

WestNet Rail

Final Determination on WNR's Proposed Costing Principles
and Over-payment Rules

March 2011

Economic Regulation Authority



WESTERN AUSTRALIA

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ISBN: <Insert ISBN number if required>

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FINAL DETERMINATION

1. On 30 September 2010, WestNet Rail Pty Ltd (**WNR**) submitted its proposed Costing Principles and Over-payment Rules to the Economic Regulation Authority (**Authority**) for approval. The submission of the proposed Costing Principles and Over-payment Rules resulted from a requirement for WNR to review the existing Costing Principles and Over-payment Rules in October 2010 after the approval of these two Part 5 instruments by the Authority in April 2009.
2. The Authority issued a notice on 9 October 2010 inviting public comment on the revisions proposed by WNR. The Authority received one public submission, from Co-operative Bulk Handling Limited (**CBH**).
3. The Authority has considered the proposed Costing Principles and Over-payment Rules in conjunction with comments made by public submission and has issued this determination as a final determination.
4. The Authority's final determination is to approve WNR's proposed Costing Principles and Over-payment Rules with the following 2 amendments to the Costing Principles.

List of Amendments

Required Amendment 1

Section 2.5 of the Costing Principles should be amended by deleting the first sentence and replacing this sentence with the following text:

"In accordance with the Code, the WACC as applied to WestNet Rail will be determined by the ERA and reviewed (by the ERA) each year at 30 June."

Required Amendment 2

- Section 1.1 of the Costing Principles should be amended to state the current ownership of WNR.
- Section 2.3 of the Costing Principles should be amended by removing the first two dot points under the "Modern Equivalent Assets" heading, as they are no longer required.

REASONS FOR THE FINAL DETERMINATION

Background

5. WNR is the principal provider of the 'below rail' freight infrastructure, covering approximately 5,000 kilometres of track, in the south-west of Western Australia. WNR is a subsidiary company 100 % owned by Prime Infrastructure. Prime Infrastructure is 100% owned by Brookfield Infrastructure Partners, which in turn is 28% owned by US listed Brookfield Asset Management.

6. Section 3 of the Western Australian *Railways (Access) Act 1998 (Act)* defines a “railway owner” to mean the person having the management and control of the use of the railway infrastructure. Within this context, WNR is considered to be the railway owner for the freight rail infrastructure.
7. The Costing Principles and Over-payment Rules are two of four Part 5 instruments set out in Section 40(3) of the *Railways (Access) Code 2000 (Code)*. These two documents of WNR’s Part 5 instruments are the subject of this determination.
8. The Costing Principles are defined as being the establishment of principles, rules and practices that are to be applied by the railway owner to determine the floor and ceiling price tests and are used to keep and present the railway owner’s accounts and financial records pertaining to the determination of these costs. Quantification of the floor and ceiling costs and the assessment of whether WNR’s costs are appropriate are not part of this determination and will be addressed in future determinations of WNR’s floor and ceiling costs.
9. The Over-payment Rules establish a basis for the railway owner to reimburse operators in the event that total revenue earned on a particular route section exceeds total costs attributable to that route section. The Over-payment Rules apply only to operators who are provided with access under the Code.
10. Pursuant to WNR’s current approved Costing Principles and Over-payment Rules, the Authority was required to commence a review of these two Part 5 instruments in October 2010. WNR submitted its proposed revised Costing Principles and Over-payment Rules to the Authority on 30 September 2010.
11. The scope of the WNR’s Costing Principles and Over-payment Rules review is limited to those matters specifically set out under Part 5 of the Code.
12. In the case of the Costing Principles, Section 46 of the Code sets out the extent of the issues considered in this review as follows:
 - (1) *As soon as is practicable after the commencement of this Code each railway owner is to prepare and submit to the Regulator a statement of the principles, rules and practices (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) *The Regulator may –*
 - (a) *approve the statement submitted by the railway owner either with or without amendments; or*
 - (b) *if he or she is not willing to do so, determine what are to constitute the costing principles.*
 - (3) *The costing principles may be amended or replaced by the railway owner with the approval of the Regulator.*
 - (4) *The Regulator may, by written notice, direct the railway owner –*
 - (a) *to amend the costing principles; or*

