

2 August 2021

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Australian Competition and Consumer Commission
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Dear Mathew

RE: DORC valuation of ARTC's Interstate network

Pacific National welcomes the opportunity to provide comments on the above document received on 15 June 2021.

The comments are divided into two parts:

1. The GHD DORC Report (the **Report**); and
2. ACCC Explanatory Paper and ACCC comments (**ACCC Response**) in relation to the report content

1 Executive Summary

Pacific National at this time does not propose to spend time on critiquing the DORC valuation outcome in detail but rather highlight the major concerns and issues in the Report. PN maintains this valuation should not be relevant in determining Network Access Charges for ARTC. Rather than a DORC revaluation, the value of the assets should be determined on the discounted value of future cashflows which is determined by the markets ability to pay.

A Depreciated Optimised Replacement Cost (DORC) valuation of the asset is more applicable 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 a monopoly rent. Rail network industries where a DORC valuation has been appropriate are in the coal industry (Central Queensland Coal Network and 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. Access rates were originally set by ARTC based on an economic assessment of the national transport market factors underpinning the national freight task and the rail freight operators and freight end-customers' 'willingness to pay'.

PN supports the comments in the ACCC Response that there are a substantial number of non-commercial assets that are included in the regulated asset base and that a change to the regulatory process is required.

2 GHD Draft Report

2.1) MEA Modern Equivalent Assets

Modern Equivalent Asset (MEA) asset values are difficult to derive, and the assumptions will always be somewhat subjective. The fact that there are so many legacy assets with incremental changes over time adds to the complexity. In responding to the report, PN poses the following question: “*What network would we build today using modern technology and methods*”?

The analysis in the Report is well thought out with a detailed review of how the actual construction would take place in current times, however, the assessment focuses predominantly on what assets are in place now with an allowance for technology, construction learning curve and capacity as token adjustments. PN maintains the assets required would look very different if decisions were taken today. This is discussed further in section 2.3 below.

PN has the view that other than the modern assets, the assets that an efficient above rail operator would not require on the ARTC network should be written down to a zero value. A commercial rational investor would not invest in a large portion of those existing assets.

The other element to consider is the presence of historical and more modern passenger services sharing the ARTC network with freight services. These services utilise a different level of capacity and require different asset quality.

2.2 Replacement cost

The replacement costs and the unit rates assumed in the Report are within the expected ranges using engineering logic. However, as described in section 2.1 and further below, PN maintains the level of assets is not appropriate as the starting point because the final values would be inflated when unit rates are applied.

2.3 Optimisation

This is a very important element in linking in with the MEA discussed above. PN is surprised at the low amount of adjustment of approximately 2% of the asset replacement cost (\$447m), given the age of assets, technology considerations and the disparity in the asset value relative to the traffic volumes.

PN does not consider the adjustment for optimisation reflects the reality. The table below is derived from an extract from table 34 on page 68 of the Report and demonstrates that there is no link with capacity and demand.

Table 2.3

NORTH SOUTH			EAST WEST			TOTAL
	\$b	\$ per km		\$b	\$ per km	
Melbourne to Newcastle	4.5	2.1	Parkeston to Adelaide	3.7	1.9	
Newcastle to Brisbane	3.8	4.5	Adelaide to Melbourne	2	2.2	
TOTAL	8.3			5.7		14
Asset Value	59%			41%		
Estimated traffic Levels	30%			70%		

Key observations are as follows:

1. The North South asset base makes up 59% of asset value of the total North South and East West intermodal networks but comprises only 30% of traffic volumes.
2. The Brisbane to Newcastle valuation comes out at \$4.5m per track km vs \$1.9m for the Parkeston to Adelaide, or more than double. PN considers this disparity to be out of range and when overlaying optimisation principles against the MEA, the averages would normally be brought closer together.

The other consideration on the capacity and matching demand is the problem of peaking. In the containerised freight business, train services tend to depart and leave at similar times given that the market requires as late as cut off time as possible for their product and earliest arrival times for end customers. This was partially addressed in the report more on the aggregate GTK levels. Given the disparity outlined above PN does not believe the report catered for the optimisation.

Emerging technologies such as ATMS will improve capacity enabling effective fleeting of trains.

2.4 Operational savings

This is described as the difference in NPV of MEA and the existing assets. It is unclear why this is included in the analysis and a \$41m adjustment for operational savings is a fraction of the final \$10.25b DORC valuation. PN understands the logic used by GHD but arguably this should be included in the efficient operating costs. These operating costs were not in scope and not related to the RAB but is relevant in the calculation of revenue ceilings.

2.5 Depreciation

The useful lives of various assets assumed is within expected ranges. PN agrees capital costs for earthworks and land clearing activities should be considered as a perpetual asset. We note at a macro level the assets in the report are considered on average half-life expired (i.e., 51% of replacement cost). An assessment of half-life would be expected in an established network with regular replenishment of assets over time. PN does not agree that this is a true representation and overall that the actual standard of infrastructure reflects assets nearer the end of life on most networks.

