Roy Hill Infrastructure Pty Ltd proposed Costing Principles

Draft Decision

March 2017

Economic Regulation Authority

WESTERN AUSTRALIA

Economic Regulation Authority

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Invitation to make submissions

Interested parties are invited to make submissions on the Draft Decision by 21 April 2017 via:

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In general, all submissions from interested parties will be treated as being in the public domain and placed on the Authority's website. Where an interested party wishes to make a submission in confidence, it should clearly indicate the parts of the submission for which confidentiality is claimed, and specify in reasonable detail the basis for the claim. Any claim of confidentiality will be considered in accordance with the provisions of Section 55 of the *Economic Regulation Authority Act 2003*.

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Introduction

1. Sections of the *Railways (Access) Code 2000* (**Code**) that are relevant to the establishment of the Costing Principles are as follows:

   - Section 46 of the Code requires a railway owner to submit Costing Principles to the Regulator for approval. Section 46(1) indicates the purpose of the Costing Principles.[1]

   - Schedule 4 to the Code "Provisions relating to prices to be paid for access" relates to the establishment of costs, and is relevant to the Costing Principles. Division 1 of Schedule 4 contains definitions of terms describing the various components of total costs. The remainder of Schedule 4 relates to the various requirements of the Regulator and provisions relating to the prices to be paid for access, and these divisions are not relevant to the Costing Principles.

2. The Code provides for amendment or replacement of the Costing Principles by the railway owner or the regulator.[2] The Code does not contain any provisions relating to consultation associated with the Regulator's approval of Costing Principles.

3. On 11 October 2016, Roy Hill Infrastructure (**RHI**) submitted Costing Principles for the Authority's approval. The Authority published RHI's proposed Costing Principles and called for submissions on 25 October 2016, despite there being no requirement in the Code for the Regulator to do so.

4. The Pilbara Infrastructure Pty Ltd was the sole submission received and is very brief. It expresses support for all of the regulatory instruments proposed by RHI without providing specific comment on any provisions of the proposals.

Draft Decision

5. This document:

   - Summarises each part of RHI's proposed Costing Principles, relates these to the relevant provisions of the Code, and compares each part with the provisions of other railway owners' approved Costing Principles where relevant;

   - Provides the Authority's assessment of relevant issues; and

   - Provides the Authority's required amendments where appropriate.

Part 1 - Introduction

6. Part 1 of the proposed Costing Principles refers to the purpose and objectives of the Costing Principles, the relationship of the Costing Principles to the negotiation of prices in an access agreement and to the administration of the Over-payment Rules.

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[1] The costing principles that are to be applied and followed by the railway owner —

(a) in the determination of the costs referred to in clauses 7 and 8 of Schedule 4; and

(b) in the keeping and presentation of the railway owner's accounts and financial records so far as they relate to the determination of those costs.

[2] Sections 46(3) and 46(4).

7. Part 1 does not refer to the sections of the Code relevant to the establishment and approval of the Costing Principles.

8. Part 1 describes RHI as a wholly owned subsidiary of RHH. Parts 1.1(c) and 1.1(d) describe the business of RHH and refers to the proposed recovery of costs incurred by RHH by virtue of the operation of the Act and the Code.

9. Part 1.1(e) refers to the purpose of the Costing Principles as providing the framework for the calculation of floor and ceiling prices, as referred to in section 9(1)(c)(i) of the Code.

10. Part 1.1(h) refers to a linkage between the Costing Principles and the Over-payment Rules, and describes the objectives of the two instruments. The linkage is not described.

11. In part 1.1(h) RHI states that the Over-payment Rules are "required by the ERA" under section 47 of the Code.

12. Part 1.2 states that the Costing Principles are a set of principles that will need to be supported by databases and costing models.

13. Part 1.3 addresses the relevance of the Costing Principles. This part refers to the calculation of incremental and total costs, and the negotiation of prices between the floor and ceiling price. This part also refers to clause 13 of Schedule 4 to the Code, which provides guidance on the negotiation of prices

14. Part 1.3 also indicates that the rights and protections offered under the Code are not extended to negotiations and agreements made outside the Code.

