation of the Interstate Network using a DORC methodology would:

- result in a significant windfall gain to ARTC as the current replacement cost would be materially higher than the value of the RAB calculated in 2001 (and escalated to 2006) due to material increases in construction costs over this period.
- allow ARTC to include the value of assets which were grant funded by the Australian Government and/or justified based on benefits to non-freight users.
- allow ARTC to include the value of investments made since 2008, which would increase the value of the RAB, despite no economic justification of these investments being made available as required by the 2008 access undertaking.

[1] For example, the ACCC should consider whether ARTC's application to revalue its interstate RAB, given that all governments' are committed to encouraging modal shift, moving freight from road and on to rail, road safety and passenger transport policies.

Secondly, we do not agree that a revaluation of the Defined Interstate Network will reduce the number of unresolved issues in ARTC's Replacement IAU application. Given the positions previously put by ARTC in its 2018 IAU, it appears dis-ingenuous for ARTC to state:

> *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]

In the 2018 IAU, ARTC proposed to establish a price floor and price ceiling based on the regulatory revenue building block model used by the coal rail network providers operating in the Hunter Valley (ARTC) and central Queensland (Aurizon Network). The problem with this approach was that the pricing bandwidth was so wide it was ineffective as a constraint on ARTC's negotiating power with rail freight operators. Specifically, ARTC's proposed floor and ceiling pricing bandwidth could see tariffs increased by between 2.5 and 5 times the existing tariffs (depending on the line section), leaving customers with no recourse to the regulatory dispute processes. Such price increases would make rail uncompetitive with road and sea in nearly all of Australia's transport supply chains servicing the National Freight Task.

3.2.1. Windfall gains

The original RAB value of the interstate network was determined in a DORC valuation conducted in 2001, and since then the asset base has been rolled forward using CPI as an escalator. An asset revaluation today would determine a replacement cost based on available benchmarks such as the Inland Rail business case and the cost of work completed by ARTC on the interstate network in recent years.

The 2008 DORC valuation resulted in the ARTC network being valued at $1,052,327 per kilometre in 2006 dollars (ACCC, Review of ARTC DORC Valuation, March 2008, Table 6.1). This has figure has been escalated by ARTC using CPI to around $1.2m in 2019. The Inland Rail study estimated the cost per kilometre of the network to be approximately $4,154,800 in 2014 dollars (ARTC Inland Rail Business Case, Table 0.4 – Capital cost $6,926m; length 1,667m). If this figure is escalated by CPI to 2019 it equates to $4.4m, over 3 times higher than the basis of the ARTC valuation. While the Inland Rail study is only a cost estimate it is highly likely to be referenced in any revised valuation of the ARTC network and strongly suggests that the result will be a significant windfall gain to ARTC. As noted by Stephen King, 'raising the asset base by including a windfall gain, under building block regulation, will in general lead to higher prices for access seekers and will lead to a lower level of allocative efficiency'[3].

3.2.2. Inclusion of assets built between 2008 and 2018 without any evidence of prudency

A full revaluation would include the valuation of assets built between 2008 and 2018, despite the fact the assets were built without any required evidence of prudency as required under the terms of the 2008 IAU. This disconnect between the 2008 Access Undertaking and the proposed asset valuation for the next regulatory period creates considerable regulatory uncertainty. It also presents a material risk that assets which were not built prudently, based on the economic merits of the investment at the time, will be included in the asset base because the terms of the asset valuation do not allow it to be optimised.

3.2.3. Inclusion of assets built between 2008 and 2018 funded by government grants

PN has previously raised the issue of government funded assets being included in the ARTC's regulated asset base in the context of the original 2008 asset valuation. ARTC's proposed revaluation application would continue the approach of attempting to make a commercial return on assets which were built based on

[2] ARTC, ARTC Proposal to ACCC re Methodology for Revaluation of the Interstate Network, August 2019, p4.
[3] King, S. An Independent Review of Reports by Professor Menzies prepared for the QCA, May 19, 2016, p5.

economic rather than commercial business cases. In the case of the investment in the ARTC network funded by the Rudd government in response to the GFC, the investment decisions were primarily based on their ability to prop up the Australian economy. In the case of many other projects, the investments were justified on economic grounds which typically include benefits outside of the rail sector itself. For example, these projects provide associated benefits for road users or the environment which fall outside of the commercial decision making of a rail operator.

