OPR
oakajee port & rail

Mr Jeremy Threlfall
Assistant Director, Rail
Economic Regulation Authority
PO Box 8469
PERTH BC WA 6849

8 January 2010

Dear Mr Threlfall,

SUBMISSION ON THE TPI COSTING PRINCIPLES

Oakajee Port and Rail Pty Ltd (OPR) has reviewed the Economic Regulation Authority's Draft Determination on The Pilbara Infrastructure's (TPI) proposed Costing Principles. OPR has prepared a submission outlining areas of interest which is attached.

There are provisions contained in some of the amendments which OPR believes need to be considered in the context that TPI rail network is a greenfields development which may not be specifically covered within the Railways (Access) Code 2000 and the Economic Regulation Authority should consider benchmarking the proposed TPI provisions against another bulk commodity rail infrastructure provider rather than WestNet Rail due to differences in the operations between TPI and WestNet Rail.

The submission is not confidential and can be made available on the Economic Regulation Authority's website.

If you have any queries raised in the submission, do not hesitate to contact me on (08) 9486 0715.

Yours sincerely

Michael Jansen

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OAKAJEE PORT AND RAIL SUBMISSION ON DRAFT DETERMINATION OF THE PILBARA INFRASTRUCTURE COSTING PRINCIPLES

Introduction

Oakajee Port and Rail Pty Ltd (OPR) has reviewed the Economic Regulation Authority's (ERA) Draft Determination of The Pilbara Infrastructure Pty Ltd (TPI) proposed Costing Principles. OPR has comments on some of the proposed amendments outlined in the Draft Determination.

OPR notes that the ERA has benchmarked the TPI proposed Costing Principles, on the advice of its consultant PricewaterhouseCoopers (PwC), against the WestNet Rail (WNR) Costing Principles approved by the Rail Access Regulator in 2006. There are, however, some important differences between the WNR and TPI rail networks which make any comparison problematic.

WNR is a mature rail infrastructure provider with multiple existing rail users, at least two rail operators and the owner of a rail network that has not been extended since the former WA Government Railways commercial freight network was privatised and the WA Rail Access Regime took effect in September 2001. WNR is also a stand alone rail infrastructure provider with separate ownership of the ports that the rail network feeds into and not all of the rail users utilise the port facilities. The WNR rail network also supports a range of traffics from bulk commodities to containerised traffic.

TPI, on the other hand, is a greenfields rail and port infrastructure provider transporting a single product- iron ore. As a greenfields multi-user rail infrastructure provider, which only commenced operations in July 2008, there will be a need to extend the TPI rail line to the mines of other iron ore producers as the mines are developed. As a greenfields operator, TPI will also incur costs that are not currently incurred by WNR, the most significant being lease payments associated with land acquisition costs. These costs should be recoverable by a greenfields operator.

The ERA should also take into account that investment in greenfields infrastructure will be encouraged if greenfields railway owners have certainty that the reasonable costs that they incur in building railway facilities are recoverable under the Railways (Access) Code 2000 (Code). Such an approach is consistent with the Railway (Access) Act 1998 (Act) objective of encouraging efficient investment in railway facilities. This objective will be furthered by allowing TPI to recover its actual costs where it can demonstrate that those costs are appropriate and efficient.

Comments on Draft Determination

OPR comments on some of the proposed amendments that it has issues with and does not have any comment on the other proposed amendments.

The amendments have been summarised in the interests of brevity and the individual requirements numbered for ease of cross reference in the comments.

Route Sections

OPR agrees with the ERA's view that TPI should not be required to determine route sections until such time as new rail lines are constructed connecting to the existing TPI rail network as any requirement to do this prior to the rail lines being constructed would make the route sections arbitrary and probably inaccurate.

Amendment 2 requires TPI to submit its proposed floor and ceiling costs submission to the ERA within two months of the final determination of the Costing Principles. OPR considers this requirement unreasonable as the time is to short and believes a timeline of three months is more reasonable as this would be consistent with the three months that ERA requires for TPI to re-submit its Costing Principles for approval when there are new rail lines connecting to the TPI rail network.

