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Our Ref:

Tuesday, 1 October 2008

Mr Russell Dumas
Director-Gas and Rail Access
Economic Regulation Authority
6th Floor, 197 St George's Tce
Perth WA 6000

Dear Mr Dumas

The Economic Regulation Authority (ERA) has called for public submissions on The Pilbara Infrastructure Pty Ltd (TPI) Overpayment Rules and Costing Principles with a closing date of 1 October 2008. HPPL has had a report prepared by consultants Acil Tasman on the two documents that were released by the ERA. That report is attached and is the submission by HPPL in response to the ERA call for submissions on the TPI documents. No claim for confidentiality is made in respect of the Acil Tasman report.

HPPL is aware that the ERA has released an issues paper on the determination of the WACC for the TPI rail, along with a submission by TPI on the same matter. HPPL intends to provide comment on both by the closing date of 15 October.

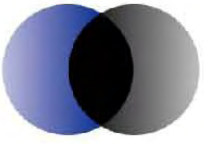
Peter Murphy
General Manager, External Affairs and Government Relations
Hancock Prospecting Pty Ltd

Commentary on TPI's proposals

Costing Principles
Over-payment Rules

Prepared for Hancock Prospecting

September 2008



ACIL Tasman

Economics Policy Strategy

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Contents

1 Introduction

The purpose of this paper is to comment on TPI's proposals regarding its Costing Principles and Over-payment Rules as submitted to the Economic Regulatory Authority (ERA).

Once the Costing Principles have been approved, TPI may be asked by ERA to provide floor and ceiling costs for specific route sections where the regulator considers an access request is likely (under Clause 9 of Schedule 4 of the Code). TPI's proposals on floor and ceiling costs will be submitted to ERA for approval, along with TPI's Costing Model.

Section 2 of the report examines TPI's proposed Costing Principles. It follows the structure of TPI's proposals, with sub-sections covering:

- Introduction
- Timing and route selections
- Determination of capital costs
- Determination of operating costs
- Overhead costs
- Other matters
- Review and consultation

Section 3 of the report considers the Over-payment Rules, and covers:

- Basis of the over-payment rules
- Over-payment rules
- Compliance
- Definitions

For each of these topics, we comment on TPI's in the light of Hancock Prospecting's likely requirements for access and make recommendations for changes to TPI's principles and rules.

2 Costing principles

2.1 Introduction

2.1.1 Commentary

TPI's draft principles do not contain any definitions. By contrast, WestNet's Costing Principles contain a comprehensive set of definitions, covering: Access Agreement, Act, Ceiling, Ceiling Price Test, Code, Contractor, Costing Principles, CPI, Cyclical Maintenance, Efficient Costs, ERA, Floor, Floor Price Test, GRV, GTK, MEA, MPM, Network Management, Overheads, Over-payment Rules, Rail Safety Act, Route Section, Routine Maintenance, Total Cost, WACC, Costing Model and Working Timetable.

TPI could usefully refer to its obligations to support the Costing Principles with databases and costing models. TPI should also indicate that the floor and ceiling prices provide the upper and lower bound to potential final prices which can be established by negotiations under the Code. (Under Clause 7 of Schedule 4 of the Code, the Floor Price Test requires that an operator pay no less than the incremental cost of access, and that the total of payments by all operators must not be less than the incremental cost resulting from the combined operations of all operations on the route. Under Section 8 of Schedule 4, the Ceiling Price Test requires that an operator pay no more than the total costs attributable to that route and infrastructure, and that the total payments by all operators on a route must not be more that the total costs attributable to the route.)

Also relevant is the fact that Clause 13, Section 4 of the Code provides the Pricing Principles on which negotiated access prices under the Code are to be based.

Wording to cover these points, based on the WestNet Costing Principles, is suggested below.

2.1.2 Recommendations

We recommend that TPI include a comprehensive set of definitions, along the lines of the definitions included in WestNet's Costing Principles.

TPI should acknowledge that the Costing Principles need to be supported by databases and costing models containing considerable detail, which will change from time to time. Such detail is not contained in the Costing Principles, but TPI should recognise that it must:

- Prepare and have the information available for the ERA at all times and its preparation and maintenance must be consistent with the Costing Principles
- Respond to any request or Determination by the ERA related to these Costing Principles and their application
- Comply with its obligations under the Code.

TPI should state that the Code allows TPI to negotiate prices between the Floor and Ceiling and as such the Floor and Ceiling costs provide the upper and lower bound to potential final prices for access which will be established by negotiations (and if necessary arbitration). TPI should also state that Clause 13, Schedule 4 of the Code provides the Pricing Principles on which access prices negotiated under the Code are to be based.

2.2 Timing and route selection

2.2.1 Commentary

Timing

TPI is proposing that its Costing Model be produced 18 months after approval of the Costing Principles. The time taken for ERA to approve the Costing Principles could be as long as 18 months (based on WestNet's experience)[1], to which a further year could be added for ERA to approve TPI's Floor and Ceiling Costs. Altogether this implies that it could take up to 4 years from now for approved floor and ceiling costs to be available from TPI. (We would hope that ERA's approval processes would take less long this time around, as many of the issues "of principle" will have been addressed during ERA's reviews of WNR's proposals. Nonetheless, it is clear that the time frames are likely to be significantly slower than required by genuine access seekers).