While ARTC does not make its business cases public, Building Queensland document business cases on their website and has three notable rail projects featuring disaggregated economic results. The breakdown of the road-rail benefit split is presented in the table below, along with the 2015 Inland Rail report. Rail share of the benefits associated with these projects ranges from 2% to 71%. The proposed valuation approach would include 100% of the value of the asset in the RAB.

Rail Share or Economic Benefits Modelled

	Beerburrum to Nambour Duplication	Cross River Rail	Townsville Eastern Access Rail Corridor	Inland Rail
Road	42%	61%	57%	11%
Rail	57%	33%	2%	71%
Other	1%	6%	41%	18%

3.2.4. ARTC's pricing process is not fit for purpose

ARTC's pricing approach in the 2008 IAU and, as foreshadowed in the 2018 IAU, demonstrates that ARTC's application to revalue its RAB is part of a coordinated strategy to establish a price floor and price ceiling bandwidth that will be so wide that it will be an ineffective constraint on ARTC's negotiating power in the forthcoming Replacement IAU.

By seeking to rely on a revaluation of the RAB, ARTC demonstrates that it is out of step with:

- a market-based valuation of the access revenue currently earnt on the interstate network
- a detailed understanding of the National Freight Task, including the competitiveness of the rail freight industry in providing a competitive rail freight value proposition when rail freight operators must negotiate with multiple below rail network providers to move rail freight between major capital cities within Australia
- a detailed understanding of the transport supply chains servicing the National Freight Task and the competitiveness of road versus rail freight in the provision of freight transport services to freight customers.

There is nothing in this most recent ARTC RAB revaluation application which provides us with the comfort that ARTC has heard our concerns with respect to the ability of rail freight operators to compete on a level playing field with the road freight industry. ARTC's continued reliance on a regulatory building blocks valuation model assumes the investor (i.e. Commonwealth Government) is earning a regulatory return on and return of their investment in the interstate rail network (as is the case for ARTC in the Hunter Valley coal network). In contrast, a market-based valuation of the interstate network would consider the positive public benefit externalities regularly factored into the decision-making process which underpin state and Commonwealth government investments in rail freight infrastructure investment projects being undertaken across Australia. The fact that state and Commonwealth governments reference these benefits when announcing these projects demonstrates that they cannot be justified solely based on the 'willingness to pay' of the end customers involved in moving freight within the National Freight Task.

3.3. No justification for ARTC's interstate network to be re-valued in 2019

ARTC is proposing an asset revaluation in response to the ACCC review of the theory and application of the assumption that track assets should be treated as perpetual assets. The ACCC's conclusion was that going forward this assumption should be amended and track assets should be depreciated[4].

PN considers a full revaluation to be both unnecessary and unwarranted to address the issues raised by the ACCC in its 2018 Draft Decision.

The key arguments put forward by ARTC in favour of a revaluation were that there '*would be inconsistencies between the historic model and 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 network*
- *A consistent regulatory RAB definition across ARTC's two regulated networks*'[5]

None of ARTC's arguments provide a strong rationale for the ACCC to approve a revaluation, nor do they appropriately address the access criteria under Clause 44ZZA of the CCA.

3.3.1. Asset specific depreciation of the 2001 DORC valuation of the Interstate Network

ARTC's original Regulatory Asset Base (RAB) is currently used on a line section basis for pricing. It was derived using a DORC valuation approach by asset class. Going forward, a revised opening asset value for these assets could be derived based on the original DORC valuation models. It could then be used to estimate the appropriate incremental depreciation that should be applied to these original rail assets. It would therefore then be a relatively simple exercise to estimate the appropriate valuation of a proposed variation to valuations of assets in the existing asset base, if required. Even if this were not the case it is noted that, to avoid unnecessary complexity, other regulated assets bases are depreciated using a weighted average opening asset life.

