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20 June 2008

By e-mail: escosa@escosa.sa.gov.au

Attention: Mr Nathan Petrus

AustralAsia Access Code Guideline Review
Essential Services Commission of South Australia
GPO Box 2605
ADELAIDE SA 5000

Dear Sirs

Draft Decision in relation to the Review of the AustralAsia Railway (Third Party Access) Guidelines

This further submission is made by Asia Pacific Transport Pty Ltd (in its capacity as agent of the Asia Pacific Transport unincorporated joint venture) (APT), in response to the draft decision of ESCOSA dated May 2008 (Draft Decision).

The Draft Decision relates to ESCOSA's review of the AustralAsia Railway (Third Party Access) Code (Code), pursuant to the *AustralAsia Railway (Third Party Access) Code: Guideline Review Issues Paper dated November 2007 (Issues Paper)*.

This further submission is in addition to APT's submission to ESCOSA dated 19 December 2007 (Initial Submission), in respect of ESCOSA's invitation for public comment on the Issues Paper. Like the Initial Submission, this further submission is made for the purposes of providing ESCOSA with further information that APT considers relevant to the Draft Decision to vary or revoke the Guidelines, or to develop and publish or substitute new guidelines for access to the Railway.

APT notes the contents of the Draft Decision, and provides the following additional information and comment.

1. Asset Roll Forward (Draft Decision, Section 3)

1.1 Background

- (a) APT's position outlined in the Initial Submission was one of concern that the application of a roll forward provision to the DORC valuation without provision for future amendments, and without appropriate measures to take into account various increased costs of operating the Railway, may not accurately reflect the value of Railway assets over time (particularly later in the concession arrangement), and could may result in an artificially low value of Railway assets. Upon application of the Pricing Schedule in the Code, this could have a downward impact on the ceiling price to be applied.
- (b) APT's principal concern is that an inappropriate application of the roll forward provisions to the DORC valuation could impact APT's ability to realise an *appropriate* return on investment at the end of the 50 year concession period. That concern is based upon two factors; namely:
- (i) that the concession arrangement, and the pricing structure, is such that a positive return on investment for APT's stakeholders will only be achieved late in the concession period; and
 - (ii) an appropriate return on investment should be viewed as one that, in APT's view, recognises losses and/or low returns on investment in the early years of operation under the Concession Deed.

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Brown & Root Investments Pty Ltd
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Domin Rail Hc. 3 Pty Limited
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- (c) For those reasons, APT indicated its support for the proposition that a new DORC valuation could be required over time, or that if no new DORC valuation were implemented, then appropriate roll forward provisions could be included in Guideline No. 2, with appropriate safeguards so that any annually revised valuation methodology would not adversely impact APT's ability to achieve a positive (or an appropriate) return on investment over the concession period.

1.2 Section 3.3.3 (Annually updating asset values)

- (a) APT notes from the Draft Decision that ESCOSA's preferred outcome is for the introduction and implementation of an annual roll forward mechanism to take account of changes to the value of the Railway Infrastructure Assets, rather than the use of further DORC valuations.
- (b) APT further notes ESCOSA's comments in the Draft Decision that implementing an annual roll-forward mechanism has certain advantages over (what is perceived as) the reasonably inflexible and subjective alternative approach of further DORC valuations over time. The Draft Decision therefore presents ESCOSA's position as mutually exclusive alternatives. That is, provision is made either for future DORC valuations or an annual roll forward mechanism is to be used to update the value of the Railway Infrastructure Assets based upon the Initial DORC valuation of those assets (ie; \$1,696.6 million dollars, in dollars as at 1 July 2003).
- (c) APT considers that the maximum level of flexibility should be retained by ESCOSA (appropriately reflected in amendments to the Guidelines) to adopt an alternative (and possibly complementary) approach to future updates of Railway Infrastructure Assets. As much as APT is supportive of the annual asset roll forward methodology, the ability to use further DORC valuations in certain appropriate circumstances should not be excluded.
- (d) Further, APT's view is that both methodologies could also be used in combination, such that a revised DORC valuation were carried out every 5 years (or at such other periodic interval), with asset roll forward calculations implemented in between, based upon the most recent DORC valuation. APT believes that this strategy would benefit from the advantages of each system, without becoming an administrative inconvenience to any party. This would result in a system similar to that used by ARTC, and achieve the aim of aligning the regulation of the Railway more closely with the ARTC system.
- (e) The principal circumstances where APT considers that a DORC valuation should be used in preference to an asset roll forward calculation are:
 - (i) **Recovery/Restoration of Functionality of Railway** - in the event of a major capital expenditure in respect of the Railway Infrastructure Assets that was not clearly an addition or disposal, nor an event of depreciation or linked to inflation (ie; the critical replacement of a material part of the asset, to restore functionality after a major natural disaster or other unforeseen event);
 - (ii) **Use of Inappropriate Inflatons in Asset Roll Forward Calculation** - where APT (acting reasonably) disagreed with the proposed application of Inflationary indicators (such as CPI) in the asset roll forward calculation, and where it considered that other variables were more suited to recording the inflationary pressures on the operation of the Railway (on the understanding that a revised DORC valuation would derive an updated replacement value of the Railway); or
 - (iii) **By Mutual Agreement** - where ESCOSA and the access provider (both acting reasonably) agreed that the use of a revised DORC valuation were more appropriate than the use of the annual asset roll forward mechanism.
- (f) The effect of the proposed amendments to Guideline 2, Section 2 will be to mandate one mechanism (ie; annual asset roll-forward calculation) to the exclusion of the other (revised DORC valuation).



