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2 April 2015

Attention: Assistant Director, Rail
Economic Regulation Authority
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Via email: publicsubmissions@era.wa.gov.au

Dear Sir/Madam

REVIEW OF THE RAILWAYS (ACCESS) CODE 2000

1. On 20 February 2015, the Economic Regulation Authority (**ERA**) released its Issues Paper in relation to its Review of the *Railways (Access) Code 2000* (**Code**). This Submission sets out our response to the Issues Paper.

2. We engaged Ernst & Young (**EY**) to prepare a paper commenting on certain matters raised in the Issues Paper, based on its regulatory and commercial experience. A copy of that paper is attached and forms part of our Submission.

BACKGROUND

3. The main object of the *Railways (Access) Act* 1998 (**Act**) is to establish a rail access regime that encourages the efficient use of, and investment in, railway facilities by facilitating a contestable market for rail operations. The Act, according to its Preamble, aims to promote competition in the operation of rail services.

4. The Act requires the Minister to establish a Code in accordance with the Act, to give effect to the Competition Principles Agreement, in respect of railways to which the Code applies. Parts of the Competition Principles Agreement are set out in Schedule 5 of the Code.

5. The Competition Principles Agreement was made between the Commonwealth and the State and Territories on 11 April 1995 and was amended subsequently. Clause 6(5) of the Competition Principles Agreements provides that in regulating access to certain infrastructure, a State or Territory is entitled to choose from a range of approaches, including a regime for access by negotiated agreement, with provisions for arbitral resolution of disputes, or one based on regulated access prices and standard terms and conditions of access. The Act specifically required the Code to adopt the negotiated access agreement/arbitral dispute resolution approach to railway regulation. There were sound economic reasons for adopting this approach,

which are based on the complexities of operating a multi-user railway and determining appropriate terms and conditions of access.

6. The object of regulating infrastructure to promote competition is concerned with competition in dependant markets and ensuring economic efficiency, which generally relies upon freedom of action. Where freedom of action is to be constrained by requiring third party access to be made available to privately owned infrastructure, this must be carefully limited and must be on reasonable terms in order to encourage maintenance, investment and technical innovation, so as to enhance economic efficiency.

7. Negotiated agreements with tariffs and terms that are appropriate to the specific access that is sought, with a facility for arbitral determination where agreement cannot be reached reduce the risk of regulatory error in setting prices and allow for more efficient access prices to be set. Accordingly, we do not support a move to a more prescriptive regime with a regulated, tariff-setting approach.

PART 2 – PROPOSALS FOR ACCESS

8. Section 8(1) of the Code entitles an entity to make a proposal in writing "for the use of railway infrastructure". A proposal must conform to the requirements in sections 8(2) and 8(3) of the Code. Section 8(2) confines the purpose for which a proposal may be made to the purpose of carrying on the operation of rolling stock on a part of railway infrastructure to which the Code applies. Section 8(3) requires a proposal to:

   - specify the route, including the railway infrastructure the use of which is sought;
   - the times when that use is required; and
   - the nature of the proposed rail operations.

   The proposal must be accompanied by a written notice of the proponent's intention to enter into negotiations under the Code for an access agreement between the railway owner and the proponent for the use of the railway infrastructure by the proponent.

9. A railway owner should only be obliged to participate in negotiations with a proponent who has a genuine requirement to use the railway infrastructure, and who intends to make a binding agreement for actual use of railway infrastructure. The Code is not aimed at assisting a proponent to make an agreement by which rail capacity is effectively reserved, especially for a long period of time, while the proponent ascertains whether and when it has genuine requirements for use of railway infrastructure and whether it is able to, and wishes to, actually use the railway infrastructure. This reservation of rail capacity is not consistent with the economic objectives of the Code nor the Competition Principles Agreement.

10. Accordingly, the Code would benefit from clarification that:

    - the proponent owes a duty of good faith to the railway owner in making an access proposal;
    - the proponent must have a genuine intention to enter into an access agreement with the railway owner to actually use the railway infrastructure; and
    - the proponent must provide a specific indication of the times when access is required, not merely a time from which access might possibly be required. This requirement should require the proponent to specify the times of day and the days of the week when access is required, along with a commencement date that the proponent genuinely believes it can meet.

PART 3 – NEGOTIATIONS

11. Sections 14-20 of the Code govern a railway owner's duty to negotiate, and a proponent's entitlement to insist upon the railway owner engaging in negotiations for an access agreement. Under sections 14 and 15 of the Code, a railway owner is entitled to require a proponent to show three things, namely that:

    a) it has or will be able to and will engage the services of another entity which has the necessary knowledge and experience to carry on the proposed rail operations;
    b) it has the necessary financial resources to carry on the proposed rail operations, and to pay its share of any extension or expansion costs, including that it has the necessary ability to meet its financial obligations under an access agreement to the railway owner and to other persons, including excesses under policies of insurance;
    c) having regard to the capacity of the relevant route and any information provided under sections 6 and 7 of the Code, the route (with any relevant extensions or expansions) can accommodate the proposed entry and exit times to which the proposal relates and the length and speed of the proposed rolling stock.

12. Sections 14 and 15 provide important protection for a railway owner, in the context of a scheme which may lead to the railway owner being bound by an agreement for the use of its railway infrastructure by a third party. Accordingly, these provisions are, and should be treated as, threshold issues that the proponent is required to establish at the date of making a proposal for access or shortly thereafter. The satisfaction of these requirements should not be postponed until some future time if or when a proponent is ready, willing and able to decide whether it wishes to make actual use of railway infrastructure. Accordingly, the Code would benefit from an amendment which makes clear the status of sections 14 and 15 as threshold issues.

13. Further, the Code should prescribe the date by which a proponent must satisfy sections 14 and 15 (if required by the railway owner). The Code prescribes the times by which a railway owner must do certain things, including responding to a proposal, providing its floor and ceiling determination to the ERA and providing a notice of readiness to negotiate. However, the Code fails to prescribe the time

within which the proponent must satisfy the railway owner of the matters in sections 14 and 15. Given the importance of sections 14 and 15 to a railway owner, the proponent should be required to meet these threshold issues either at the time of lodging the access proposal or within a short time thereafter. A delay by the proponent in satisfying the railway owner of the matters contained in sections 14 and 15, especially a long delay of more than 12 months, creates uncertainty for the railway owner and is not consistent with the economic objectives of the Code or the Competition Principles Agreement.

PART 6 – GENERAL

14. Section 50(1) of the Code provides that the ERA may disseminate information that relates to the carrying out of the Act, the Code or matters provided for by them. However, this right is subject to an important limitation, in section 50(3), namely that the ERA is not authorised to disclose information that is confidential without the consent of the person to whom the protection of confidentiality belongs.

15. Section 50(3) does not, as the ERA states in its Issues Paper, prevent the railway owner to claim confidentiality over any information required to be provided by provisions of the Code other than section 50. The ERA does not provide a basis for its interpretation of section 50 of the Code.

16. The protection of confidential information provided in section 50(3) of the Code provides an important protection for railway owners and rail users (including proponents). The Code requires railway owners and proponents to disclose certain commercially sensitive, confidential information to the ERA or to the other party, for example, in lodging an access proposal or making a floor and ceiling determination. The ERA is not necessarily best placed to determine whether such information should be disseminated, whether or not the information relates to the carrying out of the Act, the Code or matters provided for by them.

17. Accordingly, the express protection in section 50(3) must be retained (and properly interpreted) to ensure the protection of commercially sensitive, confidential information, the unauthorised disclosure of which may compromise the integrity of the Code and cause economic loss.

CONCLUSION

18. For the reasons set out above and in the paper prepared by EY, we submit that:

    (a) The Code should provide that in making an access proposal, the proponent owes a duty of good faith to the railway owner and that proponents must have a genuine intention to enter into an access agreement with the railway owner to actually use the railway infrastructure;

    (b) The Code should clarify that an indication of times when access is required under clause 8(3)(b) requires a proponent to provide a specific indication of the times when access is required (including a commencement date that the proponent genuinely believes it can meet, and the times of day and days of

the week when access is required), not merely a time from which access might possibly be required;

(c) Sections 14 and 15 should be treated as threshold issues that the proponent must establish as at the date of lodging its access proposal;

(d) The protection of confidential information provided for in section 50(3) of the Code should be retained and should not be diluted;

(e) All time limits in the Code, not just the time within which the ERA must approve the railway owner's floor and ceiling costs determination or make its own determination, should be reviewed to ensure reasonable time is provided to the railway owner and ERA in meeting their obligations under the Code, taking into account the complexities of the issues involved;

(f) The ERA should review the approach in the Code to the selection and appointment of arbitrators;

(g) Gross Replacement Value as a means of estimating capital costs should be retained. A change in the valuation approach to a building block method would require amendments to those sections of the Code which prescribe negotiation and arbitration procedures and, in our view, there is no justification for such a change;

(h) A merits review of ERA decisions should be introduced to reduce the risk of regulatory error.