The other three issues raised appear to have only administrative rather than technical merit.

'A RAB model which reflects the specific assets on the ground'

Regulatory precedent applied over the last 20 years strongly reinforces the regulatory principle that once a set of assets has been valued for inclusion in an approved RAB, then the value of those assets should not change unless it can be shown that they have become redundant and can be optimised out of the RAB. Regulatory assets bases differ materially from the traditional financial accounting, taxation treatment and strategic management of assets. For example, the Central Queensland Coal Network's (CQCN) asset base was derived in 2001 and only in the last QCA decision was the decision made to capitalise the ballast cleaning works undertaken by Aurizon Network since 2001, and from 2001 to 2013, all rail replacement was expensed each year. This means the CQCN's track assets that have been included in the QCA approved RAB do not reflect the 'assets on the ground'. Importantly, even given this distinction, Aurizon Network has not sought, and the QCA has not approved, to revalue its RAB.

In terms of the freight rail networks, Queensland Rail has only recently sought to value its West Moreton rail network for the provision of coal haulage services. An important part of this assessment was the decision not to value assets which were still being utilised but had been in operations for longer than their original asset life[6]. It is also noted that Queensland Rail has not sought QCA approval of a DORC valuation for the purposes of pricing on any of its containerised, regional and bulk freight networks on the Western and Central

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[4] ACCC, Draft Decision, Australian Rail Track Corporation's 2018 Interstate Access Undertaking, 20 December 2018, p120.
[5] ARTC, Proposal to the ACCC re Methodology for Revaluation of the Interstate Network, August 2019, p3.
[6] QCA, Decision, Queensland Rail' Draft Access Undertaking, June 2016, p 209.

Queensland, North Coast and Mt Isa rail corridors. However, Queensland Rail does publish access tariffs for rail freight services on all of its rail freight corridors.

'A consistent valuation approach across the entire network'

ARTC's argument for a consistent valuation approach across all assets is inconsistent with the management of other regulatory asset bases. Both the ARTC's Hunter Valley Network and Aurizon Network's CQCN maintain their asset bases by rolling forward the value of assets in the original DORC valuation and then adding in assets determined to be prudent investment over the period at cost. As a result, very similar assets (such as 60kg) rail built only two years apart could have widely different values depending on the state of the market for rail at the time they were built. This inconsistency is accepted as reasonable by both the relevant economic regulators and asset owners.

'A consistent regulatory RAB definition across both of ARTC's two regulated networks'

Finally, it is unclear to PN why ARTC needs to have a consistent approach to the valuation of the Hunter Valley and interstate network's RABs and why this provides any benefits to either the coal customers or to the rail freight operators, freight forwarders and freight customers.

ARTC's proposed approach appears to be a reactionary response to the realisation that they have not effectively managed either the investment in, or roll forward of, their Interstate RAB. However, inefficient management of ARTC's RAB is not an issue the ACCC should take into account when determining whether or not to approve a revaluation of the Interstate RAB. The ACCC decisions with respect to the 2001 and 2008 undertakings were clear and well-reasoned regarding the prudency tests that would be applied when rolling any new rail assets into the Interstate RAB. For example, the 2008 IAU Decision clearly specifies that only prudent capex could be included in the asset base, and that disposals must be accounted for.[7]. We do not consider ARTC should be protected because it failed to take heed of standard regulatory practice in accounting for its post 2008 investment in the Interstate Network. The fact that ARTC is now stating that it cannot appropriately document its prudency assessments of assets built since 2008 is not a reasonable explanation to warrant a RAB re-valuation, particularly when ARTC has not sought to account for the asset disposals that result from such significant investment.

Since 2008, the ARTC have been fully aware it was managing the Interstate RAB as an "evergreen" or perpetual RAB (with no depreciation schedule), while at the same time replacing a significant proportion of the RAB during this period. Yet, ARTC did not seek to raise the potential RAB disconnect between these two facts when it undertook its five-year review of the 2008 IAU in 2014[8].

