Review of the Railways (Access) Code 2000

Final Report

December 2011

Economic Regulation Authority
WESTERN AUSTRALIA

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EXECUTIVE SUMMARY

1. This review of the *Railways (Access) Code 2000* (**Code**) is being undertaken pursuant to the provisions of section 12 of the *Railways (Access) Act 1998* (**Act**).

2. In October 2009, the Economic Regulation Authority (**Authority**) invited submissions from interested parties on matters in relation to this review and published an issues paper to assist interested parties in making their submissions on the review.

3. In November 2010, the Authority published its draft report on the review of the Code.

4. The draft report listed six recommendations on which the Authority sought comment from interested parties. These recommendations are referred to as Draft Recommendations in this final report. Public comments received on each of the Draft Recommendations are addressed in this final report.

5. In addition to the comments relating to Draft Recommendations, some additional issues raised in public submissions are also addressed in this final report.

List of Recommendations

Final Recommendation 1

Part 2A of the Code should be amended by adding a further requirement that the information required to be provided by a railway owner as described under sections 6(a) and 6(b) of the Code should be published on the railway owner's website. If a railway owner does not have a website, but information relating to the railway is maintained on the website of an associated company, then the required information as described under sections 6(a) and 6(b) should be published on that company's website.

Final Recommendation 2

Section 7 of the Code should be amended by adding a new sub-section noting that any capacity information provided by the railway owner must be compiled on a reasonable basis consistent with the railway owner's obligation under section 16(2) not to unfairly discriminate between the proposed rail operations of a proponent and the rail operations of the railway owner.

Final Recommendation 3

Section 25 of the Code should be amended such that the definition of disputes includes all information provision and negotiation obligations on railway owners, which are relevant to access seekers, under Parts 2 and 3 of the Code.

Final Recommendation 4

Part 5 of the Code should be amended as follows:

- **Section 42 should be revised to only require public consultation for variations to segregation arrangements considered by the Authority to constitute a material change.**

- **Section 45 should include the costing principles and over-payment rules in order to ensure consistency in the public consultation process across all Part 5 instruments.**

- **A new provision should be added to provide for the review of all Part 5 instruments every 5 years or as otherwise determined by the Authority.**

Final Recommendation 5

Sections 52(1), 52(2), 52(3), 52(4) and 53 of the Code should be deleted as these transitional provisions are no longer relevant.

Final Recommendation 6

Schedule 1 should be amended as follows:

- Item 52 should be amended by replacing the words "... the railway constructed pursuant to the TPI Railway and Port Agreement" with "... the railway constructed pursuant to the TPI Railway and Port Agreement and defined as 'Railway' in that Agreement".

Schedule 4 should be amended as follows:

- Item 50A of Schedule 1 should be added to clause 3(1)(a)(i) of Schedule 4.
- Clause 3(1)(a)(ii) should be amended by replacing the words "in the other items in that schedule" with "in items 1 to 48 in that Schedule".
- Clause 3(2) should be amended to ensure that the public consultation arrangements set out in sections 3(3) to 3(5) of Schedule 4 apply to the initial WACC determination for any new railway which comes under the Code.

Final Recommendation 7

The Department of Treasury undertake further consultation in relation to the specific considerations a railway owner should be allowed to take into account when providing differential treatment to prospective operators, and Section 16 of the Code should be amended to provide a non-exclusive list of those considerations.

Final Recommendation 8

The Department of Treasury undertake further consultation in relation to the desirability of requiring a standing set of model Part 5 instruments to be maintained by the Authority, and if desirable, that these model Part 5 instruments should apply to all new railways from a date six months prior to the commencement of the operations of the railway.

INTRODUCTION

Background

6. The main objective of the Act is to establish a rail access regime that encourages the efficient use of and investment in railway facilities within a contestable market for rail operations.

7. Part 2 of the Act provides for the establishment of the Code as subsidiary legislation. The Code contains provisions as set out under the requirements of Part 2 of the Act, including the process for the negotiation of access agreements between the railway owner and the entity seeking access, the arbitration of disputes during the course of such negotiations and the Regulator's role in this process.

8. The Authority is the Regulator responsible for administering the Act and the Code.

9. Under Section 12, Part 2 of the Act, the Authority is required to commence a review of the Code on the third anniversary of its commencement and every five years thereafter. The Code commenced on 1 September 2001.