Thank you for the opportunity to make this Submission on the Issues Paper.

Yours sincerely

Assistant Commercial Compliance Officer
The Pilbara Infrastructure Pty Ltd

Review of the Railways (Access) Code 2000

Submission in response to the Economic Regulation Authority of Western Australia Issues Paper

April 2015

Building a better working world

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1. Introduction

1.1 Background

The Economic Regulation Authority (the ERA) of Western Australia (WA) is in the process of undertaking a review (the review) of *the Railways (Access) Code 2000* (the Code). Section 1.4 below summarises the ERA's responsibilities in undertaking the review. The ERA published an issues paper (the Issues Paper) in February 2015 calling for public submissions to inform the review.

The Pilbara Infrastructure Pty Ltd (TPI) has engaged EY to provide insight and point-of-view recommendations on matters relevant to the review in a submission to the Issues Paper.

This report provides the outcome of our work. It seeks to make a balanced, evidence and experience- based contribution to the review.

1.2 EY Scope of Work

EY has been engaged to provide some views on issues relevant to the review in the context of:

- Recent legal, policy and regulatory developments in the sector

Section 3 provides views on specific issues raised by the ERA in the context of the above.

EY has also been instructed to comment on a number of issues not specifically raised by the ERA, but within the scope of the review. Section 4 below identifies and addresses these issues.

1.3 Limitations

Basis of Our Work

We have not independently verified, or accept any responsibility or liability for independently verifying, any information provided to us or in the public domain, nor do we make any representation as to the accuracy or completeness of the information. The scope of this Report has not involved forecasting and/or verifying the forecast assumptions underpinning the analysis. To the extent that our conclusions are based on forecasts, we express no opinion on the achievability of those forecasts and thus they should not be relied upon.

We accept no liability for any loss or damage which may result from your reliance on any research, analyses or information so supplied.

1.4 The legislative basis of the ERA's Review of the Code

Western Australian rail access legislation is intended to give effect to Federal access laws and agreements and the review is intended to ensure the Code is suitable for this purpose. The legislation and agreements that give rise to the review are:

- The *Competition Principles Agreement 1995 (as amended to 13 April 2007)* (the CPA) - a set of principles which emerged from the *National Competition Policy Review* and agreed to by the Council of Australian Governments on 25 February 1994 and which in part provides the basis for a national regime that enables third party access to services provided by means of significant infrastructure facilities
- The *Railways (Access) Act 1998* (the Act), which requires the ERA to undertake a periodical review of the Code

Section 12(2) of the Act states that *"The purpose of a review is to assess the suitability of the provisions of the Code to give effect to the … [CPA] in respect of railways to which the Code applies."* Beyond this, the Act is neither prescriptive nor restrictive in what issues the ERA is obliged to address as part of the Code review. However, the Code does require the ERA to call for public comment on the review in the form of written submissions.

1.5 Outline of this submission

The remainder of this submission is structured as follows:

- Section 2 outlines some views relevant to the review in light of recent legal, policy and regulatory developments and the commercial issues relating to the provision of access
- Section 3 addresses the specific issues raised by the ERA and draws on section 2 to do so
- Section 4 addresses some additional issues which are relevant to the review

2. Key issues relevant to the review

The ERA expresses an interest in learning the views of stakeholders as they relate to the wider issue of the prescriptiveness of the regime. This includes whether a more prescriptive regime – that is, a regime which requires a benchmark tariff for access to a benchmark service to be established rather than cost boundaries as a basis for negotiation on price – would be better in giving effect to the CPA than the current approach based on the floor and ceiling price tests prescribed in the Code.

The ERA identifies no new issues relevant to Parts 1 and 2A of the Code in the issues paper, but invites further comments relating to provisions of Parts 1 and Parts 2A of the Code.

This section provides views relevant to the review in light of:

- Recent legal, policy and regulatory developments
- Commercial issues relating to the provision of access

2.1 Recent legal, policy and regulatory developments

Some recent legal, policy and regulatory developments are potentially relevant to the review. In particular, the:

- Clarification of the meaning of 'economic to duplicate' as the ERA describes it
- Certification of the Code
- The Electricity Market Review

2.1.1 Clarifying economic duplication in the context of access

The Issues Paper notes that:

- The Act stipulates that the purpose of the review is to assess the suitability of the Code to give effect to the CPA in respect of railways to which the Code applies
- The CPA provides a framework to allow third parties to access nationally significant infrastructure facilities which cannot be duplicated economically

The Issues Paper also notes (in a footnote) that the ERA is "*aware of the 2012 Federal High Court decision in the Pilbara Rail Access Dispute, which used a different definition of the 'economic to duplicate' criterion*".[1]

The High Court's decision is highly relevant to the ERA's review of the Code.

[1] ERA (2015), Review of the Railways (Access) Code 2000 – Issues Paper, page 14, footnote 24.

The High Court's decision

One of the High Court's important findings in relation to the criteria for declaration relates to *criterion (b)*, which states that it must be uneconomical for anyone to develop another facility to provide the service.

The High Court held that criterion (b) should be assessed using a 'private profitability' test. Under this test, a service cannot be declared if it would be profitable for any person – including the incumbent infrastructure owner - to establish a second facility to provide the service. In other words, a service must not be declared if it can be shown that an existing or future market participant could reasonably expect to obtain a sufficient return on capital if it duplicated the facility to provide the service.

In reaching this conclusion, the High Court rejected the social benefit test and the natural monopoly test that have previously been applied by the National Competition Council (NCC). These tests focus on whether, from society's perspective, a single facility could meet demand at less cost than two or more facilities. In the High Court's view, the language of Part IIIA pointed to (and the objectives of Part IIIA would best be served by) an evaluation of what would be feasible or practical for an actual or potential participant in the marketplace, rather than an evaluation of efficiency from the perspective of society as a whole.

The majority of the High Court concluded that:

> *The better view of criterion (b) is that it uses the word 'uneconomical' to mean 'unprofitable'. It does not use that word in some specialist sense that would be used by an economist. Further, criterion (b) is to be read as requiring the decision maker to be satisfied that there is not anyone for whom it would be profitable to develop another facility. … When used in criterion (b) 'anyone' should be read as a wholly general reference that requires the decision maker to be satisfied that there is no one, whether in a market or able to enter the market for supplying the relevant service, who would find it uneconomical (in the sense of profitable) to develop another facility to provide that service.*[2]

In assessing whether a facility can be profitably duplicated, the High Court explained that:

> *It would not be economical, in the sense of profitable, for someone to develop another facility … unless that person could reasonably expect to obtain a sufficient return on the capital that would be employed in developing that facility. Deciding the level of that expected return will require close consideration of the market under examination. What is a sufficient rate of return will necessarily vary according to the nature of the facility and the industry concerned. And if there is a person who could develop the alternative facility as part of a larger project, it*

[2] The Pilbara Infrastructure Pty Ltd v Australian Competition Tribunal [2012] HCA 36 (14 September 2012), para 77.

> *would be necessary to consider the whole project in deciding whether the development of the alternative facility, as part of that larger project, would provide a sufficient rate of return.*[3]

The decision means that infrastructure will not be declared if it is privately profitable for anyone to duplicate the infrastructure concerned, based on industry evidence. Importantly, it reaffirms the Full Federal Court's findings that decision makers do not have a wide-ranging power to override private property rights wherever they consider sharing of infrastructure via third party access would produce a more efficient use of resources for society.[4]

The High Court has not, as the ERA implies, provided a *"different"* definition of the meaning of 'economic to duplicate'. Irrespective of whether one might subscribe to the same view, it provides the only definition relevant to assessing the suitability of the Code in giving effect to the CPA. Importantly, as discussed below, the private profitability test has also been endorsed by the Harper Review of competition policy.

