New Hope
Corporation Limited

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YOUR REF:
OUR REF: SOS:AHW

18 July 2014

Mr Stephen Wisenthal
Queensland Competition Authority
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Dear Stephen,

QUEENSLAND RAIL'S WESTERN SYSTEM COAL TARIFFS
NEW HOPE CORPORATION SUBMISSION

New Hope Group (NHG) appreciates the Queensland Competition Authority's substantial effort and rigour in considering the Western System tariff, and welcomes the opportunity to make a further submission to the Authority in response to its June 2014 Consultation Paper.

A comparison of Western System rail costs against other Australian coal rail systems demonstrates that Western System rail costs are uncompetitive (see Table 7 on page 45 of the June 2014 QCA Consultation Paper). The access tariff paid to Queensland Rail (QR), even without the additional impost of the tariff increase proposed by QR for the next regulatory period, threatens the commercial viability of NHG's existing activities relying on the Western System, and may prevent additional planned activities from passing the Group's investment hurdle. A reduction in the tariff is required to encourage long-term coal volume growth and to avoid stranding of the System's assets. In confidential Appendix 1 to this submission NHG provides financial data to substantiate these claims.

In 2006 the Western System tariff was set at 10.50/'000 gtk, a level undoubtedly influenced by low volumes. This tariff level made it the most expensive coal rail corridor in the country. Access holders could not have envisaged that QR would, in the space of only 7 years, propose a 125% tariff increase, especially in light of the significant increase in volumes on the system during that period, which would ordinarily result in lower tariffs.

In Appendix 2, using a single point tariff calculation which understates revenue, NHG estimates Western System coal access revenues in the financial year ending June 2007, CPI adjusted to the year ending June 2012 were approximately $20 million. Taking into account volume growth, and using the 2012-13 tariff, NHG estimates year ending June 2013 coal access revenue to be around $61 million – a threefold increase.

NHG is very supportive of the QCA's desire to establish a repeatable and transparent methodology for deriving the Western System tariff. This is required to allow access seekers to make informed investment decisions, to forecast costs and to quantify long term pricing risk.

This submission responds to the ten questions raised by the Authority in the order presented in the consultation paper, and also raises a number of other relevant issues under the heading "other issues".

Question:

1. ***Do you agree with the QCA's estimate that the effect of the metropolitan blackout is a reduction of 22% of possible western system train paths? If not, please provide supporting evidence with reference to the analysis in Appendix 3 of B&H's report.***

Response:

NHG acknowledges that the B&H report provides a sound methodology for the future assessment of peak period impacts on coal service capacity. However, NHG believes that the B&H analysis is likely to understate the full impact of suburban restrictions. More transparency from QR would clarify the true impact of non-revenue passenger services outside of the period 0700 to 0930, and 1500 to 1830 travelling to and from stabling, particularly on the Cleveland Line. In addition the impact of train planners and controllers' behaviour as they strive for on-time passenger services extends well beyond the peak period. NHG suggests the B&H methodology could be refined by considering a wider time band, and with access to further data from QR.

Accurate network closure data (dates, durations, nature of restrictions) on the Western System, Ipswich Line, Corinda to Yeerongpilly, Yeerongpilly to Park Road, through to Lytton Junction and the Fisherman Islands would assist in establishing network closure facts. Like passing through Swiss cheese, all the paths through each part of the network need to be open. The published network closure times understate the full impact on coal train services. Restarting coal train services after closures takes time before steady state is achieved which results in additional lost paths.

The above factors imply that the effect of the blackout in reducing train-path availability is somewhat larger than the QCA's current estimate.

NHG requests that QR be required to provide information on the number of coal trains operated during the blackout periods, and broader shoulder peak periods as well as the combined impact of potentially uncoordinated maintenance possessions. This information will enable the B&H methodology to be further enhanced to take full account of impacts in future regulatory periods.

Question:

2. Do you agree with the QCA's proposed approach to use contracted train paths in determining the volume estimate? If not, why not, and please provide supporting evidence.

Response:

The question of whether tariff calculations should be based on contracted train paths or another basis such as system capacity is difficult in the context of the Western System.

Using contracted train paths is consistent with past practice, however, NHG has concerns with the use of contracted train paths in the future. NHG's concerns relate to (i) actual capacity exceeding capacity (in terms of paths) that QR is willing to contract and (ii) the dysfunctional consequences should demand for coal paths reduce due to volume reductions. These concerns are detailed below:

(i) <u>System capacity and demand exceeds the capacity which QR is willing to contract</u>

The level of paths which is contracted is artificially constrained (below true system capacity) by Government (QR's shareholder). NHG has been seeking to contract additional train paths for the past three years and has been unable to do so because of this constraint. This, when combined with the use of contracted train paths in developing tariffs, has a number of implications, including:

- QR can readily capture additional returns by making capacity available on an ad-hoc basis. Customers will pay the full cost of the true capacity when railing at the contracted path usage, then will overpay for this same capacity if this tariff is applied to path usages in excess of contract. NHG has previously submitted that QR should earn a reduced tariff for path usages in excess of contract, based on QR's variable costs plus a nominal additional payment to provide an incentive.

- From the producers' perspective, paths in excess of contract have a lesser value than contracted paths, because their availability is uncertain and therefore these paths cannot be relied upon for investment decisions.

- Payment of the full tariff for additional paths provides an incentive for QR to limit the contracting of these paths, as QR's revenue will be maximised by withholding these paths from contracts and offering the paths on an ad-hoc basis.

- To the extent that capacity is withheld due to a Government requirement, which we understand is motivated by the potential future needs of passenger services, the cost of this uncontracted capacity should be allocated to 'non-coal' users when developing the notional coal asset base, rather than simply allocating the RAB between coal and non-coal on the basis of contracted paths.

(ii) A reduction in contracted paths should not flow through to higher tariffs

Using contracted paths in determining tariffs may suggest that tariffs will increase further in the event that contracted paths are relinquished or are not renewed on expiry. Given the high and uncompetitive existing (and proposed) tariff levels, such an increase would not be sustainable.

The above concerns could be addressed by:

- Adopting system capacity as the forecast, **OR**
- Adopting contracted train paths as the forecast **but**:
    - Developing a lower 'tier 2' tariff for train paths in excess of contract **AND**
    - If the 'allocated DORC' approach is used, allocating the cost of capacity which is not available for contracting to 'non-coal' **AND**
    - Ensuring that, in the event of any reduction in contracted paths, a full review of the derivation of tariffs is undertaken.

Question:

3. What is the appropriate asset valuation methodology for the western system? Please provide supporting evidence.

Response:

The QCA has discussed two possible approaches to asset valuation for the Western System, being an 'asset allocation' approach based on a DORC methodology, and a historic cost approach. NHG's understanding is that the historic cost approach involves coal paths paying the full cost of new investment which was triggered by demand for coal paths post 1995, and no return or depreciation for existing (pre-1995) assets, while the DORC approach treats all users as sharing in the system (regardless of the history of investment in the system), and allocates shares of the DORC of this system to coal/non-coal traffic. NHG considers that the historic cost approach is the most appropriate for the following reasons:

(i) <u>Application of DORC methodology is too subjective in the case of Western System assets</u>.

A DORC approach is feasible when the asset resembles a modern engineering equivalent and when allocation of the asset between customers can be undertaken on a reasonable basis. In the case of the Western System, the task involves such a level of subjectivity that the key driver of the resulting tariff becomes the subjective decisions themselves, more so that the original DORC valuation. Examples of the subjective judgements required when applying DORC in the Western System include:

- How should the asset value be optimised to reflect the condition of the asset and the effects of this condition on future maintenance and capex requirements?
- How should the asset value be optimised to reflect the fact that the asset is not a 'modern engineering equivalent' and therefore cannot provide a service level which is competitive with other systems? Adjustments required in this area need to reflect:
    - Impacts of low axle load and train length on above rail costs.
    - Impacts of blackout periods on above rail costs.
    - Impacts of capacity limitations on above and below rail costs.
- How should the asset value be allocated between coal and non-coal traffic? Issues include:
    - Assessment of the full impact of blackout/restriction periods.
    - Treatment of the cost of capacity which is not contracted due to Government requirements (i.e. capacity which is effectively being reserved for future passenger services).

The Metropolitan system provides a demonstration of this issue. Developing a DORC in this system would involve subjective judgements and allocation debates of such complexity that all parties involved, through successive undertakings, have accepted that a more practical alternative must be applied. As a result, tariffs in this part of the system are not based on a DORC assessment of the Metropolitan system. NHG considers that the same concerns should lead to adoption of an alternative, practical, approach for the Western System. The historic cost approach provides such an alternative that is both transparent and repeatable.

(ii) Tariffs arising from the DORC approach are unsustainable.

The uncompetitive and unsustainable level of a tariff based on the DORC approach has been demonstrated in numerous submissions of NHG and other parties. NHG considers that tariffs based on a DORC will lead to lower utilisation of the network and ultimately to lower revenue for QR. The recent closure of one of the three mines using the system demonstrates that the concern is genuine.

(iii) Historic cost approach provides full return on existing and future investment in coal paths.

Under the historic cost approach, all investment triggered by demand for coal paths is recovered from coal traffic. This ensures that QR can continue to invest in the network and earn an appropriate return on investments. An allocation approach in which a portion of post-1995 investment is deemed to be recovered from non-coal traffic (i.e. DORC) will:

- Fail to provide QR with an appropriate return on post-1995 investments.
- Provide a strong disincentive for further investment in the network.

(iv) Historic cost approach best achieves criteria under QCA Act as set in the table below:

Criteria	**Historical Cost**	**Allocated DORC**
Promote economically efficient operation of, use of, and investment in…infrastructure.	Achieves criteria	Fails: • Higher tariff will promote stranding of the asset rather than efficient use of the asset. • Allocation of a share of future capex to non-coal traffic will prevent future investment in infrastructure.