Determination of Capital Costs

Amendment 4

Section 3.1.1 of TPI's proposed Costing Principles is to be amended as follows:

Item 1: Capacity of Infrastructure

1) Add the words "for all users taken together" following the words "reasonably projected demand".
2) Delete the second sentence.

Item 2: Route optimisation

3) Delete the words "as a greenfields development" and "infrastructure configuration".

Item 4: Greenfields

4) Amend this section to be consistent with the wording in the equivalent part of section 2.3 of the WNR CP.

Item 5: Modern equivalent assets

5) Add the words "if appropriate" immediately following the words "MEA value".
6) Delete the second sentence.
7) Provide details of the process to determine the MEA and to calculate the GRV on the basis of the MEA, consistent with the wording for these processes in the equivalent part of section 2.3 of the WNR CP.

Item 6: Unit rates

8) Amend this section to be consistent with the wording in the equivalent part of section 2.3 of the WNR CP.

Item 7: Design, construction and project management fees

9) Amend this section to be consistent with the wording in the equivalent part of section 2.3 of the WNR CP.

Item 8: Finance charge during construction

10) Delete the third sentence.

11) Amend the heading to read "Financing charge during railway infrastructure construction".
12) Add wording consistent with the wording in the equivalent part of section 2.3 of the WNR CP.

Item 9: Finance charge during construction

13) Add the word "Authority's" immediately preceding the word "weighted" in the third line.

Item 10: Costs index

14) Delete the wording in the last paragraph on page 6 and replace with the words "Where it is necessary for the TPI to escalate its actual costs the escalators used will be in accordance with the nature of the costs involved".

Item 11: Extensions and expansions

15) Delete the entire first paragraph on page 7.

OPR Comment

OPR disagrees with point 2 of item 1 above as the TPI rail network is a greenfields development and the capacity of its infrastructure was a requirement of the relevant State Agreement with the WA Government.

OPR also takes issue with point 3 of item 2. The wording in the TPI Costing Principles is similar to that in the relevant section on page 7 of the WNR CP (2009). Therefore, it is unclear to OPR why point 3 is necessary. There needs to be recognition that the TPI railway is a greenfields development and the rail alignment needed to be within the rail corridor approved by the WA Government. Any other decision by the ERA would be in breach of the TPI rail corridor agreement with the WA Government.

The Code allows TPI to recover the capital costs of its railway infrastructure. The Code states that the costs that are recoverable are those costs that would be incurred by a body managing the railway network and adopting efficient practices applicable to the provision of railway infrastructure. This provision allows the ERA to ensure that the railway owner's costs are efficient. However, it does not give the ERA a broad power to determine that the railway infrastructure should have been differently aligned or have a different capacity. The ERA is required to assess the efficient costs of the actual railway infrastructure that has been built by TPI in light of the actual circumstances faced by TPI, and not the costs of the railway infrastructure that the ERA considers should have been built.

OPR disagrees with points 6 and 7 of item 5 on the basis that for greenfields developments, actual costs equate to gross replacement values. TPI has proposed the use of escalated actual costs to be modern equivalent assets (MEA). OPR contends that as long as TPI's actual construction costs have been determined to be efficient through competitive tender then the escalated actual costs would more accurately reflect MEA than if unit rates were sourced for a hypothetical construction of the railway at a different timeline when the floor and ceiling costs are to be determined. OPR also believes that with rising construction costs, the use of escalated actual costs would result in a better outcome for infrastructure users.

In regard to item 6, OPR would support the TPI proposal as providing greater accuracy for a recently constructed rail infrastructure. In the WNR context, the WNR rail network was constructed many years ago and the use of escalated actual costs would be difficult to assess. Therefore, the use of current unit rates for a hypothetical rail construction on the WNR network to determine MEA is justified, but OPR contends that this process would not be as accurate and efficient as the use of escalated actual costs for recently developed rail infrastructure which is the case for the TPI rail infrastructure assets.

In regard to item 7, OPR holds similar views to that of TPI for the use of escalated actual costs. OPR's reasoning for this is outlined in the previous few paragraphs. OPR, as a future railway owner, contends that the acceptance of escalated actual costs would give infrastructure owners increased certainty of cost recovery vis-a-vie to the ERA allowance of 20% of total costs of the infrastructure, as accepted in the WNR CP, which may be to low for actual greenfields railway developments.

