19 April 2024

Jeremy Threlfall
Economic Regulation Authority
Level 4, Albert Facey House
469-489 Wellington Street
Perth, WA 6000

Dear Mr Threlfall,

Re: Arc Infrastructure - proposed costing principles

Executive Summary

Pacific National welcomes the opportunity to comment on the 2024 Costing Principles proposed by Arc Infrastructure.

Pacific National has an interest in this process given we operate trains on the Arc Infrastructure standard gauge rail network between Perth, Kalgoorlie and Esperance.

We appreciate the recent amendment of the Railways (Access) Code 2000 (the Code) in December 2023 has expanded the scope of information to be included in the costing principles, given the change in the asset valuation method from Gross Replacement Value (GRV) to Depreciated Optimised Replacement Cost (DORC).

To support this change greater detail of the costing principles is required, along with clarity on benchmark and assurance processes. This would reduce information asymmetry, provide greater certainty for Access Seekers, and help support effective network performance and negotiations. Our recommendations to amend the Costing Principles and improve policy settings include:

- DORC methodology must be flexible enough to allow consideration of the life and conditions of the assets and place a zero value on assets whose actual life exceed their expected useful life.
- Costs should be prudent and auditable and Arc's process to establish the efficiency of operating costs should be outlined in the Costing Principles. To address information asymmetry, Access Seekers and the regulator should have visibility of costs and be provided with sufficient information to assess the prudency of costs and capital expenditure.
- Greater detail should be provided on process and consultation timeframes for the Regulatory Asset Base (RAB) valuation.
- Further information is required on the assumptions for Modern Equivalent Assets (MEA), including a definition and examples of the 'efficient entities' used as a baseline and what constitutes an 'experienced entity'.
- The Costing Principles should provide details of the optimisation process Arc will employ.
- The construction approach should specify that only development and construction costs that are based on economic merit are to be included.
- Asset indexation should be allowed to be less than zero if there is annual deflation.

- A consultation policy should be developed that sets out how the Railway Owner will consult with Access Seekers on capital expenditure projects.
- The Costing Principles should include more detailed information about how economic life will be set and the process to be used.

Further detail on these recommendations is provided within the body of this submission.

DORC Asset Valuation

The 2024 Costing Principles reflect the recent amendments made to the Code to change the asset valuation method to DORC and align the floor and ceiling cost calculations to a building block method with an initial DORC valuation.[1] Regulators typically use a DORC methodology and under the negotiate arbitrate model with an initial asset valuation, the ceiling price effectively becomes a regulatory building blocks calculation.

Pacific National agrees with the change of asset valuation methodology to DORC. However, the mechanics of the DORC methodology need to remain flexible enough to allow consideration of the life and conditions of the assets. For example, in its decision on Queensland Rail valuation, the Queensland Competition Authority (QCA) placed a zero value on assets whose actual life exceed their expected useful life. This is because it is reasonable to consider these assets have already been fully depreciated and including them would amount to double counting and excessive returns.[2]

We note that while a DORC valuation is appropriate for setting a maximum revenue cap, in the case of the Arc network it does not offer sufficient protection for rail operators against large price increases (even if revenue remains below the ceiling). This is because within the negotiate arbitrate access approach, Access Seekers are required to negotiate with a natural monopoly rail infrastructure provider. For this reason Pacific National has previously called for the development of an indicative tariff for reference services.

Addressing information asymmetry

Access Seekers and regulators face significant information asymmetry if asset owners are not compelled to provide financial information. Within the negotiate arbitrate model, access negotiations and outcomes can be improved by requiring the Railway Owner to supply a level of cost information that facilitates balanced negotiations.

Other regulatory models either contemplate or mandate this level of detail. For example, gas and electricity companies' applications to the Australian Energy Regulator for five-year regulatory revenue proposals and access arrangement decisions include their detailed financial model

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[1] DORC measures the theoretical cost of replacing an asset with a modern equivalent asset (if it were to be built today in a way that was efficient and depreciated to match the age of the asset. The DORC calculation reflects the cost of constructing the asset (to the same standard) to meet the needs of the users.
[2] Queensland Competition Authority Queensland Rail's 2013 Draft Access Undertaking, Draft Decision October 2014, p 138

spreadsheets with workings.[3] In the context of the Arc network, the Railway Owner should provide stakeholders and the regulator with sufficient information to assess the prudency of capital expenditure and this information should be audited.

