Clara Cuevas
Manager, Regulatory Reform
Department of Treasury
Locked Bag 11, Cloisters Square
Perth, WA 6850
Australia

WA Rail Access Regime Review

11 March 2019

Dear Clara,

Aurizon Operations Limited (**Aurizon**) has been an active participant in the WA Department of Treasury's review of Western Australia's Rail Access Regime (**WARAR**). Aurizon remains committed to the review processes undertaken by the Economic Regulation Authority (**ERA**) and acknowledges the transparent and engaged way WA Treasury has conducted the review.

The purpose of this letter is to further contribute and assist WA Treasury in the refinement of the proposed reforms of the Draft Decision Paper (the **Paper**) to enhance and promote workability in the following key areas:

1. the use of Depreciated Optimised Replacement Cost (**DORC**) to establish the Initial Asset Base (**IAB**);
2. the role and application of any transitional provisions;
3. the roll-forward of the Regulated Asset Base (**RAB**);
4. Pricing Guidelines, and
5. Interim orders.

1. Using DORC to establish the IAB

The use of DORC is preferred by Aurizon to the use of Gross Replacement Value (**GRV**) due to its closer alignment with the infrastructure standard and costs of providing the service. However, it is noted that any adjustments necessary to reflect the interests of the rail infrastructure owner's investment in the asset that results in the RAB drifting from its efficiency objective would substantially diminish the benefits of the change to DORC while involving significant implementation costs.

Process. The methodology for determining the initial DORC valuation described in Table 3 of the Paper outlines a process wherein the railway owner makes a proposal which is then followed by a draft decision. This process does not appear to contemplate any stakeholder consultation being undertaken prior to the making of a draft decision. This significantly diminishes the role of informed stakeholders in the regulatory process. This is particularly important as the consultants would not have the benefit of stakeholder insights and in-depth knowledge of the asset performance, and the ERA would not obtain relevant information on matters such as capital contributions and other third-party funding arrangements relevant to a DORC valuation.

Contributions. The draft decision paper does not discuss the issues around capital contributions and/or accelerated asset investment recovery programs. Aurizon notes the consideration of the legitimate business interests of the owner of the rail asset in establishing the IAB needs to be balanced against the interests of users of the service to ensure the valuation process does not result in substantial windfall gains or losses. For example, the fundamental premise of the transitional arrangements is to avoid imposing economic costs on the asset owner from the change in valuation methodology. This principle should operate symmetrically such that the asset owner does not also obtain the economic benefit of the inclusion of customer funded assets in the regulatory asset base or valuing assets which assume a longer depreciation profile which have been subject to an accelerated funding arrangement through a customer access agreement.

The economic life assumptions in the DORC valuation therefore need to reflect the extent to which the assets have been subject to capital contributions or accelerated depreciation.

2. The role and application of Transitional Arrangements

The Paper contemplates the use of transitional arrangements to protect the interests of the access provider where investment has been made based on the GRV approach. Aurizon does not support the application of transitional arrangements to assets which are subject to periodic replacement and renewal, and makes the following comments on the transitional arrangements:

- the Paper argues that in transitioning to DORC-based valuations the access provider may not have had the opportunity to earn higher revenues in the early years of the asset life when DORC capital charges exceed GRV annuity charges. This conclusion is unlikely to be relevant to the ARC Infrastructure Network which comprised a largely written down asset when the WARAR commenced. In this regard, ARC Infrastructure has not been denied the DORC based profits as the DORC capital charges at the commencement date of the regime would unlikely have exceeded the GRV annuity.

  Aurizon supports the transitional arrangements to the extent that ARC Infrastructure can demonstrate and quantify the extent of any actual economic loss from the regulatory change. As all prior access arrangements have been negotiated outside of the code then there is no direct evidence that ARC Infrastructure will have foregone any past revenue benefit from Code agreements.

- transitional arrangements should not provide a windfall gain by raising the RAB capital charges above the GRV annuity.

  The Synergies modelling assumes assets are new at time period 1 and renewals are lumpy and occur at fixed intervals. In practice, the ARC Infrastructure network comprises a weighted average life of asset and continuous renewal program. In adjusting the depreciation to lift the DORC capital charges to the GRV limit then any asset renewals over the transition period will elevate the RAB roll-forward above the GRV annuity charge.

- transitional arrangements should have regard to the extent of any renewal deficit and funding by considering the historic levels of asset replacement expenditure.

The GRV approach included compensation for the replacement of assets. In this respect when transitioning to the DORC-based approach the asset owner obtains the benefit from the prior provisioning for asset renewals (i.e. asset renewals would not have increased the ceiling limit) and then also being compensated through the inclusion of the full costs in the RAB roll-forward.