The Australian Government Competition Policy Review

As noted above, the High Court's Pilbara decision has significant implications in relation to third party access. The interpretation of criterion (b) as a private profitability test is one that is based on commercial realities rather than the hypothetical considerations which underpin the net social benefits and natural monopoly tests. From this perspective, it potentially provides more certainty for access seekers and providers because both parties will more readily be able to assess whether there are any actual or potential market participants that could profitably construct alternative facilities by reference to market conditions, costs, prices, project demand and applicable rates of return.

There has been some level of debate over the High Court's interpretation of criterion (b), including by the Productivity Commission in its recent 2014 review of the National Access Regime. In its review, the PC recommended that amendments be made to criterion (b) to either restore the natural monopoly test or retain the private profitability test but to exclude the current infrastructure owner from that test.

The matter has now been considered as part of the 'root and branch' review of Australian competition policy (the Harper Review).[5]

In respect of the High Court's decision, the Harper Review states:

"The High Court's interpretation of criterion (b) gave effect to clause 6 of the CPA, which was entered into by all Australian jurisdictions following the Hilmer Review.

[3] Ibid., para. 104
[4] Ibid., para. 172
[5] The Australian Government Competition Policy Review, March 2015

By clause 6, all jurisdictions agreed that the Regime should be a regime for access to services provided by means of significant facilities where, among other things:

- *it would not be economically feasible to duplicate the facility; and*
- *access to the service is necessary in order to permit effective competition in a downstream or upstream market.*

Those tests require an evaluation of whether duplication is feasible or practical for a participant in the market.

Understood in that way, criterion (b) directs attention to the competition objective that lies at the heart of Part IIIA: whether the facility is a bottleneck, in the sense that access to the facility is necessary or essential to participate in an upstream or downstream market. Applying criterion (b) in that way promotes both competition and economic efficiency. If it is commercially feasible to develop another facility, the facility owner and access seeker have commercial incentives to reach an access agreement where it is efficient to do so. Where the facility can be bypassed, the facility owner has no incentive to refuse access and has an incentive to allow access if its overall costs will thereby be reduced.

If the facility owner and access seeker are unable to reach agreement, it is a strong indication that substantial inefficiencies will result from access."[6]

In respect of assets like TPI, the Harper Review states:

"…imposing an access regime upon privately developed single-user infrastructure is more likely to produce inefficiency than efficiency, impeding the competitiveness of Australian industry. This is particularly so for vertically integrated export industries that are subject to the constraints of international competition in the final goods market."[7]

The Harper Review notes that there has been widely divided views expressed about the PC's recommendations. A number of parties support the PC's proposed change to criterion (b).[8] A number of other parties preferred the 'private profitability' test.[9]

The Harper Review concludes:

"The Panel considers that maintaining the 'private profitability/economically feasible' test for criterion (b) will best promote the competition policy objectives underpinning Part IIIA. Under that test, access regulation will only be considered where there is a bottleneck that needs to be addressed. Absent a bottleneck problem, competition and economic efficiency will be advanced if market participants are free to negotiate private arrangements concerning access."[10]

[6] Ibid., page 433
[7] Ibid., page 429
[8] This included the NCC, Fortescue, Anglo American Metallurgical Coal and the ACCC.
[9] This included BHP Billiton, Rio Tinto Iron Ore and Professors Ergas and Fels
[10] Ibid., page 435

It also concludes, however that: *"…it is desirable to revise criterion (b), as suggested by the PC, so as to exclude the service provider from the assessment of feasible duplication by anyone."*

The Harper Review therefore recommends that:

"Criterion (b) should require that it be uneconomical for anyone (other than the service provider) to develop another facility to provide the service."[11]

The Federal Government is now considering whether to accept the Harper Review's recommendations.

2.1.2 Certification of the Code

The Issues Paper notes that:

- The WA Rail Access Regime has been certified for a period of five years ending in February 2016
- The NCC previously recommended that the Commonwealth Minister not certify the WA Rail Access Regime as effective, but the Minister certified it anyway

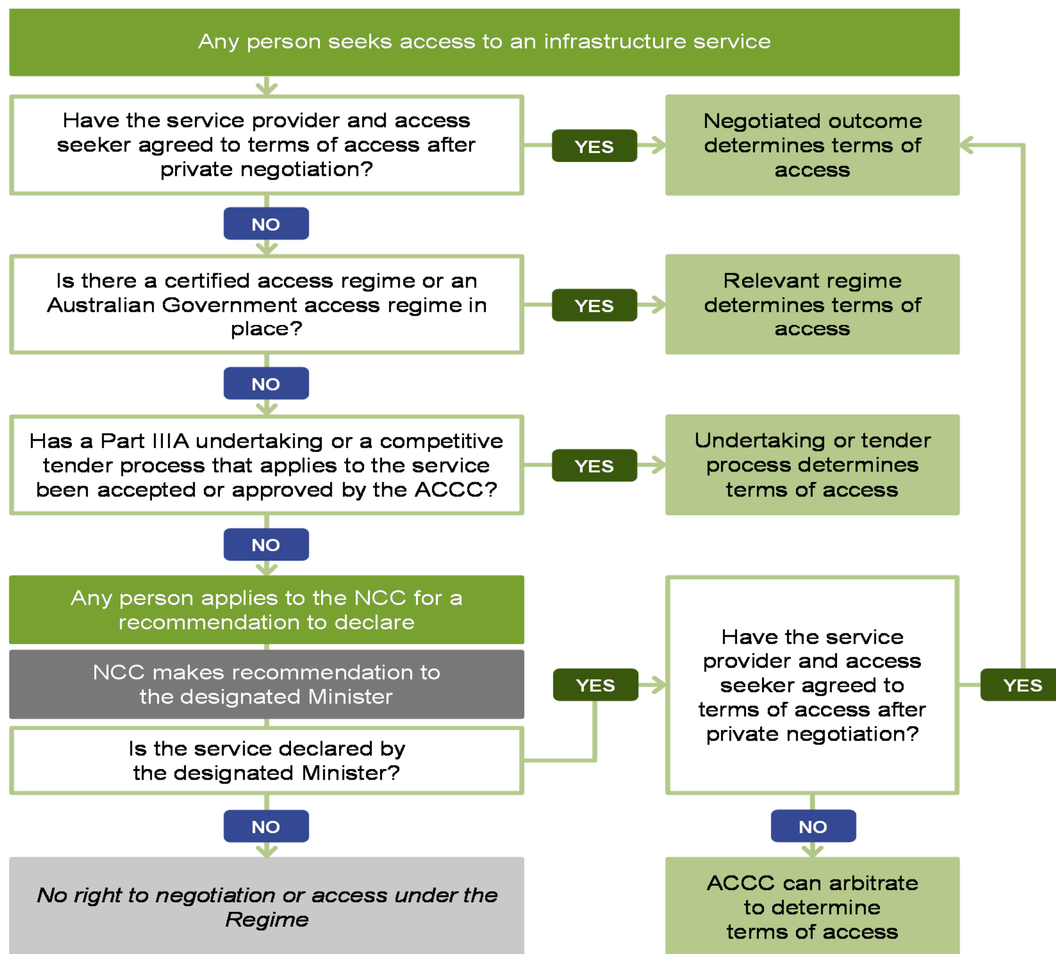
The WA Rail Access Regime (of which the Code is a subsidiary part) will therefore cease to have certified status from March 2016.

Where a state based regime is certified as being effective by the Minister, the facility to which that regime applies cannot be declared.[12] Instead, the terms of access are governed by that state based regime, rather than the national access regime. In this way, certification may allow State-based considerations to be taken into account in determining access, so long as the principles underpinning access are consistent with those in the national access regime.

It follows that where a certified state-based access regime does not exist, applications may be made for declaration under the national access regime. These applications will proceed through to the NCC, which will make its decision in accordance with the requirements of the national access regime.

The figure below provides a summary of the routes to access, including where a state based regime is not certified.

[11] Ibid., page 440
[12] At present, a service subject to a certified regime can be declared if there have been substantial modifications to the certified regime or the certification principles.



Source: Productivity Commission, Review of the National Access Regime, Figure 1

In short, the NCC will adopt the definition of 'economic to duplicate' in any assessment of whether to declare TPI or to certify the WA Rail Access Regime when the current certification ceases to have effect from March 2016.[13] If the national access regime is amended to reflect the recommendations from the Harper Review, this will likely fully entrench this approach. This reinforces the relevance of the High Court decision to the ERA's review of the rail access code.