*(b) to replace them with other costing principles determined by the Regulator,
and the railway owner must comply with such notice.*

13. In the case of the Over-payment Rules, Section 47 of the Code sets out the extent of the issues considered in this review as follows:
- (1) As soon as is practicable after the commencement of this Code each railway owner is to prepare and submit to the Regulator a statement of the rules (the over-payment rules) that are to apply where breaches of clause 8 of Schedule 4 occur on the part of that owner that could not be reasonably avoided.*
 - (2) The rules referred to in subsection (1) must give effect to the following basic requirements –*
 - (a) the excess referred to in clause 8(4) of Schedule 4 in respect of an operator or a group of operators must at all times be within a limit, being a percentage of the relevant costs, from time to time notified in writing to the railway owner by the Regulator.*
 - (b) at the expiry of each successive period of 3 years from the commencement of access by an operator or group of operators there must be no such excess in respect of that operator or group of operators.*
 - (2a) The over-payment rules may make provisions for a scheme under which amounts are to be determined that the railway owner is to pay to any relevant operator for the purpose of giving effect to subsection (2)(b).*
 - (3) The Regulator may –*
 - (a) approve the statement submitted by the railway owner either with or without amendments; or*
 - (b) if he or she is not willing to do so, determine what are to constitute the over-payment rules.*
 - (4) The over-payment rules may be amended or replaced by the railway owner with the approval of the Regulator.*
 - (5) The Regulator may, by written notice, direct the railway owner –*
 - (a) to amend the over-payment rules; or*
 - (b) to replace them with over-payment rules determined by the Regulator,
and the railway owner must comply with such note.*
 - (6) The regulator may in writing direct the railway owner to pay to an operator any amount determined under a scheme referred to in subsection (2a).*
 - (7) The railway owner must comply with –*
 - (a) the provisions of the over-payment rules; and*
 - (b) a direction given by the Regulator under subsection (6).*
14. In April 2009 the Authority approved the Costing Principles and Over-payment Rules submitted by WNR following the 2006 review of these two documents. The Authority carried out a public consultation process during the course of its assessment in

2006. In its determination, the Authority stipulated the requirement for the next review to commence in October 2010 and every five years thereafter.

15. Under Part 5 of the Code (Section 45), the Authority is required to undertake public consultation prior to making determinations on two of the Part 5 instruments (Train Management Guidelines and Statements of Policy) but not in relation to the other two Part 5 instruments. However, the Authority decided that a consistent approach to public consultation should be followed and invited public submissions on all Part 5 instruments.
16. In consideration of the Costing Principles and Over-payment Rules, the Authority recognises the need to ensure that operators' interests are protected and that WNR is not prevented from making a fair and reasonable return on its rail investments.

Legislative Considerations

17. The key areas of the Code and the Act that have relevance to the formulation and application of the Costing Principles are as follows:

- (a) Definitions of Costs (Clauses 1 and 2, Schedule 4 of the Code)

All costs referred to under the Code are those that would be incurred by adopting efficient practices in the provision and management of railway infrastructure, including the practice of operating a particular route in combination with other routes to achieve efficiencies.

Incremental costs are the operating costs and, where applicable, capital costs and overheads that the railway owner would be able to avoid in respect of the 12 months following the proposed access.

Operating Costs are the train control, signalling and communications, infrastructure maintenance, train scheduling, emergency management and information reporting costs. The cost of maintaining the railway infrastructure is to be calculated on the basis that cyclical maintenance costs are evenly spread over the maintenance cycle. All cost items are to be based on the costs that would be incurred if the infrastructure were replaced using modern equivalent assets (**MEA**).

Capital Costs are the costs comprising both depreciation and risk-adjusted return on the relevant railway infrastructure. It is to be determined using an annuity formula by applying the Gross Replacement Value (**GRV**) of the infrastructure as the principal, the Weighted Average Cost of Capital (**WACC**) as the rate of return and the economic life of the asset in years. The GRV of the rail infrastructure is calculated as the lowest current cost to replace existing assets that have the capacity to provide the level of service that meets the actual and reasonable projected demand and are if appropriate, MEA.

Total costs include the total of all operating and capital costs and overheads attributable to the performance of the access-related functions of the railway owner.