10. The Department of Treasury and Finance identified a need for certain changes to be made to the Code in a public consultation paper in November 2003. At that time, the Code had been in operation for over two years. Included in the amendments proposed by the Department and enacted by the Government on July 2004 were provisions to expand the extent of negotiable access to include expansions/extensions to a route. These amendments were aimed at improving the effectiveness of the Code.

11. In October 2004, the Authority commenced its first review of the Code pursuant to the Act requirements. The Authority's final report on the first review was provided to the Treasurer on 23 September 2005 and published by the Authority on 5 December 2005. The Treasurer gazetted amendments to the Code, following consideration of that final report, on 23 June 2009.

12. On 23 September 2011, the Treasurer gazetted further amendments to the Code to allow railway owners to recover land and land-related costs. These amendments have pre-empted consideration of some of the issues raised in public submissions to the Authority's draft report – including comments provided by the Department of Treasury and Finance - and so these issues will not be discussed further in this report.

Legislative Requirements

13. As noted above, under Section 12(1) of the Act, the Authority is required to commence a review of the Code on the third anniversary of its commencement and every five years thereafter.

14. As the Code commenced in 2001, the second review was required to commence in 2009, five years after the third anniversary of the Code's commencement.

15. Section 12(2) of the Act stipulates that:

> The purpose of the review is to assess the suitability of the provisions of the Code to give effect to the Competition Principles Agreement in respect of railways to which the Code applies.

16. Sections 12(3) to 12(5) of the Act set out the requirements for the public consultation to be undertaken by the Authority as part of its review process.

17. In accordance with section 12(6) of the Act, the Authority is required to prepare a report on the review and give it to the Treasurer.

18. Copies of the Act and the Code are available on the Authority's website (www.erawa.com.au).

Scope of the Review

19. Part 2 of the Act sets out provisions relating to the establishment of a Code.

20. Section 4(1) of Part 2 of the Act, states that "The Minister is to establish a Code in accordance with this Act to give effect to the Competition Principles Agreement in respect of railways to which the Code applies".

21. The Competition Principles Agreement (**CPA**) is defined in the Act as "the Competition Principles Agreement made on 11 April 1995 by the Commonwealth, the States and the Territories as in force for the time being".

22. The CPA provides a framework to allow third parties to access significant infrastructure facilities which exhibit natural monopoly characteristics and cannot be duplicated economically.

23. The definition under the Act means that the relevant version of the CPA of 11 April 1995, for the purpose of the Code review, is the most recent version of this agreement. The Authority understands that the CPA of 11 April 1995, as amended to 13 April 2007, is the most recent version.

24. As noted previously, section 12(2) of the Act requires the Authority's review of the Code to assess the suitability of the provisions of the Code to give effect to the CPA in respect of railways to which the Code applies.

25. Therefore, under the scope of this review, the Authority can only give consideration to amendments to the Code which are not inconsistent with the CPA (as amended to 13 April 2007) or with relevant provisions of the Act, including those set out under Part 2 of the Act.

26. Some comments made in the public submissions are outside the scope of this review including some matters which are dealt with under the Act. These comments have consequently not been referred to in the discussion of issues set out in this final report.

Consultation

27. The Authority published a draft report in November 2010 and invited submissions on the recommendations contained in that draft report.

28. Seven submissions were subsequently received, from:

- Association of Mining and Exploration Companies (**AMEC**)
- API Management (**API**)
- Co-operative Bulk Handling (**CBH**)
- North West Infrastructure (**NWI**)
- Oakajee Port and Rail (**OPR**)
- Roy Hill Infrastructure (**RHI**)

- WestNet Rail (**WNR**)

29. All submissions have been published on the Authority's website.

30. Subsequent to the receipt of these submissions, the Authority's Secretariat held meetings with some of the parties who had made submissions in order to clarify particular issues relating to the valuation methodology for determining costs.

31. The Authority acknowledges the change of name of the owner (lessee) of the WA freight network from WestNet Rail to Brookfield Rail which became effective on 17 July 2011. As the submissions received from WNR and from other stakeholders referred to the owners of the freight network as WNR, the Authority will maintain references to Brookfield Rail's former name in this final report.