2.1.3 The Electricity Market Review

The WA Government is conducting an Electricity Market Review of the South West Integrated System in light of concerns regarding the outcomes the market has been delivering.

The *Electricity Market Review Options Paper*[14] has recommended that the regulation of electricity networks be moved to the national regime (i.e. the National Electricity Rules) administered by the Australian Energy Regulator (AER). We understand the Government is also considering transferring the regulation of gas

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[13] It has already been adopted by the Australian Competition Tribunal. See: Applications by Robe River Mining Co Pty Ltd and Hamersley Iron Pty Ltd [2013] ACompT 2

[14] Public Utilities Office, *Electricity Market Review Options Paper*, December 2014.

pipelines to the AER.[15] This would substantially diminish the ERA's functions as an access regulator. The logical next step would be for the Government to transfer rail access regulation to the national regime.

2.1.4 Implications of recent legal, policy and regulatory developments

Recent legal, policy and regulatory developments are relevant to the review of the Code, and in particular, assessing its suitability in giving effect to CPA. The key implications of recent developments are as follows:

- This review of the Code and the relevant issues should be reconsidered by the ERA in light of the meaning of 'economic to duplicate'. It is perhaps worth noting that:
  - TPI's railway was economic to duplicate based on the industry evidence (e.g. the High Court's decision related to access to other facilities). The Australian Competition Tribunal has applied this interpretation in setting aside declarations of access in respect of two other Pilbara railway lines.[16]
  - The application of the 'economic to duplicate' definition has implications for the scope and coverage of the Code. Specifically, less prescription may be required given the access seeker has a viable alternative. For example, it may have implications for an appropriate ceiling price, if regulated access is to be allowed for, despite what the Code is now seeking to cover (i.e. facilities that are economic to duplicate). A more appropriate ceiling price may be up to the access seeker's 'stand-alone' costs. These costs are likely to be higher than those embodied in the current ceiling price because they would fully reflect all the commercial risks imposed on a developer of greenfield facilities (as section 2.2 below describes).
- If the Harper Review's recommendations are accepted by the Commonwealth Government, then there may well be a need to redefine the services to which access should be provided and the process and terms and conditions on which it is to be provided. The process to implement the findings may, however, take a considerable period of time as legislative change is likely to be required. Given the timeframes, it may well be the next Federal Government which is in a position to determine whether to proceed or not with implementing the Harper Review's findings. In the interim, the High Court's clarification of the meaning of 'economic to duplicate' will prevail.
- The Code will soon lose its certification and the terms of access could then be considered under the national access regime, including the aforementioned High Court decision. In these circumstances, TPI would not be covered by the national access regime. We understand however that the WA Railways Access Act and thus the Code would continue to apply notwithstanding that it is no

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[15] Some gas pipelines in Western Australia are already regulated under the National Gas Rules, but by the ERA.
[16] Applications by Robe River Mining Co Pty Ltd and Hamersley Iron Pty Ltd [2013] ACompT 2

longer certified.[17] It is not clear how the latter outcome can give better effect to the CPA, given under the proper interpretation of the CPA, TPI should not be subject to regulated access.

- The ERA may soon lose the responsibility for the regulation of electricity and gas networks (i.e. it may only have responsibility for regulating rail access in relation to some railway assets). This raises a further question as to whether rail access should also be transferred to the national regime.

The Issues Paper would benefit from a fuller explanation of the ERA's views of the implications of these developments for assessing the suitability of the Code in giving effect to the CPA.

2.2 Commercial issues relevant to the review

The ERA's interest in views around the prescriptiveness of the Code (e.g. in relation to service and tariff setting), and the specific issues it raises in the Code inevitably raises commercial issues (i.e. the commercial position of railway owners and access seekers).

To address those issues in the appropriate context, below we outline some of the commercial imperatives relevant to the review, given our sector experience and the nature of access in respect of TPI. These are the commercial imperatives that need to be reflected in the terms of access under the Code if they are to provide access consistent with giving effect to the CPA, particularly in relation to protecting the legitimate business interests of the railway owner and the need to compensate them for the commercial risks involved in providing access.

These issues are particularly relevant to extensions and expansions, the meaning of unfairly discriminate, and issues pertaining to timing and what constitutes confidential information.

This section therefore provides background for our responses in section 3 and the additional issues discussed in section 4 below.

2.2.1 Commercial principles underpinning mine logistics infrastructure development

From a commercial perspective, the starting point for any consideration of how an access regime should be applied is to understand the core commercial principles that underpin the decisions made by the original sponsors (both equity and debt) of the logistics infrastructure. We use the term 'sponsor' to capture both parties, given debt providers will typically play a key role in how risks are allocated and ultimately their exposure to those risks. The (equity) investor is typically the mine developer, or a third party on the miner's behalf.

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[17] Clause 16(3)(b) in schedule 1 of the *Railway and Port (The Pilbara Infrastructure Pty Ltd) Agreement Act 2004* states that TPI "… shall do all such things as the Minister reasonably requests for the purposes of the Access Code applying and continuing to apply to and in respect of the Railway which are not inconsistent with … [the] Agreement."

Typically these principles include:

- The infrastructure is typically purpose built to accommodate the investor's requirements or expected requirements.
- Control over the scope and performance characteristics of the infrastructure – sponsors do not wish to fund "gold plated" solutions that may impact overall project viability.
- Flexibility over the expansion and upgrade profile of the infrastructure – investors will factor into their resource production plans the ability to schedule upgrades and the ability to postpone/accelerate these plans based on actual price and contracted throughput.
- Understanding the hurdle return on capital that a mine/logistics development must meet to provide adequate risk compensation to the investor group. At the point of development it is difficult to separate the risk pricing of the logistics development from the mine development, since, typically, the support infrastructure has no alternative use in the event that the mine is closed. Applying different return requirements to different components of a mine/logistics project is impractical.
- In targeting an adequate return on capital, project costings must incorporate an appropriate contingency estimate to account for unknown costs that are likely to be incurred, but are not included in a base cost estimate.[18]
- Control over the operational protocols of the infrastructure – sponsors will typically have an expectation that the operational assumptions underpinning their projects will not be subject to unreasonable alteration.
- Integrated supply chain risk management – this is a primary motivation for investing in the logistics infrastructure. Once the infrastructure is operational, ownership and control of the infrastructure allows the investor to manage its own supply chain risks.

Proceeding to the actual design and construction of large scale logistics assets requires the resolution of the above principles into a set of risk allocation and pricing decisions that will drive the design and construct (D&C) and operating and maintenance (O&M) contracts, and the asset configuration. The risks that need to be allocated typically include:

- Asset construction cost and timing risks – the sponsors will seek to allocate these to the D&C contractor but contractors typically will not accept economic loss risk. The investor will therefore be left with the risk that late delivery triggers resource offtake contract penalties and lower sales revenues.
- Theoretical versus practical capacity - contractors will accept the risk that what they construct meets a design/specification, but not the risk that the design will deliver the required capacity. The investor retains the risk over whether asset

[18] We understand that contingency has been included by TPI when calculating the total capital costs and the Gross Replacement Value (GRV) of their railway infrastructure.

configurations they have selected can actually deliver the anticipated logistics capacity.

- Operational asset performance – in a similar situation to D&C risks, contractors engaged to provide the resource haulage and asset maintenance services will accept some performance risks, typically limiting liability to the actual contract payments. The investor typically takes on residual risks in respect of wider "force majeure" events that impact asset operations.
- Integrated Logistics System Performance – coordination of pit, port and rail operations is an important factor in the overall resource export capacity. The investor will align the infrastructure configuration and operational protocols to match their contract requirements and mine operational parameters, but cannot remove exposure to volatility. A high level of certainty over reliability is essential given the high costs that non-reliable service can impose. These include commodity offtake contract penalties, additional rail haulage and shipping costs as well as further debt finance costs where funding covenants are impacted by poor logistics performance.
- Supplier Credit Risk – above the actual physical asset performance risk, the investor is exposed to the basic financial risk that key logistics contractors and suppliers remain in business. Some mitigation is possible through requiring parent/bank guarantees from potential contractors, but this naturally increases the cost of contracted services. There is no complete mitigation of this risk – a train operator becoming insolvent will halt haulage services until an appropriately accredited replacement is engaged.
- Expansion Timing and Cost Risks - it is rarely financially or operationally feasible to lock down the scope and timing of network capacity upgrades. Evaluation of the potential cost/benefits is a complex and costly exercise analogous to pricing the purchase of a long term option. It requires sponsors to take a view on the future resource demand and pricing, the future excess capacity on his infrastructure, and the future time and cost to implement an expansion.