In regard to item 8, OPR disagrees with point 10 and supports TPI's use of actual construction costs. OPR's reasoning for this is outlined in the previous few paragraphs.

In regard to item 10, OPR supports the use of TPI's proposed index as the index better reflects the cost changes in the area of operations of TPI's rail infrastructure. There is a common understanding that operating and construction costs in the north west of Western Australia are higher than in other areas of the state. Consequently, the use of a form of Pilbara index would recognise this reality.

As noted in the introduction, OPR also considers that investment in greenfields infrastructure will be encouraged if greenfields railway owners have certainty that the actual costs that they incur in building railway facilities are recoverable under the Code provided that they are reasonable and efficient. Such an approach, will further the Act's objective of encouraging efficient investment in railway facilities. OPR also notes that section 20(4)(a and b) of the Act requires the ERA to take into account the railway owner's legitimate business interests and the railway owner's costs of providing access, which OPR submits would best be addressed by using actual costs of a greenfields railway provided that the owner can demonstrate that its actual costs are efficient.

<u>*Amendment 5*</u>

Appendix A of TPI's Costing Principles should be amended as follows:

1) Item 1- Delete the figure '50' under the heading 'Life expectancy (Years)' and replace this figure with '100'.
2) Item 2(a)- Delete the figure '50' under the heading 'Life expectancy (Years)' and replace this figure with '100'.
3) Item 5(a) [Curve > 800m & tangent]- Delete the figure '20' under the heading 'Life expectancy (Years)' and replace this figure with '60'.
4) Item 11, 12 and 13- delete these items.

OPR Comment

OPR disagrees with the requirements of this amendment as the ERA's basis for this decision is not appropriate. OPR does not consider that the WNR rail network is an appropriate benchmark for the determination of the asset lives for the TPI rail network due to a number of reasons. First, the TPI railway is a heavy haul railway only transporting bulk commodities whereas the WNR railway transports a combination of traffics from grain, containers to some bulk commodities. Further, OPR contends that the TPI railway has a greater asset standing risk than the WNR rail network due to limited life of iron ore reserves vis-a-vie to the traffics such as grain and containers carried on the WNR rail network which would have an unlimited life. In addition, OPR understands that the TPI railway can accommodate wagons with axle loads double that of the axle loads (23tal as approved in WNR Floor and Ceiling Costs (2003)) on the WNR rail network. The TPI railway has been designed to haul at least 70Mta of iron ore whereas the traffic on the most heavily utilised WNR rail line (Kwinana to Bunbury) is about 25-30Mta. Finally, the weather conditions in the Pilbara region, where TPI conducts its rail operations, is much more severe than in the regions traversed by the WNR rail network.

On the basis of the above factors, there is sufficient evidence to suggest that the "wear and tear" on the TPI rail network would be greater than the WNR rail network which would necessitate a greater maintenance requirement on the TPI rail assets than on the WNR assets which would also result in shorter asset life relative to the WNR rail assets. Accordingly, the ERA should accept the asset lives proposed by TPI for this Costing Principles determination and undertake a study into the asset lives of heavy haul railways prior to the next review of the TPI Costing Principles.

OPR disagrees with point 4 above as items 11, 12 and 13 were accepted by the ERA in the WNR Costing Principles (April 2009) as outlined in Annexure 7 of that document which accepted 50 year asset lives for the three categories identified as items 11, 12 and 13.

Amendment 6

Section 3.1.3 of TPI's proposed Costing Principles should be amended by deleting the second, third and fourth sentences under this section.

OPR Comment

In this section, OPR agrees with the deletion of the second and third bullet points on the basis that the ERA has accepted in the Final Determination of the WACC to apply on the TPI railway that debt issuance costs as legitimate costs and also indicated that Asymmetric Risk would be assessed during the review of TPI's proposed floor and ceiling costs.

