



Ms Audrey Hia
Senior Project Officer
Economic Regulation Authority
PO Box 8469
PERTH BC WA 6849

3 February 2010

Dear Ms Hia,

SUBMISSION ON THE REVIEW OF THE RAILWAYS (ACCESS) CODE 2000

Oakajee Port and Rail Pty Ltd (OPR) welcomes the opportunity to comment upon the Economic Regulation Authority's (ERA) issues paper on the review of the Railways (Access) Code 2000. Attached is OPR's submission. The submission is not confidential and can be made available on the ERA website.

The OPR submission provides high level comments on the material issues arising from the issues paper identified by OPR at this stage. OPR also provides comments on a number of other issues which have not been canvassed in the issues paper which it believes should be addressed in this review

OPR remains very interested in this review and is willing to assist the ERA as appropriate. In particular OPR will provide further detailed comments on the issues raised in this submission and the ERA's draft report in the next phase of the public consultation.

OPR understands that the ERA is considering holding a stakeholder workshop as part of its consultation process. OPR supports the workshop proposal and would appreciate the opportunity to participate in any such stakeholder workshop.

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

Yours sincerely

Phil McKeiver

GENERAL COUNSEL



OAKAJEE PORT AND RAIL SUBMISSION ON THE REVIEW OF THE RAILWAYS (ACCESS) CODE 2000

1. Introduction

Oakajee Port and Rail Pty Ltd (OPR) has reviewed the Economic Regulation Authority's (ERA) Issues Paper on the review of the *Railways (Access) Code 2000* (Code). OPR has comments on some of the issues outlined in the Issues Paper. However, OPR also outlines some further issues which have not been canvassed in the Issues Paper which OPR believes is important for greenfields railway owners and infrastructure asset owners which are part of an integrated supply chain.

OPR understands there are currently no access agreements negotiated within the processes outlined in the Code and that all existing access agreements have been commercially negotiated outside the Code. OPR also notes that some of the issues raised in the Issues Paper were recommended as changes to the Code at the last review some five years ago but were not followed through and consequently did not result in changes to the Code.

2. Comments on the Issues Paper

Part 2- Proposals for Access

The Issues Paper¹ seeks comments whether section 9 of the Code should allow for the railway owner to also provide floor and ceiling prices to a proponent for future upgrading of rail infrastructure to meet that proponent's proposed traffic requirements.

OPR supports this proposal, and submits that the Code amendments should go further and allow the railway owner to later amend floor and ceiling prices which were based on future upgrading costs to reflect *actual* upgrading costs once these are incurred, even where costs are incurred during the 3 year determination period.

OPR notes that in previous WestNet Rail floor and ceiling cost determinations by the ERA that the Gross Replacement Value (GRV) has increased between 15 and 20 per cent over the four rail lines assessed in the three years of the 2003 and 2006 determinations. For this reason, OPR believes greater flexibility to permit actual cost incurred as well as future forecast costs should be permitted.

Part 3- Negotiations

The Issues Paper² seeks comments on whether section 16(2) of the Code should be expanded to clarify the meaning of the term 'unfairly discriminate'.

¹ fourth bullet point on page 8

² second bullet point on page 10



OPR does not consider that amendment to the term 'unfairly discriminate' is necessary. However, if the ERA intends to recommend amendment of this term, OPR submits that the Code should expressly permit the following range of factors to be considered by a railway owner when the owner is assessing the merits of competing Access Seekers, among other things:

- 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 to pay the railway owner in a timely manner an amount due to the railway owner; and
- any prior negotiations between an Access Seeker and the railway owner which have been terminated by the railway owner.

The ERA also invites comment on whether the circumstances which constitute a 'dispute' under the Code should be expanded. OPR is giving this matter further consideration and may provide comment on it on the Draft Report.

Part 5- Certain approval functions of the Regulator

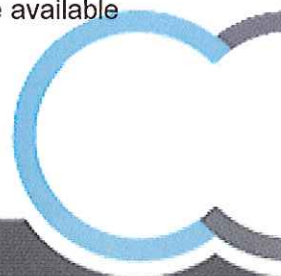
The Issues Paper, fourth bullet point on page 12, seeks comments on the proposal to amend section 42 of the Code to the effect that public consultation is only required for segregation arrangements or variations to segregation arrangements considered by the ERA to constitute material changes.