TPI's proposal for 18 months to produce its Costing Model is slow relative to the time taken for WestNet to produce its proposed floor and ceiling costs. WestNet Rail had its first Costing Principles approved on the 27th September 2002. On the 10th October 2002 the Regulator advised WNR of its intention to determine floor and ceiling costs for four specific route sections and two months later, in December 2002, WNR submitted its draft floor and ceiling costs to the Regulator. ERA's final determination on the floor and ceiling costs was published on 24th September 2003, following considerable discussion of costing details.

[1] WNR submitted its proposed Costing Principles in December 2005 on which ERA published its Final Determination in August 2006.

The issue is that, unlike WNR, TPI's railway is a Greenfield construction, with no previous operating history. TPI wants to have the benefit of experience before having to forecast its operating and maintenance costs.

However, the capital intensive nature of the infrastructure means that the vast majority of costs will relate to capital, for which operating experience is not relevant. (In the case of WestNet Rail, capital costs amount to 70 to 90% of the total ceiling costs determined by ERA for many route sections[2]).

Moreover the Code imposes a series of time constraints on the railway owner which are inconsistent with TPI's 18 month proposal.

Given interest by Hancock (and others) in obtaining access, and the requirements of the Code for the railway owner to avoid unreasonable delays in negotiating access agreements[3], it is inappropriate for TPI to propose such a long timeframe for implementing the Costing Principles into a Costing Model.

Further, Clause 12 of Schedule 4 provides for review and redetermination of costs in the event of a material change in circumstance. On that basis, TPI should be required to prepare its Costing Model within a reasonable time frame (say a month or so) on the basis of available information, recognising that costs may change as more information becomes available.

Finally, we note that TPI makes no mention of service quality. By contrast, WestNet (in Section 1.5 of its costing Principles) makes a commitment to adopt efficient practices to provide a network which maintains service quality at specified operational levels. Thus key performance indicators (KPIs) have been agreed with ERA, and reported by WestNet. WestNet also negotiates specific KPIs in its Access Agreements.

Route selection

TPI has proposed a single route section for the time being, with additional sections defined as extensions and expansions are made. While there is a single operator using the entire length of the railway, this would seem to be reasonable in the first instance.

However, issues arise as soon as other operators seek access, as such access will inevitably not involve the entire existing route of TPI's railway. The route section is the basic unit to which the Costing Principles and Over-payment

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2 ERA, July 2007, WestNet Rail;s floor and ceiling costs review: Final determination on the proposed floor and ceiling costs, Appendix 3

3 Section 16 (1) of the Code.

Rules apply, with each route sections having its own ceiling and floor costs and prices. The Regulator has suggested that a negotiated route could equate to a route section or part thereof or a combination of several route sections[4]. However if a negotiated route covers only part of a route section, costs and revenues need to be allocated to parts of route sections, a process for which there is no guidance under TPI's Costing Principles or Over-payment Rules.

We believe that it is important to retain the route section as the basic "building block" for costs and prices, which requires that route sections be defined according to the points that operators join or leave the railway. This means that TPI needs to explain how they would handle the definition of Route Sections once an access application is made or a branch line is added to the railway. For example, TPI has already indicated that it intends to connect a branch line at Christmas Creek, so that Christmas Creek would seem to provide an appropriate division of the existing route into two route sections.

2.2.2 Recommendations

Timing

TPI should commit to providing the Costing Model within a reasonable time period, ie a month or so, after approval of the Costing Principles. TPI should also indicate that floor and ceiling costs may be re-determined in the light of improved data.

TPI should commit to adopting economically and technically efficient practices to provide a network which maintains service quality at specified operational levels. TPI should agree appropriate KPIs with ERA and report on these annually.

Route selection

TPI should reassess its route sections as proposals for access are received, in addition to reassessments made following expansions and extensions of the current railway. The Costing Principles also needs to define the process whereby Route Sections would be re-defined and associated ceiling and floor costs re-calculated.

[4] Office of the Rail Access Regulator, June 2002, Over-payment rules to apply to WestNet Rail, Draft Determination, p2

2.3 Determination of capital costs

2.3.1 Commentary

Infrastructure included

Clause 2(2) of Schedule 4 of the Code states that railway infrastructure does not include land on which infrastructure is situated or of which it forms part. However, in its 2002 review of WestNet's Costing Principles, ERA argued that the railway owner is entitled to a return on the costs associated with cuttings and embankments. Accordingly the Regulator instigated a change in the Code, so that Clause 2(2)(a) of Schedule 4 specifies that railway infrastructure is to be taken to include a cutting or embankment (but not the value of the land of which it forms part). TPI's proposals are consistent with this approach.

TPI's proposal to include assets which support operating functions within operating or overhead cost calculations is consistent with the WestNet Costing Principles.