However, OPR does not agree with the requirement to delete the fourth sentence as the ERA will assess TPI's proposal for the acceptance of Asymmetric Risk within its operating costs for the floor and ceiling calculation. OPR contends that as the Costing Principles is a document that outlines the assumptions that underpin the calculation of the floor and ceiling costs, that the sentence should remain until the ERA has made its Final Determination on TPI's proposed Floor and Ceiling Costs.

Determination of Operating Costs

Amendment 8

Section 4.1 of TPI's proposed Costing Principles should be amended as follows:

1) The second sentence should include the words "managing the railway network in a manner consistent with the efficient costs definition under section 4 of

Schedule 4 of the Code”, immediately following the words “efficient stand alone operator”.

2) Add the first paragraph under section 3.3 of the WNR CP as the second paragraph.

3) Add the words “TPI has defined terms routine and cyclical maintenance as the to detail what activities have been included in operating costs” as the third paragraph.

4) Delete the first three dot points and the last two dot points on page 8.

5) Delete the words “and major planned maintenance” from the fourth and fifth dot points on page 8.

6) Add the following four headings and provide a detailed description of the appropriate definitions, principles and processes under each of these headings, consistent with those set out under section 3.3 of the WNR CP:

    a. Routine and cyclical maintenance for track.

    b. Routine and cyclical maintenance for signalling and communications.

    c. Network management costs.

    d. Working capital.

7) Add details of TPI’s track maintenance model in a manner similar to the description of WestNet’s track maintenance model set out under section 3.3 of the WNR CP.

8) Incorporate TPI’s track maintenance model into its costing model.

OPR Comment

OPR does not agree with item 4 above of the proposed amendment because as TPI has identified in the first bullet point of section 4.1 of its proposed Costing Principles that major periodic maintenance will only be recouped for the maintenance requirements to maintain the economic life of the assets and not extend the economic life of the assets. Therefore, this provision should be allowed for in the operating cost base as long as major maintenance is undertaken to preserve the existing life of the assets.

In addition, OPR has concerns that the ERA has dis-allowed the costs associated with leasing part of the land which the covered infrastructure is constructed. OPR maintains this is a legitimate cost in the acquisition of land for the corridor within which the railway has been built.

The ERA does not provide sufficient reasoning for rejecting the recovery of these costs as operating costs. The Draft Determination bases the rejection of these costs of sections 2(2) and 2(2a) of the Code. However, these sections only apply to capital costs. The Code draws a clear distinction between capital costs and operating costs and there is no similar provision that states that costs associated with the value of land cannot be included in operating costs.

The fact that the Code contains a specific exclusion of land costs in the capital costs provisions strongly implies that land costs would have been included as capital costs if that specific exclusion was not contained in the Code. The absence of such an exclusion in relation to operating costs strongly implies that land costs can be included in the calculation of operating costs. OPR considers that lease costs that relate to the land on which the railway is located are costs that are incurred in relation to the operation of the railway infrastructure and these costs are therefore covered by the definition of operating costs.

OPR also contends that under the provisions of section 20(4)(a and b) of the Act these costs are legitimate costs incurred by the railway owner and unless recouped will represent a cross subsidy from the owners of TPI to the owners of the mining companies that will use the infrastructure. Further, OPR understands that the lease payment being claimed by TPI is a payment to the WA Government for the use of crown land as the TPI railway traverses crown land and should be recognised as a legitimate operating cost by the ERA. In the event that TPI were required to make this as an upfront payment to the WA Government then this payment should be recognised within the asset base as a capital cost. While OPR recognises that Schedule 4, clauses 2(2) and 2(2a) of the Code specifically exclude the cost of land in the asset base, OPR contends that the Code was developed for an existing railway which the WNR railway and PTA networks are and not for greenfields railways such as the TPI rail network. This is an omission in the Code which the ERA should recognise as a deficiency and which should be corrected in the ERA's current review of the Code.

Points 7 and 8 above require TPI to develop a track maintenance model and to include this model in TPI's costing model. OPR understands that in the past few WNR floor and ceiling determinations, the ERA did not recognise the WNR track maintenance model and instead benchmarked WNR track maintenance costs against similar rail lines in Queensland on an average dollar per Km basis. On this basis, OPR contends that the development of a TPI track maintenance model is rather onerous and unnecessary, especially if the ERA is going to benchmark TPI's track maintenance costs.