Where the mine developer develops the logistics infrastructure, the relevant component of all of the above risks and the capacity to control them (to the extent that this is possible) is internalised to them in the first instance

Where the developer of the logistics infrastructure is a third party it will seek to mitigate these risks by ensuring the investor has the appropriate take or pay arrangement in place over the life of the relevant asset (i.e. the mine) and seeks to recover all the relevant costs of the infrastructure over that period. For example, Arrium has recently had to close several iron ore mines, but is still obliged to pay the railway owner such as Genesee Wyoming under long term take or pay arrangements.[19]

[19] http://www.smh.com.au/business/mining-and-resources/arrium-the-latest-australian-miner-to-be-stung-by-takeorpay-rail-contracts-20150215-13f36l.html

The investor may also seek some certainty having 'most favoured nation' clauses in foundation contracts. These clauses are designed to provide reasonable certainty to foundation customers whose contracts underwrote the development of the asset.[20] These clauses typically ensure that subsequent access seekers can be provided with no better terms than those agreed by the parties (the investor and the foundation user). If they were provided with better terms, they must be provided to the foundation user.

The critical role played by foundation contracts in underpinning investment is reflected in the National Gas Law and, most specifically, the Greenfields pipeline incentives as outlined in the 15-year no coverage provisions under Part 2 (sections 151-159). The three major gas transportation assets underpinning the development of the coal seam gas export market in Queensland have utilised the Greenfields pipeline incentives. The Australian Energy Market Commission has recognised the importance of long term contracts in stating that: "A positive feature of these arrangements is that the risk associated with the investment in gas infrastructure is borne by the investor who is best placed to manage it, and not by consumers."[21]

Similarly, if higher interest rates are offered to new lenders when 'most favoured nation' clauses appear in a sponsor's loan terms, those higher interest rates will also be passed through to existing lenders. This highlights the view that debt providers have in respect of the risks they are taking and the assets over which they seek security.

The developer of logistics infrastructure, where it is a third party, will also need to have the appropriate parent company / bank guarantees in place.[22] But these will not offer complete risk mitigation. The recent bankruptcy of one of the foundation miners in the WICET coal logistics development (Bandanna Energy) highlights the risk exposure to a developer, even when take or pay agreements are in place.[23] Before proceeding with the project the infrastructure developer required that the portion of access revenue lost with the miner's insolvency be replaced, either with a new credit worthy counterparty, or through spreading the lost revenue across the remaining foundation users.

[20] One exception is electricity transmission, but this is invariably regulated in part because of the less specific nature of the service provided. Where it is potentially not regulated and point to point (e.g. to serve a new mine), it is unlikely to be developed without long term contracts. Similar mechanisms are widely used in other parts of the economy to manage market risk (e.g. property developers will typically only get funding to proceed with major developments with a significant level of presales).

[21] AEMC, Strategic Priorities for Energy Market Development 2013, October 2013, page 23

[22] The Pilbara Infrastructure State Agreement (Railway and Port (The Pilbara Infrastructure Pty Ltd) Agreement Act 2004) imposes a guarantee on Fortescue Metals Group Ltd in respect of performance of TPI in respect of all its obligations under it. This would appear to be designed to achieve a similar outcome.

[23] http://www.afr.com/business/wicet-bandanna-collapse-ok-20140923-jfydt

These arrangements reflect the commercial imperatives that need to be met to enable the development of most infrastructure assets.[24]

2.2.2 How access can impact upon the risks borne by the project sponsor

The granting of access can have a material impact on the quantum and allocation of all the risk elements identified above as it requires the logistics system to accommodate additional throughput that is unlikely to have been envisaged in the original operational protocols and infrastructure design.

The key impacts on these risks include:

- Additional operations and maintenance risks - apart from the additional basic asset wear costs, third party access can increase the complexity and cost involved in managing the expansion or compression of capacity on a network. Moreover, investors are exposed to re-scheduling costs and issues where new users do not comply with agreed operational rules, degrading the overall reliability of the logistics system.
- Access seeker credit risk - new users are typically required to execute take or pay contracts to secure access so that the network owner is not exposed to a user volume risk. This is essential where an investor commits to network expansion to accommodate new access seekers. Take or pay arrangements still leave investors exposed to additional credit risk since an insolvent miner cannot make the required payments.
- Expansion option value loss - where access is granted, available capacity is used. This reduces the flexibility the investor has in managing their expansion profiles and their capability to deal with price volatility.
- Supply chain disruption risk - third party access results in the railway owner losing complete control of above rail assets. This may remove the railway owner's self-insurance against supply chain risks.
- Contingency cost cross-subsidisation - this will occur if third party access legislation does not confer sufficient contingency provisions for dealing with unforeseen circumstances that may be faced by the access seeker over the life of an access arrangement, particularly when long periods of access are negotiated with far-off future starting dates.

The true costs associated with the provision of third party access can therefore be higher than the direct infrastructure-related costs, and not readily amenable to ex post compensation in the rate of return (e.g. because it creates binary risks that were addressed when the relevant investment decisions were made). If these risks were contemplated at the time of the original investment, they would most likely have altered the business case for the project.

[24] One exception is electricity transmission, but this is invariably regulated in part because of the less specific nature of the service provided. Where it is potentially not regulated and point to point (e.g. to serve a new mine), it is unlikely to be developed without long term contracts. Similar mechanisms are widely used in other parts of the economy to manage market risk (e.g. property developers will typically only get funding to proceed with major developments with a significant level of presales).

In other words, what appears to be a relatively high access price would need to be negotiated to *"generate expected revenue … that is at least sufficient to meet the efficient costs of providing access … and include a return on investment commensurate with the regulatory and commercial risks involved"*[25]. This would likely reflect the 'stand alone' costs of the access seeker developing similar assets.

The erosion of the risk allocation of investors/foundation customers highlights that, while the economic rationale for "open access" is sound, achieving an appropriate balance between the commercial interests of the current users and owners, and those of the access seekers is a key challenge. If not handled appropriately, regulated access may work to the detriment of:

- "…economically efficient … investment in, significant infrastructure"[26]
- "the owner's legitimate business interests and investment in the facility"[27]
- "the interests of all persons holding contracts for use of the facility"[28]

2.2.3 Implications for appropriately balanced access

Whereas the typical view of access is for the present term and access to existing spare capacity, this is clearly not the circumstance that typically arises for mine logistics infrastructure like TPI. Access to mine logistics infrastructure often have the following characteristics:

- The need for access is typically for a number of years into the future, but with significant uncertainty over whether it will be required, when it will be required and how much will be required
- A high level of uncertainty over these variables exists, reflecting the risk over the intervening period around whether the project is economically viable and the parties that are proposing it are bankable and can execute the process effectively to proceed to development

Access seekers are therefore seeking a firm allocation of network capacity while providing only limited assurance that they will be take up the capacity and commence payments.

It is also worth noting that the WA rail access regime applies a "one size fits all" regulatory framework, but purpose built, single user railways are quite different to other types of rail facilities.

Elements of the processes adopted by mine logistics infrastructure networks either independently owned or controlled by existing users highlight more equitable approaches. In particular:

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[25] CPA, s 6.f.2.1
[26] CPA, s 6.f.1
[27] CPA, s 6.e.9.1
[28] CPA, s 6.e.9.4

- An access "request" is not effective unless it is formatted as a definitive request, setting out in detail the capacity requested, the mine development profile, the financial capacity of the seeker to commit to the contract payments and the progress made in acquiring port access. This reduces the costs and time involved in responding to more speculative requests. Broadband and LPG networks deal with this issue with the concept of a non-firm capacity reservation, and charging a reservation fee to entities who cannot / will not commit to a firm access agreement.
- Discriminatory access terms/pricing is an appropriate mechanism for mitigating the credit risk inherent in a network owner providing access on a take or pay basis and reflecting the risk costs absorbed by the initial infrastructure sponsor. This is especially significant where such agreements underpin substantial network upgrade costs.
- The current railway owner is best placed to coordinate efficient and safe operations with the available network capacity.
- Network owners should not be forced to commit substantial capital for network upgrades to address access requests in excess of available capacity. "User funding" structures can provide an appropriate mechanism for access seekers to sponsor upgrade transactions.