Legitimate business interests of owner or operator	Achieves criteria. Full return is received on post-1995 investment. Pre-1995 investment was based on non-coal traffic and QR's revenue from non-coal traffic is not adversely impacted by the entry of coal traffic. In fact, as noted by the QCA, (5.2 of consultation paper) "*without coal services, the pre-1995 network would generate revenues below its operating cost, and would be unlikely to cover even the lower capital spending that would have been required for QR to keep the track safe and operable*". The value of pre-1995 assets, in the absence of coal traffic, would be scrap value or, as a going concern, substantively negative.	Fails: • QR will not receive appropriate return on post-1995 investments.
Public interest	Achieves criteria. Promotes continuation of existing mining operations and encourages growth of the industry.	Fails: • Likely loss of employment and royalties. • Reduced competition in coal markets. • Likely loss of revenue for Government (as QR shareholder) as higher tariffs drive reduced utilisation and risk stranding.
Interests of Access Seekers	Achieves criteria	Fails: • Severe impact on competitiveness of mining operations and possible (further) mine closures. • Loss of business for above rail operator.

Effect of excluding existing assets for pricing purposes	Effect of exclusion of pre-1995 assets is reasonable due to nature and value of these assets. Recovery of value from these assets is excluded from coal traffics, but continues from non-coal traffic.	Inclusion of pre-1995 assets risks stranding assets and may ultimately reduce QR revenue.
Pricing principles	Achieves criteria: • Ongoing QR costs are recovered (opex, sustaining capex, maintenance) • Full return on post-1995 investment is received • QR may seek return on the (negligible) written down value of pre 1995 assets from non-coal users.	Fails: • Allocation of a portion of post-1995 and future capex to non-coal will not provide an appropriate return on this investment.

Finally, NHG submits that the extreme difficulties and subjectivity involved in applying the allocated DORC approach is a relevant issue. NHG suggests that, as for the Metropolitan System, a simple and transparent alternative must be found. Historic cost is simple, transparent, easily rolled forward to future periods, and best meets each of the criteria of the QCA Act.

Question:

4. Are B&H's asset valuation and related asset lives appropriate? If not, why not?

Response:

NHG considers B&H's asset life assumptions to be reasonable on the basis the Western System coal mines are a going concern. NHG is not in favour of a DORC valuation for the Western System, because it is such an extreme outlier in terms of service attributes and capacity limitations, and the assets are not equivalent to a modern engineering standard.

Question:

5. Is the QCA's proposed approach to maintenance costs for the western system appropriate? Stakeholders are requested to have regard to the B&H report.

Response:

NHG is of the opinion that the analysis undertaken by B&H has sufficient rigour and professionalism to be relied upon by the QCA. Although of the opinion that further efficiencies can be gained through work practices and alternative possession planning, NHG accepts the QCA proposals on apportioning maintenance costs on a gross tonne kilometre basis, and reducing the resleepering costs by $10m.

NHG interprets B&H's assessment (as set out on page 25 of the QCA Consultation Paper) as indicating that maintenance costs incurred to fit the Western System for its heavy-haul purpose should be treated as CAPEX (to be recouped over future periods) rather than as currently expensed OPEX. QR's long term capital and maintenance plans should be made available to customers and the QCA. These plans would provide much greater transparency and insight of QR's strategy. Regular and transparent reporting of actual expenditure would also assist in building confidence in QR's asset plans.

NHG requests that the QCA require QR to provide long term capital and maintenance plans for the Western System, and be required to report regularly on expenditure and progress.

Question:

6. Is the proposed approach to operating costs for the western system appropriate? Stakeholders are particularly invited to comment on the QCA's proposed estimate of train control costs.

Response:

Although of the opinion operating costs could and should be lower, NHG supports the QCA's proposed approach to operating costs for the Western System and in particular the assessment by B&H that train control costs should be reduced to $2m.

NHG would like to reiterate that the "glide path" concept introduced by QR is not acceptable. It sees no justification for Western System users to contribute to the costs of redressing QR's inefficiencies, especially if these are consequences of the government's privatization process. Hence, NHG strongly supports the QCA's position to reject QR's glide-path proposal (see page 29 of the Consultation Paper), noting that the proposal should be rejected whether or not QR has an appropriate business plan to deal with the inefficiencies.

Question:

7. What is the appropriate approach for determining the regulatory asset base for western system coal tariffs in the context of the QCA's approval criteria in s.138(2) of the QCA Act? Stakeholder comments are sought on the QCA's proposed options – the asset allocation approach and the historic cost approach.

Response:

For the reasons discussed as part of NHG's answer to QCA's question number 3 of this submission, NHG considers that determining an asset valuation for the Western System based on an allocation of a DORC does not meet the approval criteria under s138(2) of the QCA Act. In contrast, the historic cost approach achieves all of the criteria.

NHG has previously sought advice from Gilbert and Tobin lawyers on a range of matters including:

- The flexibility of the QCA to consider a range of asset valuation approaches.
- The basis on which the choice of approach ought to be made.
- The relevance, in reaching a decision regarding asset valuation, of impacts which a particular tariff may have on the sustainability and competitiveness of mining operations.
- Regulatory precedents in which alternative asset valuation approaches have been adopted, and in which the impacts of tariffs on customers has been a relevant consideration.

We have attached the advice at Appendix 3. While we appreciate that the QCA will be well aware of all of the matters set out in the advice, we provide it as part of this public submission for the benefit of other stakeholders.

The key points of the advice are:

- The QCA is not constrained under the statutory framework to adopt or accept a DORC valuation. There is no requirement under the QCA Act to use any particular valuation methodology, and in G&T's view, there are a range of methodologies potentially open to the QCA.
- Depending on the circumstances, a reasonable balancing of the factors set out in the QCA Act may properly support the adoption of a different methodology, or combination of methodologies.
- If the adoption of one methodology is likely to have adverse impacts on upstream or downstream investment, this may suggest that, having regard to all of the relevant factors, an alternative methodology may be more appropriate.

- In this case, a relevant consideration bearing on the choice of methodology would be the sustainability and competitiveness of access seekers' coal mining operations. If the effect of adopting a particular methodology would be to seriously damage the sustainability and international competitiveness of Western System users, this may suggest that a different methodology should be considered.

- There are numerous cases in which regulators have adopted methodologies other than pure DORC within the context of similar economic principles (including 'efficiency' tests). In several of these cases the regulator's decision on the asset value has explicitly taken into account the effects on pricing for customers, and values lower than DORC have been adopted in order to achieve acceptable price outcomes – the ACCC's 2011 decision in respect of Telstra, the original valuations of the Victorian electricity distribution networks, and the OffGAR's 2000 decision in respect of AlintaGas are all appropriate examples.

In summary, G&T's advice confirms the need to select a valuation methodology based on the statutory criteria, confirms the existence of regulatory precedents for adopting methodologies other than DORC, and confirms that the impacts which a particular approach may have on customers is a relevant consideration.

NHG's analysis (Question 3) suggests that an allocated DORC approach achieves few of the statutory criteria, and will achieve none of the criteria in the event that the resulting high tariffs cause further mine closures. In contrast, the historic cost approach meets all of the criteria.

Question:

8. Is there a way to address stakeholder concerns about high tariff levels while recognising the interests of Queensland Rail in receiving adequate revenue?

Response:

NHG recognises that the pricing principles in the QCA Act require the QCA to provide QR with tariffs that allow it to earn revenue sufficient to recover its full efficient costs, including a risk-appropriate return on the efficient coal specific assets funded by QR since 1995. We consider that the historic cost approach best delivers this outcome.

NHG believes that unless the pricing mechanism encourages volume growth and the achievement of economies of scale, there is a significant danger that a downward spiral could develop with attempts to recover costs via high tariffs, discouraging volumes and leading to even higher prices and the eventual stranding of the Western System assets.

NHG is of the opinion that, subject to the necessary mining approvals, competitive rail tariffs (above and below rail) may lead to a minimum of 20mtpa of coal utilising the Western System.

Question:

9. Is extending the western system tariff across the metropolitan system reasonable?

Response:

NHG appreciates the QCA's consideration of this issue. NHG has two concerns, one relating to how the metropolitan tariff is derived and the other relating to the potential for the Western System to be acquired by ARTC.

(i) Tariff Derivation

Concerning how the tariff is derived, NHG supports the view of the QCA on page 38 of the Consultation Paper: *"The QCA does not accept Queensland Rail's assertion that there will be a consistent split in future capital investment between…east and west of Rosewood."* NHG also accepts the QCA view *"that there needs to be an explicit mechanism for Queensland Rail to recover coal and freight-specific investment in the metropolitan network in order to create the right investment incentives. Simply extending the tariff between Columboola and Rosewood across the metropolitan system does not provide for this"* (p38, Consultation Paper).

NHG accepts that maintenance and operating cost allocations for the suburban system will be somewhat subjective given that:

- Coal and freight services are incremental users of a system designed primarily for passenger trains;
- Passenger trains receive higher standard below rail services in terms of infrastructure quality and priority for paths during passenger train operating hours; and
- QR's assessment of capacity to pay for various traffics does not seem to be consistent, with higher value grain and minerals being charged less per thousand gross kilometre than coal of lower value.

Consequently, NHG proposes a slight variation to the QCA's proposed approach in order to address the separate investment requirements of the Suburban and Western systems. Understanding the difficulties of determining appropriate share of maintenance and operating costs across the metropolitan system, NHG proposes that the maintenance and operating costs west of Rosewood should be extended across the metropolitan system.

A similar extension approach to investment is however **totally inappropriate** because:

- There is unlikely to be a "consistent split in future capital investment between…east and west of Rosewood"; and
- "There needs to be an explicit mechanism for Queensland Rail to recover coal and freight-specific investment in the metropolitan network in order to create the right investment incentive".