15. Part 1.4 provides service quality commitments, and refers to the negotiation of key performance indicators as part of access agreements.

Authority Assessment

16. Part 1.1(b) of the proposed Costing Principles states that the Act requires the RHI Railway to be made available for access by third party rail operators. This can be more accurately stated as the railway routes subject to the regime are those referred to in Schedule 1 to the Code. The inclusion of the RHI railway in the regime is the result of the operation of the *Railway (Roy Hill Infrastructure Pty Ltd) Agreement Act 2010* (**Agreement Act**).

17. The relevant parts of the Agreement Act are Part 3, Division 1 ("Modification of the *Railways (Access) Act 1998*") and Division 2 ("Modification of the *Railways (Access) Code 2000*"). Clause 15 of Schedule 1 to the Agreement Act (""Access Obligations for Railway") describes the provisions of the Agreement Act relevant to third party access.

18. It is not necessary that the above level of detail is included in the Costing Principles; however, the following elements are relevant to the Authority's consideration of RHI's proposal:

    - The railway has been built subject to a commercial agreement with the WA Government (the **State Agreement**);
    - The State Agreement refers to the construction of the railway, not the railway and the port; and

- The costs imposed by the Agreement Act and the *Railways (Access) Act* and Code are not "additional" costs but the normal costs of operating an open-access railway,[3] and costs which are anticipated in the commercial agreement. The incidence of these costs (either on RHI and RHH) are immaterial to this fact.

19. As the RHI railway was constructed pursuant to a commercial agreement, and as the agreement requires that the railway be subject to the Act and the Code, Part 1.1(d) is not accepted for inclusion in RHI's costing principles.

20. With reference to Part 1.1(e), the objectives of the Costing Principles are to provide the framework for calculating Total and Incremental Costs, which form boundaries for the negotiated Floor and Ceiling Prices referred to in section 9(1)(c)(i) of the Code, not to provide the framework for the calculation of those prices directly.

21. The objectives of the Costing Principles include to define the manner in which the keeping and presentation of the railway owner's accounts and records will occur. The proposed Costing Principles do not address this matter.

22. At 1.1(h) RHI proposes that the Over-payment Rules are "required by the ERA" under section 47 of the Code; however, the requirement arises directly from the Code.

23. Part 1.3(d) refers to RHI's willingness to discuss access either inside or outside the Code and states that Code rights and protection do not extended to negotiations and agreements outside the Code. This statement reflects the provisions of section 4A of the Code, which do not affect the Costing Principles, and the statement should be removed. The Costing Principles are relevant to the railway owner's responsibilities as detailed in Part 2 of the Code, prior to negotiations and the making of agreements which are detailed in Parts 3 and 4 of the Code respectively.

24. The proposed provisions contained in Part 1.4 are not relevant to the Costing Principles. The actual service standards and efficient practices of the railway owner are not relevant to the valuation or costing of a railway under the Gross Replacement Value method prescribed in Schedule 4 of the Code. The inclusion of performance measurement, incentives and penalties are relevant to the making of an access agreement, and not to the determination of costs.

[3] See pages 6 and 7 of Authority Decision in accordance with Section 10 relating to TPI's legitimate business interests: https://www.erawa.com.au/cproot/11565/2/20130830%20110918%20-%20TPI%20-%20Corrigenda%20Decision.pdf

Required Amendment 1

Part 1 of RHI's proposed Costing Principles should be amended such that:

- Part 1.1(d) is deleted
- The words "Floor Price and the Ceiling Price required under clause" are replaced with "costs referred to in section" in 1.1(e)(i)
- 1.1(e)(ii) is deleted
- The words "the ERA under" are removed from 1.1(h)
- 1.3(d) and 1.4 are deleted

Part 2 – Determination of Capital Costs

25. Part 2.1 of RHI's proposed Costing Principles provides assurances in relation to the establishment of capital costs.

26. Part 2.1 refers to the Code as setting out the basis for determining the capital cost component of total costs, but does not refer specifically to Division 1 of Schedule 4 of the Code, where the requirements for the establishment of costs is laid out.