- The proposed framework for managing the transition seeks to apply annuity depreciation for a five-year period. While unclear from the Paper it is assumed that the RAB roll-forward will then switch to a straight-line method from year 6 going forward. Aurizon does not support the proposed transitional arrangements if they artificially inflate the RAB valuation and distort asset values from forward looking costs and benefits.

- the valuation needs to differentiate assets based on:

  - financial capital maintenance (economic depreciation);

  - physical capital maintenance (remaining useful life)

  Where assets require periodic maintenance and renewal on the basis of asset utilisation then the valuation of these assets should reflect their remaining service potential. The capital charges associated with these assets will therefore more closely align with the long-term marginal costs. This approach also avoids distorting future prices by increasing the likelihood that at the time an asset is replaced or renewed it will be fully depreciated in the RAB.

  Where transitional arrangements require the 'backloading of depreciation' this should occur through non-depreciating assets which are unlikely to require replacement, upgrade or renewal such that it does not distort future utilisation or investment decisions.

  The following table demonstrates how this would apply in practice.

Asset Type	*Asset depreciation*	*Depreciation Method*
Bridges	Time based	Economic
Culverts	Consumption based	Condition
Track Grade	Time based	Economic
Formation	Consumption based	Condition
Tunnels	Time based	Economic
Ballast	Consumption based	Condition
Sleepers	Consumption based	Condition
Rail/Turnouts	Consumption based	Condition
Signalling/Communications	Time based	Straight-line

3. Roll-forward of the RAB

The Paper notes that the RAB would be reviewed periodically (five years) by the ERA.

It is desirable that ARC Infrastructure be required to prepare and publish an indicative roll forward annually to provide transparency regarding asset renewals and investments. Aurizon recognises that the proposals seek to strike the right balance between costly periodic regulatory reviews by the regulatory and the benefits of maintaining the RAB roll-forward approach.

Aurizon notes that several issues have arisen in the ACCC's draft decision on the Interstate Access Undertaking on the RAB roll-forward associated with delayed ex-post prudency reviews of past capital expenditure. In this regard, an annual capital expenditure report would allow stakeholders to track the RAB roll-forward for transparency and reduce the regulatory burden associated with an annual capital expenditure review. It would also reduce the risk of regulatory error and mitigate information quality and data availability issues at the 5-year review.

Aurizon also recommends that the Code should clarify that the WACC is in real pre-tax terms and that the RAB is indexed (or appreciated) annually by CPI

4. Pricing guidelines

Aurizon considers that the primary beneficiaries of, and therefore the relevant market for, standing offer prices is likely to be interstate intermodal services. To reduce the risk of regulatory creep and to support good regulatory governance and accountability Aurizon recommends that where the ERA proposes to require the railway owner to publish a standing offer then the ERA should publish a notice of its intention and invite submissions of interested stakeholders to assess the costs of and benefits of requiring the standing offer.

Aurizon considers that the use of Competitive Imputation Pricing (CIP) to have merit in providing a benchmark price to support price negotiations and arbitration proceedings. Aurizon also notes that CIP is comparable to economic concepts such as an 'Efficient Component Pricing Rule' and 'Retail-Minus-Pricing'. CIP pricing under the Australasian Rail Code remains largely untested and the factors relevant to what discount rail requires against the competitive alternative could be quite diverse and complex. Therefore, Aurizon supports the recommendation that CIP should be restricted to providing guidance to the determination of an access price rather than being used as the primary method of determining a price. As noted in earlier submissions this is also necessary to ensure that the CIP does not produce an access price which does not allow the railway owner to recover its direct and actual investments and efficiently incurred costs for the route.

5. Interim Orders

Aurizon support the draft recommendation 13 to allow for an arbitrator to make an interim order on an access price and the terms of access if parties have an existing access agreement. However, Aurizon considers the recommendation that this only apply to the extension of an existing Code access agreement to be overly restrictive. In this regard the changes would provide limited practical benefit to existing Non-Code access agreements, which represents all existing access arrangements.

Provided the arbitrator has the ability, and the access seeker agrees for the decision of the arbitrator to have retrospective effect, then the issuance of an interim order would be solely with respect to terms and condition under a Code agreement. It would therefore be unnecessary to make the distinction between a Code and non-Code agreement as proposed in the draft decision.

Aurizon continues to support the WARAR’s focus on promoting appropriately balanced and informed commercially negotiated terms and conditions of access while striking an appropriate balance between regulatory prescription and efficient negotiation processes.

Aurizon would welcome the opportunity to further engage with WA Treasury over the content of the Paper and the subsequent response contained herein. Aurizon has a high degree of confidence that the final recommendations made through the review of the WARAR will result in a more efficient and competitive market for rail operations in WA.

Kind regards,

Peter Klein
Head of Strategic Growth & Partnerships