Consequently, NHG proposes that capital costs (coal specific post 1995 and genuine future coal required expenditure within the suburban system) should be used to determine the return on assets and depreciation components of the suburban system access tariff.

The new metropolitan tariff would then reflect the combination of:

- operating and maintenance costs based on the extension of the Western System tariff; plus

- coal-specific post 1995 metropolitan coal asset return and depreciation.

This combined tariff would ensure that coal services pay the full incremental capital cost and also make a contribution to fixed costs (well in excess of their incremental maintenance and operating costs).

This will also ensure that Queensland Rail is provided the right incentives for future investment. NHG is comfortable that the QCA is in a position to ensure that only investments which are appropriately categorised as coal requirements investments are included in the metropolitan tariff.

(ii) Potential ARTC Acquisition

In the event of the transfer of the Western System to ARTC, the Western System tariff to Rosewood levied by ARTC and the metropolitan tariff levied by QR should not exceed the tariff determined for this regulatory period which would otherwise apply where the network was not divided up. NHG has expanded on this concern and the proposed solution under the heading of “Other Issues”.

Question:

10. Is it reasonable to have a separate asset base for coal and freight-specific investment in the metropolitan system? Please explain and justify any alternative approaches.

Response:

As noted in our response to Question 9, NHG supports a separate asset base for coal specific assets genuinely required to support coal services. Where assets are required for additional coal services, NHG supports their incorporation into a metropolitan coal asset base. This support acknowledges that the QCA has a rigorous investment approval process to ensure that the investment is required for coal, and the cost of the asset has been optimised.

Other Issues:

Potential acquisition of the Western System by the ARTC:

NHG notes that since the current regulatory period commenced the ARTC has been invited to conduct due diligence on the regional assets of QR Ltd, including the Western System assets to the west of Rosewood. For the remainder of the track east of Rosewood (i.e., Rosewood to Port of Brisbane) it is expected that QR will retain ownership and control.

As noted in the response to Question 9 above, NHG is concerned that existing users are not disadvantaged by such a transaction which could result in two independently set access tariffs adding to exceed the final decision on Western System tariffs for the current regulatory period.

One way the QCA can assist in providing certainty to users, QR and ARTC is by separating the Western System and Suburban System Tariffs now. This is consistent with our approach to determining how the Metropolitan Tariff should be determined.

Payload Variation

During the regulatory period it is highly likely that alternative train configurations will be allowed, or new rolling stock introduced that will increase train payload. These changes could result in fewer train paths being required to shift the same level of tonnage, increasing the capacity of the Western System. The existing two part tariff allows the benefits of efficiencies to be shared, however, if an access holder wishes to relinquish already held paths as a result of efficiency gains, there is currently a relinquishment fee, which is payable if there is any difference in QR's net revenue. This approach fails to ascribe any value to the opportunity to seek further users of the additional capacity and may lead to the regrettable situation where efficiencies are not pursued because a collier will receive no economic benefit. NHG requests that the QCA seek to ensure that the tariff-setting mechanism and the relinquishment arrangements do not discourage the adoption of such system efficiencies.

WACC

NHG notes the QCA's discussion of QR's WACC in Section 3.4 of the Consultation Paper. It notes that the QCA is conducting a wider investigation into WACC settings for its regulated entities, focusing especially on Aurizon and QR, and that the Consultation Paper does not seek specific feedback on the topic from Western System stakeholders.

NHG is concerned to ensure that QR's Western System WACC does not over-compensate QR for the risks it bears. NHG also requests that the QCA make a determination on QR's WACC as early as is practical and that it ensures that the basis for the determination is transparent and repeatable. Uncertainties about key determinants of QR's access tariffs are problematic for access holder's business planning, including investment decision making processes.

Conclusion

NHG contends that DORC is not an appropriate methodology when considering an "outlier" corridor such as the Western System which has limited scale economies, standards far from modern engineering equivalents, and significant above rail cost impositions due to those standards restricting both train length and axle load. While a holistic approach to optimisation, accounting explicitly for above rail impacts, may, in theory, deliver a realistic starting point for a regulated asset base, the subjective judgements required to implement this approach are so complex and material that they call into question the relevance of the starting point. An alternative approach is required. NHG supports the alternative 'historic cost' proposal which provides a simple, transparent and less subjective approach to determining the coal asset base. This approach achieves all of the statutory criteria, while the allocated DORC approach fails to meet the criteria and may ultimately result in the stranding of the assets of both QR and the coal miners.

NHG also suggests that QR should be required to provide long term asset management strategies including capital and maintenance expenditure to provide greater certainty and transparency for coal producers. In addition, regular reporting on expenditure and progress of works would inspire greater confidence.

NHG also supports the QCA's suggestion that the western system tariff be split into two separate 'stand-alone' tariffs, i.e. a metropolitan tariff and a western tariff. The objective is to reduce the risks associated with possible change of ownership of parts of the network leading to a higher combined tariff in future, to ensure that the cost of capex incurred in the Western System is not over-recovered, and to eliminate the disincentive to invest, for coal services, in the metropolitan system.

NHG recognises that QR's access tariffs should allow it to recover full efficient costs, including an appropriate return on capital invested in the provision of coal services. The historic cost approach achieves this, while ensuring that the cost recovery process does not jeopardise the commercial viability of users' existing operations or their expansion plans. The historic roll-forward approach delivers a tariff significantly lower than the current tariff, but one that is still comparatively high. It does begin to address the key issue that is inhibiting system volume growth and threatening asset stranding.

Yours faithfully,
NEW HOPE CORPORATION LIMITED

Shane Stephan
Chief Executive Officer

APPENDIX 2:

Railed tonnages 2006-2007								
Origin	Tonnes x 1,000	Tariff /1000 gtk	#Tariff/tonne	#Approximate Revenue				
Western System	3,615	$10.50	$4.50	$16,267,500				
Ebenezer	610							
Total System	**4,225**			**$16,267,500**				
*CPI adjusted to Jul 2012				$19,579,798				
Railed tonnages 2012-2013								
Origin	Tonnes x 1,000	** Tariff /1000 gtk	#Tariff/tonne	#Approximate Revenue				
Western System	7,320	$18.22	$8.40	$61,488,000				
Ebenezer	1,260							
Total System	**8,580**			**$61,488,000**				
% increase Western System		74%	87%	278%				
# Western System revenue is understated as this figure assumes all railings from a single point								
Railed tonnages 2006-2007 derived from Port of Brisbane trade figures using the same logic as per QCA discussion paper table 1 page 8								
Railed tonnages 2012-13 sourced from QCA discussion paper Table 1 page 8								
* CPI data taken from Appendix 3, Quarter ending Sept 2006 = 83, Quarter ending Sept 2012 = 99.9								
** estimate								

APPENDIX 3: Gilbert and Tobin Advice

Memorandum of advice

Confidential and privileged

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22 April 2014

To New Hope Group

From Simon Muys / Geoff Petersen

Subject **Queensland Rail proposal re Western System assets - asset valuation methodologies under the QCA Act**

1 Overview

1.1 Background

New Hope Group (**New Hope**) has sought advice in relation to asset valuation methodologies which may be adopted by the Queensland Competition Authority (**QCA**) for Queensland Rail's Western System assets.

Queensland Rail has advocated a depreciated optimised replacement cost (**DORC**) methodology for valuing its Western System assets, for the purposes of determining reference tariffs submitted as part of its June 2013 draft access undertaking (**June 2013 DAU**). Queensland Rail has argued that this methodology is at least preferable having regard to the statutory criteria.

New Hope has sought advice on whether there is any requirement to use a DORC valuation methodology under the access to services framework in Part 5 of the *Queensland Competition Authority Act 1997* (Qld) (**QCA Act**), and if not, what other methodologies may be available to an access provider and/or the Queensland Competition Authority.

New Hope has also asked whether, in determining an appropriate asset valuation and reference tariff for Queensland Rail's Western System assets, the sustainability and competitiveness of access seekers' coal mining operations may be a relevant consideration.

1.2 Summary of advice

The QCA is not constrained under the statutory framework to adopt or accept a DORC valuation. There is no requirement under the QCA Act to use any particular valuation methodology, and in our view, there are a range of methodologies potentially open to the QCA.

Depending on the circumstances, a reasonable balancing of the factors set out in the QCA Act may properly support the adoption of a different methodology, or combination of methodologies. For example, if the adoption of one methodology is likely to have adverse impacts on upstream or downstream investment (particularly for access seekers and others with long-lived and sunk assets) this may suggest that, having regard to all of the relevant factors, an alternative methodology may be more appropriate.

In this case, a relevant consideration bearing on the choice of methodology would be the sustainability and competitiveness of access seekers' coal mining operations. If the effect of adopting a particular methodology would be to seriously damage the sustainability and international competitiveness of Western System users, this may suggest that a different methodology should be considered.

Our conclusions are based on the following:

- our interpretation of the relevant legislative provisions governing the QCA's decision-making, particularly the object of Part 5 of the QCA Act, and the pricing principles;

- the relevant background to these legislative provisions, including statements made by the Productivity Commission (**PC**) when it recommended the incorporation of similar provisions in the national access regime; and

- our review of previous regulatory decisions and judicial authority on asset valuation methodologies which may be adopted under these (or similar) criteria.

The QCA Act requires the QCA to have regard to a range of factors in assessing a draft access undertaking. These include (but are not limited to), the object of Part 5, the pricing principles (in s.168A), the interests of both the service provider and access seekers, and any other issues which the QCA considers relevant. The list of relevant factors is broad, and different factors may at times point in a different direction, in terms of the most appropriate choice of valuation methodology.

It may be that, depending on circumstances, a proper balancing of the statutory criteria favours a different methodology over DORC, such as an historic cost methodology. For example, if the relevant assets were constructed relatively recently and good historical cost records are available, the advantages of simplicity and transparency inherent in an historical cost approach may outweigh any perceived advantages of DORC. Alternatively, if adoption of a DORC methodology would produce undesirable price outcomes for network users (e.g. prices that are likely to distort usage and complimentary investment decisions), then this may suggest DORC is also not appropriate.