- (g) ESCOSA's comment that "[u]pdating asset values to reflect new capital invested and the return of funds to investors (regulatory depreciation) provides greater certainty that investments made in the Railway will be recovered, and thus provides further incentive for investment" is noted. It is not clear to APT what the relevance of regulatory depreciation is to the concept of investor return on investment. Further explanation is sought on this point.
- (h) APT notes ESCOSA's comment that by opting for an annual roll-forward methodology (and thereby not permitting a revisitation of the Initial Railway asset value), the access provider could be denied a windfall gain that could result in the application of pricing on the basis of a revised (ie; increased) initial Railway asset value. Although (in theory) windfall gains could result, APT's view is that, in combination (as the access provider) APT's prudent operation of the Railway;
- (i) the regulatory oversight of access arrangements to the Railway; and
 - (ii) commercial pressures on APT to provide access at competitive rates,
- are such that windfall gains would be unlikely to result.

Therefore, APT does not agree with ESCOSA's conclusion resulting from this point.

- (i) Although APT notes ESCOSA's comment that the "... *main point at issue in any roll forward relates to additions to Railway Infrastructure Assets*", APT does not consider that 'additions' to infrastructure are the *only* or, for that matter, the *main* relevant variable consideration in the proposed roll-forward methodology. APT's position (and a principal basis for its concern relating to the adoption of an appropriate forward valuation methodology) is that the other variables also referred to by ESCOSA – depreciation, disposals and inflations – should be fully taken into consideration.
- (j) Whereas APT considers that instances of disposals of Railway Infrastructure Assets are likely to be infrequent, the impact of inflation (particularly in relation to the cost of labour, goods, services and consumables procured by APT for the continued operation of the Railway) is considered to be of primary importance as well.
- (k) APT notes ESCOSA's observation that three factors are relevant in determining whether 'additions' to Railway Infrastructure Assets should be taken into consideration in roll-forward methodologies.
- (l) The first is that "*any additions to the Railway must be consistent with the coverage of the Code*". Presumably this means that in order for an addition to Railway Infrastructure Assets to be a relevant consideration taken into account in an annual roll-forward calculation, it must first be an addition that is consistent with the purposes and objectives of the Code. This concept is referred to as "*allowed capital expenditure*" in ESCOSA's proposed guideline amendments.
- (m) APT acknowledges and agrees with this comment. Given:
- (i) the capital intensive nature of infrastructure additions to the Railway; and
 - (ii) the operational requirements of existing customers/access seekers (particularly in relation to the development of the bulk minerals business),

all additions to the Railway to date are, and all foreseeable future additions are likely to be, consistent with the Code's objectives. APT considers there to be an extremely low likelihood of a Railway addition that is not consistent with Code objectives, unless it is an addition that is independently funded by an access seeker (in which case it is likely to be proximately linked with some other asset – such as a mine – near the Railway).