Accordingly, PN does not support ARTC's revaluation application on the grounds it would effectively reward ARTC for mismanaging its approved 2008 RAB.

4. The appropriate regulatory approach to determining ARTC's Interstate RAB opening value

PN suggests that consistent with regulatory precedent in all other regulated industries, that the opening RAB value at the end of the 2008 regulatory period should be determined using 'a line in the sand approach' and based on the original 2008 RAB valuation. In doing so, it is appropriate for ACCC to apply the prudency and efficiency criteria in the 2008 IAU and to adjust the 2008 RAB valuation for:

[7] ACCC, Final Decision on the ARTC Interstate Rail Access Undertaking, July 2008, p137
[8] ARTC, Letter to the ACCC – Interstate Access Undertaking – Five Year Review, 9 May 2014.

- a DORC valuation of the new line segments (Queensland border to Acacia Ridge, SFL and MFN), taking account of whether the new line segments were transferred (in part or in full) via the payment of a peppercorn lease agreement ($1) and predicated on the basis of future investment to be undertaken by ARTC in future periods;
- the value of any RAB assets which have been disposed of over this period.

Other investments made by ARTC over the period should be classified as sustaining capex and excluded from being rolled into the RAB unless the ARTC is able to demonstrate the new assets:

- have resulted in material additions to the network which, without that investment, would not have resulted in the significant uplift in rail freight volumes being hauled across the interstate freight network
- have resulted in improved operational performance of rail freight rollingstock which, without that investment, would not have enabled the rollingstock to operate at such performance levels
- were prudently built based on an independently assessed business case and were not funded by government grants.

The application of this traditional RAB roll forward regulatory approach is not overly complex and is consistent with the perpetual regulatory asset methodology proposed by ARTC when it lodged the 2008 IAU, and which was approved by the ACCC. Indeed, the rationale for the exclusion of replacement assets was clearly stated in the ACCC's final decision.

> '*Given that the cost of MPM [major periodic maintenance] includes a charge for asset replacement, the ACCC considers that ARTC's approach to not charging depreciation on these assets is appropriate. To do otherwise would mean that users would be paying twice for the cost of replacing assets*.'[9]

Going forward into the next 2019 or 2020 regulatory process, we consider this revised asset base can be used as the basis for determining regulatory depreciation.

The following tables detail how PN considers each of the key issues identified by ACCC in its Draft Decision's assessment of the roll forward of the asset base, can be resolved without initiating a formal revaluation of the 2008 RAB.

4.1. PN response to issues identified by the ACCC

Identified Issue	Proposed Regulatory Solution
Providing insufficient support for the prudency of capex	The ACCC decision provides a thorough assessment of the weakness of ARTC's Prudency assessment process and the implications of the limitations of this process (unless addressed by the ARTC) on the value of capex to be included in the regulatory asset base. This process should be allowed to be completed, noting that it will be simplified to some extent by the decision to exclude of track replacement investment (as they do not impact on the value of the perpetual track assets through the period to the end of the first Access Undertaking) or investment funded by government grants.
Not providing support for corridor capex	The asset is to be included in the RAB if ARTC is able to demonstrate that the investment was determined to be prudent at the time the investment was made, otherwise the asset should be excluded as per the requirement of the undertaking.

[9] ACCC, Final Decision on the ARTC Interstate Rail Access Undertaking, July 2008, p166

Identified Issue	Proposed Regulatory Solution
In the context of track assets having a perpetual life, allocating corridor capex fully to track assets	Where appropriate (i.e. when an investment has been shown to be prudent), the ACCC review investments and reclassify by asset type as appropriate and in accordance with the 2008 IAU.
Not treating capex funding through government grant appropriately	Remove all investment in rail assets which were funded by governments (both Commonwealth and state government) without appropriately documented business cases.
In the context of track assets having a perpetual life, adding asset replacement expenditures to the RAB with the effect of double counting the value of track assets and the return on track assets	By excluding all investments in replacement track assets through the period of the first undertaking this issue will become redundant
Including capex on Segments not part of the Interstate Network	Exclude all investment in segments which are not part of the network
Not applying the correct inflation rates	Recalculate opening values with correct indexation rate
Not including any disposal of assets.	Review investments to determine if any non-perpetual assets were replaced and should be removed from the asset base