27. Part 2.1 outlines the proposed circumstances under which RHI would include a capital cost component in its determination of incremental costs, refers to the economic life assumptions listed in Annexure A of the proposed Costing Principles and lists the elements of the calculation which underpin the determination of the capital cost.

28. Part 2.2 and Part 2.3 refer to the capital costs associated with land, and the railway infrastructure assets which are included in capital costs. These parts reflect the components of capital costs indicated in Clause 2(5) of Schedule 4 to the Code and are consistent with the definition of railway infrastructure at Section 3 of the Code.

29. Part 2.3 also outlines that the costs of cuttings and embankments are to be included in capital costs, and that the capital costs of assets which support operating functions are included in operating or overhead costs, as appropriate.[4]

30. Part 2.4 outlines the component parts of the Gross Replacement Value (**GRV**) and includes consideration of capacity expansion, contributed assets and greenfields site works.[5]

[4] The Code does not refer to the valuation of these asset components specifically. Examples of appropriate treatments of these components has been established by the Authority in approval of Brookfield Rail's and TPI's Costing Principles.

[5] The Code does not refer to the valuation of these asset components specifically. Examples of appropriate treatments of these components has been established by the Authority in approval of Brookfield Rail's and TPI's Costing Principles.

31. Part 2.4 also details the calculation elements of establishing a GRV, and makes detailed proposals for the treatment of unit rates, design construction and project management fees, and construction financing charges.[6]

32. Part 2.4(a)(iv) states that "for the purposes of calculating the GRV, the replacement cost calculations are to assume a Greenfields site. However, costs relating to constructing around and over other existing railways and rail traffic, and other surface diversions shall be included in the replacement cost calculations".

33. Part 2.4(a)(ix) of the proposed costing principles refers to Annexure A for a list of economic lives. RHI states that it has based its evaluation of the economic lives of assets on "generally accepted industry lives and RHI's own experience", and that the proposed economic lives are generally consistent with those accepted in other regimes. RHI has proposed economic lives which are significantly shorter than those approved for inclusion in the Brookfield Rail (**BR**) and the Pilbara Infrastructure (**TPI**) costing principles.

34. Part 2.5 states that a nominal pre-tax WACC will be determined by the ERA each year, and that this is in accordance with the Code.

35. Part 2.6 outlines the specific form of the annuity calculation proposed to annualise capital costs. The requirement for an annuity calculation is outlined in Clause 2(3) and 2(4) of Schedule 4 to the Code, however, the specific form of the calculation is not prescribed.

36. At 2.6(d), RHI introduces the concepts of under- and over-payments, and appears to relate the payment of amounts to the inclusion of working capital amounts in the operating costs calculation.

Authority Assessment

37. Part 2.1(b) proposes that incremental costs will include a capital charge where RHI agrees that capital expenditure is necessary to provide the service, either because of the need to expand capacity or because of the characteristic of the service requested. Part 2.1 goes on to propose that any capital expenditure associated with a required expansion will be included as an incremental cost, and that the funding of a required capital expansion will be completely at RHI's discretion.

38. The propositions contained in part 2.1 are not accepted. There are no conditions under which capital expenditure associated with capacity expansions would be appropriately included in incremental cost. The Code anticipates that the costs of providing extensions and expansions will be dealt with separately to establishing the replacement cost of existing infrastructure.[7] The Authority has previously accepted

[6] The Code does not refer to the valuation of these asset components specifically. Examples of appropriate treatments of these components has been established by the Authority in approval of Brookfield Rail's and TPI's Costing Principles.

[7] The Code defines GRV at Clause 2(4)(c) of Schedule 4 as being "the lowest current cost to replace existing assets". At Section 9(2), the Code outlines that if an expansion is specified, then the sums notified to the proponent under 9(1)(c) are for the infrastructure as it exists and not for any proposed extension or expansion. Section 9(2)(b) outlines the process for a railway owner to "quote" for an extension or expansion.

capital expenditure of the type described in Part 2.3(c) as operational costs.[8] Consequently, these may be accepted as incremental costs.[9]

39. Part 2.2 (relating to capital costs associated with land) and Part 2.3 (specifying infrastructure to be included as a capital cost) both include elements which are either prescribed in Schedule 4 of the Code as components of the GRV, or which conform with precedents established in other railway owners' Costing Principles.[10]

40. Part 2.4(a)(i) is a paraphrase of similar statements in BR's and TPI's Costing Principles. The statement is intended to provide an assurance that the railway owner will not claim 'spare capacity' as required for 'own use' unless the railway owner can substantiate that claim.