The language of the object and pricing principles themselves (which are common to many Australian regulatory frameworks) does not indicate a requirement to use any particular valuation methodology, nor does it prohibit the use of any methodology. The pricing principles provide high level guidance on the pricing conditions which will satisfy the objectives, but do not prescribe any methodology for determining the cost base.

While there is a reference to the recovery of "efficient costs" in the first of the pricing principles in s.168A, we do not share the apparent view of Queensland Rail that this necessitates or requires the adoption of a forward-looking asset valuation methodology such as DORC in all cases. It simply means that the service provider is only entitled to recover costs that are efficiently incurred, and will not be entitled to recover costs imprudently or inefficiently incurred.

Clearly if past investments were prudent and efficient, the service provider ought not to be prohibited from including the cost of those past investments in its capital base, and recovering those costs through access charges (i.e. an historic or actual cost valuation of the relevant assets would not necessarily be inconsistent with this outcome or the statutory pricing principles).

This interpretation is strongly supported by the relevant background materials. It is clear that the Productivity Commission (**PC**), which originally proposed pricing principles of the kind that now appear in the QCA Act, did not intend for those principles to restrict a regulator in terms of its choice of asset valuation methodology (or indeed its pricing methodology more generally). On the contrary, the PC intended that regulators consider valuation methodologies on a case-by-case basis.

Finally, we note that there are numerous cases in which regulators have adopted methodologies other than pure DORC within the context of similar economic principles (including 'efficiency' tests). In several of these cases the regulator's decision on the asset value has explicitly taken into account the effects on pricing for customers, and values lower than DORC have been adopted in order to achieve acceptable price outcomes – the ACCC's 2011 decision in respect of Telstra, the original valuations of the Victorian electricity distribution networks, and the OffGAR's 2000 decision in respect of AlintaGas are all examples of this.

We also note that another area in which regulators generally have some discretion, and where the impact of price outcomes on customers may be a relevant consideration, is in relation to the profile of capital cost recovery over time. There are several cases in which regulators have chosen to make adjustments to the capital cost recovery profile (or have accepted adjustments proposed by businesses), involving either deferral of depreciation or loss capitalisation. These adjustments have often been made in order to reduce tariffs for users in the short to medium term, and ensure efficient use of the relevant infrastructure.

2 Background

2.1 Available asset valuation methodologies

There are a number of valuation methodologies that are recognised as providing the basis for determining a regulatory asset base (**RAB**).[1] The types of valuation methodologies typically identified by regulatory authorities as being available are:[2]

- **Historic cost** – this is the original cost of acquiring the asset including the relevant financing costs during construction.
- **Replacement cost** – this is the current cost of replacing the asset with another asset that provides the same service potential. This need not be the same asset, but rather the asset that hypothetically is the best (least-cost) option under current technology.
- **Optimised deprival value (ODV)** – this is the cost to the asset owner if deprived of the asset. In practice ODV equals replacement cost, except where the asset would not be replaced (in which case ODV is the market value of the asset, as determined by the foregone net revenues for supplying its services).
- **Reproduction cost** – this is the cost of reproducing the existing plant in substantially the same form at current prices.
- **Scrap value** – this is the value of the asset in its next best alternative use.

Within each of these types of methodology, there are variations and methodological choices. This is particularly the case in relation to optimised replacement cost methodologies, as various assumptions need to be made about how an optimised asset would (hypothetically) be designed. For example, in determining replacement costs, it may be assumed that the design of an asset is *fully* optimised when it is replaced, or only *partially* optimised.[3] Alternatively, it may be assumed that only the technology choice is optimised, and not the network design. These types of methodological choices which need to be made in applying a replacement cost methodology can in some cases be hotly disputed.[4]

[1] "Regulatory asset base" is the term most commonly used by Australian regulators to identify the set of assets used to supply a regulated service. In some cases other terms may be used, such as "regulatory asset value" (RAV) or "depreciated asset value" (DAV).

[2] The ACCC has considered various valuation methodologies in several formative publications, namely: ACCC, *Access pricing principles – telecommunications: a guide*, July 1997 at pp41-43; ACCC, *Draft Statement of Principles for the Regulation of Transmission Revenues*, May 1999, at pp39-42.

[3] For example, in its *Draft Statement of Principles for the Regulation of Transmission Revenues* (May 1999) the ACCC noted in relation to optimisation as part of a DORC methodology: "Discretion is available in deciding how the optimal system configuration should be determined. Even in the absence of alternative technologies there is an issue as to what level optimisation should be considered and whether it should be done in respect of each item of infrastructure or on a system-wide basis. There is clearly an important trade-off involved in the level of detail considered and the cost of conducting the evaluation."

[4] For example, when a replacement cost methodology was applied for the purposes of pricing Telstra's fixed-line services, significant dispute arose as to the extent of optimisation that should be assumed. There were three possible approaches considered (existing network design, "scorched node" and "scorched earth"), along with variations to these approaches. The

Moreover, under any of these methodologies, there are various ways in which inflation and depreciation of the asset value over time may be treated. In some cases the asset value will be adjusted to account for inflation over time, while in other cases the asset value may be left in nominal terms, with inflation accounted for in some other way (e.g. through the application of a nominal rate of return). Accumulated depreciation may be accounted for in a variety of different ways, including through a simple application of straight-line depreciation, or alternatively by seeking to account for past capital returns.

It is generally recognised that each of these methodologies has strengths and weaknesses. Accordingly, the choice of methodology in any particular case will depend on the circumstances of that case, including the characteristics of the asset, the nature of demand, and any previous practice in relation to valuation of that asset.

In some cases, the valuation ultimately adopted may reflect a blending of two or more of the above methodologies, or an adjusted form of one methodology. Depending on the circumstances, it may be appropriate to adopt an adjusted or hybrid methodology instead of applying one methodology in its 'pure' form (some examples of this are set out in section 4 below). Thus, the set of methodologies set out above will in some cases only provide a starting point for the asset valuation exercise.

As noted by former ACCC Commissioner, Professor Stephen King, in an early paper on asset valuation and access:[5]

> "The choice of an appropriate asset valuation technique will depend on both the questions being addressed and the nature of the relevant assets. There is neither a single valuation method that is appropriate for all circumstances, nor is there always an unambiguously preferred choice of valuation method for any specific situation."

Professor King's paper goes on to explain the strengths and weaknesses of various valuation methodologies, including historic cost, reproduction cost, replacement cost, deprival value and scrap value. He says that his analysis broadly supports the use of historic cost valuation, although he notes that there are various circumstances in which alternative methodologies may be preferable. Professor King concludes:[6]

> "The analysis presented in this paper broadly supports the use of historic or original cost asset valuation for access purposes. The arguments in favour of historic cost are impressive. It is administratively simple and transparent. It involves less subjective assessment and guesswork and usually will provide adequate incentives for investment and equivalent operational incentives compared with alternative valuation procedures.
>
> That said, the case for historic cost is not overwhelming. We have noted a variety of circumstances where alternative valuation procedures may provide better incentives for allocative, productive or investment efficiency. For example, scrap valuation is likely to lead to greater allocative efficiency for existing sunk assets compared to historic cost valuation. Generalised replacement cost valuation will provide improved productive incentives and standard replacement cost procedures may improve investment incentives under certain types of asymmetric information."

The ultimate conclusion of Professor King's paper, which is now reflected in the general practice of Australian regulators, is that asset valuation methodologies should be considered on a case-by-case basis.

ACCC sought to apply a "scorched node" approach, which involved taking existing network nodes as given, and optimising cable routes between those nodes. However there was significant dispute between the ACCC, Telstra and access seekers as to how this approach should be applied in practice to determine the optimised network design (and hence the optimised replacement cost valuation). Some of this dispute is summarised by the Australian Competition Tribunal in its review the ACCC's decision to reject Telstra's 2008 ULLS undertaking (*Application by Telstra* [2010] ACompT 1, [104]-[112]).

[5] Stephen P. King, 'Asset Valuation and Access' (Discussion Paper No 365, Australian National University Centre for Economic Policy Research, April 1997), p 10.

[6] Stephen P. King, 'Asset Valuation and Access' (Discussion Paper No 365, Australian National University Centre for Economic Policy Research, April 1997), p 19.

2.2 Queensland Rail's proposed approach to asset valuation

Queensland Rail has proposed to use a DORC valuation methodology for the purposes of determining reference tariffs for its western system coal services, submitted as part of its June 2013 DAU.

Queensland Rail argues that DORC has a number of advantages over other methodologies, such as depreciated actual cost (**DAC**), including:[7]

- the optimisation process ensures that obsolete, poorly sized or poorly located assets are not included in the capital base and consequently are not paid for by users;
- assets can be valued in a way that reflects current technology rather than outdated technology; and
- it establishes asset values that will minimise incentives for 'inefficient' by-pass of the network.

Queensland Rail also states that "DORC is the preferred valuation approach as evident in other regulatory jurisdictions", and that DAC would be unsuitable for valuing Queensland Rail's assets.[8]

The June 2013 DAU is currently being considered by the QCA under Part 5 of the QCA Act.

3 Legislative framework

3.1 Relevant objectives and principles under the QCA Act

The framework for assessment of draft access undertaking is set out in Part 5 of the QCA Act.

Relevantly, Part 5 of the QCA Act sets out the factors affecting approval of a draft access undertaking as follows:[9]

> (2) The authority may approve a draft access undertaking only if it considers it appropriate to do so having regard to each of the following—
>
> > (a) the object of this part;
> >
> > (b) the legitimate business interests of the owner or operator of the service;
> >
> > (c) if the owner and operator of the service are different entities—the legitimate business interests of the operator of the service are protected;
> >
> > (d) the public interest, including the public interest in having competition in markets (whether or not in Australia);
> >
> > (e) the interests of persons who may seek access to the service, including whether adequate provision has been made for compensation if the rights of users of the service are adversely affected;
> >
> > (f) the effect of excluding existing assets for pricing purposes;
> >
> > (g) the pricing principles mentioned in section 168A;
> >
> > (h) any other issues the authority considers relevant.