OPR agrees with this proposal and supports the ERA's discretion being used in these circumstances.

Schedules

The Issues Paper seeks comments on the following areas:

- Whether under Schedule 2; (a) any clarification of any of the items listed under this schedule is required or (b) there is a need for any further information to be made available by the railway owner under this schedule.



- Whether Schedule 4 should include provisions setting out a review period for floor and ceiling determinations, along similar lines to that suggested for the Part 5 Instruments and segregation arrangements (i.e. five years or as otherwise determined by the Authority).
- Whether the GRV methodology under section 2 of Schedule 4 should be amended to include the provision for floor and ceiling cost calculations to take into account forecast expenditure by the railway owner on the upgrading of rail routes as previously discussed in the issues paper under Part 2 of the Code.

In regard to point 1 above, OPR believes that the current level of information is appropriate as the amendments to the Code resulting from the last review are sufficient.

In regard to point 2 above, OPR supports the proposal by the ERA to have consistency in the review period between the floor and ceiling determinations and the Part 5 instrument determinations. However, OPR asserts that there should be consistency in the review periods for the Costing Principles and the floor and ceiling cost determinations as the asset valuation methodology outlined in the Costing Principles is the same as the methodology used to establish the capital costs in the floor and ceiling costs.

In regard to the final bullet point, OPR supports the proposal to amend the Code to allow for forecast floor and ceiling cost calculations to take account of forecast expenditure related to capacity enhancements as this provides greater certainty for railway owners.

3. Comments on issues not included in Issues Paper

Regulatory Discretion

The review of the Code and existence of Competition and Infrastructure Reform Agreement (CIRA) (discussed below) provides an opportunity to address the exercise of regulatory discretion and potential for regulatory risk.

In this regard, there is considerable scope under the WA rail access regime for the ERA to exercise its discretion in making determinations, and this increases the difficulties for the ERA in discharging its statutory functions and increases the risks for railway owners, which is particularly of concern for a greenfields development.

Many of these broad discretions could be clarified/defined to reduce the uncertainty as to the breadth of the discretion to some degree. For example, it could include:

- establishing provisions for a lighter handed form of regulation to be applied in certain circumstances;
- providing for recognition of the additional risks associated with greenfields infrastructure in the regulator's determination of the WACC;
- establishing factors to be taken into account in determining the Part 5 instruments, in particular, the segregation arrangements. For example, it could state that in deciding if

Oakajee port & rail

functional separation is required, the regulator must take into account whether it is a greenfields railway and whether it is vertically integrated; and

- establishing factors that the regulator must take into account when assessing prudence of operating and capital costs.

Continuing periodic reviews of the WA rail access regime, perhaps performed by an independent body such as that exists for reviews of the national gas access and electricity codes which may include the performance of the regulator in discharging its responsibilities under the regime, would be another means of improving regulatory accountability.

Merits Review

The ability of a regulated infrastructure owner to seek a merits review of a regulatory decision is an important element of a balanced and fair regulatory regime. It allows recourse for the infrastructure owner where the infrastructure owner believes the regulator has made an error in its decision which may adversely affect the continued operation of the infrastructure and any future further expansion of development of the facility owner's business.

OPR understands that various forms of merit reviews exist in other regulated industries around Australia such as for gas pipelines and electricity networks. OPR notes that the ERA administers access regimes which cover gas pipelines and distribution networks and electricity transmission and distribution networks where there are provisions for merits review and contends that merits review should also apply in the WA rail access regime which would also ensure consistency for all assets regulated by the ERA.

Supply Chain

A critical issue for an infrastructure service provider is overall supply chain efficiency, yet the ERA has applied the Code without regard to the fact that Pilbara railways are dedicated parts of a supply chain. This approach fails to take account of the integrated nature of these infrastructure operations and how they can impact on each other. For example, regulatory requirements relating to train scheduling can have adverse implications for port operational efficiency and the entire iron ore supply chain.