(b) Determination of the WACC (Clause 3, Schedule 4 of the Code)

The Authority is required to determine, as at 30 June each year, the WACC for the railway infrastructure associated with the networks described in Schedule 1 of the Code. From 2003 and every five years thereafter, the Authority is to publicly consult when determining the WACC.

(c) Nature of costs (Clause 4, Schedule 4 of the Code)

All costs are to be those that would be incurred by adopting efficient practices for the provision of railway infrastructure, including the practice of operating a particular route in combination with other routes to achieve efficiencies.

(d) Allocation of costs to determine the floor (Clause 7, Schedule 4 of the Code)

The floor cost of a route and associated railway infrastructure is the incremental cost resulting from the combined operations of all operators and other entities on that route and use of that infrastructure.

(e) Allocation of the costs to determine the ceiling (Clause 8, Schedule 4 of the Code)

The ceiling cost of a route and associated railway infrastructure is the total cost attributable to that route and infrastructure.

(f) Determination of the floor and ceiling costs on routes for which access proposals are likely to be made (Clause 9, Schedule 4 of the Code)

The Authority is required to nominate the routes which it considers that proposals for access are likely to be made and ask the railway owner to propose the floor and ceiling costs for these routes. The Authority will make a determination on these costs and will seek public comment before making the final determination.

(g) Determination of the floor and ceiling costs on routes which have not been assessed under Clause 9 (Clause 10, Schedule 4 of the Code)

When a proposal is made on a route where floor and ceiling costs have not previously been determined by the Authority, the railway owner will be required to notify the Authority of its costs. The Authority will either approve the railway owner's proposed costs or make an appropriate determination of the costs. In both instances, the Authority may seek public comment on the determination, as long as the time limit imposed on the railway owner to present to the operator a draft access agreement for consideration is not breached. This time constraint can be waived by the operator who is seeking access (Clause 11, Schedule 4 of the Code).

18. The key areas of the Code and the Act that have relevance to the formulation and application of the Over-payment Rules are as follows:

Clause 8 of Schedule 4 of the Code states:

- (1) An operator that is provided with access to a route and associated railway infrastructure must pay for the access no more than the total costs attributable to that route and that infrastructure.

(2) For the avoidance of doubt it is declared that the calculation of total costs under subclause (1) -

(a) is for the whole of the route and associated railway infrastructure; and

(b) is to be the same for all operators,

regardless of the extent of the operations or use of the route and infrastructure by any particular operator.

(3) The total of –

(a) the payments to the railway owner by –

(i) all operators;

(ii) all other entities,

that are provided with access to a route, or part of a route, and associated railway infrastructure (“the route”); and

(b) the revenue that the railway owner’s accounts and financial statements show as being attributable to its own operations on the route,

must not be a sum that is more than the total costs attributable to the route.

(4) It is not a breach of this clause for –

(a) payments to the railway owner mentioned in subclause (1) to exceed the total costs referred to in that subclause; or

(b) the total sum mentioned in subclause (3) to exceed the total costs referred to in that subclause

if the over-payment rules approved or determined under section 47 are complied with.

19. The Act also provides a framework within which the Authority’s determination required under Section 46 of the Code is to be made. Section 20(4) of the Act states:

In performing functions under the Act or the Code, the Regulator is to take into account -

(a) the railway owner’s legitimate business interests and investment in the railway infrastructure;

(b) the railway owner’s cost of providing access, including any costs of extending or expanding the railway infrastructure, but not including costs associated with losses arising from increased competition in upstream or downstream markets;

(c) the economic value to the railway owner of any additional investment that a person seeking access or the railway owner has agreed to undertake;

(d) the interests of all persons holding contracts for the use of the railway infrastructure;

(e) firm and binding contractual obligations of the railway owner and any other person already using the railway infrastructure;

- (f) the operational and technical requirements necessary for the safe and reliable use of the railway infrastructure;
- (g) the economically efficient use of the railway infrastructure; and
- (h) the benefits to the public from having competitive markets.

The nature of the decision-making power given to the Authority under Section 47 of the Code is mandatory in that the Authority must take into account all factors listed in Section 20(4) of the Act. However, the Authority has the discretion to allocate such weight to each of the factors listed in Section 20(4) of the Act as it considers appropriate for each particular case.