41. The corresponding statement in BR's and TPI's costing principles refer to the railway owner – not the proponent – demonstrating a commitment to expanding its own use on its railway. The requirement for a proponent to demonstrate that its proposed operations may be accommodated on a route or an expanded route that is the basis for capacity extensions arises at Code section 15 and after the railway owner's obligations associated with these Costing Principles arise.

42. The statements as proposed by RHI at 2.4(a)(i) are prejudicial, and are not sufficiently general to hold in the event that RHI undertakes an expansion in the absence of an access proposal (that is, for its own purposes).

43. The inclusion of Parts 2.4(a)(ii), (iii), (v)-(viii) is accepted.[11] These sections mirror the equivalent provisions in Brookfield Rail's and TPI's approved costing principles.

44. Part 2.4(a)(iv), which proposes that the GRV calculations "assume a Greenfields site", but that costs relating to surface diversions be included, is not accepted. The proposition that the costs of surface diversions would be included in a "greenfields" costing is not consistent with a "greenfields" assumption. Brookfield Rail's and TPI's Costing Principles explicitly exclude these costs on the basis of the "greenfields" assumption.[12]

45. The second paragraph of Part 2.4(a)(ix) states that RHI's evaluation of the economic lives of assets is based on generally accepted industry lives and RHI's own experience, and that the economic life of assets adopted by RHI are generally consistent with those accepted in other regimes. In determining appropriate

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[8] For example, capital expenditure on the following items has been considered eligible as operational/incremental costs for other railway owners: motor vehicles, computers, printers, facsimile machines, photocopiers, system hardware and software, mobile and fixed communications, office furniture and equipment.

[9] The Code allows for the inclusion of capital costs as incremental costs at Schedule 4 1(b)(i).

[10] See for example footnotes 4, 5 and 6. which identify proposed elements of GRV which are not specified in the Code but have been accepted in other railway owners' costing principles..

[11] These parts include (ii) Route optimisation, (iii) Contributed assets, (v) Modern Equivalent Assets, (vi) Unit rates, (vii) Design, construction and project management fees, and (vii) Design, construction and project management fees.

[12] A 'greenfields' assumption is an assumption that the GRV of an asset is established on the basis that there is no other infrastructure in place which the replacement asset must build around or divert from. This assumption is used in both the Brookfield Rail and TPI costing principles on the basis that the third party operator should contribute, by way of payment to the railway owner, its share of the current value of the network. Alternative valuations (such as Depreciated Optimised Replacement Value) contemplate the operator remunerating the railway owner for actual depreciated expense incurred in establishing the asset (not its gross replacement value).

economic lives of assets, the experience of other railways in the Pilbara is at least as significant as the experience of RHI as a railway owner. The experience of other railways in the Pilbara is also more significant than the experience of railway owners subject to other regimes, as these regimes do not cater for heavy haulage railways of the type owned by RHI. Accordingly, the statement should be removed.

46. Part 2.5 suggests that it is a Code requirement that the ERA determine a nominal pre-tax WACC each year for the RHI railway. This is not correct, as the Code requires only that an annual WACC be determined. The Code does not prescribe that the WACC should be real or nominal, post- or pre-tax. For practical reasons,[13] the ERA determines the annual WACC on a real pre-tax basis. Part 2.5 should be amended such that the words "nominal" and "pre-tax" are removed.

47. With reference to Part 2.6, RHI has proposed the same form of annuity calculation as is approved in Brookfield Rail's and TPI's Costing Principles.