4.2. Specific Responses to ACCC Questions

ACCC Question	Pacific National Response
Do Stakeholders prefer a RAB roll forward or a full DORC revaluation?	A RAB roll forward of the 2008 RAB is preferred.
Do stakeholders have comments on the use of a RAB roll forward for setting the RAB for the Replacement IAU?	A RAB roll forward is appropriate if it undertaken as per the 2008 Access Undertaking.
Do stakeholders have comments on the use of a full DORC revaluation for setting the RAB for the Replacement IAU?	A full DORC valuation is inappropriate as it would provide a windfall gain to the ARTC and allow the capitalisation of asset which may not have been prudently built
Do stakeholders have comments on the effect of a valuation of the RAB in setting Access Charges in future IAU applications?	In the current competitive environment is does not appear as if a DORC defined RAB will have an impact on the pricing of the network.
If a full DORC valuation was undertaken, do stakeholders have comments on the suitability of the ACCC engaging a consultant to undertake the valuation?	If a revaluation was to go ahead, the ACCC should engage suitably experienced engineering and accounting firms to undertake the task rather than rely on ARTC and/or any ARTC appointed engineering and accounting consultants.
Do stakeholders have any other comments on the approach to valuing the RAB?	The use of a DORC valuation has been justified by economic regulators because it provides the most appropriate means of avoiding the circularity that is derived when the DORC value is used to derive a price.

	In this context, economic regulators have historically only undertaken a DORC valuation of the asset for network industries where there is a very real threat that the regulated business may use its monopoly position in the market to set prices at a level which may result in it earning monopoly rent. Network industries where a DORC valuation has been appropriate are in the coal industry (Central Queensland Coal Network, West Moreton Coal Network and the Hunter Valley Coal Network). In contrast, state-owned rail freight networks have not gone down the path of undertaking a DORC valuation as the means of setting rail freight access tariffs to their rail infrastructure networks. Given ARTC's 2008 access tariffs on the interstate freight network: • were originally set by ARTC based on an economic assessment of the national transport market factors underpinning the National Freight Task and the ability of rail freight operators and freight end-customers 'willingness to pay" • have been automatically escalated by annual CPI for more than 10 years, and without any economic justification on the efficiency of such an escalation factor, ARTC's proposal to rely on an independent DORC valuation of the Interstate Network appears to be redundant, as well as waste of time and effort. Indeed, given the significant cost involved in engaging expert consultants to undertake an efficient roll-forward of the Interstate Network, PN recommends ARTC and the ACCC consider basing the value of the 2019 / 2020 RAB on the discounted value of future cashflows based on the FY2020 access tariffs already in place.

More broadly PN notes that the use of a DORC valuation is historically justified because it provides the most appropriate means of avoiding the circularity that is derived when the DORC value is used to derive a price. Given the prices on the interstate network have been increased at CPI for at least 10 years and are forecast to continue to increase at this rate in the future, independent of investment in the network this argument appears to be redundant. If the regulatory asset base is to be reset, rather than a simple DORC revaluation, consideration should be given to basing the value of the asset base on the discounted value of future cashflows based on these prices.

5. Pricing rail freight access to ARTC's Interstate Network

PN has only been asked to comment on the asset valuation issue specifically. However, both the ARTC application and the ACCC Issues Paper raise the issue of how prices will be set in the future. Specifically, ARTC states that prices won't be set based on either the current or proposed asset valuations[10]. In making this statement, ARTC clearly highlight that any re-valuation application is of secondary importance to the setting of the pricing framework that will be included in the Replacement IAU.

We consider that the pricing framework to be included in the Replacement IAU to be strategically more important than any other issue to be considered by the ACCC. To help facilitate ACCC and rail industry stakeholder consideration of the pricing framework to be included in the Replacement IAU, we commissioned NERA Economic Consulting to report on the regulatory rail freight pricing frameworks that exist across the

[10] ARTC, ARTC Proposal to ACCC re Methodology for Revaluation of the Interstate Network, August 2019, p4.