In the ERA's Final Determination on TPI's Proposed (Revised) Train Path Policy, 18 August 2009, the ERA did not take into account that the TPI railway is a dedicated part of a supply chain. In order to avoid the risk of costly litigation by parties who wish to seek judicial guidance and to encourage greater efficiency and certainty, the Code should be amended so that the ERA's power clearly includes the obligation to consider the impact of their decisions on an integrated supply chain (and the ERA decisions are subject to merits review, as above).

The review of the Code provides an opportunity to develop new provisions which recognise that:

- the regulation of different infrastructure facilities on a supply chain should have regard to whole-of-supply chain issues, including the system operating mode (that is, they cannot

Oakajee port & rail

be examined in isolation). Of particular interest is the recognition in the regulatory framework for the treatment of capacity across the whole supply chain and not the individual elements of the supply chain; and

- the regulatory framework must be flexible enough to respond to market challenges that can often require a whole-of-supply chain response.

OPR contends that this issue is most important for both infrastructure service providers and infrastructure users in order to ensure efficient outcomes which would minimise demurrage costs and other fees and charges to the infrastructure users.

Regulation of Greenfields Infrastructure

The WA rail access regime provides a regulatory framework for an existing 'brownfields' railway. This means that it was drafted with established infrastructure and organisations in mind. Any contemplation of new developments is limited to access applications that may require an extension to the existing facility. As a result, there are many elements of the existing regime that do not readily translate to a 'greenfields' development such as The Pilbara Infrastructure's (TPI) railway and OPR's proposed railway.

The principal risk associated with application of the existing regime is that a greenfields developer's return on its investment will be constrained to the regulated return on capital, which would be unlikely to allow for an increased rate of return to take account of the risks associated with a large greenfields infrastructure project.

More generally, the key differences in a greenfields development environment include:

- infrastructure is either not yet built or is under construction;
- capital and operational costs are not known with certainty;
- revenue risk maybe greater than for an established business due to uncertainty about future volumes;
- there are likely to be additional efficiency benefits of close interaction between all elements of the business (rail and port) in the early years in co-ordinating the development of and operationalising the infrastructure; and
- These differences have important implications for the existing rail regulatory framework, as they make several elements of it impractical and/or very costly compared to the benefits.

The unique circumstances facing greenfields infrastructure developments were recognised in the recent energy market reforms, with special arrangements applying to greenfields gas pipelines to enhance investment incentives. These include the options of a 15 year no coverage determination and a price regulation exemption.

The areas of the WA rail access regime that should be amended to reflect the operating environment of a greenfields railway include:

Light handed regulation option – the regime currently allows for a revenue cap to be determined by the regulator. It also sets out a detailed approach that must be followed in establishing access prices, including the use of Gross Replacement Value method in valuing assets. A greenfields development faces greater risk than an established railway as future demand by third parties may be uncertain, yet the greenfields development involves significant investment in fixed cost infrastructure by the infrastructure owner. A heavy handed regulatory approach for a greenfields railway may therefore limit any 'upside' from taking this risk and reduce incentives to invest. A more light handed regulatory approach, similar to the national gas model, should be contemplated by the WA rail access regime for greenfields projects;

Functional Segregation requirements – the existing requirements are too invasive for a greenfields railway as they do not allow for the legitimate benefits of vertical integration to be realised in the critical early years of construction and operation as demonstrated by the ERA's final determination on the TPI segregation arrangements. As access negotiations may take place in this period it will be essential to have in place measures to protect confidential information. However, requirements to functionally separate an integrated organisation will impose significant costs and restrict operational efficiencies that are important in establishing the new business which are not otherwise required until there is a bona fide access application;

Costing Principles – the Code requires a railway owner to prepare costing principles for regulatory approval. These are the principles, rules and practices that are to apply in the determination of floor and ceiling costs and the preparation of regulatory financial accounts. However, these costs will not yet be known with certainty for a railway that has only commenced operation. As a result, it is premature to develop costing principles at operational commencement when there is little experience of the organisation's actual costs and what drives them. OPR submits that at least 9 months post-operation should be permitted before greenfields railway owners are required to submit costing principles for approval by the regulator.