Costs should be prudent and auditable

In determining the DORC for each Route Section of the Railway Network there must be transparency around the modelling process and assurance requirements to ensure costs are prudent. This would reduce information asymmetry and help support effective negotiations and network performance.

Arc should provide full disclosure of costs (i.e. design development, planning and approval costs; material costs; construction costs; project and construction management costs; funding costs) with cost calculations made available to rail operators and Access Seekers. If Access Seekers don't have visibility of independently-tested cost information it places them at a disadvantage in negotiating efficient access prices, as only the access provider has detailed knowledge of their costs. Without this, it is impossible for an Access Seeker to assess the reasonableness of a proposed access charge given the asymmetry of information between the Railway Owner and Access Seeker.

We note that the Code s47(W) requires the Regulator to assess the efficiency of operating expenditure, but the need for prudent and efficient operating costs should also be reflected in the Costing Principles. Arc should test whether the applicable operating costs are efficient by comparison to benchmarks and industry standards and the process Arc intends to use to establish the efficiency of operating costs should be outlined in the Costing Principles.

Regulatory Asset Base

<u>RAB Valuation Date</u>

The Costing Principles state that the Railway Owner will determine the value of the Initial RAB of the Railway Network as at 31 December 2024, or such other date as agreed with the Regulator.

Pacific National would appreciate greater certainty being provided on the timeframes for public consultation and would welcome the ERA publishing the process and expected timeframes for approval of the RAB and DORC valuation. This would improve certainty and guidance around expected timeframes for Access Seekers, particularly in light of the lengthy processes that have occurred for DORC valuation of the Interstate network.

<u>Replacement Cost</u>

The asset replacement cost used in the Initial RAB will be based on construction of Modern Equivalent Assets (MEA). Asset values are difficult to derive, and the assumptions will always be somewhat subjective. For this reason there must be transparency for rail operators and stakeholders around the process and assumptions.

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[3] ACCC Draft decision Australian Rail Track Corporation's 2018 Interstate Access Undertaking 20 December 2018, p 116

As the Costing Principles note, the MEAs comprise the assets and form of construction which would be designed and constructed at the valuation date, using modern design techniques, constructed from modern materials using modern methods, and in compliance with prevailing legislation and prevailing standards.

However, all networks include legacy assets and in addition to focusing on what assets are in place now (with an allowance for technology, construction learning curve and modern design techniques) there also needs to be consideration of what network would be built today using modern technology and methods. The assets required today may look very different if decisions were being taken today.

The assets that an efficient above rail operator would not require on the Arc network should be written down to a zero value. A commercial rational investor would not invest in a large portion of those existing assets.

<u>Benchmarks</u>

Definitions of proposed benchmarks should be included in the Costing Principles. For example, where the Costing Principles state that:

> *design development, planning and approval costs, construction costs, and project and construction management costs will be based on those typical for efficient entities developing an asset of this scale, considering variations in cost relating to distance, geography and local factors at each Route Section*

the use of 'efficient entities' as a benchmark should be defined and updated to include examples of the 'efficient entities' that will be considered.

Detail should also be provided in the following section as to what constitutes an 'experienced entity' and how Arc will benchmark this:

> *funding and opportunity costs will be estimated by applying the appropriate Weighted Average Cost of Capital (which will be determined by the Regulator) to a development cost curve over a realistic project development duration. The project schedule will be developed to represent the realistic minimum duration, without being unduly rushed, that an experienced entity would require to complete the development*.

<u>Contributed Capital</u>

Pacific National supports the notion of removing grant funding from the asset calculation, particularly where legacy assets have been established with Government funding.

<u>Optimisation</u>

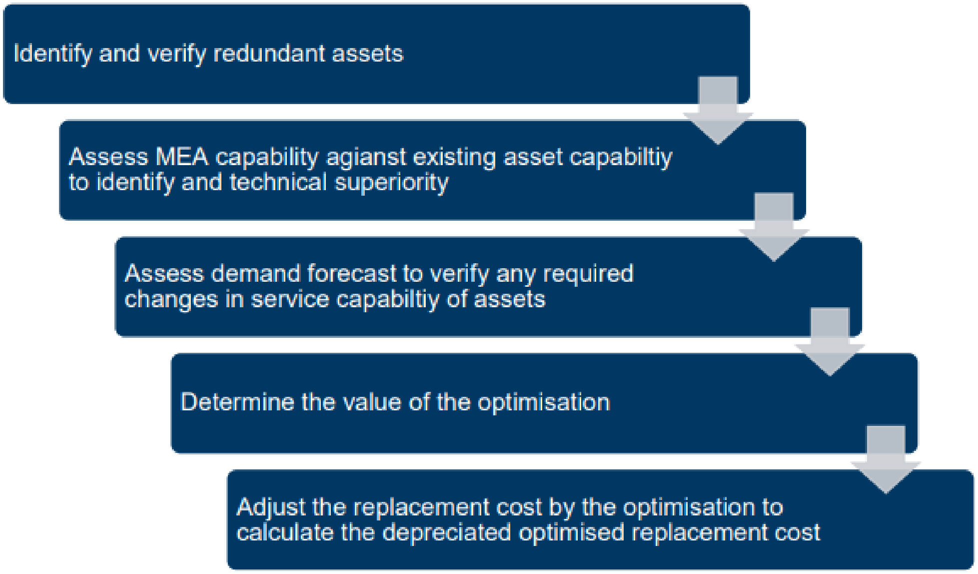
The Costing Principles state that:

> *The optimised asset configuration will be that which has the capacity to meet the actual and reasonably projected demand, within the physical constraints of the existing rail corridor, that can be constructed at least cost. To achieve this, the asset replacement cost will be based on an optimised asset configuration where the existing asset configuration is adjusted as required to deliver the level of service.*

More detail on the optimisation approach should be supplied in the Costing Principles, including an explanation of what the ‘reasonably projected demand’ is and how it will be calculated. We suggest that Arc utilises at least ten years of historical demand data to inform their projections and provides Access Seekers and the regulator with a clear explanation of their forecasting methodology.

We would expect to see a set of optimisation principles included in the Costing Principles. As an example, the optimisation approach that was proposed for the ARTC Interstate Network is shown in Figure 1.

Figure 1: Overview of approach to optimisation for the ARTC Interstate Network



Source: GHD Advisory & ACCC, *Developing a Regulatory Asset Base value for the Australian Rail Track Corporation Interstate Network, using the Depreciated Optimised Replacement Cost method Draft Public Report*, June 2021[4]

<u>Construction Approach</u>

The construction approach should outline the need for prudency in developing the cost of constructing the asset and specify that only development and construction costs that are prudent and based on economic merit are to be included.

<u>Asset Indexation</u>

Pacific National disagrees that the Asset Indexation value should not be less than zero. The CPI index should apply regardless of the direction of CPI movement. This avoids the Railway Owner being overcompensated, which would have been the case for example during/after the COVID pandemic.[5]

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[4] https://www.accc.gov.au/system/files/GHD%20Advisory%20-%20Draft%20Public%20Report%20-%20ARTC%20Interstate%20Network%20DORC%20valuation.pdf?ref=0&download=y

[5] During the COVID19 pandemic Australia experienced annual deflation, but this was followed by a sharp rise in CPI that saw it reach 7% in 2023.

We also recommend that All groups, 8 capital cities CPI should be used instead of Perth CPI. This would support regulatory harmonisation with other rail networks and regulated industries.

Capital Expenditure

The Costing Principles should state that capital expenditure must be confirmed as prudent before it can be added to the RAB and include a consultation policy that sets out how the Railway Owner will consult with Access Seekers on a capital expenditure project.

A consultation process is likely to result in better outcomes to rail operators and Access Seekers and provide surety that capital expenditure is prudent. As a process, Pacific National suggests that the Railway Owner could release a consultation paper that articulates the capital expenditure project objective and provides options to meet the objective and allocate funding. This would then trigger a public consultation. The process could be strengthened by introducing a requirement to conduct a high-level cost benefit analysis or ex-ante and ex-post project review, to consider economic outcomes from the investment.

Depreciation and Economic Life

There is reference in the Code in s47(K)(5) to parameters around the depreciation profile and economic life. This should be reflected in the Costing Principles and more information should be provided about how economic life will be set and the process to be used.

Pacific National considers that any process for setting or adjusting asset lives should be designed to minimise the risk of price shocks, and seeks clarity on how Arc will be setting them to minimise uncertainty for rail operators. We note that s47(K)(5)(d) of the Code states that the depreciation schedule should be:

> *designed so that access prices will vary over time in a way that promotes efficient growth in the market for rail access* and *allow for the legitimate business interests of the railway owner, Access Seekers and access holders*.

We trust you find our feedback on the proposed costing principles useful. If you wish to discuss the contents of this submission please contact me on 0474 368 293 or at Susan_Furze@pacificnational.com.au.

Yours sincerely,

Susan Furze
Regulation Access & Policy Manager – Pacific National