[7] Queensland Rail, *AU1 West Moreton Reference Tariff Reset Overall Submission*, June 2013, pp 10-11.

[8] Queensland Rail, *AU1 West Moreton Reference Tariff Reset Overall Submission*, June 2013, p 11.

[9] *Queensland Competition Authority Act 1997* (Cth), s 138.

Many of the factors identified in section 138 of the QCA Act mirror those appearing in other Australian access regimes, including the general national access regime (Part IIIA of the Competition and Consumer Act 2010 (Cth) (**CCA**)) and the telecommunications access regime (Part XIC of the CCA). For example, the references to "*legitimate business interests*" and "*the interests of persons who may seek access*" both also appear in Part IIIA and Part XIC of the CCA.[10]

It is clear that these factors will not always point in the same direction, and hence some balancing may be required. In particular, some balancing between the legitimate business interests of the access provider, and the interests of access seekers, is likely to be required.

The object of Part 5 of the QCA Act (referred to in factor (a)) is as follows:[11]

> "The object of this part is to promote the economically efficient operation of, use of and investment in, significant infrastructure by which services are provided, with the effect of promoting effective competition in upstream and downstream markets."

The pricing principles (referred to in factor (g)) are as follows:[12]

> The pricing principles in relation to the price of access to a service are that the price should—
>
> (a) generate expected revenue for the service that is at least enough to meet the efficient costs of providing access to the service and include a return on investment commensurate with the regulatory and commercial risks involved; and
>
> (b) allow for multi-part pricing and price discrimination when it aids efficiency; and
>
> (c) not allow a related access provider to set terms and conditions that discriminate in favour of the downstream operations of the access provider or a related body corporate of the access provider, except to the extent the cost of providing access to other operators is higher; and
>
> (d) provide incentives to reduce costs or otherwise improve productivity.

The objects clause and pricing principles also mirror the objectives and principles set out in other Australian third party access regimes.[13] As will be discussed further below, objectives and principles of this nature were originally recommended by the Productivity Commission (**PC**) for the national access regime, and were subsequently integrated into other access regimes (including the QCA Act regime) pursuant to a COAG agreement.

Beyond the overall objective and high level pricing principles, there is no further guidance in Part 5 of the QCA Act in relation to methodologies to be adopted for pricing of access to services. There is no reference to particular methodologies to be used for asset valuation, or for any other aspect of price calculations.

3.2 Background to the object and pricing principles

The object of Part 5 of the QCA Act and the pricing principles were both inserted by the *Queensland Competition Authority Amendment Act* 2008 (Qld). As noted in the second reading speech accompanying the amending bill, these changes to the QCA Act implemented certain commitments made by the State of Queensland in the 2006 COAG Competition and Infrastructure Reform Agreement (**CIRA**).[14] The CIRA had included an agreement by COAG to streamline third party access regimes, and include in these regimes a consistent set of regulatory principles.[15]

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[10] CCA, ss 44ZZA(3), 152BCA(1).

[11] *Queensland Competition Authority Act 1997* (Cth), s 69E.

[12] *Queensland Competition Authority Act 1997* (Cth), s 168A.

[13] For example: CCA, ss 44AA, 44ZZCA.

[14] Queensland, *Parliamentary Debates*, Legislative Assembly, 13 February 2008, 151 (AP Fraser).

[15] Council of Australian Governments, Competition and Infrastructure Reform Agreement, 10 February 2006, clause 2.4.

The objects clause and pricing principles which were agreed to in the CIRA, which now appear in the QCA Act, were originally formulated by the PC as part of its 2001 review of the national access regime. In its final report on the national access regime, the PC recommended the insertion of an objects clause and pricing principles in Part IIIA of the CCA. The PC saw a number of benefits in doing this, including:[16]

- an objects clause would reduce uncertainty by assisting all parties — regulators, the judiciary, access seekers, facility owners and potential infrastructure investors — to interpret the intent of various criteria;
- pricing principles would provide guidance on how the broad objectives of access regimes should be applied in setting more detailed terms and conditions; and
- pricing principles would provide a measure of certainty to regulated firms and access seekers.

The PC recommended that the objects clause be as follows:[17]

> "The object of this Part is to:
>
> (a) promote economically efficient use of, and investment in, essential infrastructure services; and
>
> (b) provide a framework and guiding principles to discourage unwarranted divergence in industry-specific access regimes."

This wording was ultimately adopted in the objects clause for Part IIIA (s 44AA), with only relatively minor amendment. The wording of limb (a) was also adopted in the CIRA, again with only relatively minor amendment. The core of the PC's recommended objective – to promote economically efficient use of, and investment in, essential infrastructure – now appears as the central objective of third party access regimes around Australia, including the QCA Act regime.

The pricing principles recommended by the PC were as follows:[18]

> (a) that regulated access prices should:
>
> > (i) be set so as to generate expected revenue across a facility's regulated services that is at least sufficient to meet the efficient long-run costs of providing access to these services;
> >
> > (ii) include a return on investment commensurate with the regulatory and commercial risks involved;
> >
> > (iii) generate revenue from each service that at least covers the directly attributable or incremental costs of providing the service.
>
> (b) that the access price structures should:
>
> > (i) allow multi-part pricing and price discrimination when it aids efficiency;
> >
> > (ii) not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operators is higher.
>
> (c) that access pricing regimes should provide incentives to reduce costs or otherwise improve productivity.

[16] Productivity Commission, *Review of the National Access Regime: Inquiry Report*, 28 September 2001, pp 126, 143.

[17] Productivity Commission, *Review of the National Access Regime: Inquiry Report*, 28 September 2001, p 134.

[18] Productivity Commission, *Review of the National Access Regime: Inquiry Report*, 28 September 2001, pp 338-339.

As can be seen, the principles recommended by the PC are very similar to those that were ultimately agreed to in the CIRA and adopted in the QCA Act. The only changes made in the CIRA were to combine limbs (a)(i) and (a)(ii), remove limb (a)(iii), and slightly amend the wording of limb (b)(ii).

In its final report, the PC explained its proposed pricing principles at some length, including how they were intended to be applied in practice. Most importantly, the PC emphasised that its pricing principles were not intended to mandate any particular methodology for determining access prices. Rather, the pricing principles were intended to provide high level guidance on the pricing conditions which will satisfy the objectives of the access regime.[19] The PC explicitly noted that "*a range of pricing methodologies will comply with these principles and will be suited to different circumstances*", and that "*the approach taken to implementing any pricing principles depends on the instruments available to regulators and the way they can be applied*".[20]

Specifically in relation to asset valuation, the PC noted various methods may be available to regulators, including DAC and DORC. The PC further noted that each of these methodologies may have strengths and weaknesses, and should therefore be assessed on a case-by-case basis. The PC noted that in many circumstances DAC will have advantages over DORC, particularly in terms of simplicity, transparency and objectivity.[21]

Importantly, the PC concluded that regulators should not be bound to any particular valuation approach. The PC stated:[22]

> "Clearly, the myriad of specific issues that arise across infrastructure sectors means that regulators should not be bound to use one particular asset valuation approach in all situations. Rather, the Commission considers that the approach used should have regard to specific circumstances."

Thus, it is clear that the PC, which originally drafted the pricing principles that now appear in the QCA Act, did not intend for these principles to restrict a regulator in terms of its choice of asset valuation methodology (or indeed its pricing methodology more generally). On the contrary, the PC clearly intended that regulators consider valuation methodologies on a case-by-case basis. The pricing principles were intended to provide high level guidance only on the pricing conditions which will satisfy the objectives of the access regime.

3.3 Conclusions on the legislative framework

The QCA Act does not mandate any particular asset valuation methodology to be used in determine prices for access to services.

There is no reference any particular methodologies which are to be used, nor is there any prohibition on any method. If the QCA Act was intended to be prescriptive as to the asset valuation methodologies to be used for access pricing purposes, we would have expected this to have been explicit.

The legislative framework requires that, as with any aspect of a draft access undertaking, in considering a proposed asset valuation methodology the QCA have regard to the factors set out in section 138. Depending on the circumstances of a particular case, a balancing of these various factors may favour one methodology over another. However it seems unlikely that one methodology would be preferable in all cases, having regard to these factors.

The list of relevant factors is relatively broad, and will not always point in the same direction in terms of the appropriate choice of valuation methodology. It may be that in some cases DORC is seen as appropriate because historical cost records are poor, and the outcome of applying this method would provide an appropriate balance between the interests of the access provider and access seekers.

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[19] Productivity Commission, *Review of the National Access Regime: Inquiry Report*, 28 September 2001, p 338.

[20] Productivity Commission, *Review of the National Access Regime: Inquiry Report*, 28 September 2001, p 339.

[21] Productivity Commission, *Review of the National Access Regime: Inquiry Report*, 28 September 2001, p 364.

[22] Productivity Commission, *Review of the National Access Regime: Inquiry Report*, 28 September 2001, p 366.

However in other cases a proper balancing of the statutory criteria may favour a different methodology, such as an historic cost methodology. For example, if the relevant assets were constructed relatively recently and good historical cost records are available, the advantages of simplicity and transparency inherent in an historical cost approach may outweigh any perceived advantages of DORC. Alternatively, if adoption of a DORC methodology would produce undesirable price outcomes for network users (e.g. prices that are likely to distort usage and complimentary investment decisions), then this may suggest DORC is not appropriate.