48. The reference to over-payments and the payment of accounts (undertakings which are contingent on the making of an access agreement) is not accepted for inclusion in the Costing Principles, which apply to a regulatory process preceding the making of an access agreement.[14]

49. With respect to Part 2.6(e) provisions for the calculation of working capital are detailed adequately in Part 3.3(c)(v) of the proposed Costing Principles.

Required Amendment 2

Part 2 of RHI's proposed Costing Principles rules should be amended such that:

- 2.1(b) is replaced with "Incremental costs will include capital costs only where RHI assesses that it is necessary to make capital expenditure (of the type referred to in 2.3(c) of these Costing Principles) to provide the proposed access".

- The second paragraph of 2.4(a)(i) is replaced with "RHI considers that the network as constructed can meet current and reasonably projected demand for all users taken together. If RHI requires additional infrastructure to meet its own projected demand in conjunction with an access proposal, then it will demonstrate the basis of and financial commitment to the demand projection."

- In Part 2.4(a)(iv), the word "However" is deleted, and the word "included" is replaced with "excluded".

- In Part 2.4(a)(ix), the second paragraph is removed.

- The words "nominal pre-tax" are replaced with "annual" in Part 2.5.

[13] The ERA calculates a pre-tax WACC to avoid the need for the railway owner to produce comprehensive nominal tax accounts. The ERA publishes both real and nominal WACCs for all railways; however, a nominal (dollar of the day) annuity is generally calculated for the purposes of railway owners negotiations.

[14] Notwithstanding similar wording in BR and TPI's Costing Principles.

- Parts 2.6(d) and 2.6(e) are replaced with "This formula calculates the costs at the beginning of the period. Provisions for the calculation of working capital amounts based on consideration of the mid-point of the annuity period are made at Part 3.3(c)(v).

Part 3 – Determination of "Operating Costs"

50. Part 3 of RHI's proposed Costing Principles describe the proposed regime for calculating Operating Costs as part of the determination of Total Costs by the railway owner. The Code outlines a broad definition of Operating Costs at Clause 1 ("Terms used") of Schedule 4 to the Code. RHI's proposed Costing Principles do not refer to this definition, except to note that "Operating Costs" is a defined term.

51. The definition of Operating Costs in Schedule 4 to the Code includes the following:

    - Train control costs, signalling and communications costs, train scheduling costs, emergency management costs, and the cost of information reporting;
    - The cost of maintenance of railway infrastructure calculated on the basis of cyclical maintenance costs being evenly spread over the maintenance cycle; and
    - Payments made in respect of any lease or licence that the railway owner holds over any land.

52. The Brookfield Rail and TPI Costing Principles contain detailed explanation of operating cost components and the description of the way various maintenance activities interact. This level of detail is not prescribed in the Code but has been established as appropriate by the Authority in approving Brookfield Rail's and TPI's Costing Principles.

53. Parts 3(a) to 3(c) of RHI's proposed Costing Principles provide a level of detail in this respect similar to that shown in the other railway owners' Costing Principles, and based on the same format and categories, with the exception of:

    - Part 3.3(c)(iii) which proposes that Network Management Costs include the whole of all discreet additional network management costs resulting from the provision of access, and relates these costs to RHI's obligations to provide access under the Act and the Code
    - Part 3.3(c)(vi) which proposes to include insurances in Operating Costs.

54. Insurance is not nominated as an operating or overhead cost in Brookfield Rail's costing principles and is nominated as an overhead in TPI's Costing Principles.

55. Part 3.4 of RHI's proposed Costing Principles describes the Allocation of Operating Costs to route sections. The method of allocation of operating costs is not prescribed in the Code. This part is substantially identical to Brookfield Rail's and TPI's Costing Principles.

56. Part 3.5 proposes a regime for the payment of Operating Costs. The Code requires that Costing Principles determine only the costs which may be recovered, not the terms of payment by operators.

Authority Assessment

57. For the most part, the provisions of Part 3 of RHI's proposed Costing Principles are appropriate. These are very similar to the provisions outlined in the Brookfield Rail and TPI Costing Principles, which have been determined as appropriate in the review and consultation process leading to the approval of those documents.

58. Part 3.1 refers to the determination of operating costs in the past tense, and this part should be altered to indicate that operating costs will be determined on the basis of efficient costs at the time of receipt of a proposal.