These types of limitations mitigate the "free rider" issues where parallel projects bank the value created by infrastructure sponsors bearing the design and development risks in the initial delivery of the infrastructure.

These are the commercial imperatives that need to be reflected in the terms of access under the Code if they are to provide access consistent with giving effect to CPA, including protecting the owners' legitimate business interests and ensuring they are adequately compensated for the commercial risks associated with providing access.[29] These commercial imperatives are therefore relevant to the review, including considerations in respect of its degree of prescription.

[29] CPA, s 6.f.2.1

3. Issues explicitly identified in the Issues Paper

Issues explicitly identified in the Issues Paper that the ERA is seeking comments on relate to:

- The meaning of 'unfairly discriminate'
- Extensions and expansions
- Price limits determination
- The time limit for ERA determination of costs
- Arbitration
- Confidential information

This section discusses the issues raised by the ERA and provides some views regarding their alignment or otherwise with the commercial imperatives outlined in the previous section, and which must be conveyed in the Code for it to give effect to the CPA.

3.1 Meaning of 'unfairly discriminate'

The ERA's Issues Paper seeks comment on whether section 16 of the Code should be expanded to clarify the term 'unfairly discriminate'. We note that in its second review of the Code, the ERA recommended that Treasury undertake further consultation towards amending section 16 to provide a non-exclusive list of considerations that may provide for 'permissible discrimination' by a railway owner. This recommendation had merit in that it would provide additional guidance and reduce the likelihood of unnecessary disputes, and reduce costs and delays for all parties.

We note that the CPA allows for:

"multi-part pricing and price discrimination when it aids efficiency [but does] 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."

We also note that the CPA (s 6.e.9) already provides a list of considerations that a dispute resolution body should take into account when deciding upon the terms and conditions for access. To give effect to the CPA, this list should provide the basis for considerations that may provide for 'permissible discrimination' by a railway owner under the Code.

Section 2.2 above outlines the commercial issues that should be captured under reasonable discrimination while meeting the requirements of the CPA; in particular

that it should be construed in light of the commercial risks that access provider incurred in the developing the assets.[30]

They include the ability to discriminate against rail users according to:

- Their contribution to the railway owner's capital costs and risks
- Their contribution to the railway owner's operations and maintenance costs and risks
- Credit risk
- The amount and quality of security offered to the railway owner
- Any loss of expansion option value resulting from proposed access
- Supply chain disruption risk
- The extent of any cross-subsidy between existing users and new users.

The non-exhaustive list proposed by Oakajee Port and Rail in their 2010 submission to the ERA's last review of the Code are appropriate considerations that may provide for 'permissible discrimination' by railway owners. We reproduce that list below:

- *The present value of future returns to the railway owner from the provision of access to an Access Seeker;*
- *The risks to the railway owner of increased costs or reduced revenues, such as maintenance costs;*
- *The quality of information provided to the railway owner by Access Seekers;*
- *The amount and quality of security offered to the railway owner by Access Seekers;*
- *The duration of an agreement or proposed agreement between the railway owner and an Access Seeker;*
- *The lifetime of an Access Seeker's mineral resource that would be transported on the railway owner's infrastructure;*
- *Any prior failure by an Access Seeker to pay the railway owner or pay the railway owner in a timely manner an amount due to the railway owner; and*
- *Any prior negotiations between an Access Seeker an the railway owner which have been terminated by the railway owner.*[31]

3.2 Extensions and expansions

There are two matters explicitly raised in the Issues Paper that relate to extensions and expansions of railway infrastructure to augment capacity in support of an access proposal. These are:

[30] CPA, s 6.f.2.1

[31] Oakajee Port and Rail (2000), *Submission on the Review of the Railways (Access) Code 2000*, 3 February 2010, page 3.

1. Whether section 10 of the Code compels a railway owner to enter into negotiations on an access proposal prior to a viable plan being finalised to extend or expand the network to the extent required to accommodate the proposed access
2. Sections 13, 14 and 15 of the Code which convey a railway owner's lack of duty to negotiate with an access seeker that cannot demonstrate:
   a. Necessary managerial and financial ability to extend or expand the network
   b. That the extension or expansion will be sufficient to accommodate the proposed access
   c. That the extension or expansion will be technically and economically feasible and not undermine the reliability and safety of the network

3.2.1 When can an extension or expansion be proposed?

Sections 10, 13, 14 and 15 of the Code do not:

- Prevent an access seeker from proposing an extension or expansion during the course of negotiations
- Compel a railway owner to negotiate until the criteria provided by sections 14 and 15 of the Code have been met.

The preceding two points are not inconsistent with one another, as:

- If both parties wish to enter into negotiations, sections 8(5) and 10 of the Code allows for them to commence those negotiations prior to an extension or expansion being proposed
- If the railway owner does not wish to enter into negotiations because the ability to meet criteria under sections 14 and 15 of the Code is not demonstrated, the railway owner is not compelled to do so until the access seeker's ability to meet the criteria is demonstrated.

This provides an appropriate allocation of rights and responsibilities from a commercial perspective because it gives the railway owner reasonable assurance that D&C and O&M risks lie within reasonable tolerances prior to the commencement of negotiations.

The Issues Paper raises sections 14 and 15 in the context of the validity of an access proposal having been challenged on the basis that a particular expansion has not / could not be proposed while satisfying those criteria. The ERA asks whether the Code should be clarified to ensure sections 14 and 15 are treated as 'threshold issues'. These 'threshold issues' are the access seeker's requirement to demonstrate:

1. Adequate capacity to accommodate the proposed operations
2. The managerial and financial ability to carry on the proposed operations, including network expansions or extensions

Clarification should be consistent with the fact that sections 14 and 15 of the Code apply to the proposed rail operations as a whole, and not only to extensions and expansions.

In terms of the financial ability to pay threshold, for a mine logistics infrastructure development in WA this is in practice predicated upon the access seeker holding:

- A relevant State Agreement
- An underwriting commitment letter from a financial institution with sufficient assets to provide security for the entire mining project, not only the logistics operation

Without such guarantees, the railway owner and existing / future users of the infrastructure assets will be saddled with considerable and unmanageable access seeker credit risk which would be likely to compromise "the owner's legitimate business interests and investment in the facility" [32] and "the interests of all persons holding contracts for use of the facility"[33].

The access seeker's demonstration of financial resources should include the capacity to provide the railway owner with a security deposit to cover the cost of high consequence binary events such as the risk of supply chain disruptions caused by the access seeker's rolling stock.

By definition, any challenge in relation to expansions and extensions will result in a dispute, and disputes are invariably time consuming and costly for all parties involved. Clarifying Sections 14 and 15 as 'threshold issues' would reduce the likelihood of challenges and as a result reduce delays and costs related to proposed extensions or expansions.

3.2.2 Proposals which may preclude access: when is section 10 relevant?

The Issues Paper invites comment on whether the intent and meaning of section 10 of the Code should be clarified and does so in the context of railway network extensions and expansions. Paragraph 106 of the Issues Paper offers the following interpretation of section 10:

> *"Section 10 provides for the railway owner to seek approval from the Regulator to enter into negotiations on a proposal, under circumstances where providing the proposed access may preclude any further access to the existing infrastructure."*

The exact wording of Section 10(1) is:

> *"10. Regulator's approval required in certain cases*
>
> *(1) Where –*

[32] CPA, s 6.e.9.1
[33] CPA, s 6.e.9.4

> *(a) a proposal has been made; and*
>
> *(b) the railway owner considers that it would involve the provision of access to railway infrastructure to an extent that may in effect preclude other entities from access to that infrastructure,*
>
> *negotiations on the proposal must not be entered into by the railway owner without the approval of the Regulator."*

The remainder of section 10 relates to the ERA's decision making process.

Section 10 appears to have the following intention:

- To cause the railway owner to consider whether or not a proposal may preclude access by other entities. In other words, to consider whether or not the network's capacity may be a limited resource if the proposed access eventuates.
- In the case where a proposal may preclude access, cause the ERA to focus on the public interest, which in accordance with good regulatory practice ought to recognise that limited resources should be allocated to their highest valued use while respecting existing property rights and commercial imperatives.
- Be silent as to whether or not negotiations are being sought by the railway owner, the access seeker or both parties.