Calculation of the annuity

TPI's proposals do not make clear the processes by which ceiling and floor prices are updated over time. For WNR the Regulator requires GRV to be updated every three years[5], at which point the floor and ceiling costs are re-determined by ERA. We presume that a similar review cycle should apply to TPI. In between the three years, floor and ceiling prices are escalated by a specified index (see below for further discussion).

Gross replacement values

GRV and MEA values

Clause 2(4)(c) defines GRV as the lowest current cost to replace existing assets with assets that have the capacity to provide the level of service that meets the actual and reasonably projected demand, and are, if appropriate, modern equivalent assets. MEA is not explicitly defined by the Code. However, the Regulator defines MEA for rail as:

> *Any optimised network that is reconfigured using current modern technology serving the current load with some allowances for reasonably projected demand growth for up to five years into the future. The MEA excludes any unused or under utilised assets and allows for potential cost savings that may have resulted from technological improvement*[6].

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5 See ERA, July 2007, WestNet Rail's Floor and Ceiling Costs Review: Final Determination, p5

6 ORAR, Sept 2002, Costing Principles to apply to Westnet Rail, 023

Spare capacity and MEA

Consistent with this definition, in Section 3.1.1 of its proposed Costing Principles TPI states that it considers the network capable of meeting current and reasonably projected demand. It is not clear, however, whether the reasonably predicted demand relates only to demand by associated TPI companies or includes possible demand from access seekers.

On the one hand, TPI has indicated to Hancock Prospecting that access seekers should expect to pay for capacity if they wish to gain access to the railway. On the other hand, TPI is claiming that serving "junior miners" will give rise to asymmetric risk through the possibility of asset stranding, which implies that access seekers will be accommodated within existing capacity on the line.

Given the importance of this issue to access seekers, TPI should be required to provide greater detail on current and expected spare capacity on the line, and on what basis the need for capacity enhancements will assessed by TPI.

In our view, it would be plausible for "reasonably projected demand" to include at least some demand from non-associated access seekers. For TPI to do otherwise, ie to reserve all current spare capacity for itself, would be discriminatory. Moreover, it is likely that the capacity required by Hancock would fit within the demand growth envelope expected for TPI services. This might bring forward the need for future capacity enhancements (eg additional passing loops), but should not involve capital expansions at this stage.

Given the age and state of its rail network, a major issue for WestNet was the implication of re-optimisation (for capital values and the amount of maintenance and operating costs allowed as "efficient"). The Greenfield nature of TPI's railway means that this is not such an issue, and it is reasonable for TPI to assume that the existing configuration is optimal.

MEA "when appropriate"

TPI's Costing Proposals specify that replacement values must reflect MEA values. This differs from the WestNet precedent, which adds the caveat "where appropriate"[7] in line with the requirements of the Code[8]. The Regulator has interpreted this to mean that MEA valuations should be applied only where they lead to reductions to the GRV. Given the inflationary pressures facing WA and mining areas in particular, and the lack of "optimisation", in our view it is unlikely that application of MEA principles will result in lower asset values. Accordingly, we consider that GRV should be the default valuation approach.

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7 WestNet Rail, Sep 2007, Costing Principles, p8

8 Clause 2(4) of Schedule 4 of the Code.

Greenfields vs brownfields

TPI propose that replacement cost reflect actual costs incurred when re-locating infrastructure be included in GRV. This would appear to constitute a "Brownfields" rather than a "Greenfields" approach. For the existing railway, this approach would seem reasonable, since Brownfields and Greenfields would essentially amount to the same thing. However in the case of future capacity expansions, particularly around the port, the two are likely to diverge. The Regulator has previously indicated that Greenfields assumptions should be used, so that:

> *... costs related to constructing around rail traffic, surface restoration and other surface diversions are excluded from the GRV*[9].

Indexation of unit rates

TPI proposes that the unit rates used for valuation purposes be indexed to current values, using the Perth Building Index adjusted for the average of the Port Hedland and Tom Price regional indices. In principle, it is appropriate to use a specific-cost index to identify the current (least cost) cost of replacing existing assets. However this raises an important issue regarding the definition of normal profits and excess returns to the railway owner, which are relevant to the calculation of ceiling prices.

Where a regulator is seeking to replicate the effect of a competitive market in regulating prices, and in particular avoid monopoly returns to a price-making firm, the appropriate concept of profit is financial capital maintenance (FCM). FCM seeks to maintain the real value of shareholders' capital in terms of the purchasing power of their original investment. It is the concept that underpins price regulation of utilities in Australia and the UK, and corresponds to the real terms system of accounting that was advocated in the accounting literature[10].

FCM profit measurement takes account of the effect of both specific and general price changes. Changes in the specific price of assets are important because investors will consider the future change in value of their assets when choosing whether to invest in the activity. The movement in general prices needs to be taken into account to ensure that their investment has been maintained in real terms, ie to compensate for the loss of purchasing power of their original money investment.