59. The inclusion of the last paragraph of Part 3.3 (iii) is not appropriate.[15] This is because incremental costs are defined in the Code as costs which the railway owner would be able to avoid in the 12 months following commencement of access if it were not to provide access. Further, as noted in paragraph 18, the costs incurred by RHI in complying with the Act and the Code can only be normal business costs of a regulated railway.

60. RHI has proposed the inclusion of insurances as an operating cost at 3.3(c)(vi). Given the corporate structure of RHH, it will procure and manage insurances for the group, including for RHI. The management of insurances for RHI by RHH would be similar to the arrangement indicated in TPI's costing principles (Appendix B) whereby FMG provides these services to TPI, and where TPI includes the cost of these services as a corporate overhead.

61. The inclusion of insurances as an operating cost is not accepted, as the definition of operating costs in Clause 1 of Schedule 4 to the Code refers only to (a) train control, signalling costs, (b) cyclical maintenance costs, and (c) payments in respect of land leases. Insurance costs may be included as an overhead cost.

62. The inclusion of Part 3.5, which proposes a regime for the payment of Operating Costs, in the Costing Principles is not accepted, as it is not the function of Costing Principles to prescribe the terms and conditions normally found in access agreements.

Required Amendment 3

Part 3 of RHI's proposed Costing Principles should be amended such that:

- In part 3.1 the words "has determined" are replaced with "will determine"
- The last paragraph of Part 3.3(c)(iii) is deleted
- Part 3.3(c)(vi) is deleted
- Part 3.5 is deleted

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[15] Part 3.3(c)(iii) states:

> "These costs include the whole of any additional costs incurred by RHI resulting from the provision of access to another Operator in managing the network (including the entire cost of employing or engaging any additional persons required as a consequence of complying with RHI's obligations to provide access under the Act and the Code)."

Part 4 – Overhead Costs

63. Part 4 of RHI's proposed Costing Principles defines overhead costs and describes the means by which RHI proposes to allocate these costs across route sections of the railway. The Code does not provide guidance on overhead costs, except to prescribe their inclusion in total costs at clause 1(c) of Schedule 4 to the Code. In this subclause, overhead costs are referred to as "the overheads attributable to the performance of the railway owner's access-related functions whether by the railway owner or an associate".

64. At 4.1 RHI lays out that RHI is a "separate legal entity" with an overhead structure which relates to its business of access provision, and that it sources corporate and related functions from RHH. Part 4.1 outlines that only those overhead costs attributable to the Code's definition of "railway infrastructure" will be included in costs.

65. Part 4.2 refers to the allocation of overhead costs, and indicates an allocation method at Annexure B. Part 4.2 proposes that overhead costs will be allocated to route section in the first instance, and that "subsequent allocation to the Route Section level will be determined by the ERA".

66. Annexure B of RHI's costing principles provides details of the proposed overhead costs allocation. Annexure B does not indicate whether this allocation is applicable to the route level, and/or to the route section level.

67. Part 4.3 stipulates rules for the payment of overhead costs by operators.

68. Part 4 is substantially the same as Part 4 of Brookfield Rail's Costing Principles and Part 5 of TPI's costing principles with the exception of the inclusion by RHI of Part 4.3, which does not appear in the other railway owners' Costing Principles.

Authority Assessment

69. In referring to overhead costs, RHI's statement that "only those costs attributable to activities related to the Code definition of 'railway infrastructure' will be included" is inconsistent with the description in the Code of overhead costs as being those attributable to access-related functions.[16]

70. In relation to Part 4.2, it is not appropriate for RHI's costing principles to excuse RHI from its responsibility to provide a determination in the first instance, and to make the Regulator responsible for determining the allocation of overhead costs to the route section level.[17]

71. Annexure B should be properly referred to as providing criteria for the allocation of overhead costs.

72. The inclusion of Part 4.3 in the Costing Principles is not accepted, as it is not the function of Costing Principles to prescribe the terms and conditions of access agreements.

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[16] Notwithstanding the use of "separate" and "railway infrastructure" in both BR's and TPI's costing principles.