KEY ISSUES

32. In this final report, discussion of issues is presented in the same order in which the Draft Recommendations were presented. These were presented in line with the structure of the Code, as shown below:

- Part 2A – *Publication of information*
  Draft Recommendation 1 applies to Part 2A
- Part 2 – *Proposals for access*
  Draft Recommendation 2 applies to Part 2
- Part 3 – *Negotiations (Division 3)*
  Draft Recommendation 3 applies to Part 3
- Part 5 – *Certain approval functions of the Regulator*
  Draft Recommendation 4 applies to Part 5
- Part 6 – *General*
  Draft Recommendation 5 applies to Part 6
- Schedules
  Draft Recommendation 6 applies to the Schedules

33. The discussion of issues as they pertain to each part of the Code will be divided into sections reflecting public comment on the recommendations contained in the draft report and the Authority's final recommendation. The sections for discussion of issues pertaining to each part of the Code will be as below:

- *Code Provisions* – a description of the purpose of that part of the Code.
- *Draft Recommendation* – a restatement of the Draft Recommendations which pertain to that part of the Code.
- *Public Submissions on Draft Recommendation* – comments received in submissions which relate to the Draft Recommendations.
- *Authority's Assessment.*
- *Final Recommendation* – the Authority's final recommendation on issues raised in relation to the relevant Draft Recommendation.

34. This final report includes a section describing additional issues raised in public consultation. This section includes Authority final recommendations in relation to these additional issues, where appropriate.

35. This final report includes an Appendix which provides an assessment of the issues bearing on that part of Draft Recommendation 6 which relates to the valuation method prescribed in Schedule 4. These issues are addressed in a separate Appendix due to the comprehensive comments received on this element of Draft Recommendation 6.

Part 2A – Publication of information

Code Provisions

36. Part 2A of the Code deals with the publication of information by the railway owner. The purpose of this section is to provide entities interested in seeking access to the railway with preliminary information (required information) on the railway network. In particular, Schedule 2 specifies the level of information required to be provided to prospective access seekers by the railway owner for each route section. The railway owner must make this required information available, in a publication, to prospective access seekers at a reasonable price.

Draft Recommendation

37. Draft Recommendation 1 addressed the provisions of Part 2A of the Code.

Draft Recommendation 1

Part 2A of the Code should be amended by adding a further requirement that the information required to be provided by a railway owner as described under sections 6(a) and 6(b) of the Code should be published on the railway owner's website. If a railway owner does not have a website, but information relating to the railway is maintained on the website of an associated company, then the required information as described under sections 6(a) and 6(b) should be published on that company's website.

Public Submissions on Draft Recommendation

38. The submission provided by AMEC (page 1) supported Draft Recommendation 1.

39. The submission provided by API (paragraph 2.1.5, page 3) supported Draft Recommendation 1.

Authority's Assessment

40. In the absence of any views opposing Draft Recommendation 1, the Authority upholds that recommendation.

Final Recommendation

Final Recommendation 1

Part 2A of the Code should be amended by adding a further requirement that the information required to be provided by a railway owner as described under sections 6(a) and 6(b) of the Code should be published on the railway owner's website. If a railway owner does not have a website, but information relating to the railway is maintained on the website of an associated company, then the required information as described under sections 6(a) and 6(b) should be published on that company's website.

Part 2 – Proposals for access

Code Provisions

41. Part 2 of the Code deals with proposals made to the railway owner for access to the railway owner's network.

42. Section 7 sets out details of the preliminary information which an entity seeking access can request from the railway owner.

43. Sections 8 and 9A set out the requirements which an entity making a proposal for access (proponent) must meet in terms of the proposal and any subsequent withdrawal of the proposal.

44. The railway owner's obligations on receipt of a proposal from a proponent are set out in section 9.

45. Sections 10 and 11 deal with the railway owner's obligation to seek the Authority's approval should a proposal, under section 10(1)(b), be likely to preclude other entities from access to that infrastructure.

46. Section 10, in particular, requires that if a railway owner considers that providing access will preclude other entities from access, negotiations on the proposal must not be entered into without the approval of the Regulator, who must approve allocation of the last available capacity. Section 11 relates to time limits applicable to section 10.

47. Section 12 deals with the requirement for the railway owner to maintain a register of all proposals.

Draft Recommendation

48. Draft Recommendation 2 addressed the provisions of Part 2 of the Code.

Draft Recommendation 2

Section 7 of the Code should be amended by adding a new sub-section noting that any capacity information provided by the railway owner must be compiled on a reasonable basis consistent with the railway owner's obligations under section 16(2) not to unfairly discriminate between the proposed rail operations of a proponent and the rail operations of the railway owner.