Over-payment rules – a railway owner must prepare these rules to apply when a breach of the ceiling revenue test occurs. These rules presently provide for a maximum three year carryover period (as applied in the WestNet Rail determination) before any over-recovery of revenue must be returned to railway operators. As noted above, a new railway operation will face some uncertainty as to its costs and revenues in the early years of operation due to lack of practical experience of the operation. This means there is a greater risk of either under or over recovery of costs in this early period. As such, a period of more than three years would ideally be allowed to carryover over-payments for a greenfields railway;

Train path policy/train management guidelines – heavy haul operators on an iron ore rail network can operate trains on a 'run when ready' basis, generating considerable efficiencies through optimising supply chain capacity as demonstrated in the Pilbara railway operations of BHP-Billiton and Rio Tinto. However, regulatory requirements may force a change in this system operating mode as a result of third party entry. As a result, the regulatory framework should allow supply chain issues to be explicitly recognised in an access provider's capacity management policies, including imposing obligations on third party access seekers in relation to the system operating mode.

Asset Valuation Methodology

The asset valuation methodology used in the WA rail access regime to calculate capital costs is Gross Replacement Value (GRV). This methodology is unique to the WA rail access regime as the methodology used in other regulated industries and in other rail access regimes is Depreciated Optimised Replacement Cost (DORC). DORC provides for a greater representation of the infrastructure owners actual costs. OPR considers that the possibility of using historical costs, rather than replacement costs, may have merit in some circumstances for greenfields projects given the greater likelihood of partial asset stranding in such projects.

For rail infrastructure owners who provide access for bulk commodity traffics the different depreciation profiles implicit in either approach is important. A key consideration is that DORC based valuations normally adopt straight line depreciation that brings forward the cash flows relative to a GRV valuation due to straight line depreciation being a more aggressive profile. This issue is critically important to greenfields rail developers where financing considerations require depreciation to be brought forward to be compatible with financiers lending requirements and the traffics being carried on the rail lines where there is a limited life such as reserves for mine developments.

Under the GRV approach it is less certain whether the original value will be recovered, although the WestNet Rail Costing Principles seems to countenance accelerated depreciation where a rail line serves a mine with a limited life:³

There may be circumstances where the economic life of an asset is dependent on the life of a specific business such as a mine. If assets are included in the GRV specifically to service a time-limited project then the annuity will be calculated on that life. WestNet will advise the ERA of the reasons for the shorter life assumption. In addition, the three year review of the GRV would also assist the ERA in assessing the validity and continuation of that assumption.

The GRV approach also creates a risk of asset writedowns in the event that construction occurs at the peak of a construction or finance pricing cycle.

In theory the GRV approach ensures a more stable revenue stream over time compared with the DORC approach. However, under both approaches revenues and prices would need to be recalculated following significant volume increases or major capital expansions or scheduled reviews of Costing Principles. Also, revenue and price smoothing activities are common features of building block/DORC based regulatory arrangements. A DORC approach can therefore deliver a pricing regime with equivalent predictability to GRV.

With delays associated with a return of capital under GRV, annuity based depreciation heightens stranding risk due to the length of time to recover capital. In principle, the ability to revisit the economic life of the infrastructure with the re-submission of Costing Principles may reduce some of the stranding risk. Nevertheless, where the lives of time limited customer

³ WNR Costing Principles, p12.

projects are known at the outset to be less than the rail asset life, a GRV approach increases the stranded asset risk.

In conclusion, consideration should be given to accommodating either GRV or DORC approaches to be adopted by railway infrastructure owners. OPR will give further consideration on this issue and clarify its position with respect to its preference at the next stakeholder consultation phase following the release of the ERA's draft report.

Competition and Infrastructure Reform Agreement

There are a number of matters arising from the Competition and Infrastructure Reform Agreement (CIRA) agreed by the Council of Australian Governments (COAG) in February 2006 which will need to be reflected in the WA rail access regime.

CIRA's aim is to establish a simpler approach to economic regulation of significant infrastructure.

In relation to rail access, the intent of CIRA appears to be to facilitate and encourage jurisdictional rail access regimes to move towards a lighter handed model, where appropriate in operational circumstances, as part of the evolution to a simpler and consistent national approach.

OPR supports the aims of CIRA.

OPR thanks the ERA for the opportunity to make this submission and looks forward to the release of the ERA Draft Report.

Phil McKeiver

General Counsel

Oakajee Port and Rail Pty Ltd