- (n) As one example, APT agrees that an independently-funded siding from the Railway to access a third party asset (such as a bulk minerals storage facility or a mine) may not be an "addition" appropriately taken into consideration for an annual roll-forward calculation. However, a passing loop constructed to service the Railway as a consequence of increased usage of the Railway from that siding would, by contrast, be an appropriate "addition" to be considered, and it must be considered in any roll-forward calculation. Therefore, to quarantine certain additions so that they cannot be taken into account for roll-forward calculations risks excluding a category of ancillary expenditure that is, conversely, appropriate to take into consideration.
- (o) ESCOSA's second observation is that *"the value of the asset acquired or constructed must not have been recovered (for example by capital contributions and donations)"*. Whereas APT agrees with that observation as a general comment, it should also be acknowledged that the construction or inclusion of a fully-funded "addition" to the Railway in circumstances that ESCOSA considers inappropriate for consideration in a roll-forward calculation, can also lead to various cost increases on APT's part that are relevant to the operation of the Railway Infrastructure Assets, and which are therefore relevant considerations for roll-forward calculations when viewed as a whole. For instance, APT may incur expenditure in relation to the operation and maintenance of those "additional" assets.
- (p) Finally, APT agrees with ESCOSA's observation that it is not appropriate to subject the amount of any capital expenditure to any test of efficiency or prudence (presumably in the application of the roll-forward methodology). In one sense, APT's position on this point is similar to that in response to ESCOSA's first observation (outlined in paragraph 1.2(g) above). That is, given:
- (i) the requirements of existing access seekers; and
 - (ii) the operational requirements of the Railway,

APT considers that all additions to Railway Infrastructure Assets to date will have met, and future additions will most likely meet, tests of efficiency and prudence when viewed as a whole.

1.3 Proposed Amendment to Guideline No. 2, Section 2 (*Ceiling Price*)

- (a) Subject to paragraph 1.3(b) and (c) of this submission, APT is supportive of the proposed amendments to Section 2 (*Ceiling Price*) of Guideline No. 2. APT agrees that this will be effective in introducing a roll-forward methodology for future valuations, without the need for periodically revised DORC valuations.
- (b) APT's support is conditional on the proposed amendments being interpreted and applied in such a way as to satisfy the concerns outlined by APT in Sections 3.9(c) of the Initial Submission. That is, the proposed amendment must not adversely impact upon APT's ability to achieve a positive (or an appropriate) return on its investment over the 50 year concession period under the Concession Deed.
- (c) As noted in section 1.2(b) to (d) of this further submission, if it is accepted that alternate future valuation methodologies for Railway Infrastructure Assets are appropriate, such that future DORC valuations can be used in certain prescribed circumstances, then further amendment is required to Section 2 of Guideline No. 2.
- (d) APT proposes that the first paragraph in the part of Section 2 to be headed 'Value of the Railway as at the commencement of operations' be worded as follows:

"Unless the Arbitrator and the Access Provider (both acting reasonably) otherwise agree that a revised DORC value should be used, this sub-section will be apply to the establishment of the value of the Railway as at the beginning of one year on the



roll forward of the value of the Railway to that year from the immediately preceding year.

In the event that it is agreed that a revised DORC value should be used, then that value is to be established and/or verified by an experienced and independent valuer using valuation principles and methodologies consistent with the principles and methodologies applied in the independent valuation of ARTC's Interstate Network assets approved by the AGCC (or should that cease to apply, then such other equivalent substituted approved methodology)".

1.4 **Proposed Amendment to Guideline No. 2, Section 5 (Arbitrated Price where there is no Sustainable Competitive Price)**

- (a) APT repeats the position outlined in the Initial Submission regarding ESCOSA's proposal for reference pricing, especially in circumstances where it is considered that the "no sustainable competitive pricing model" should be applied to new or emerging streams of business on the Railway (principally bulk minerals transportation).
- (b) APT's position remains that the current reference pricing model is adequate for application to bulk minerals transportation on the Railway. This is because it can be demonstrated that sustainable, alternate, competitive transport modes exist for the majority of freight tasks on the Railway.
- (c) Against that background, APT notes ESCOSA's proposed amendments to Section 5 of Guideline No. 2, and considers that there are likely to be relatively few instances where these amendments will be applied in practice.
- (d) Subject to the remaining sub-paragraphs of this section 1.4, APT is supportive of the proposed amendments to Section 5 of Guideline No. 2.
- (e) APT acknowledges that these proposed changes are necessary as a consequence of the amendments made to Section 2 of Guideline No. 2 to introduce a roll-forward methodology (notwithstanding APT's view about alternate valuation methodologies). In so far as the amendments to Guideline No. 2, Section 5 are merely consequential changes, APT has no specific issues to raise, and is supportive of the changes.
- (f) Secondly, APT seeks to clarify that the rate of return should be calculated across the full duration of the access provider's investment in the Railway Infrastructure Assets (ie; the period of 50 years under the Concession Deed).