European Union. Pricing information provided by NERA has been incorporated into this submission and the NERA report is attached for stakeholder consideration.

The NERA report highlights, that across Europe, rail freight tariffs are priced to recover the marginal cost of rail access unless it can be shown that the freight commodity or rail corridor can operate commercially by paying more than this. This approach has been adopted to formalise European government's commitment to promoting rail freight. While this approach may not be directly applicable to Australia because of the size of the rail passenger market in Europe, a similar recognition of the wider benefits of rail freight in the pricing of the interstate network in Australia is clearly required.

Based on the principles outlined in the NERA report, we would like to draw ACCC's attention to the positive public benefit externalities regularly factored into the decision-making processes underpinning state and Commonwealth Government announcements of rail freight infrastructure investment projects being undertaken across Australia. The fact that state and Commonwealth governments are the entities making these announcements demonstrates that these investments cannot be justified solely based on the 'willingness to pay' of end customers involved in the national freight task.

Indeed, the cost benefit analysis for the Inland Rail business case demonstrates that at a discount rate of 7%, the benefits to freight users do not exceed the costs.[11] Consistent with this, the financial analysis in the business case found that:[12]

> *The results suggest that below rail revenue is not sufficient to recover the significant capital outlay required for construction of Inland Rail. The results also indicate Inland Rail has positive operational cash flows, i.e. if capital costs are excluded, an operational Inland Rail is cashflow positive.*

As NERA notes,[13] the involvement of government subsidies and justifying investment based on non-rail freight benefits raises a question as to what the "efficient costs" of providing the regulated track access service are when there are externalities to non-rail freight users from investing in rail.

5.1. The Floor Price should be set equal to variable/marginal Costs

In the absence of congestion, the efficient floor price is ARTC's "reservation price", i.e. the lowest price it would rationally accept for a train to run, equal to the variable cost of an individual train completing its train path. Prices below this marginal cost level may result in over-use of the network in circumstances when the social cost of using rail freight in fact exceeded the benefits to society from doing so.[14]

ARTC defined incremental costs by reference to an entire segment of the network, despite effectively acknowledging that this hypothetical increment is nonsensical in practical terms because removing a segment would break the network.[15]

ARTC's 2018 IAU defined incremental costs as the costs that could have been avoided if a segment was removed from the network excluding depreciation and a return on assets employed. Because of the relatively linear nature of ARTC's network, the question of removing segments from the network is purely hypothetical. In most cases, removal of a segment would break the rail transport link between the east and west (or north and south of the east coast) of Australia. It is unlikely that the relevant ARTC business on either of these national rail corridors would continue in each case.

ARTC's line segment pricing approach is inconsistent with how the interstate network is used and priced by above rail operators, where train operators purchase "train paths" from origin to destination. A rail freight

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[11] See Table 9.2 of *Inland Rail Business Case*. Using a discount rate of 7% The PV of the costs are ~7m and the PV of the benefits to rail freights are between 4.5b and 5b.
[12] Page 202, *Inland Rail Business Case.*
[13] Paragraph 53-54 and 56, *NERA report*.
[14] This assumes that road access is not under-priced. If road access is under-priced, then from a social opportunity cost perspective the efficient price could be below variable cost.
[15] Page 32, *2018 IAU Explanatory guide*.

operator's train paths encompass multiple line segments on ARTC's interstate network as well as multiple rail corridor segments on the adjacent networks of other rail network owners.[16] The rail freight operator is then required to combine all of these line and corridor segments of all network providers in order to form a portion of a "freight corridor" that they are able to package into a rail freight service offering to customers in the National Freight Task.

As noted by NERA[17], incremental cost depends on the increment chosen. At one end of the spectrum, if the increment is a single train running along a train path, then the incremental cost would be the short run marginal costs (SRMC) of that train running on the tracks (which is effectively just an estimate of track damage).

At the other end of the spectrum, as is assumed by ARTC, if the incremental cost is based on all traffic across a given segment (or corridor), then the incremental cost would resemble the methodology proposed by ARTC in the 2018 IAU.