The language of the object of Part 5 and the pricing principles (both relevant factors under section 138) does not indicate that the regulator is to be bound to any particular valuation methodology. The pricing principles simply provide high level guidance on the pricing conditions which will satisfy the objectives of Part 5 of the QCA Act – that is, in order to provide incentives for economically efficient operation of, use of and investment in, significant infrastructure, the service provider ought to be provided with an opportunity to recover at the least the efficient costs it incurs in providing access. However the pricing principles do not prescribe any methodology for determining the cost base.

In our view, the reference to recovery of "efficient costs" in the pricing principles does not imply that a forward-looking asset valuation methodology such as DORC will be required in all cases. It simply means that the service provider is only entitled to recover costs that are efficiently incurred, and will not necessarily be entitled to recover costs imprudently or inefficiently incurred. Clearly if past investments were prudent and efficient, the service provider should be entitled to recover the cost of those investments.

This interpretation is strongly supported by the relevant background materials. It is clear that the PC, which originally drafted the pricing principles that now appear in the QCA Act, did not intend for these principles to restrict a regulator in terms of its choice of asset valuation methodology (or indeed its pricing methodology more generally). On the contrary, the PC clearly intended that regulators consider valuation methodologies on a case-by-case basis.

4 Relevant precedent

4.1 Approach taken by Australian regulatory authorities to asset valuation

(a) Approach taken by the ACCC to valuation of Telstra's fixed-line assets (2011)

A recent example of a regulator taking into account various methodologies, and exercising judgement in its final choice of valuation, is the ACCC's 2011 decision in respect of Telstra's fixed-line assets.

As part of a transition from a TSLRIC+ methodology[23] to a building block model for pricing of Telstra's declared fixed-line services, the ACCC needed to establish an initial valuation for the fixed-line assets. In this context, the ACCC considered various methodologies, including DORC, DAC, and indexed (inflated) historic cost. The ACCC derived a DAC value of approximately $13 billion, based on the depreciated value of Telstra's fixed-line assets, as recorded in its regulatory accounts. As an alternative to this DAC value, Telstra had submitted DORC and indexed historic cost values of $32 billion and $28 billion respectively.[24]

In considering these alternative valuations, the ACCC noted that there is no uniquely 'correct' value for the initial RAB, and that an element of judgement is therefore required to determine an appropriate value. The ACCC noted that the key considerations in setting the RAB value include:

- the legitimate commercial interests of the access provider and access seekers;

[23] TSLRIC+ stands for total service long-run incremental cost, plus a contribution to common costs. The TSLRIC+ methodology was applied by the ACCC to determine prices for declared access services in the telecommunications sector until 2011. Since 2011, the ACCC has applied a building block methodology to determine prices for declared telecommunications services.

[24] ACCC, *Inquiry to make final access determinations for the declared fixed line services: Final Report*, July 2011, p 39.

- the level of past recovery on the assets received by the access provider;
- the incentives for efficient future investments in network assets;
- industry confidence in making future investment decisions; and
- the reliability of the valuation methodology.[25]

In its final decision, the ACCC adopted a value between its DAC valuation and Telstra's DORC. The ACCC used its DAC value as a starting point, and made various upwards adjustments to this value, ultimately arriving at a valuation which allowed it to maintain price stability for one of the fixed-line services (the unconditioned local loop service, or ULLS), while allowing prices for other services to fall.[26] The valuation ultimately adopted by the ACCC ($17.22 billion as at 1 July 2009) was closer to its DAC valuation than Telstra's DORC or indexed historic cost values.

The ACCC explained its reasoning as follows:[27]

> "The ACCC confirms its view that there is no uniquely 'correct' value for the RAB. Consequently, the ACCC considered a number of alternative valuation methodologies including DAC, DORC and current cost accounting in settling on an appropriate initial RAB value. The ACCC also considered the views and information submitted during the consultation process, the limitations of the historical records (particularly for long-lived assets), and price stability to the extent that it supports past investments and promotes industry confidence in making future investment decisions.
>
> The ACCC has calculated a value within the suitable range of RAB values set by the DAC and DORC values for Telstra's network assets. In calculating an appropriate value within this range, the ACCC used the DAC value as a starting point because the more substantial limitations associated with estimating a DORC value meant that it was not considered an appropriate starting point."

The asset valuation adopted in this decision was "locked in" through a set of fixed principles included in the ACCC's access determination, and will be rolled forward for the purposes of future price resets for Telstra's declared fixed-line services.

(b) Approach to valuation of energy network assets

The ACCC has similarly noted in the context of energy network regulation that there is no singularly correct approach to asset valuation.

In its *Draft Statement of Principles for the Regulation of Transmission Revenues* (May 1999) the ACCC noted the absence of any clear economic answer to the asset valuation question, and emphasised the need for exercise of regulatory judgement in determining RAB values. The ACCC stated:

> "In determining an appropriate asset valuation methodology economic principles and analysis do not provide an unambiguous decision rule for the valuation of existing sunk assets. Rather economic principles provide lower and upper bounds – scrap value and replacement cost. Within these bounds there is opportunity for regulatory judgement."

RAB valuations for most electricity network businesses are now, in effect, locked in under the National Electricity Rules (**NER**), with provision for roll-forward at each price/revenue reset for new capital

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[25] ACCC, *Public inquiry to make final access determinations for the declared fixed line services: Discussion Paper*, April 2011, pp 44-45.

[26] As noted by the ACCC in its final decision, while the ULLS price was to remain relatively stable under its valuation approach, prices for other regulated services, particularly the line sharing service (LSS), wholesale line rental (WLR) and the local carriage service (LCS), would fall (ACCC, *Inquiry to make final access determinations for the declared fixed line services: Final Report*, July 2011, pp 44-45).

[27] ACCC, *Inquiry to make final access determinations for the declared fixed line services: Final Report*, July 2011, p 43.

expenditure, disposals, depreciation and inflation.[28] These locked in valuations are mostly the product of asset valuations undertaken in the 1990s by jurisdictional regulators, using different methodologies and having regard to various considerations.

For example, the valuations for each of the five electricity distribution networks in Victoria were all set around the time of privatisation of those utilities, and were set with the express objective of providing uniformity of pricing for customers across urban and rural areas of Victoria. The objective of price uniformity was given such primacy in the setting of asset values that explicit adjustments needed to be made to estimated DORC values for each of the five businesses in deriving the final valuations. For businesses operating rural parts of Victoria, a downward adjustment to the estimated DORC values was required, while for businesses in metropolitan areas there was an upward adjustment to estimated DORC values. The final valuations for each of the businesses (as at 1 July 1994), and the explicit adjustments made to arrive at these valuations, are set out in Table 1 below.[29]

Table 1: Asset valuations for Victorian electricity distribution businesses ($m, as at 1 July 1994)

	Eastern (now SP AusNet)	Powercor	Solaris (now Jemena)	Citipower	United
DORC estimate	1,046	1,227	361	482	743
Adjustment for equalisation of tariffs	(218)	(161)	61	129	136
Adjusted opening asset value	828	1,066	422	611	879

Source: *Victorian Electricity Supply Industry Tariff Order 1995* (Vic), 5.10(b).

For gas networks and pipelines subject to tariff regulation, RAB values have been set using various methodologies, including actual/historic cost, DORC, ODV and some hybrid methodologies. This may in part reflect the fact that the previous Gas Code expressly allowed for various valuation methodologies to be taken into account.[30]

For example, a hybrid asset valuation methodology was adopted by the West Australian Office of Gas Access Regulation (**OffGAR**) for the Mid-West and South-West Gas Distribution Systems, owned by WA Gas Networks (formerly AlintaGas). The valuation approach for these distribution systems used DORC as a starting point, but with reductions to ensure that resulting tariffs would be consistent with an acceptable tariff outcome for consumers.[31] In adopting this approach the took into account the balance of interests between the service provider and users, and considered various methodologies. OffGAR states in its final decision:[32]

> "In assessing the value of the Initial Capital Base proposed by AlintaGas, the Regulator considered several alternative valuation methodologies, the valuations that arise from these methodologies, and the

[28] National Electricity Rules, Chapter 6, Schedule 6.2 (for distribution), and Chapter 6A, Schedule 6A.2 (for transmission).

[29] *Victorian Electricity Supply Industry Tariff Order 1995* (Vic), 5.10(b).

[30] Section 8.10 of the gas code provided for various factor to be taken into account in valuing the initial capital base. These included "the value that would result from taking the actual capital cost of the Covered Pipeline and subtracting the accumulated depreciation for those assets charged to users" (8.10(a)) and "the value that would result from applying the "depreciated optimised replacement cost" methodology in valuing the Covered Pipeline" (8.10(b)).

[31] OffGAR, *Final Decision: Access Arrangement – Mid-West and South-West Gas Distribution Systems – Submitted by AlintaGas*, June 2000, Part A, pp 12-14.

[32] OffGAR, *Final Decision: Access Arrangement – Mid-West and South-West Gas Distribution Systems – Submitted by AlintaGas*, June 2000, Part A, pp 13-14.

advantages and disadvantages of each methodology and valuation in the context of the distribution systems.

In determining the most appropriate Initial Capital Base for the AlintaGas gas distribution systems, the Regulator considered a balance of interests between AlintaGas, Users and Prospective Users. The Regulator accepted that AlintaGas's proposal to set the Initial Capital Base to be consistent with retail gas prices expected to prevail in the gas market during the Access Arrangement Period would provide a reasonable balance of interests between the relevant parties."

These examples show how regulators have balanced various considerations in arriving at asset valuations. In each of the cases referred to above, price impacts for customers have been an important consideration, and have led to explicit adjustments being made to the final asset value. In several of these cases, the adjustments made to account for customer pricing impacts have led to a value lower than DORC being adopted.

4.2 Relevant judicial authority

In a small number of cases, matters of asset valuation have been considered by the courts or by the Australian Competition Tribunal (**Tribunal**).

