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Mr Mark Caputo
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Essential Services Commission of South Australia
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Dear Mark,

**Tarcoola to Darwin rail infrastructure: Review of asset valuation methodologies for periodic revenue reviews**

Please accept this as ARTC's submission to ESCOSA's review on asset valuation methodologies that could be adopted for the purposes of reviewing the revenues earned by the access provider of rail infrastructure services between Tarcoola and Darwin.

ARTC is currently in the process of renewing its voluntary Interstate Access Undertaking (IAU) with the Australian Competition and Consumer Commission (ACCC). This has been a lengthy process that has involved multiple extensions of the 2008 IAU to ensure regulatory certainty whilst the ACCC undertakes its review of the appropriate framework for the IAU. The first stage of this review was a requirement to revalue the Regulatory Asset Base (RAB) to allow the accurate calculation of the proposed revenue ceiling. This valuation was undertaken based on the use of Depreciated Optimized Replacement Cost methodology and commenced in April 2020 with a draft valuation published in July 2021 (and finalized in October 2021). A key finding from this process was that the ceiling which arises from this RAB value was not sufficient to constrain prices and in August 2021 the ACCC published an Issues Paper seeking views on the appropriate regulatory framework to apply to the Interstate Network which included an assessment of alternative methods of calculating a RAB valuation based on discounted cash flows of future revenue.

In July 2022 the ACCC published a Guidance Paper which indicated that the ACCC was open to a regulatory framework based on commercial arbitration to resolve pricing disputes provided the framework adopted price control measures. That is, the recommendation acknowledged that a cost based maximum revenue ceiling was not appropriate for the current circumstances of the IAU.

This conclusion was addressed in IPART's October 2021 Draft Report on its Review of the NSW Rail Access Undertaking. This report addressed the appropriate asset valuation methodology to be used and concluded (at p90) that DORC methodology was the appropriate methodology as it "ensures that access seekers pay no more than they would face if they were building the network to meet their needs". The report considered alternative cash flow methodologies and concluded that future earnings are a function of the RAB so the calculation is "fundamentally circular ... This circularity problem is not resolvable".

The key conclusions from these reviews are that:

- Where an asset valuation is required, DORC is the preferred valuation methodology as this ensures users pay no more than it would cost them to build the network themselves; and

- Where the network is utilized by freight, which is subject to modal competition resulting in these freight volumes being contestable, (such as freight moved on the Interstate Network), the pricing ceiling that arises from the RAB will not provide sufficient protection and alternative measures are required, such as a commercial arbitration framework. Hence the market constrains prices rather than the ceiling.

ARTC firmly supports the conclusion that, where a DORC is not required, commercial flexibility produces the most efficient outcomes for infrastructure managers, their customers and the industry by allowing an exchange of rights and risks, resulting in the most competitive freight offering for rail. This is further enhanced by the principles of transparency and non-discrimination which have been present throughout the history of the IAU.

Related to this is that some network operators are required to use the imputation pricing rule as the below rail pricing mechanism in the presence of contestable freight because contestable services fall outside price ceilings and revenue reviews. ARTC supports the current arrangements the use of commercial arbitration to resolve access disputes.

Where a DORC is required, there is some question about the treatment of funding contributions or lease payments associated with the asset. These are questions which were addressed as part of a series of cases related to a pricing dispute between Glencore and the Port of Newcastle that were addressed in a 8 December 2021 decision of the High Court of Australia (Port of Newcastle Operations Pty Limited v Glencore Coal Assets Australia Pty Ltd [2021] HCA 39) which confirmed the decision of the Australian Competition Tribunal that DORC valuations were forward looking and that past financing contributions should not be included in the valuation. Further it found (at para [70]) that "even if some regard was had to the financing of particular dredging projects (for instance), this would need to be done as part of a comprehensive examination of historical matters".

This decision therefore provides clarity on the appropriate methodology for DORC calculations, being that the asset valuation should reflect the cost of constructing the asset (to the same standard) to meet the needs of the User and is independent of past financing decisions; but if historical funding aspects are considered, this must include all historical matters, including historical under recoveries of the economic ceiling.

The comprehensive analysis of historical matters is consistent with the Recovered Capital approach that has been utilized as part of the reforms for the regulation of natural gas transmission pipelines, where pipeline owners are required to assess the recovery of actual invested capital in the pipeline, where variances to the allowed return on asset result in an adjustment to the asset value via depreciation. That is, if revenue is greater than the allowable return, the depreciation of the asset is accelerated and if lower, this economic loss is effectively capitalized. Where the invested capital cannot be determined due to the passage of time, and because these historic pipelines were subject to DORC valuations at a point in time, the original DORC valuation could be used as a proxy for the initial construction cost with capital costs post that valuation date added as part of the calculation.

The High Court in the Port of Newcastle decision therefore provides a clear conclusion that either the asset is valued via a DORC process independent of historical funding decisions, or by the Recovered Capital approach provided this considers all relevant costs and revenues. It cannot be a hybrid approach that uses some aspects of each methodology. ARTC believes the clarity provided by this precedent is valuable and should always be followed by Regulators in assessing asset valuation, with the preferred approach being a function of available data (noting the historical nature of much of ARTC's Interstate Network would preclude the Recovered Cost methodology).

ARTC therefore believes that, where the asset valuation is high relative to the revenue earned (such as for the Interstate Network), that the optimal regulatory framework is a commercially focused negotiate-arbitrate model coupled with high-levels of transparency. Where the revenue ceiling associated with a RAB value does have purpose, ARTC would agree with IPART that a DORC methodology is the most appropriate, provided this reflects the findings of the High Court in the Port of Newcastle decision that the valuation is forward looking; but of historical funding matters are taken into account, this must account for all historical matters akin to the Recovered Capital approach utilized under the National Gas Law.

I hope this submission provides useful consideration for ESCOSA in its review of valuation methodologies. As always, if you have any questions, concerns or would like to discuss anything in this submission please feel free to contact me on 0438 400 250 (ph) or jteubner@artc.com.au (email).

Yours sincerely

Jonathan Teubner
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