It is critical to the competitiveness of the National Freight Task that ARTC's rail pricing framework has the flexibility to set targeted prices for different commodities (that is commodities that can be readily differentiated such as bulk grain, bulk minerals, bulk aggregates) and different volumes of traffic along major rail corridors. Doing otherwise, could result in freight moving to road when it could have been more efficiently transported by rail.[18] This suggests that ARTC's incremental floor price should, at the very least, be defined in relation to the identifiable freight characteristics and volume levels (where the volumes may require multiple train services) or simply be set at variable cost, recognising that the banded negotiate arbitrate model simply sets the broad parameters within which negotiation will occur, rather than setting the price itself.

Setting the price floor in this way would be consistent with how track access for freight is levied across the European Union, which similarly comprises government-owned rail networks and mandatory access regimes for third parties to access the rail networks. As described by NERA, European Union track access charges are generally levied based on short run marginal cost (SRMC) plus a mark-up for customer segments that can bear it. More importantly, NERA's report also identifies that, of the 23 countries for which data is available, 16 European countries do not levy mark ups on any rail freight traffic segments across their networks.

5.2. ARTC's Interstate revenue ceiling should be the discounted value of future cashflows based on the FY20 access tariffs already in place

PN recommends ARTC and ACCC consider basing the value of the proposed Replacement IAU RAB on the discounted value of the revenue stream that the interstate network will generate assuming the access charges are set[19] based on ARTC's published FY2020 Pricing Schedule. This valuation would be consistent with the Australian accounting standards and would eliminate the need for ARTC and the ACCC to undertake a costly asset valuation process and remove the complexity of the roll forward analysis contemplated in the ACCC Draft Decision.

If ARTC's proposed Replacement IAU RAB was determined by valuing ARTC's projected net revenues using current tariff levels and ARTC's proposed WACC, then the value of individual line sections could be aggregated and used to determine a revenue ceiling for each of ARTC's major rail corridors and collectively set an overall revenue ceiling for ARTC's interstate network business. Once the revenue ceiling by corridor and network is established, then ARTC could apply the negotiation framework that is outlined in the NERA report.

[16] PN operates rail freight services on a national basis. For example, the Brisbane to Perth freight corridor traverses' networks owned by Queensland Rail, ARTC, Sydney Trains, ARTC and Arc Infrastructure.

[17] Paragraph 30, *NERA report.*

[18] In the sense that the incremental revenue ARTC would receive for that load travelling across its network would exceed the incremental costs it incurs.

[19] As they have been set for the past ten years and how ARTC has forecast that they may be set for the next regulatory period.

NERA noted that in a negotiation framework for rail freight operators, the price ceiling should be the reservation price of rail freight operators. The reservation price for rail freight operators is their customer's maximum willingness-to-pay for a rail operator to move their freight by rail as opposed to their next best freight alternative mode of transport. This means that, depending on the freight customer's market, their willingness to move freight by rail is driven by road and sea freight prices as well as the rail operators' profitability in carrying the rail freight. For example:

- Increases in access tariffs passed straight through to end-customers via rail freight charges will eventually result in freight switching to road because the end customers of rail freight have an "outside option" to use road or sea freight. It is the cost of a customer's next best freight alternative and the rail operators' profitability requirements which inevitably constrain a rail operators' willingness to pay a network provider for track access.
- If the track access price at which freight customers would switch from rail to road is lower than the value of ARTC's revenue ceiling on the relevant rail corridor to be accessed by the rail freight operator, then the customer's 'next best freight alternative cost' should become the rail corridor price cap in NERA's banded negotiate arbitrate model. In practical terms, this rail corridor price cap would become the effective market value of the line sections in question.

Adoption of the NERA negotiation framework would allow ARTC to set the prices for individual rail corridors with the reference to the reservation prices within major rail corridors. Under this model ARTC would have the flexibility to negotiate higher access charges where it can be demonstrated that the current price is significantly below the reservation price and lower prices on rail corridors where the current price is above the reservation price.