Under FCM, profit is determined only after the gains and losses from holding the company's assets and liabilities have been recognised, whether these are monetary or non-monetary, realised or unrealised. Similarly for any comparison with the cost of capital, the rate of return earned by a company

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9 ORAR, Op cit, p27

10 See Ian Byatt HM Treasury, 1986, Accounting for economic costs and changing prices", London HMSO and Wittington, G, 1983, Inflation accounting: an introduction to the debate".

needs to include holding gains (which can be done through the use of "economic depreciation"). With a real cost of capital, real holding gains are relevant: comparison with a nominal cost of capital requires that nominal holding gains be taken into account.

For example, jurisdictional regulators such as the ESC, IPART and ERA generally use real frameworks when regulating electricity and water prices, with regulatory asset values (RAVs) being adjusted for inflation. As a result there are no real holding gains, and the rate of return on the RAV is compared to a real cost of capital. Under the National Electricity Rules (NER), the ACCC regulates transmission and distribution prices within a nominal framework. This calculates regulatory depreciation by deducting inflationary gains on the RAV from nominal straight-line depreciation[11]. In Queensland a nominal framework is also used, in which nominal holding gains are likewise recognized when calculating rates of return for comparison with a nominal cost of capital.

For the Victorian rail freight network, the ESC has applied a real building block approach, consistent with its approach to other utilities. The RAV is based on accumulated capital expenditure since privatization (April 1999), valued at original cost indexed for inflation, less accumulated depreciation and disposals and any relevant capital contributions. In the absence of specific price adjustments, real holding gains are zero and the resultant rate of return is comparable to a real cost of capital. We are not aware of any discussion of the holding gain issue in DORC-based rail regimes (such as the ARTC). We suspect that this is because rail access prices are such a long way below the level required to remunerate DORC values, that any DORC revaluations are "theoretic" and generate no real holding gains (since they do not automatically generate additional revenue).

The Code specifies the use of a real cost of capital, which implies that real holding gains should be taken into account. If GRV were indexed by inflation, there would no real holding gains. However, TPI is proposing that the unit rates used to calculate MEA values be indexed by a specific price index, which implies the presence of real holding gains (or losses). One approach to resolve this would be to use GRV, rather than MEA values, and to index GRV over time using CPI. An alternative approach might be to calculate the revaluation component of the change in GRV (adjusted by inflation to identify the real holding gain), and to include its annuitized value within the revenue used to assess over-payment in the Ceiling Price Test.

[11] Where depreciation is calculated in real terms on a straight line basis and then converted into nominal terms.

Contributed assets

TPI's proposals regarding contributed assets are consistent with the approach taken by ERA for WestNet Rail. Capital contributions paid by operators, or provided by government, are annuitized and included as part of the revenue recognised for the route section. In this manner it reduces the ceiling prices that can be charged for the route section.

However, in the Costing Principles there is no direct link between the ceiling prices that could be charged to an operator and any capital contributions made. In theory, the revenue annuity could be "accredited" to all or any operators on the route, and not necessarily the one that made the contribution. In fact, TPI's proposed over-payment rules are specific that any annuity from contributed assets should be allocated to the operator who made the contribution, but only by the specification of the formula in Section 3, and the issue is not discussed in the section explaining the basis of the over-payment rules.

The extent of spare capacity on the WestNet network made this much less of an issue than it is for the Pilbara. The nature of the rail lines in the Pilbara region, and their relatively heavy utilisation, means that over time capacity constraints will arise and access seekers will be required to contribute towards the capital costs of any required expansion. While access seekers can ensure they are treated equitably in this regard through the negotiation process, in our view the Costing Principles would benefit from improved clarity on this point. In particular, the Costing Principles and the Over-payment Rules should indicate more clearly that TPI expects to credit any revenue annuity to the particular operator making the capital contribution when negotiating prices within the ceiling.

Fees and financing charges

TPI's proposal to include in GRV the actual design, construction and management fees (indexed to current values) would seem reasonable. (With the above caveat about consistent treatment of real holding gains).

TPI's proposal to include a financing charge to allow for the cost of capital during construction also appears reasonable.

Equity raising costs

TPI proposes to include in GRV an estimate of the cost of raising equity capital. The Costing Principles for WestNet Rail do not include any allowance for equity raising costs. However the circumstances of TPI are very different, since FMG/TPI has had to raise the finance required for investment in the network, whereas WestNet Rail was the product of a privatisation process for existing assets.

In ERA's recent report on the WACC[12], ERA argued that, where appropriate, equity raising costs should be recognised in the valuation of the regulatory asset base and in new capital expenditures and not in the WACC itself. On this basis, we agree that TPI's proposal to include equity raising costs in the GRV is reasonable.

Economic life

The economic lives proposed by TPI are for the most part similar to those used by WestNet. However there are a few exceptions, as follows:

- Earthworks for track - 50 years compared to WNR's 100 years
- Bridges (not footbridges) – 50 years compared to WNR's 100 years
- Rail life for a curve > 800m & tangent – 20 years compared to WNR's 60 years.

A somewhat shorter rail life may be appropriate for TPI given the substantially heavier loads being carried on the railway. The reason for a shorter life for earthworks and bridges is less clear. It may reflect TPI's view on the economic life of the mines, but requires justification from TPI.