(a) High Court decision in relation to the Moomba to Sydney pipeline

In the case of the Moomba to Sydney gas pipeline, the High Court was asked to consider permissible approaches to asset valuation under the Gas Code. The Gas Code (which is no longer in operation) had referred to a range of methodologies which could be used to set a value for a pipeline's initial capital base (**ICB**). The question before the High Court was whether the methodology adopted by the ACCC for the Moomba to Sydney pipeline ICB was permissible under the Code.

As observed by the High Court, the objective of the Gas Code access regime was (similar to the objectives of Part 5 of the QCA Act) to allow recovery of efficient costs for infrastructure owners, while preventing supra-competitive pricing. The High Court observed:[33]

"The framework for third party access to natural gas pipelines set out above directs attention to the multiple objectives of an approved access regime. Stripped to essentials, such a regime is at least intended to allow efficient costs recovery to a service provider and at the same time ensure pricing arrangements for the consuming public which reflect the benefits of competition, despite the provision of such services by monopolies. The balancing of those objectives properly has a natural flow-on effect for future investment in infrastructure in Australia."

The High Court then went on to identify the range of asset valuation methodologies that were permissible under the Gas Code regime, which included (but were not limited to) DAC and DORC. Importantly, it was observed that a range of methodologies were available, and that the regulator had a "wide but limited" discretion in choosing between them. The High Court noted:[34]

"The primary and natural significance of the words used in, and the structure of, s 8.10(a)-(d) mandates consideration of values derived from "well recognised asset valuation methodologies" followed by a comparative weighing up of these approaches to valuation. It is clear that a range of well recognised asset valuation methodologies can be considered and within that range a choice of value may be made. The discretion permitted is wide but limited. The reference to well recognised asset valuation methodologies emphasises that valuation, in this context, is a practical exercise."

Ultimately, the High Court decided that the approach taken by the ACCC in relation to the ICB for the Moomba to Sydney pipeline fell outside the range of asset valuation methodologies that were permissible under the Gas Code regime. Accordingly, the earlier decision of the Tribunal to vary the ACCC's methodology was upheld.

[33] *East Australian Pipeline Pty Limited v Australian Competition and Consumer Commission* [2007] HCA 44, [49].

[34] *East Australian Pipeline Pty Limited v Australian Competition and Consumer Commission* [2007] HCA 44, [51].

(b) Tribunal decision in relation to Telstra's fixed-line assets

In a more recent case, the Tribunal had cause to consider what approaches to asset valuation would be most likely to promote efficient use of, and investment in, infrastructure. In its review of the ACCC's decision of Telstra's 2008 draft access undertaking, the Tribunal considered the approach to asset valuation underpinning Telstra's proposed prices, against the relevant statutory criteria.

As part of the TSLRIC+ pricing methodology which was applied at that time,[35] Telstra had adopted a replacement cost methodology to value the assets used to supply the ULLS, with replacement costs estimated on the basis of a "hypothetical new entrant". The Tribunal indicated that it did not consider this approach would be consistent with the applicable statutory criteria, including because it would not promote economically efficient use of Telstra's network, or efficient investment by Telstra or access seekers. The Tribunal's primary concern was that the costs of a hypothetical new entrant would not reflect the costs actually faced by Telstra in respect of its sunk network assets, and as such, pricing on this basis would not drive efficient investment decisions.

The Tribunal stated:[36]

> "The price estimated by the TEA Model is based on the cost of a new entrant starting all over again and building a copper-based CAN from scratch, but using a scorched node approach in which cable routes are constrained to be at best a subset of those laid over many decades in Telstra's legacy access network…
>
> Such a price would not encourage the economically efficient use of Telstra's network infrastructure unless the price reflects the long-run costs to the community of the resources tied up in, and used to operate, the ULLS (s 152AB(2)(e)). If, say, the costs of a hypothetical new entrant (and hence the price of the ULLS to an access seeker) were higher than Telstra's costs of supplying the ULLS to itself, then Telstra would have an advantage providing retail voice and broadband services to end-users. Given that the network is in place, but is to be or may be in the future replaced by, or at least compete with, the NBN, the long-run costs to the community of those resources are not those of a new entrant hypothetically building a replacement copper access network within the constrictions permitted by the TEA Model at present.
>
> For the same reason, such a price would not encourage efficient investment by access seekers. It would not reflect the true resource costs to the community of providing the ULLS (i.e. the opportunity cost of not being able to use those resources in a higher value way). And such a price would have no bearing on Telstra's investment decisions, since it does not reflect costs actually faced by Telstra, which has trenches, ducts, etc already in place (s 152AB(2)(e))…
>
> Nor would such a price reflect Telstra's legitimate business interests, which are to receive a commercial return on its prudent (past) investment in the infrastructure used to supply the ULLS, not a hypothetical new investment (s 152AH(1)(b)).
>
> Whether such a price had due regard to the interests of access seekers turns on the same condition that determines whether the price would promote (efficient) competition, viz whether they would face the same cost in purchasing the ULLS as Telstra faces in using it to supply retail services (s 152AH(1)(c)). But there is no relation between that cost and that of a hypothetical new entrant. As already stated, such a price does not reflect the direct costs of providing access (s 152AH(1)(d))."

Ultimately, the Tribunal upheld the ACCC's decision to reject Telstra's draft access undertaking.

Subsequent to this decision, the legislative framework for regulation of Telstra's declared fixed-line services has changed, and the ACCC has also changed its approach to the determination of access prices. As noted above, the ACCC has now transitioned from the TSLRIC+ methodology to a building block model for pricing of Telstra's declared fixed-line services, and in doing so has locked in a value for the underlying assets which is between DAC and DORC.

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[35] TSLRIC+ stands for total service long-run incremental cost, plus a contribution to common costs. The TSLRIC+ methodology was applied by the ACCC to determine prices for declared access services in the telecommunications sector until 2011. Since 2011, the ACCC has applied a building block methodology to determine prices for declared telecommunications services.

[36] *Application by Telstra Corporation Limited* [2010] ACompT 1, [240]-[245].

5 Relevant factors bearing on the choice of valuation method and determination of the reference tariff

New Hope has asked whether the sustainability and competitiveness of access seekers' coal mining operations could be a relevant factor bearing on the choice of asset valuation methodology and determination of the reference tariff, in the particular case of Queensland Rail's Western System assets.

5.1 Relevant factors

We have noted that there are potentially a range of factors affecting the QCA's decision to approve a draft access undertaking. These include (but are not limited to):[37]

- the object of Part 5 of the QCA Act, which is to promote the economically efficient operation of, use of and investment in, significant infrastructure by which services are provided, with the effect of promoting effective competition in upstream and downstream markets;
- the public interest, including the public interest in having competition in markets (whether or not in Australia);
- the interests of persons who may seek access to the service; and
- any other issues the QCA considers relevant.

In this context, the sustainability and competitiveness of Western System users would be a relevant matter in consideration of the appropriate asset valuation methodology for Western System assets, and in any assessment of the draft access undertaking more generally. The object of Part 5 of the QCA Act is explicitly directed at promoting effective competition in *upstream* and *downstream* markets, which implies that the effect of access prices on the competitiveness of access seekers in upstream and downstream markets should be a relevant factor. Other relevant factors listed in section 138 of the QCA Act would also support taking this into account, including the interests of access seekers and the public interest in promoting competition in markets (and particularly Australian competitiveness in international markets[38]).

5.2 Bearing on the choice of asset valuation methodology

In this case, we consider that the effect on access prices and the sustainability and competitiveness of access seekers' coal mining operations would be a relevant consideration bearing on the choice of asset valuation methodology. If adopting a particular methodology would be likely to have the effect of seriously damaging the sustainability and competitiveness of Western System users, this may indicate that a different methodology which did not give rise to the same risk was more consistent with the statutory criteria.

Clearly there will be other relevant matters to be taken into account, such as the legitimate business interests of the service operator. However each of these matters need to be appropriately balanced, having regard to the particular circumstances of this case.

5.3 Bearing on determination of tariffs for the current period

Once an appropriate asset valuation is established, there are further decisions to be made about how capital costs will be recovered over the life of the relevant assets, and how these capital costs will feed into the determination of tariffs. This is another area in which the sustainability and competitiveness of

[37] *Queensland Competition Authority Act 1997* (Cth), s 138.

[38] While not explicit under the QCA Act, the relevance of international competitiveness to the application of a similar 'public interest' test applied under the Competition and Consumer Act 2010 is referred to explicitly in section 90(9A).

access seekers' coal mining operations may be a relevant factor for the regulator to consider. The key issue for the regulator in this respect will be the appropriate capital cost recovery profile (as opposed to the total amount to be recovered, which is more relevant to the question of asset valuation), as this will affect the path of tariffs over time.

There are various ways in which capital costs may be recovered over the life of the relevant assets. While some approaches are more commonly applied than others, there is certainly no one approach that will necessarily be appropriate for all circumstances.

The key mechanisms by which the cost recovery profile may be adjusted are the depreciation profile, treatment of asset inflation, and use of loss capitalisation accounts. Some options in this respect include:

- real straight-line depreciation with no loss capitalisation (i.e. real straight line depreciation is recovered through user charges in the year or period in which it is incurred);
- nominal straight-line depreciation with no loss capitalisation;
- 'tilted' depreciation profiles (i.e. back-loading or front-loading of depreciation);
- 'tilted' annuities (i.e. back-loading or front-loading of capital cost recovery, including both depreciation and the return on capital);
- application of straight-line depreciation, but with tariffs set below cost recovering level in early periods and losses capitalised for later recovery.

In this particular context, the impact of tariffs on the sustainability and competitiveness of access seekers' coal mining operations would be a relevant factor in determining the appropriate cost recovery profile. If, notwithstanding the approach taken to asset valuation, adopting a particular approach to capital cost recovery would lead to tariff outcomes which are likely to seriously damage the sustainability and competitiveness of Western System users in the short to medium term, it may be appropriate to adjust the cost recovery profile to reduce tariffs in the near term (e.g. through deferral of some depreciation and/or loss capitalisation).