This approach will address a clear weakness of both the approved 2008 RAB valuation methodology and ARTC's revaluation application. Under both the 2008 RAB valuation methodology and ARTC's proposed DORC asset revaluation, the replacement cost is (or is likely to be) materially higher than the current access charges applying across all line sections and corridors. As a result, ARTC's proposed DORC asset revaluation will have no impact on the pricing framework or the price negotiations that will need to occur with all key stakeholders. In this circumstance, ARTC will continue to hold significant market power in the negotiation process with rail freight and passenger operators (for example, ARTC's proposed setting of Access Tariffs from FY2021 onwards). Importantly, and of most concern to Pacific National, is the fact that ARTC may seek to use the outcome of its proposed DORC asset revaluation process to establish even higher price ceilings for its line sections and rail corridors and thereby enabling ARTC to continue to annually set prices by referencing a CPI adjustment to the previous year's tariffs without any reference to freight market factors and road versus rail freight access pricing competitiveness.

5.3. Annual Escalation Factor

ARTC's setting of its FY2020 access tariffs based on the FY2019 tariffs and escalated by CPI has sent the National Freight Task a clear signal that rail freight transport costs will continue to increase more quickly than the costs of those of its major freight competitor (heavy vehicles) for the foreseeable future. ARTC's proposal to increase all rail tariffs by CPI is not economically credible as it has not been directly linked to changes in the costs of operating the network or the quality of the service offered.[20] Should ARTC continue to include an annual CPI adjustment in the 2019 IAU then it will continue to negatively impact customer perceptions on the competitiveness of rail freight in comparison to road freight.

The application of an annual CPI escalation of ARTC's access tariffs does not consider the declining competitive position of rail compared to its main competitor road. In contrast, PN has estimated that heavy vehicle operators have enjoyed only a 0.3 per cent increase in road user access charges from 2012-13 to

[20] The 2008 IAU also explicitly precludes ARTC reducing its electricity tariffs in the event CPI is negative.

2017-18[21]. This increase for rail is an order of magnitude higher than road and significantly hampers the establishment of an efficient national competitive freight market for all transport modes. Moreover, CPI is not appropriate when there is any doubt about the efficiency of the starting point. ACCC Chairman Rod Sims made the follow observations[22] which PN agrees with:

> '*On the face of it, using a benchmark such as CPI may seem like a reasonable outcome. However, simply defaulting to CPI price increases does not necessarily mean that prices will reflect efficient costs over time. Firstly, what is the starting point; initially prices may not reflect efficient cost. Further, increasing volumes could mean that the average cost of providing services may actually decrease over time while, at the same time, revenues may increase due to both higher volumes and prices. This could increase the gap between costs and revenues and (potentially) monopoly rents.'*

In its deliberations on the Replacement IAU, the ACCC should be guided by whether ARTC's proposed pricing framework encourages the economically efficient use of, and economically efficient investment in, freight transport supply chain infrastructure. ARTC presents itself as the 'unashamed champions of rail as a cost efficient, reliable, safe and responsible mode of transport'[23]. However, this stands in contrast to reality where ARTC's pricing methodology is, signalling to the freight market that rail freight access charges will continue to increase more quickly than those of its major transport competitor (road) for the foreseeable future.

Finally, while the ACCC ultimately rejected ARTC's proposal to increase East-to-West rail tariffs by an additional real 2% (4.5% in total), it remains a significant concern for us that ARTC's 2018 IAU sought to include the price surcharge with no economic justification beyond an assertion that 'the market can bear it', and with no reference to independent evidence in support of their position. Should ARTC seek to include a real 2% price escalation on East-West tariffs in the Replacement IAU, then it will negatively impact freight customer perceptions of the competitiveness of rail freight in comparison to its road and sea freight alternatives.

[21] National Transport Commission (NTC): PAYGO – Heavy Vehicle Charges Model. Version 2.2 (25 May 2018).
[22] Ports: What measure of regulation', Rod Sims, Port Australia Conference, Melbourne, 20 October 2016
[23] https://www.artc.com.au/about/