Rate of return

ERA has released an Issues Paper on the WACC appropriate for TPI's Pilbara railway[13], in conjunction with a submission from TPI regarding the treatment of asymmetric risk[14]. Detailed comment on the rate of return will be given in a separate response to these papers.

For the moment we simply note that adjustments for asymmetric risk have rarely been made in regulatory decisions[15]. ERA, in common with other regulators, has not generally allowed a premium for asymmetric risk within the WACC, since the WACC is intended to reward only systematic risk (through the beta factor). Non-systematic risk is diversifiable and hence does not require a premium.

In the context of gas pipelines, arguments have been made that if forecast cashflows are asymmetric in nature, it may be appropriate to allow for this through the incorporation of a notional self insurance premium as a

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12 ERA, June 2008, final determination: 2008 WACC for the Freight (WestNet Rail) and Urban (Public Transport authority) Railway Networks, p36

13 ERA, 4 Sept 2008, Issues Paper: Determination of the weighted average cost of capital for TPI's railway from the Cloud Break iron ore mine in the Pilbara to Port Hedland.

14 TPI, 29th July 2008, Asymmetric risk and the TPI railway

15 And the Issues Paper makes this point.

component of forecast operating costs. However, proposals for self insurance premiums or equivalent adjustment to the WACC have rarely been accepted. For example, in its Further Final Decision for the Goldfields Gas Pipeline, ERA concluded that GGP had not provided sufficient justification for the notional self-insurance cost, and disallowed it[16]. A fuller discussion on this issue will be provided in a separate response to ERA's Issues Paper on the Cost of Capital and TPI's submission on asymmetric risk.

Annuity calculation

TPI provides no detail on the method of calculation of the annuity. By contrast, WestNet defines the annuity calculation formula and terms, and explains the justification for a working capital adjustment within operating costs.

2.3.2 Recommendations

Calculation of the annuity

TPI should indicate that GRV is to be up-dated every three years, at which point floor and ceiling costs would be re-determined by ERA. It would aid clarity if TPI were to also state here that in between the three yearly up-dates, floor and ceiling prices are to be escalated by an approved index.

Gross Replacement Value

TPI should apply MEA valuations to calculate GRV only when appropriate, namely when it reduces GRV.

TPI should be explicit that it will apply a Greenfields approach to any future capacity expansions, with an appropriate definition of Greenfields included in the Costing Principles.

Any revaluation of assets needs to be treated consistently. If GRV values are updated using specific price indices, the associated real holding gain needs to be taken into account when ceiling prices are determined. Alternatively, indexation of GRV values could be undertaken using CPI.

TPI should indicate that it would normally credit any revenue annuity for contributed assets to the operator making the contribution when calculating ceiling prices.

[16] ERA, July 2005, Further final decision and final approval on the proposed access arrangement on the Goldfields Gas Pipeline, p15

Rate of Return

TPI needs to provide a strong justification for any premium on costs (such as a self insurance premium) or any premium on the WACC to allow for asymmetric risk. Such allowance should not given "blanket" approval within the Costing Principles.

As indicated above, separate comment will be provided on this issue, in response to the 4th September issues paper on the appropriate cost of capital for the TPI railway.

Annuity calculation

TPI should define the annuity calculation in terms of the formula and terms within it. This should include the justification for including a working capital adjustment within operating costs.

2.4 Determination of operating costs

2.4.1 Commentary

Definition of operating costs

TPI's proposals to include routine and cyclical maintenance, network management costs and working capital are consistent with the precedent of WestNet Rail. In addition, TPI has proposed additional items comprising:

- Major planned maintenance (MPM) costs for track, signalling and communications
- Rental payments or other costs associated with the corridor, and
- An allowance for asymmetric risk, if not recovered in the WACC.

The Code allows for the recovery of land leasing costs, so that the inclusion of corridor rental payments is appropriate. It is not clear what the "other costs" comprises, and TPI should be asked to specify these.

As discussed above, we do not believe blanket allowance should be made for asymmetric risk within the Costing Principles, and a separate response to ERA's Issues Paper on the cost of capital will be made.

The inclusion of MPM maintenance is a key issue. Under the GRV, maintenance costs need to be appropriate to a permanently new asset. Inclusion of MPM together with the depreciation implied by the annuity formula amounts to double counting if the MPM involves asset renewal aimed at maintaining the infrastructure in perpetuity. On the other hand, MPM costs are appropriate for inclusion if they are targeted at achieving asset life.

TPI does not define MPM, or cyclical or routine, maintenance, or indicate how it will distinguish between MPM aimed at renewal versus achieving asset life. WestNet has addressed the issue by defining as cyclical maintenance all costs associated with achieving asset life, so that no MPM costs are included in the Costing Model.