It should be noted that whatever approach is adopted to the capital cost recovery profile, this should be applied consistently over the life of the relevant assets, so as to avoid over-recovery or under-recovery of capital costs. This means that if a decision is taken to capitalise losses or defer depreciation to later periods, these deferred amounts should be allowed to be recovered later on. Consistency of approach is necessary to ensure that the regulated business has a reasonable opportunity to recover the efficient costs of providing access, over the life of the relevant assets.

Set out below are some examples of where regulatory frameworks expressly permit flexibility around the cost recovery profile and where adjustments have been made by regulators or service providers with a view to reducing prices and stimulating demand in the short to medium term.

(a) Express provision for flexibility around depreciation profiles under the National Gas Rules

The National Gas Rules (**NGR**) expressly contemplate that different approaches may be taken to depreciation for different gas pipelines, depending on the particular circumstances of each pipeline. The NGR also make explicit reference to possible deferral of depreciation in some cases, particularly where there is a need to keep tariffs low in the short-term, in order to stimulate demand.

The NGR do not prescribe a particular approach to depreciation which must be applied in all gas access arrangements. Rather, the NGR (in Rule 89) simply state that the depreciation schedule to be

applied in determining reference tariffs for a pipeline should be designed so as to satisfy the following criteria:[39]

- so that reference tariffs will vary, over time, in a way that promotes efficient growth in the market for reference services;
- so that each asset or group of assets is depreciated over the economic life of that asset or group of assets;
- so as to allow, as far as reasonably practicable, for adjustment reflecting changes in the expected economic life of a particular asset, or a particular group of assets;
- so that (subject to the rules about capital redundancy), an asset is depreciated only once (i.e. that the amount by which the asset is depreciated over its economic life does not exceed the value of the asset at the time of its inclusion in the capital base (adjusted, if the accounting method approved by the AER permits, for inflation)); and
- so as to allow for the service provider's reasonable needs for cash flow to meet financing, non-capital and other costs.

Rule 89 further states that compliance with these criteria "*may involve deferral of a substantial proportion of the depreciation*", particularly where the where the present market for pipeline services is relatively immature and/or the pipeline has been designed and constructed so as to accommodate future growth in demand.[40]

(b) Back loading of depreciation

Gas pipeline operators have in the past proposed deferral of depreciation on some pipeline assets, particularly newer assets where there is a need to stimulate demand.

For example, in proposing revisions to its access arrangement for the Victorian gas transmission system to roll-in its $75.5 million Southwest Pipeline (**SWP**) investment, GPU GasNet proposed to defer depreciation in the early years of the lie of the SWP. The main objective of this was to keep tariffs low in the early years, in order to stimulate demand. GPU GasNet proposed negative depreciation of $2.7 million on the SWP over the first three years of its life, and proposed to defer a total of $8.2 million in depreciation for recovery in later years (being the $2.7 million of negative depreciation, plus $5.5 million which would have been recoverable in the first three years under straight line depreciation). GasNet noted that this approach "*more closely matches the revenue requirement to the rate of growth of the load and avoids the disadvantages and inefficiencies of front-loaded tariffs on new pipelines with relatively low initial flows*".[41]

Pipeline users generally supported GPU GasNet's proposal for back loading of depreciation on the SWP, as it would have had the effect of reducing tariffs in the early years of the pipeline's life.[42]

The ACCC rejected GPU GasNet's proposed revisions to its access arrangement for other reasons. However in its Final Decision the ACCC noted that back-loading of depreciation, as proposed by GasNet, may be appropriate in some circumstances. The ACCC commented in its Final Decision:[43]

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[39] National Gas Rules, Rule 89(1).

[40] National Gas Rules, Rule 89(2).

[41] GPU GasNet Pty Ltd, *Application for Revision to Access Arrangement – Southwest Pipeline*, 11 September 2000, Annexure 3, p 24.

[42] For example: AGL submission, 15 December 2000, p 2.

[43] ACCC, *Final Decision: Access Arrangement for the Principal Transmission System – Application for Revision by GPU GasNet Pty Ltd – Southwest Pipeline*, 29 June 2001, p 64.

> "The Commission considers it appropriate that changing usage over time be reflected for regulatory purposes in the depreciation schedule. It has concluded that GPU GasNet's proposal to back-end load depreciation from October 2000 is not unreasonable."

(c) Use of tilted annuity profiles in telecommunications access pricing

Until recently, the ACCC applied a pricing methodology in the telecommunications sector which involved deferral of substantial amounts of depreciation. Under the TSLRIC+ methodology which applied to regulated fixed-line services until 2011, the ACCC calculated access prices using a positively tilted annuity profile. The effect of this was to reduce the amount of capital costs reflected in access prices in the short-term, relative to a straight-line depreciation approach (i.e. some capital cost recovery was deferred to later years). The ACCC's stated rationale for applying a positively tilted annuity was to align the path of prices over time with trends in input costs.[44]

(d) Loss capitalisation under the ARTC Hunter Valley Access Undertaking

In the rail sector, loss capitalisation has been used as an alternative to deferral of depreciation. Under loss capitalisation, depreciation may be calculated for each year on a straight line basis, but tariffs are set below what is required to recover all capital costs for some period, with losses accrued in that period capitalised for recovery at some later stage.

The ACCC has approved loss capitalisation as a means of addressing short-term tariff impacts, in the context of ARTC's Hunter Valley Access Undertaking. Loss capitalisation was seen by the ACCC as a means of allowing cost recovery for ARTC over the long run, while ensuring that in the short term tariffs were not so high as to discourage efficient use of infrastructure (particularly new infrastructure),

The ACCC noted that:[45]

> "The intent of loss capitalisation is to allow under-recovery of economic cost for a period and then recovery of the relevant shortfall at a later date. In appropriate circumstances, loss capitalisation may therefore operate to facilitate investment in new assets where there is limited initial demand by allow initial under-recovery of relevant costs in the expectation of 'making up' the shortfall when demand reaches an appropriate level."

While the ACCC initially indicated that it would only allow loss capitalisation in respect of new assets, in its final decision it allowed loss capitalisation for both new and existing assets, on the basis that this was generally supported by users.[46]

(e) Loss capitalisation under the NBN Co Special Access Undertaking

Loss capitalisation is also provided for under NBN Co's Special Access Undertaking, which was accepted by the ACCC in December 2013 (**NBN Co SAU**).

Under the NBN Co SAU, initial prices for NBN products and services are set at levels which are designed to encourage economically efficient take up and usage of those products, having regard to pricing of existing services and end-users' expected willingness to pay for new NBN services.[47] These initial prices are not linked to an assessment of NBN Co's costs, but rather are set so as to facilitate a smooth transition for customers from legacy networks to the NBN. As a result, it is expected that NBN Co will significantly under-recover its costs, at least for its first decade of operation.

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[44] For example: ACCC, *Assessment of Telstra's Unconditioned Local Loop Service Band 2 monthly charge undertaking: Final Decision*, April 2009, pp 255-275.

[45] ACCC, *Position Paper in relation to the Australian Rail Track Corporation's proposed Hunter Valley Rail Network Access Undertaking*, 21 December 2010, p 81.

[46] ACCC, *Decision in relation to Australian Rail Track Corporation's Hunter Valley Rail Network Undertaking*, 29 June 2011, pp 43-44.

[47] NBN Co, *Supporting Submission: NBN Co Special Access Undertaking*, 28 September 2012, Chapter 6.

The NBN Co SAU therefore includes a mechanism by which initial losses may be capitalised for later recovery. Under the NBN Co SAU, any losses accrued in the early years of NBN Co's operation will be added to an "initial cost recovery account".[48] Over the term of the NBN Co SAU, NBN Co may continue to increase prices for its services at an annual rate of CPI less 1.5% until the initial cost recovery account is fully extinguished (i.e. until all initial losses are recouped). Once the initial cost recovery account is fully extinguished, NBN Co will be subject to a traditional revenue cap.

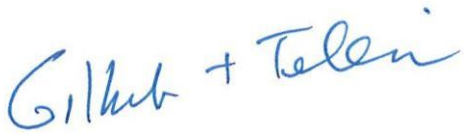
6 Conclusion

Based on our review of the legislative provisions, the relevant background materials, and recent regulatory and judicial precedent, we conclude that in the QCA is not bound to any particular asset valuation methodology in setting access prices under the QCA Act and its associated pricing principles.

The QCA Act requires that, a number of factors be considered and balanced under section 138. These factors include (but are not limited to), the object of Part 5, the pricing principles, the interests of both the service provider and access seekers, and any other issues the QCA considers relevant. Depending on the circumstances of a particular case, a balancing of these various factors may favour one methodology over another. It seems unlikely that one methodology would be preferable in all cases, having regard to these factors.

While there is a reference to the recovery of "efficient costs" in the first of the pricing principles in s.168A, we do not share the view of Queensland Rail that this necessitate or requires the adoption of a forward-looking asset valuation methodology such as DORC in all cases. It simply means that the service provider is only entitled to recover costs that are efficiently incurred, and will not necessarily be entitled to recover costs imprudently or inefficiently incurred. Clearly if past investments were prudent and efficient, the service provider should be entitled to recover the cost of those investments.

Finally, we note that there are numerous cases in which regulators have adopted methodologies other than pure DORC, when applying similar efficiency criteria. In several of these cases the regulator's decision on the asset value has explicitly taken into account the effects on pricing for customers, and values lower than DORC have been adopted in order to achieve acceptable price outcomes – the ACCC's 2011 decision in respect of Telstra and the OffGAR's 2000 decision in respect of AlintaGas are both examples of this.



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[48] NBN Co SAU, clauses 1E.5 (Module 1) and 2C.5 (Module 2).