[17] In the corresponding part, BR's costing principles indicate that the route section allocation will be "determined by the ERA". TPI's costing principles indicate that the allocation will be "reviewed by the ERA".

Required Amendment 4

Part 4 of RHI's proposed Costing Principles should be amended such that:

- The term "railway infrastructure" in Part 4.1 is replaced with "access-related functions".
- In Part 4.2, the words "determined" and "Details of" are replaced with "reviewed" and "Allocation criteria for" respectively, and the word "included" is removed.
- Part 4.3 is removed.

Part 5 – Other matters

73. Part 5 of RHI's proposed Costing Principles provides for matters relating to the currency of cost determinations, specifically the indexation of costs for the purposes of administration of the over-payment accounts. RHI has proposed that determined costs will be indexed for a period of five years, and will remain unadjusted over any period beyond five years.

74. These matters are not contemplated by the Code, but have been addressed by the Authority in a decision published in 2011.[18]

75. In Part 5.1(c), RHI proposes to index determined costs on the basis of actual cost increases, or a CPI applicable to the Pilbara region of Western Australia. Other railway owners' costing principles have provided for indexation on the basis of an efficiency-discounted "CPI-X" method. Apart from this difference, RHI's proposal is equivalent to the provisions in TPI's costing principles. BR's costing principles provide for indefinite indexation of costs.[19]

76. Part 5.2 allows for the consideration of asymmetric risk in the determination of operating cost. This part is substantially identical to Part 6.2 of TPI's costing principles. Asymmetric risk is not defined in RHI's proposed costing principles.

Authority Assessment

77. RHI has used the word "predetermine" in the last sentence of 5.1(a), where the word "re-determine" would be appropriate.

78. RHI's proposal to index costs on the basis of actual cost movements (including movements resulting from changes in law) is not appropriate. Cost shifts resulting from actual movements in costs would require a re-determination of costs, either by the railway owner or by the Authority, consistent with the provisions of Clause 12 of Schedule 4 to the Code. Clause 12 provides for a re-determination of costs if the Regulator considers that there has been a material change in any of the

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[18] https://www.erawa.com.au/cproot/9819/2/20110825%20Final%20Decision%20-%20Review%20of%20the%20Requirements%20for%20Railway%20Owners%20to%20Submit%20Floor%20and%20Ceiling%20Costs.pdf paragraphs 133-135.

[19] BR's costing principles were last approved in 2010, prior to the Authority's decision referred to in paragraph 74.

circumstances that existed at the time when costs were determined under Clause 9 or 10 in respect of a proposal.

79. Further, the use of a price index applicable specifically to the Pilbara region of Western Australia is not accepted for the purpose of indexing costs. The Australian Bureau of Statistics does not produce regional prices indexes. The Western Australian Department of Regional Development does produce regional price estimates, but it updates them infrequently. Moreover, many of the costs of constructing a railway are established outside the Pilbara region, in particular where rail or other components are manufactured.

80. The inclusion of an "X" factor of -0.25 is required as an efficiency factor for cost indexation purposes, consistent with the provisions of the Brookfield Rail and TPI Costing Principles.[20]

81. The proposal at Part 5.2, that an allowance for asymmetric risk is considered on a case-by-case basis, is accepted. However, such an allowance should not be included as an operating cost, but may be considered for incorporation into the capital cost calculation on a case-by-case basis.[21] This is because the definition of operating cost in Clause 1 of Schedule 4 to the Code includes only (a) train control and signalling costs, (b) cyclical maintenance costs and (c) payments in respect of land leases.

Required Amendment 5

Part 5 of RHI's proposed Costing Principles should be amended such that:

- the words "predetermined" is replaced with "re-determined" in 5.1(a)
- Part 5.1(c) is deleted and replaced with "RHI will index Incremental and Total Costs based on CPI minus the "X" factor. The "X" factor will be set at one quarter of CPI. In determining CPI, the Australian Bureau of Statistics Weighted Average of Eight Capital Cities All Groups CPI index will be used. The annual change will be calculated as the percentage change in the average of the four quarters to March of each year from the average of the previous four quarters."
- The words "annual Operating" are replaced with "Overhead" in Part 5.2.