WestNet define the various maintenance categories as follows"

- Routine maintenance for track comprises routine inspections and the corrective action taken as a follow up to routine inspections. The inspections regime includes patrolling, on-train inspection, track condition monitoring, defined event inspections by patroller and structures inspection.
- Cyclical maintenance for track represents tasks that are taken at regular intervals which are necessary to achieve the expected asset life and include:
  - Track resurfacing, rail grinding, ballast topping up and cleaning, rail defect removal and structures maintenance to achieve economic life
  - Firebreaks, scrub slashing, drainage, access roads and road seal on level crossings to meet operational and safety requirements.
- The cost of repairing incidents is included only to the extent it is not covered by insurance
- Routine maintenance for signalling and communications is based on industry accepted inspection regimes and based on fault history. It includes specified periodical inspections and procedures (including testing) and responses to faults.
- Cyclical maintenance for signalling and communications includes component rebuilds to achieve economic life.

The Code requires that cyclical maintenance costs be "evenly spread over the maintenance cycle" (Clause 1 of Schedule 4). Also, the Regulator has noted that

> *cyclical maintenance costs for a MEA would be less than for a mid-life network as it is assumed, for example, that new drains do not immediately require cleaning and that fire breaks are established as part of the construction process*[17].

This raises an issue, in that the "spreading over the maintenance cycle" allows TPI to increase maintenance costs in the Costing Model over and above the actual costs incurred – particularly early on. The difficulty will be ensuring that the "average" cyclical maintenance cost incorporated into the Costing Model does not include any element of cost that is the result of ageing infrastructure.

[17] ORAR, Op cit, p19

Efficient cost tests

The tests proposed by TPI to ensure operating costs are efficient are similar to those proposed by WestNet. Moreover, identifying efficient costs is easier for the TPI network, since the network is new and hence there is no significant difference between it and an MEA network (as is the case for WestNet). Given this, TPI's reliance on competitively tendered costs would seem appropriate.

Allocation of operating costs

TPI proposes to allocate line specific assets and maintenance directly, with other system-wide assets and operations being allocated by train kms. This differs from the approach used by WestNet, allocates network management functions by number of trains and maintenance related functions by Gross Tonne Kilometres (GTKs).

Allocations according to number of trains will differ from those based on train kms if routes vary in length. Thus the use of train kms will advantage access seekers located closer to the port. In addition, the use of train kms to allocate maintenance costs will favour operators with longer and/or heavier trains. As the incumbent operator, this is likely to be to TPI's advantage. Maintenance costs on heavily used track (as in this case) is quite closely related to weight, so GTKs would appear to be a more appropriate allocator.

2.4.2 Recommendations

Definition of operating costs

TPI should define working capital charge.

TPI should identify what "other costs" it proposes to include alongside corridor rental payments.

TPI should define routine, cyclical and MPM maintenance, and indicate how expenditure aimed at renewing assets will be identified (and excluded from the Costing Model).

The Costing Principles should provide some commitment to the provision of a track maintenance model within the Costing Model. Such a model should specify the detailed assumptions made when estimating maintenance cost level over time and the method of averaging.

Allocation of operating costs

Operating costs and assets related to maintenance related functions should be allocated on the basis of GTKs.

2.5 Overhead costs

2.5.1 Commentary

TPI does not provide any indication of how it will allocate overheads between its rail infrastructure and haulage business units. Neither does TPI indicate how the allocated amount of FMG corporate services costs will be determined.

TPI proposes to allocate overhead costs on the basis of train km. Previously the Regulator assessed that an allocation methodology based on a combination of train movements and GTKs as being standard rail industry allocators for distributing common costs[18]. In comparison, TPI's methodology will tend to disadvantage access seekers with smaller freight loads.

2.5.2 Recommendations

TPI should indicate that it will allocate overheads fairly between FMG, TPI rail infrastructure and TPI rail haulage, and indicate the basis on which the allocations will be made.

Overheads allocated to rail infrastructure should be allocated to route sections on the basis of train numbers and GTKs, with ERA determining the appropriate weighting to be given to each allocator.

2.6 Other matters

2.6.1 Commentary

Indexation of floor and ceiling

Floor and ceiling costs determined for WestNet are indexed between determinations by CPI-X. In other words, both capital and operating costs are indexed by CPI-X, where ERA monitors and assesses the movement in costs to determine an appropriate X factor for the years after the re-set. In the 2006 review, ERA set the X factor to be one quarter of CPI for the second and third years.

TPI's proposal removes the "efficiency factor", and instead envisages an escalation of operating costs likely to be faster than inflation, using a cost escalator yet to be defined. TPI should be subject to the same incentives for efficiency improvements as other rail service providers.

[18] ERA, Aug 2006, Final determination and approval of the proposed costing principles, p10.

The fact that ERA would examine likely future operating costs in setting the X factors would mean that the X factor would balance the competing influences of cost escalation and productivity improvements.

Calculation of floor and ceiling

TPI's proposals regarding the calculation of the floor and ceiling are similar to WestNet's Costing Principles and appear to be reasonable.

2.6.2 Recommendations

Indexation of floor and ceiling

TPI's floor and ceiling costs should be indexed by CPI-X, with ERA setting an appropriate X factor in the light of its consideration of future cost movements in operating TPI's rail infrastructure.