Public Consultation

20. On 6 October, the Authority issued a notice calling for submissions from interested parties on WNR's proposed revised Costing Principles and Over-payment Rules. One public submission was received, from Co-operative Bulk Handling Limited. This submission is available on the Authority's website (www.erawa.com.au).
21. Some of the comments in CBH's submission fall outside the scope of the review. The Authority's determination is limited to the scope of this review and consequently, comments which fall outside this scope have not been considered by the Authority in making its determination.
22. The following issues raised by CBH have nonetheless been noted by the Authority:
 - CBH has submitted that, in relation to the allocation of revenues described in the Over-payment Rules, there is a degree of uncertainty as WNR has defined only 22 route sections in the Over-payment Rules. CBH has requested that a more comprehensive list of route sections be created so that costs and revenues can be "properly tracked".

The list of route sections for which WNR is required to calculate floor and ceiling costs appears in annexure 7.3 of WNR's Costing Principles, and in section 2.1 of WNR's Over-payment Rules. This list of route sections has been arrived at on the basis that WNR should be required to calculate floor and ceiling costs for lines which are likely to be subject to a proposal for access.

The Authority notes that section 2.1 of WNR's Over-payment Rules states that:

The following division of the freight network has been proposed by WNR and approved by the ERA. These route sections were selected on the basis of differences in track characteristics and traffic densities, and may be redefined over time, subject to approval by the ERA.

None of the route sections nominated in WNR's Costing Principles and Over-payment Rules are currently subject to an access arrangement or proposal. The Authority will not require WNR to amend the list to include all route sections which are not subject to access proposals. The provisions in the Code relating to nomination by the Authority of routes it considers are likely to

be subject to an access proposal, are outlined in Clause 9, Schedule 4 of the Code.

Section 1.4 of WNR's Costing Principles states:

The route section for key parts of the network, which will be used in the application of these Costing Principles, are included as Annexure 7.3. If Floor and Ceiling costs calculations are required for the rest of the network in Schedule 1 of the Code, they will be provided to access seekers in accordance with Section 9(1) of Part 2 of the Code.

- CBH has suggested that if there are government contributions to further development of WNR's infrastructure, WNR should not be permitted to increase the Gross Replacement Value (GRV) to allow for a return on capital which was not WNR's contribution.

The Authority notes that WNR's Costing Principles adequately address this issue. Section 2.3 of WNR's Costing Principles states:

...the value of the contributed capital will be accounted for as an equivalent annuity payment which is to be included in the revenue earned on the asset, for the purpose of the Ceiling Price Test.

This revenue amount is referred to as "Non-access Revenue" in section 2.3 of WNR's Over-payment Rules.

- CBH also commented that some parts of WNR's grain network do not meet the Modern Equivalent Assets (MEA) standard and therefore the attribution of the MEA standard is inappropriate for those sections for the purpose of determination of the ceiling costs.

This issue is not considered further in this review as WNR's Costing Principles (section 2.3) state that:

Where the ceiling costs calculated for a specific route using MEA is significantly higher than the existing infrastructure calculation, the ERA may determine that it is not appropriate to apply MEA. Under these conditions the pre existing infrastructure may be used in determining the Ceiling Costs if the existing infrastructure meets current and anticipated operational and safety standards and if the infrastructure components are available in the market.

The application of an MEA standard to the calculation of GRV is an issue for consideration in conjunction with a floor and ceiling costs proposal by WNR.

- CBH expressed the view that the increase in Weighted Average Cost of Capital (WACC) sought by WNR is inappropriate, given the condition of a portion of WNR's grain network, the lack of capital allocated to this portion and the general return on capital.

The determination of the WACC value to apply to the WNR network is the responsibility of the Authority and is not an issue for consideration in this determination. This issue is open for public comment only in conjunction with the Authority's regular WACC determinations.

REASONS FOR THE FINAL DETERMINATION

Discussion of the issues

23. The amendments proposed by WNR to its Costing Principles and Over-payment Rules, issues raised by public submission and additional issues identified by the Authority are discussed below.
24. The discussion of each of these items commences with an outline of the proposal by WNR, relevant public comments on these items, and is followed by the Authority's assessment and final determination.