1.5 **Determining a 'Reasonable Rate of Return' Under Guideline No. 2**

- (a)
- (b)
- (c)

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(d)

(e)

(f)

2. **Reference Prices (Draft Decision, Section 4)**

2.1 In response to Section 4.3 of the Draft Decision (dealing with ESCOSA's analysis of the application of reference pricing to the Railway) APT's position is as follows.

2.2 In the Draft Decision, ESCOSA notes that:

"In some situations, access prices that differentiate between the direction of traffic may not be cost based and may reflect the misuse of market power. In some instances, however, it



may be a reflection of other factors. For example, differentiation between northbound and southbound pricing could simply reflect a high fixed component to APT's pricing."

- 2.3 As a general observation about pricing structures (unrelated to APT's operation of the Railway), ESCOSA's comment reflects one of the possible bases for the structuring of access pricing by some access providers in relation to other assets. However, APT rejects – absolutely, and in the strongest terms – any implication conveyed by this statement (whether or not intentional) that differential access pricing between traffic on the Railway in different directions results from any misuse of market power by APT.
- 2.4 APT requests that all subsequent versions of the Draft Decision and ESCOSA's final decision be amended:
- (a) to delete the following sentence:
- "In some situations, access prices that differentiate between the direction of traffic may not be cost based and may reflect the misuse of market power",*
- with appropriate amendment to associated parts of the decision; or
- (b) so that the above sentence and subsequent sentences clarify the non-specific nature of ESCOSA's statement, to remove any implication of an abuse of market power by APT in access pricing:
- "It is acknowledge that in situations (not specifically related to APT's operation of the Railway), access prices that differentiate between directions of traffic may not be cost based and may reflect misuse of market power by a relevant party in control of access to an asset. In some instances, however, it may be a reflection of other factors. For example, and with specific reference to APT's operation of the Railway, differentiation between northbound and southbound pricing could simply reflect a high fixed cost component to APT's pricing."*
- 2.5 In other respects, APT agrees with, and welcomes, ESCOSA's assessment that it is too early to justify imposing ARTC-like reference pricing on the access provider by way of a variation to Guideline No. 1.
- 3. ARTC undertaking and CIRA (Draft Decision, Section 5)**
- 3.1 In response to Section 5 of the Draft Decision, APT notes ESCOSA's conclusion that "[f]or now there is little that the Commission can do to further align the guidelines to ARTC's Interstate Access Undertaking".
- 3.2 This statement implies that ESCOSA is inclined to take further steps to vary or amend the Guidelines to make them more consistent with ARTC's Interstate Access Undertaking (which undertaking, it is noted, is separately under review). The statement therefore implies ESCOSA's preparedness to take positive action in this regard. The draft decision proposing not to vary the Guidelines "at this time" is noted. In other words, ESCOSA has indicated that the likelihood of it taking no further action to align the Guidelines to the ACCC undertaking, despite APT's comments in the Initial Submission, is low.
- 3.3 In response to the Draft Decision, APT repeats the position outlined in the Initial Submission. That is, APT:
- (a) generally supports the principal of consistency between access regimes that govern the Railway and the ARTC system under the ACCC undertaking;
- (b) considers that the existing provisions in Guideline No. 1 and 2 regarding consistency with the ARTC undertaking are an adequate level of regulation;



- (c) remains **not supportive** of principles of consistency regarding reference pricing between the Railway and the ARTC system;
- (d) remains **not supportive** of the proposition that the emergence of bulk minerals traffic on the Railway is a relevant consideration in examining consistency between the Railway and the ARTC system;
- (e) considers that there are not compelling reasons, presently, why ESCOSA needs to take into account matters relevant to CIRA in reviewing the Guidelines; and
- (f) does not consider that the Guidelines need be impacted by any of the CIRA implications, because the existing provisions of the Guidelines regarding alignment of the access regimes of the Railway and other nationally significant railway infrastructure, is already adequate.

APT trusts that this further submission to ESCOSA in response to the Draft Decision, is useful.

Yours faithfully

John Fullerton
Chief Executive Officer

CC: Ms Vanessa Loughlin – Asia Pacific Transport Pty Ltd