2.7 Review and consultation

2.7.1 Commentary

TPI proposes review the Costing Principles within two years of ERA's approval of the principles, rather than the three years required by the Code (and as undertaken by WestNet). TPI state that this is to allow assessment of the principles in the light of actual experience with operation of the railway, and this would seem appropriate.

Although TPI indicate that ERA can direct the railway owner to amend or replace the principles, TPI does not indicate that access seekers and operators can at any time request ERA to consider amendments.

2.7.2 Recommendations

TPI should state explicitly that access seekers and operators can at any time request the ERA to consider amendments to the Costing Principles.

3 Over-payment rules

3.1 Basis of the over-payment rules

3.1.1 Commentary

Definition of route sections

As discussed above, TPI should be required to re-define route sections as and when proponents make proposals for access, and/or as new sections are added to the railway. The over-payment rules need to explain how changes in the definition of route sections will be handled.

Regulatory ceiling

TPI's proposals largely follow the wording of WestNet Rail's over-payment rules. A small difference is that TPI refer to **a** ceiling, whereas WestNet is specific that there is **one** ceiling to apply to each route section.

In its first determination of WestNet's over-payment rules, ORAR considered the question as to whether different ceiling levels can exist between different operators. ORAR concluded that the intent of the regime is for only one ceiling to apply to all operators for each route section and for operator differences to be reflected in the price being negotiated. Thus capital contributions made by operators and/or government are taken into account through the over-payment rules rather than being incorporated into the definition of the ceiling cost.

Revenue for the purpose of the ceiling test

Unlike WestNet's rules, TPI's proposal does not define access revenue and non-access revenue in this section (although definitions are provided in the definition section at the end). For clarity, it would be helpful for the definition of each to be provided in the text as well.

Breaches of the Ceiling Test

TPI's proposals largely follow the wording of WestNet Rail's over-payment rules. However, in the third paragraph TPI does not restrict the breaches (which give rise to the over-payment procedures) to those that are due to temporary or unpredictable fluctuations in traffic volumes or revenue. The Regulator has indicated that where breaches are considered to be permanent, due to the result of long term factors, the railway owner will immediately need to negotiate a new access price with all affected parties using the route section.

Over-payments and under-recoveries

TPI's proposals regarding over-payments are similar to WestNet Rail's approach, and would seem reasonable.

However, TPI's proposals regarding under-payments appear to be internally inconsistent. On the one hand, and unlike WestNet Rail, TPI is proposing that net under-payments be repaid by operators at the end of the three year period. TPI then goes on to propose a limited set of circumstances whereby the underpayment can be carried forward. This provision is unnecessary if operators are required to pay back the under-payments, and appear to reflect the wording of WestNet Rail's over-payment rules, under which operators are specifically **not** required to pay back under-payments.

Requirements of the Code

The Code does not specify how under-recoveries are to be treated, and the Regulator has noted that there was debate as to:

> *Whether the over-payment system, as described by Section 47 of the Code:*
>
> … *Permits railway owners to average out the net of any over-payments and under-recoveries over 3 years with a refund of a net over-payment to operators, but no claw back of any net under-recovery; or*
>
> … *Requires railway owners to refund every three years all over-payments and disregard any under-recoveries*[19].

The Regulator concluded that:

> *over-payments can be used by the railway owner to offset against under-recoveries over that three year period. However, a net under-recovery over the three year period does not mean that operators will be required to make up the railway owner's revenue to the ceiling*[20]

but did allow WestNet to carry forward under-payments in certain restricted circumstances.

Application to TPI

The proposed application of the over and under-payment regime to TPI is of concern, however, given that TPI was able to negotiate prices with FMG for up to 45 million tonnes pa of capacity under the provisions of the Railway and Port (The Pilbara Infrastructure Pty Ltd) Agreement Act 2004. It is not known if FMG took advantage of the Agreement provision. However what is clear is that any such negotiation would have been between related parties and not arm's length. The revenues from FMG's iron ore volumes transported under these arrangements will be included in the determination of overpayments –

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[19] ORAR, Sept 2002, Op cit p7-8

[20] ORAR, Ibid

however these revenues are likely to reflect a relatively low negotiated access price.

As a consequence, even if other operators pay close to the ceiling price, and even if volumes increase above expected levels, the "under-payment" from FMG's "Agreement" volumes would seem likely to produce under-payments overall and largely preclude the recognition of over-payments. This would seem inequitable to other operators.

One option would be to impose some form of "arms-length" pricing on FMG's "Agreement" volumes for the purpose of the ceiling test. For example, FMG's "Agreement" revenues could be included on the assumption that they paid the volume weighted average of above-floor prices paid by other operators. This would ensure that the assessment of over-payments to other operators was not distorted by TPI's access arrangements with its associated freight operator, FMG.