Changes proposed by WNR to its Costing Principles

Change 1 – Section 2.5

25. WNR has proposed to update section 2.5 of its Costing Principles to nominate the WACC for its network as determined by the Authority to apply from 1 July 2010 to 30 June 2011.

Public Comments

26. No relevant public comments were received on this proposal. As noted previously, CBH commented on the quantum of the WACC determined by the Authority and this is a matter which is not relevant to this determination.

Authority's Assessment

27. The Authority does not agree with WNR's proposal to nominate the WACC value in its Costing Principles as this value is determined each year by the Authority.
28. If a WACC value is nominated in WNR's Costing Principles, that value would become redundant within 12 months, when the WACC value is re-determined by the Authority.
29. The Authority notes that a WACC value has previously been nominated in WNR's Costing Principles, but considers that this is now not appropriate.
30. Therefore, the Authority's view is that WNR should remove the WACC value shown in section 2.5 of its Costing Principles and should instead refer to the annual determination of the WACC by the Authority.

Final Determination

Required Amendment 1

Section 2.5 of the Costing Principles should be amended by deleting the first sentence and replacing this sentence with the following text:

“In accordance with the Code, the WACC as applied to WestNet Rail will be determined by the ERA and reviewed (by the ERA) each year at 30 June.”

Change 2 – Section 5.1

31. WNR has proposed that section 5.1 of its Costing Principles be amended such that the calculation of the CPI variation to apply to the annual adjustment of WNR’s floor and ceiling costs is made on the basis of the percentage change in CPI in the March quarter of each year from the March quarter of the previous year.
32. The calculation of the CPI variation to apply to the annual adjustment of WNR’s floor and ceiling costs is currently described in WNR’s Costing Principles as:

“The annual change in CPI is 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 relevant CPI is the Weighted Average of Eight Capital Cities All Groups CPI.

33. WNR has indicated to the Authority that it has concerns relating to the ongoing application of this formula on two grounds:
 - WNR is not aware of this type of variation formula being used in other jurisdictions; and
 - WNR considers that it is not appropriate to use an index which is based on data up to two years old.

Public Comments

34. No public comments were received on this proposal.

Authority’s Assessment

35. The Authority acknowledges WNR’s concern that the current formula for CPI indexation relies on some data which is two years old.
36. The Authority notes that the inclusion of the current formula in WNR’s Costing Principles provides an average increase over all four quarters of each year, and therefore smooths annual CPI-based indexation.
37. The Authority notes that there were no objections to the proposal by WNR to amend this formula.
38. The Authority accepts the amended formula as proposed, as quarter-on-quarter CPI adjustment is standard Authority practice for some other regulatory purposes.

39. To ensure continuity within the current regulatory period, the amended formula will not apply until after the next determination of floor and ceiling costs for WNR.

Changes proposed by WNR to its Over-payment Rules

40. WNR has proposed to change the text of four sections of its Over-payment Rules. WNR has proposed some changes to terminology, to ensure consistency with its Costing Principles and the Code. These include changing “WNR” to “WestNet” and capitalising terms defined in the Code, such as ‘Operator’ and ‘Railway Owner’. Proposed changes to the relevant sections are shown below. Only material additions are underlined.

- Section 2.4 (*Breaches of the Ceiling Price Test*), last paragraph:

If breaches of the Ceiling Price Test occur as a result of variations in traffic volume or revenue that are deemed to be temporary or unpredictable in nature, and if WestNet has Access Agreements with Operators under the Code, then WestNet will advise the ERA of such circumstances and will follow the procedure set out in these over-payment rules to deal with such over-payments.

- Section 2.5 (*Over-payments and under-recoveries*), third paragraph:

The ERA has determined that net over-payments will be assessed over a successive three year period, during which overpayments in a particular year may be balanced out by under-recoveries in a subsequent year or preceding year within the three year period. Net over-payment in a three year period will be paid back to Operators according to these Over-payment Rules.

- Section 2.7 (*Allocation of Non-Access Revenue*), second paragraph:

[...] Where capital is spent over multiple route sections, the actual expenditure will be allocated appropriately into each route section based on the actual expenditure on each individual route section at the time it was incurred. The allocation principles for Access Revenue do not apply to Non-Access Revenue.