Amendment 9

Section 4.2 of TPI's Costing Principles should be amended as follows:

1) Delete the first paragraph and replace with wording similar to that in the first paragraph of section 3.2 of the WNR CP.
2) Delete the words "having regards to the market conditions that are presently being experienced in the Pilbara region" in the first dot point.
3) Delete the word "will" in the second dot point and replace with the word "may".
4) Add the words "or unit costs", as appropriate," immediately following the word "actual" under the third dot point.
5) Delete the second sentence in the last paragraph and replace with wording similar to the sentence under section 3.1 of the WNR CP.

OPR Comment

OPR does not consider there is anything wrong with the first paragraph of section 4.2 of the TPI Costing Principles as it indicates that actual costs will be used where appropriate and will demonstrate to the ERA that these costs are efficient. OPR notes that in the last two bullet points in section 3.2 of the approved WNR CP (April 2009), WNR has indicated it will also use actual costs where appropriate which is consistent with the third bullet point in section 4.2 of the TPI Costing Principles.

OPR does not agree with point 2 above as this indicates that the ERA fails to recognise the different set of cost conditions that exist in the Pilbara. OPR supports the use of Pilbara specific parameters in cost assessments as this more accurately reflects costs incurred in the region where TPI operates its infrastructure. OPR has outlined its reasoning for this in the fourth paragraph of page 4 of this submission.

In regard to point 4, it is unclear to OPR why this is included as the TPI provision is consistent with the last two bullet points of section 3.2 of the approved WNR CP (April 2009) which does not include the use of the words "or unit costs, if appropriate".

Amendment 10

Section 4.3 of the proposed Costing Principles and Appendix B on page 14 should be amended as follows:

1) Amend section 4.3 by:

    a) Deleting the words "specific operating costs, including track and signalling maintenance costs, centralised train control cost and" from the first sentence.

    b) Inserting the first two sentences from section 3.4 of the WNR CP as the first paragraph.

    c) Deleting the last sentence.

    d) Inserting the last sentence under section 3.4 of the WNR CP as the last sentence in this section, excluding the words "will be determined by the ERA" and replacing these words with "will be reviewed by the ERA".

2) Amend the Operating Costs part of Appendix B by:

    a) Deleting all references to costs related to land (corridor and non-corridor land).

    b) Deleting references to operating costs which are directly attributable and listing indirect operating costs under the headings 'railway infrastructure management costs' and 'network management costs'.

    c) Inserting GTK's as the cost allocator for railway infrastructure management costs.

    d) Inserting train numbers as the cost allocator for network management costs.

OPR Comment

In regard to point 2(a), OPR has previously argued why the cost of land for greenfields rail developments are legitimate costs recognised under the section 20(4)(a&b) of the Act (see pages 6 and 7 of this submission). On this basis, the ERA should accept the need for TPI to provide an allocation methodology for the common lease costs as TPI has done in its proposed Costing Principles. The ERA should determine whether the proposed allocation methodology for this component is acceptable.

Other Matters

Amendment 13

Section 6.1 of TPI's Costing Principles should be amended as follows:

1) Delete the third paragraph.
2) Replace the above paragraph with the first four sentences from section 5.1 of the WNR CP.

OPR Comment

TPI has proposed an escalation of the operating cost components of its floor and ceiling costs to be based on an index incorporating regional factors where it has its operations. OPR has already discussed the merits if using a form of Pilbara index for cost escalation as TPI's rail operations are based in the Pilbara and it is commonly understood that the cost base in the north west of Western Australia is higher than in the rest of the state. Further, OPR does not consider that the TPI escalated costs should be discounted by an X factor as the ERA has proposed in point 2 of this amendment as the TPI railway is a new greenfields operation which is expected to be operating efficiently. Unless the ERA has sufficient evidence to suggest that TPI is not operating efficiently then it should not require the escalation to be discounted by the X factor.

OPR considers that the ERA accept the proposal as outlined in TPI Costing Principles and undertakes a review of the proposal to determine whether any X factor should apply to greenfields assets prior to the next review of the Costing Principles in two years time.