2.6 Pre-construction costs and IDC

The pre-construction assessment is a very theoretical exercise. The IDC is a significant addition to the assessed replacement costs on a 47-month construction (approximately 17% or \$3b). The IDC treatment is discussed in section 3.1 below in our comments on the ACCC Response

3 ACCC Explanatory Paper

3.1 Calculation of the WACC and the Interest During Construction (IDC)

The WACC calculation is comparable to other regulatory assets, with the movement lower than recent calculations almost entirely due to the fall in the risk-free rate.

As already noted, IDC assumptions added \$3b to the reported replacement cost. PN argues that a cost of debt rate is more appropriate such and that the 10-year bond rate may be a better proxy than the WACC for the IDC as typically assets were funded by the federal and state governments over the years.

3.2 Grant funding for exclusion from the Regulated Asset Base (RAB) following the DORC

PN supports the notion of removing grant funding from the asset calculation. As discussed further in section 2.1 and 3.1 above PN maintains that several of the legacy assets in the ARTC network were established with Government spending. The recognition of \$447m seems low, representing only 2% of a total replacement cost of \$19b.

3.3 Treatment of Operational Savings

This is addressed as a comment on the GHD report in Section 2.4 and to reiterate the main point, the savings when calculated were a very small number, being \$41.6m of \$10.25b final RAB valuation and PN maintains that this element should be addressed along with other benchmarks of efficiency in the efficient operational costs assessment that was outside the scope of the GHD report scope.

3.4 Expectations on the approach for ARTC to update the RAB value between 1 July 2019 and the date the replacement IAU

The precedent has been set in other undertakings that CPI adjustments are used as the bridging method to adjust the start time. In terms of the access charges, PN is of the view these should be frozen at their current level and not pegged in any way with the valuation.

3.5 ACCC Response on Draft Report and Regulation Generally

ACCC COMMENTS	PN RESPONSE
<p>“In our preliminary view, the valuation GHD has prepared satisfies the terms of reference that the ACCC set.”</p>	<p>PN agrees that the Report broadly satisfies the terms of reference. There are several issues and these have been highlighted in the comments above.</p>
<p>“Our preliminary analysis of the valuation indicates the ceiling limits established using GHD’s draft valuation, and existing prices, are high in comparison to the revenue ARTC is likely to earn.”</p>	<p>PN agrees with this statement and has estimated that current prices charged by ARTC across all sectors are circa 25% (weighted average) of the implied Revenue Ceiling. This ranges from around 10% to 60% within the 13 segments.</p>
<p>“We note the high ceiling limits are driven, in part by the likely inclusion of historical non-commercial assets (assets that an efficient commercial operator would not have invested in) in the asset base (despite GHD excluding assets funded by government grants between 2008 and 2018).”</p>	<p>PN agrees and refers to this in the comments above specifically in 2.1 and 2.3</p> <p>The assessment of future cash flows is best at determining asset values and these cash flows currently support access charges far lower than the theoretical ceiling.</p>
<p>“High ceiling limits give ARTC the ability to significantly increase prices and increase the</p>	<p>PN agrees there is potential to do this but the level of cashflows to ARTC would reduce significantly with any prices increases as freight volumes would</p>

<p>potential for ARTC to earn a return on the included non-commercial assets.”</p>	<p>reduce and ARTC would receive less revenue as a result. In the short term there may be supply chain distortions as freight subject to a price increase would not immediately be able to transition to other transport modes.</p>
<p>“We are concerned that ARTC in the future may have the incentive to significantly increase prices towards the ceiling. Particularly if developments in market dynamics, government policy or other factors change the competitiveness of rail relative to other transport modes.”</p>	<p>PN acknowledges this view but contends that there is no scope for increases in price and the current access tariffs represent a default price ceiling.</p> <p>A change in policy on sea transport may lead to rail gaining market share. The impact on end users would be mixed and for most participants the adjustment would be problematic in the short term.</p> <p>In terms of disruption to road transport the relative advantage already enjoyed with current government policy means there is few excess rail assets to cater for any increases in volumes in the short term.</p>
<p>“We are concerned the introduction of Inland Rail may exacerbate the issue of high ceiling limits due to the inclusion of further non-commercial assets in the RAB.”</p>	<p>The transition to Inland Rail is also a concern for PN. Without favourable industry settings Pacific National does not see commercial sense in investment to transition away from current operations.</p> <p>Access rates 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’.</p>
<p>“Given the concerns we have in relation to the DORC methodology and the current regulatory framework for the Interstate network, this year we will consult on a future regulatory framework for the network. We will soon publish an Issues Paper that will seek to understand stakeholders’ views.”</p>	<p>PN agrees with ACCC.</p> <p>Regulatory settings ideally would:</p> <ul style="list-style-type: none"> • encourage economic investment in rail for the long term, despite short term financial challenges in rail within Australia due to current demographics • Reinforce the importance of innovation and technology in below-rail monopolies to allowing above-rail operators to compete with other modes

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| | <ul style="list-style-type: none">• Re-balance the differences between road and rail charges across the national freight task.• Ensure there is investment and rehabilitation of assets to improve network resilience• Provide confidence for rail operators to invest in more efficient assets and new technology |
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In conclusion Pacific National does not support the DORC valuation as the basis for network pricing and looks forward to the opportunity to debate the merits of changes to the current regulatory framework and settings as soon as possible.

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