- Section 3.15 (*The Over-payment Rules*) text to be inserted:

If there are Operators with Access Agreements under the Code, then the Over-payment Accounts must be audited each year by an independent auditor appointed by WestNet at WestNet’s expense. The audit must be completed by 31 August. The audit will ensure that each of the amounts credited to the Over-payment Account is correct and in respect of the audit for the year which is the end of the 3 year period that the interest credited and payment of amounts from the Over-payment Account is appropriate and consistent with the Over-payment Rules. The auditor’s report is to be provided to the ERA as soon as it is completed, and is to be confirmed by the ERA.

41. WNR has proposed to change the text of three definitions in Section 6 (*Definitions*) as follows:

- Access Agreement:

Means an agreement in writing entered into by an Operator and WestNet for access by the Operator to the Network.

- Non-Access Revenue:

Means revenue other than Access Revenue received by WestNet that may include private and government contributions in accordance with the ERA's approved set of Costing Principles to apply to WestNet.

- Operator:

Means an entity to which WestNet provides access to the Network under an Access Agreement.

Public Comments

42. No public comments were received on these proposed changes.

Authority's Assessment

43. In regard to the changes proposed to Section 2.4, the Authority's view is that WNR's Over-payment Rules apply to "Operators who are provided with access under the Code" (last dot point on page 3 of the Over-payment Rules), which is sufficient to establish that these rules do not apply to out-of-Code operators. Therefore, the Authority does not consider the amendment to this section to be necessary.
44. In regard to the changes proposed to Section 2.5, the Authority does not consider amendment of this section to be necessary as section 2.5 adequately deals with calculations of the over-payments and under-recoveries.
45. In regard to the changes proposed to Section 2.7, the Authority considers that this section adequately deals with the allocation of the non-access revenue, therefore does not consider the amendment of this section to be necessary.
46. In regard to changes proposed to section 3.15, as previously noted, the Authority considers that WNR's Over-payment Rules apply to operators who are provided with access under the Code and as such this is sufficient to establish that the Over-payment Accounts must be audited every year if there are operators with access agreements under the Code.
47. However, on the basis that the proposed changes are declaratory in nature and there were no objections to the amendments proposed by WNR to sections 2.4, 2.5, 2.7, 3.15, the Authority accepts these proposed amendments.
48. The Authority also accepts WNR's proposed changes to Section 6 (Definitions) as these changes do not alter the meaning of these terms and the new definitions are consistent with those stipulated in the Code.

Additional issues raised in public submissions

49. No relevant additional issues were raised by public submission.

Further issues identified by the Authority

50. The Authority notes that ownership of WNR is now 100 per cent Prime Infrastructure and not 51 per cent Babcock and Brown Infrastructure and 49 per cent Babcock and Brown investment vehicles, as listed in the proposed Costing Principles.

51. This issue is dealt with summarily and requires an amendment to the proposed Costing Principles.
52. The Authority notes that Section 2.3 of the Costing Principles, *Gross Replacement Values*, contains outdated information related to the modern equivalent assets on several sections of the WNR railway network. In this section, under the heading “Modern Equivalent Assets”, the first two dot points state that:
 - *75 kilometres of timber sleepered track in two sections between Koolyanobbing and Kalgoorlie where concrete sleepers rather than timber sleepers have been used as MEA. Both sections will be replaced with concrete sleepers in 2007;*
 - *concrete sleepers have also been considered to be MEA on the South West mainline between Kwinana and Picton Inner Harbour; Stage 1 Kwinana to Pinjarra and Stage 2 Brunswick to Bunbury Inner Harbour are complete with the remaining sections to be undertaken within the next 2/3 years.*
53. These upgrades were completed by the end of the 2009 financial year. The qualifications which relate to these upgrades proposed by WNR in its Costing Principles are no longer required.
54. The Authority requires that the proposed Costing Principles be amended by correcting section 2.3 as indicated above.

Final Determination

Required Amendment 2

- Section 1.1 of the Costing Principles should be amended to state the current ownership of WNR.
- Section 2.3 of the Costing Principles should be amended by removing the first two dot points under the “Modern Equivalent Assets” heading, as they are no longer required.