Such an approach would continue to provide TPI with protection from freight volume fluctuations, to the extent that they average out within the 3 year period. In addition, it allows TPI to offset below-ceiling prices against volume risk. Thus to the extent that TPI chooses to negotiate prices below the ceiling, this will be offset against any volume increases (and hence increased revenues) received from other operators. Given this ability for TPI to offset price risk (which is within TPI's control) against volume fluctuations (which are not), it would seem inappropriate for TPI to be able to recover under-payments from operators at the end of the 3 year period. This is consistent with the position for WestNet Rail.

Allocation of Access Revenue

TPI's proposals largely follow the wording in WestNet's over-payment rules. However TPI provides a less extensive explanation of the economic principles underpinning the ordering of the allocation process.

We note that in reviewing WestNet's arrangements, ERA considered that there is merit in providing WNR with some degree of discretion to allocate revenues back to individual route sections[21]. In particular, ERA agreed that the proposal for branch or feeder infrastructure to rank ahead of shared infrastructure is reasonable on the basis that there is no other traffic to find the dedicated infrastructure and unless those costs are recovered the branch line may close.

When reviewing WestNet's arrangements, ERA recognised the ability of the railway owner to "game" the allocation of revenues. ERA indicated that it

[21] Ibid, p14

would be monitoring any adjustments to access rates that favoured one operator over another. In addition, ERA endorsed the option provided by WNR to track users to fix revenue allocation on a route section basis in their access agreements. However, TPI's proposals do not include any such provision. Where TPI and operators have reached agreement to a different access revenue allocation arrangement in an Access Agreement, that arrangement should prevail.

Allocation of Non-access Revenue

TPI's proposals follow the wording in WestNet's over-payment rules. Although they do not specify that annuity from capital contributions should be allocated to the operator making the contribution, this is in fact done in over-payment rules themselves.

Allocation of an over-payment

TPI's proposals largely follow the wording in WestNet's over-payment rules and as such are reasonable.

3.1.2 Recommendations

Definition of route sections

TPI should explain how changes in the definition of route sections would be handled in the over-payment rules.

Regulatory ceiling

For clarity, in section 2.1.2 TPI should specify that each route section has one regulatory ceiling that will apply to all operators.

Revenue for the purpose of the ceiling test

It would be helpful for TPI to define access revenue and non-access revenue in the text of this section of their proposal.

Breaches of the Ceiling Test

The third paragraph of Section 2.1.4 should be restricted to breaches that arise as a result of temporary or unpredictable variations in traffic volumes or revenues.

Over-payments and under-recoveries

The calculation of revenue used for the ceiling price test should be based on arms-length prices for TPI's associated operator, FMG, "Agreement" volumes. (We suggest a volume weighted average price paid by arms length users may be the appropriate price)

TPI should not be able to reclaim under-payments from operators at the end of the 3 year period. Carry-over of under-payments should be limited, as for WestNet Rail and proposed by TPI.

ERA should consider whether it is appropriate for TPI to be able to offset low negotiated prices against volume fluctuations when assessing the amount of over or under-payments.

Allocation of Access Revenue

TPI should recognise that where TPI and operators have reached agreement to a different access revenue allocation arrangement in an Access Agreement, that arrangement should prevail.

Allocation of Non-access Revenue

TPI should indicate that for the purpose of allocating over-payments to operators, the annuity based on any capital contribution will be attributed to the operator who made the payment.

3.2 Over-payment rules

3.2.1 Commentary

The over-payment rules largely follow WestNet's Rail's wording. A few minor points are:

- TPI does not indicate when the over-payment rules will commence.
- TPI does not specify the dates of its financial year beginning and end
- For clarity notes to the formula in point 3 should be included to cover the fact that total annual access and non access revenue includes the revenue of non-regime operators, and that non regime operators entitled to a share of the net over-payment by virtue of provisions in their access agreement will have their shares calculated using the same formula.
- TPI's proposed rules do not include the detailed provisions given in Schedule 1 of WNR's over-payment rules, and point 13 of the rules is not complete.

3.2.2 Recommendations

For clarity, TPI should include further details in its over-payment rules regarding:

- The date when the over-payment rules will commence.
- The dates of its financial year beginning and end
- The notes to the formula in point 3 should include the fact that total annual access and non access revenue includes the revenue of non-regime operators, and that non regime operators entitled to a share of the net over-payment by virtue of provisions in their access agreement will be calculated using the same formula.
- The detailed provisions given in Schedule 1 of WNR's over-payment rules, with point 13 of the rules expanded in line with WNR's rules.

3.3 Compliance

3.3.1 Commentary

Unlike WNR, TPI does not offer to review the over-payment rules every third year to determine whether any amendments are required.

TPI does not indicate that access seekers and operators can at any time request the ERA to consider amendments to the over-payment rules.

3.3.2 Recommendations

TPI should state that it will review the over-payment rules every third year to determine whether any amendments are required.

TPI should state that indicate that access seekers and operators can at any time request the ERA to consider amendments to the over-payment rules.

3.4 Definitions

3.4.1 Commentary

TPI has not included definitions for access agreement, access related function, network and railway infrastructure.

The definition for non-access revenue refers to WNR instead of TPI.

3.4.2 Recommendations

TPI should include additional definitions as above, and correct the definition for non access revenue.