Section 10 does not appear to place any onus on the railway owner to seek approval from the ERA to negotiate. Rather, the onus is placed on the railway owner to provide the ERA with its opinion if it considers that an access proposal may preclude other entities from access to the infrastructure. Upon receipt of such an opinion, the ERA can conduct a process leading to a decision to approve or otherwise the commencement of negotiations. On this, we note that:

- The fact that an extension or expansion may accommodate a proposal does not necessarily result in the expanded capacity becoming an unlimited resource
- If there are competing alternative uses for the expanded capacity it cannot be an unlimited resource
- Proposals that are not definite (firm) will degrade the option value of the allocated capacity and impose an uncompensated cost on the railway owner and/or other users. This would represent a form of cross-subsidisation and, as a general principle, existing users should not be forced to subsidise new users.

An economic regulator should be able to assess whether or not the proposed access is allocating limited capacity to its highest valued use, including consideration as to whether or not the proposal is viable and firm. The Code appears to provide for the ERA to make such an assessment prior to commencement of negotiations and so the current wording of the Code would appear to be appropriate. Clarification could be made to ensure that the intent and meaning of section 10 is to prevent any forced negotiation that may result in an inefficient allocation of network capacity, including degradation of option value if capacity is allocated to non-firm access.

3.3 Price limits determination

In this section we address two issues raised by the ERA in the Issues Paper:

- Whether or not GRV should remain the means of estimating capital costs under the code.
- Whether or not WA's rail access regime should be more prescriptive in setting access prices.

3.3.1 Should a DORC valuation method be adopted as an alternative to GRV?

The Code currently prescribes the use of GRV in determining the price ceiling and thus limits the range of potential outcomes under regulated access. The Issues Paper raises the question of whether there is a better means of estimating capital costs than GRV. It notes that in other states DORC is the preferred method of asset valuation. It also notes that the NCC - in assessing the Code for certification purposes and in its decision to not declare the Code effective - raised the use of GRV, although this appears to have been primarily on the basis of consistency with other rail regimes interstate, and only part of the reason.

The choice between GRV and DORC raises several issues, including:

- Is there a conceptual case for a preference for one over the other?
- Is there a material difference between the two if applied appropriately?
- If there is a case for moving to DORC, could it have value implications for the access seeker or provider?

GRV has been applied in the Code because in principle it provides a better match with the nature of below rail assets and their cost structure. These assets exhibit long lives which in many cases can be extended by regular maintenance and periodic renewal expenditure (which has some characteristics similar to both opex and capex). In this respect, GRV arguably better reflects the nature of the assets than DORC, through the different treatment of depreciation. Other similar assets are often priced on a similar basis (e.g. water assets, particularly channels in the irrigation sector). GRV will also tend to lead to more consistent prices over time.

In principle, if applied appropriately, GRV and DORC should deliver similar net present values. In practice, application can lead to relatively minor differences in outcomes (as the ERA has shown).[34]

GRV and DORC do however provide differences in the timing of cash flows, which in the event that a change is made from one method to another, can lead to material changes in net present value. This will either penalise the access provider or seeker.

[34] The issues should be viewed in the comments made above in relation to whether the ceiling should be set by reference to costs.

Changing from GRV to DORC would also involve compliance costs for the access provider under the Code.

We note that in the Final Report for the 2010 Code, the ERA considered the use of a building block method for asset valuation review (at the time the ERA meant this to mean a move away from a GRV-based approach)[35] and decided that it should not be applied. We cite the relevant conclusion below:

> *The Authority has decided not to … prescribe a building block method for asset valuation as a basis for establishing floor and ceiling costs.*
>
> *… considerations which have resulted in this decision … include:*
>
> - *the Code in its current form does not provide scope for railway owners to recover more than efficient costs, on a "build or buy" basis, for access to below-rail infrastructure.*
> - *a change in the valuation approach to a building block method would require amendments to those sections of the Code which prescribe negotiation and arbitration procedures.*
> - *the adoption of a building block approach would not improve the ability of the Code to accommodate negotiations requiring expansion or extensions of the railway infrastructure.*[36]

As section 2.1.4 notes, recent regulatory developments suggest that a less prescriptive approach to pricing would be appropriate, not least because TPI is economic to duplicate and an access seeker, if regulated access is to be provided for, should be paying a price which reflects this. In this context, and given the above, it is not obvious that the distinction between GRV or DORC is particularly relevant or why a change from GRV to DORC would have significant advantages. However, if a change from GRV to DORC were to be contemplated, it would be worth making an adjustment such that it is net present value neutral to both parties.

3.3.2 Should the Code set more prescriptive tariffs?

In paragraph 59 of the Issues Paper, the ERA also calls for views on whether "… a benchmark tariff for access to a benchmark service … rather than cost boundaries as a basis for negotiation on price - would be better in giving effect to the CPA than the current approach based on the floor and ceiling price tests as prescribed in the Code.". This implies the use of a building blocks model or similar to set a revenue cap. As noted above, recent regulatory developments suggest that a less prescriptive approach to pricing would be appropriate and the ERA rejected the use of a building blocks model in its Final Report for the 2010 Code review (see section 3.3.1 above).

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[35] Economic Regulation Authority (2010), *Review of the Railways (Access) Code 2000, Draft Report*, Western Australia, page 29.

[36] Economic Regulation Authority (2011), *Review of the Railways (Access) Code 2000, Final Report*, Western Australia, page 34.

The adoption of prescribed benchmark tariff is unlikely to allow "... third party access to [be] provided ... on the basis of terms and conditions agreed between the owner of the facility and the person seeking access"[37]. A prescribed price limits the terms available for negotiation.

3.4 The time limit for ERA determination of costs

The ERA indicates in its Issues Paper that the 30 day time limit legislated in clause 10 of schedule 4 of the Code is insufficient to either approve the railway owner's cost determination or make its own. The ERA canvases an amendment to the Code to increase the 30 day time limit and invites comment.

Based on our cost assessment experience we concur with the ERA's view that the 30 day time limit is insufficient. The fact the ERA is finding it difficult to assess and publish its determination of costs in 30 days is indicative of the complexity of the task.

The ERA should be granted more time to assess costs, but an appropriate and balanced outcome would be to also provide the railway owner with more time to submit its determination of costs, as legislated in clauses 9 and 10(2) of schedule 4 of the Code, given the greater complexity of initial cost assessment. The Code allows a railway owner 7 days to provide its cost determination following receipt of a proposal. Based on our asset valuation experience in the sector we are of the view that this time limit is likely to be inadequate given the significant work involved in calculating the GRV.

There also appears to be a lack of balance on the imposition of time limits in the Code, such that access providers and the ERA are subjected to a number of time limits whereas there are no explicit time limits imposed upon the access seekers.

3.5 Arbitration

The Issues Paper identifies that no time limits for resolution of disputes via arbitration are prescribed, and asks for comments on whether such time limits should be stipulated in the Code. As was outlined in section 2 above, the regulatory and commercial issues that relate to rail access are complex and multifaceted. It follows that to ensure due process, the resolution of disputes may require lengthy periods of debate and consideration. Time limits are inappropriate if they result in matters not being fully considered before a final decision is made.

If time limits are to be provided they may need decision points in order to allow for timely resolution of issues, with break clauses in the event that it becomes apparent that certain issues will need to be considered in more detail. They also need to be suitably balanced (i.e. two-sided to constrain the activities of both the railway owner and access seeker).

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[37] CPA, s 6.e.1

Without making any assertions about the makeup of previous panels, we note that part 3, division 3 of the Code does not require the selection of arbitrators to be conducted with a particular skill set in mind. Given that issues related to rail access are often complex and multifaceted, unreasonable delays to the arbitration process may be abated if amendments are made to the Code to ensure arbitration panels have an appropriate mix of rail transport expertise, including knowledge of the commercial principles underpinning the development of rail logistics infrastructure, as outlined in section 2 above. Therefore, the Code could be amended to require the panel to include members that have an appropriate mix of:

- Legal and process knowledge
- Technical knowledge related to rail investment and operation
- Commercial knowledge related to rail investment and operation

This may be facilitated by having the process of selection more open to a wider range of arbitrators and allowing the parties to either agree on an appropriate party or parties where a panel is used (e.g. perhaps by the ERA, the asset seekers and the asset owner selecting one party each).

By ensuring that an appropriate mix of skills is on the arbitration panel, the time required for it to fully consider issues and come to an appropriate decision should be minimised.