[20] ACIL for Hancock Prospecting, in response to TPI's proposed costing principles in 2008, submitted (page 17) "TPI's ..costs should be indexed by CPI-X with ERA setting an appropriate X factor in the light of its consideration of future cost movements" http://www.erawa.com.au/cproot/7022/2/20081015%20Public%20Submission%20-%20Hancock%20Prospecting%20Pty%20Ltd.pdf

[21] ACIL for Hancock Prospecting, in response to TPI proposed costing principles in 2008, submitted (page 13) "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 an allowance should not be given "blanket" approval within the Costing Principles".

Part 6 – Compliance and Review

82. Part 6 of RHI's proposed Costing Principles provides for the amendment and review of the Costing Principles by RHI or by the Authority, and the ability of stakeholders to express any concern in relation to the Costing Principles to the Authority.

83. This part is substantially identical to Part 7 of TPI's Costing Principles.[22]

Authority Assessment

84. Part 6 of RHI's Costing Principles is appropriate.

[22] BR's Costing Principles (at Part 6) include references to the periodic mandatory review of its costing principles and for auditing of BR's compliance with its costing principles. These provisions are additional to those contained in TPI's Costing Principles.

Appendix 1 Summary of Required Amendments

Required Amendment 1

Part 1 of RHI's proposed Costing Principles should be amended such that:

- Part 1.1(d) is deleted
- The words "Floor Price and the Ceiling Price required under clause" are replaced with "costs referred to in section" in 1.1(e)(i)
- 1.1(e)(ii) is deleted
- The words "the ERA under" are removed from 1.1(h)
- 1.3(d) and 1.4 are deleted

Required Amendment 2

Part 2 of RHI's proposed Costing Principles rules should be amended such that:

- 2.1(b) is replaced with "Incremental costs will include capital costs only where RHI assesses that it is necessary to make capital expenditure (of the type referred to in 2.3(c) of these Costing Principles) to provide the proposed access".
- The second paragraph of 2.4(a)(i) is replaced with "RHI considers that the network as constructed can meet current and reasonably projected demand for all users taken together. If RHI requires additional infrastructure to meet its own projected demand in conjunction with an access proposal, then it will demonstrate the basis of and financial commitment to the demand projection."
- In Part 2.4(a)(iv), the word "However" is deleted, and the word "included" is replaced with "excluded".
- In Part 2.4(a)(ix), the second paragraph is removed.
- The words "nominal pre-tax" are replaced with "annual" in Part 2.5.
- Parts 2.6(d) and 2.6(e) are replaced with "This formula calculates the costs at the beginning of the period. Provisions for the calculation of working capital amounts based on consideration of the mid-point of the annuity period are made at Part 3.3(c)(v).

Required Amendment 3

Part 3 of RHI's proposed Costing Principles should be amended such that:

- In part 3.1 the words "has determined" are replaced with "will determine"
- The last paragraph of Part 3.3(c)(iii) is deleted
- Part 3.3(c)(vi) is deleted
- Part 3.5 is deleted

Required Amendment 4

Part 4 of RHI's proposed Costing Principles should be amended such that:

- The term "railway infrastructure" in Part 4.1 is replaced with "access-related functions".
- In Part 4.2, the words "determined" and "Details of" are replaced with "reviewed" and "Allocation criteria for" respectively, and the word "included" is removed.
- Part 4.3 is removed.

Required Amendment 5

Part 5 of RHI's proposed Costing Principles should be amended such that:

- the words "predetermined" is replaced with "re-determined" in 5.1(a)

- Part 5.1(c) is deleted and replaced with "RHI will index Incremental and Total Costs based on CPI minus the "X" factor. The "X" factor will be set at one quarter of CPI. In determining CPI, the Australian Bureau of Statistics Weighted Average of Eight Capital Cities All Groups CPI index will be used. The annual change will be calculated as the percentage change in the average of the four quarters to March of each year from the average of the previous four quarters."

- The words "annual Operating" are replaced with "Overhead" in Part 5.2.