3.6 Confidential information

Section 50(3) of the Code allows the railway owner to claim confidentiality over information. The Issues Paper calls for comments on this without raising a specific issue.

Our general comments are:

- For the protection of all rail users, including foundation customers, it is important that the access regime protect confidential and commercially sensitive information.
- We note that there is always a difficult balance between the ERA's desire to have sufficient information provided by the railway owner to an access seeker or vice versa, and the protection of proprietary knowledge.
- The recent High Court decision (see section 0 above) upheld the Federal Court's decision to protect the private property rights of infrastructure owners in the context of regulation intended to serve the public interest. Proprietary knowledge is a form of private property, and the ERA should bear this in mind when deciding upon what information requires dissemination.

4. Other issues within the scope of the review

Paragraph 4 of the Issues Paper invites interested parties to provide comment on any matters within the scope of the ERA's review which may be considered relevant (i.e. in addition to those issues the ERA identifies explicitly in the Issues Paper). In this section we raise the following issues:

- Clarifying the definition of incremental costs in the Code
- Prices to be negotiated for extensions and expansions
- Whether or not the Code should provide for a merits review system

4.1 Clarifying the definition of incremental costs

In schedule 4 clause 1, the Code refers to incremental costs as those that the railway owner or the associate would be able to avoid in respect of the 12 months following the proposed commencement of access if it were not to provide access to that operator or group of operators.

The reference to "12 months following the proposed commencement of access" is confusing. The current wording may be interpreted in a way that causes the determination of a floor price in schedule 4 clause 7(1) to be a once off test, rather than an ongoing test.

This could result in prices that either under- or over- recover the railway owner's variable costs. For example, if a ramp-up in train movements occurs over the first 12 months after the commencement of access after which train movements remain constant, basing incremental costs on the "12 months following the proposed commencement of access" will result in prices that under- recover variable costs in the years following the ramp-up.

This does not appear to reflect the intent of the Code. The Code could be clarified to read "each of the 12 month periods following the proposed commencement of access" or similar.

4.2 Prices to be negotiated for extensions and expansions

Schedule 4, clause 6(2) of the Code goes to the apportionment of costs and benefits borne by the railway owner, current users and access seekers in respect of extensions or expansions, and requires these to be taken into account during access price negotiations. Schedule 4, clause 7A of the Code requires extension or expansion costs to be apportioned to entities in accordance with their share of the use of the extended / expanded infrastructure and the economic benefits derived from that use. However, it is unclear:

- How the allocation of benefits should translate into a specific tariff apportionment
- Whether the costs in the aforementioned clauses are total costs, incremental costs, operating costs or capital costs as defined in the Code

- That the current wording of the Code avoids the cross subsidisation of new users by existing users

Cross subsidisation of new users by existing users would not be in "… the interests of all persons holding contracts for use of the facility"[38] and so should be avoided if the principles of the CPA are to be adhered to. In this context, we refer to:

- The CPA, which requires a State's access regime to take into account "firm and binding contractual obligations of the owner or other persons (or both) already using the facility"[39]
- Section 2.2.1 above which outlines the critical role of contracts in underpinning rail infrastructure investment

The Queensland Competition Authority (QCA) is in the process of examining the issue of access pricing in the context of extensions and expansions. The QCA's review "… is still at a relatively early stage and clear positions on key issues have not been established."[40] However, in its relevant discussion paper, the QCA concluded that, to avoid the subsidisation of new users by existing users:

> *The key propositions that apply when capacity is already committed to 'established' users through long-term take-or-pay contracts, are as follows.*
> *(a) If average costs are decreasing substantially with capacity, adding the expansion costs to the cost base of the established capacity will usually provide an acceptably efficient and fair outcome. An exception would be if foundation customers signed take-or-pay contracts which included a clause that enabled them to pay the price of the lowest cost tranche of capacity.*
> *(b) If average costs are increasing substantially with capacity, a separate access price should normally be calculated and charged to those whose capacity underwrites the new tranche of capacity, which reflects the average cost of that new capacity.*[41]

The ERA should also examine this issue, after which the Code could be amended as appropriate to ensure greater clarity is provided around the treatment of the cost of extensions or expansions, and to ensure the Code gives effect to relevant sections of the CPA (e.g. those that require the interests of existing users to be protected).

[38] CPA, s 6.e.9.4
[39] CPA, s 6.e.9.5
[40] Queensland Competition Authority, *Capacity Expansion and Access Pricing for Rail and Ports, http://www.qca.org.au/Other-Sectors/Research/Pricing-(1)/Capability-Experimental-Pricing/In-Progress/Capacity-Expansion-and-Access-Pricing-for-Rail-and*
[41] Queensland Competition Authority (2013), *Capacity Expansion and Access Pricing for Rail and Ports, Discussion Paper*, Queensland

4.3 Merits review

Merits review involves reconsideration of the facts, law and policy as they apply to a particular decision in order to determine the correct or preferable decision. The general objectives of merits review are:

- Ensuring the fair treatment of all persons affected by a decision
- Improving the quality and consistency of decisions
- Enhancing the openness and accountability of decisions made by government

Merits review has been described as 'stepping into the shoes' of the original decision-maker and ensuring the making of correct and preferable decisions; correct in the sense that they are made according to law and preferable in the sense that, if there is a range of decisions that are correct in law, the decision settled upon is the best that could have been made on the basis of the relevant facts. Merits review involves an objective assessment of facts, the identification of the applicable law and the nature of any discretion involved and the application of any policy that may be relevant.

In addition to protecting the rights of citizens, merits review also has a broader, long-term objective of improving the quality and consistency of the decisions of primary decision-makers.[42] In the words of Sir Anthony Mason AC KBE, former Chief Justice of the High Court of Australia:

> "Administrative law is an ever-changing landscape that needs to be kept under constant surveillance if we are to deliver good administration in the future; administrative justice lies at the very heart of good administration"[43]

Prof. David Round, current member of the Australian Competition Tribunal ("ACT") has noted that *"Very few countries do not have some form of merits review for regulators' decisions."*[44]

The PC's review of the national access regime examined the issue of merits review. It expressed support for a system of limited merits review, noting that:

- Merits review may be the only way to correct decisions that were made on the basis of incorrect facts, given judicial review will rarely allow factual errors in decisions to be corrected.
- Restricting the availability of review to matters of law risks significant errors in the exercise of regulatory discretion being left unaddressed.

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[42] Administrative Review Council, What decisions should be subject to merit review? 1999, paragraph 1.3-1.5.

[43] Sir Anthony Mason, 'Delivering administrative justice: looking back with pride, moving forward with concern', a paper delivered to the Australian Institute of Administrative Law Forum, 22 July 2010, page 8.

[44] Prof. David Round, 'The merits of merits review process for regulatory decisions: Why New Zealand should have it', presented at the conference 'Contemporary issues in Regulatory Theory and Practice', Wellington, 22 March 2005, page 24

- Decisions on access are complex and technical, and significant judgment is required on when and how to intervene. The possibility of regulatory error is therefore quite high. Given the 'at large' nature of the Regime and its application to infrastructure of national significance, allowing merits review to correct errors is important, and contributes to investor confidence.

The issues in respect of merits review have been extensively examined twice in the context of energy sector network regulation over the last decade.[45] In both cases, policy makers determined that a form of merits review was justified.

The rationale for having merits review for regulatory decisions has been examined in detail not just in the context of economic regulators' decisions but also a wide range of administrative duties undertaken by various parts of governments more generally. There is strong support for having some form of merits review of economic regulator's decisions.

The importance of having merits review is heightened where the regulator possesses a high degree of regulatory discretion. The degree of regulatory discretion is often heightened in less prescriptive regulatory regimes. Less prescriptive regulatory regimes can therefore heighten the need for the powers of regulators to be appropriately balanced by the power of merits review.

There is a strong case that merits review should apply to decisions made by the ERA under the Code.

[45] For the first see: MCE Standing Committee of Officials, Review of Decision-making in the Gas and Electricity Regulatory Frameworks, October 2005; MCE, Review of Decision-Making in the Gas and Electricity Regulatory Frameworks, Decision, May 2006, page 11; MCE Standing Committee of Officials, Regulatory Impact Statement, Review of Decision-Making in the Gas and Electricity Regulatory Frameworks, 16 Dec. 2005. For the second see: http://www.scer.gov.au/workstreams/energy-market-reform/limited-merits-review/

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