Public Submissions on Draft Recommendation

49. The submission provided by AMEC (page 2) supported Draft Recommendation 2.

50. The submission provided by API (paragraph 2.2.5 page 3) supported Draft Recommendation 2, with the following comment:

> *API acknowledges that access seekers should also be provided with forecasts of available capacity over future years, but only to the extent that such information can be reasonably forecasted [sic] by a railway owner, taking into account a railway owner's obligations not to unfairly discriminate.*

Authority's Assessment

51. In the absence of any views opposing Draft Recommendation 2, the Authority upholds that recommendation.

Final Recommendation

Final Recommendation 2

Section 7 of the Code should be amended by adding a new sub-section noting that any capacity information provided by the railway owner must be compiled on a reasonable basis consistent with the railway owner's obligation under section 16(2) not to unfairly discriminate between the proposed rail operations of a proponent and the rail operations of the railway owner.

Part 3 – Negotiations (Division 3)

Code Provisions

52. Part 3, Division 3 of the Code deals with the arbitration process for disputes between the railway owner and a proponent in the negotiation of access agreements.

53. Under the arbitration process set out in Part 3, Division 3, the Authority is required to appoint an arbitrator (section 26(2)) to hear the dispute. The arbitrator is required to carry out the arbitration process under the *Commercial Arbitration Act 1985* subject to the provisions set out under sections 28 to 35 of the Code.

54. Section 25 sets out the circumstances which constitute "disputes" under the Code in relation to the negotiation of access agreements. Proponents are able to refer these disputes to arbitration through notification to the Authority under section 16(1).

Draft Report Recommendation

55. Draft Recommendation 3 addressed the provisions of Part 3 of the Code.

Draft Recommendation 3

Section 25 of the Code should be amended such that the definition of disputes includes all the information provision and negotiation obligations on railway owners, which are relevant to access seekers, under Parts 2 and 3 of the Code.

Public Submissions on Draft Recommendation

56. The submission provided by AMEC (page 2) supported Draft Recommendation 3.

57. API commented, in its submission (paragraph 2.5.2, page 4) that it does not support any amendment to section 25 as to what constitutes a 'dispute'. API noted that the wording of section 25 defines a dispute as an access seeker's grievance with a railway owner. API considers that the wording of sections 25 and 26 be amended to allow either party to refer the dispute to arbitration.

58. The submission provided by NWI (second paragraph of page 6) includes the following statement:

> *Due to the potential information imbalance between the parties, NWI submits that it is difficult for an access seeker to reliably determine whether the proponent is negotiating in good faith. It remains difficult for an access seeker to challenge a proponent in these circumstances.*

Authority's Assessment

59. The Authority considers that the provisions of sections 25 and 26 are intended to provide the access seeker with recourse to arbitration if the access seeker is of the view that they may have been discriminated against, or that available information has been withheld. The Authority is therefore of the view that these sections of the Code are intended to provide protection to access seekers and are not intended to provide a recourse to arbitration by railway owners.

60. The Authority upholds Draft Recommendation 3.

Final Recommendation

Final Recommendation 3

Section 25 of the Code should be amended such that the definition of disputes includes all information provision and negotiation obligations on railway owners, which are relevant to access seekers, under Parts 2 and 3 of the Code.

Part 5 – Certain approval functions of the Regulator

Code Provisions

61. Part 5 of the Code sets out the approval functions of the Authority in relation to the Part 5 instruments. The provisions under Part 5 require a railway owner to submit these instruments to the Authority for approval, consisting of the train management guidelines, the train path policy, the costing principles and the over-payment rules.

62. Part 5 also contains provisions relating to the public comment process which must be undertaken by the Authority on the railway owner's train management guidelines, train path policy (section 45) and segregation arrangements (section 42) before the Authority can approve these documents.

Draft Recommendation

63. Draft Recommendation 4 addressed the provisions of Part 5 of the Code.

Draft Recommendation 4

Part 5 of the Code should be amended as follows:

- *Section 42 should be revised to only require public consultation for variations to segregation arrangements considered by the Authority to constitute a material change.*
- *Section 45 should include the costing principles and over-payment rules in order to ensure consistency in the public consultation process across all Part 5 instruments.*
- *A new provision should be added to provide for the review of all Part 5 instruments every 5 years or as otherwise determined by the Authority.*

Public Submissions on Draft Recommendation

64. The submission provided by AMEC (page 2) supports Draft Recommendation 4.

65. The submission provided by API (paragraph 2.7.3, page 6) supports the amendments to Part 5 proposed in Draft Recommendation 4.

Authority's Assessment

66. In the absence of any views opposing Draft Recommendation 4, the Authority upholds that recommendation.

Final Recommendation

Final Recommendation 4

Part 5 of the Code should be amended as follows:

- Section 42 should be revised to only require public consultation for variations to segregation arrangements considered by the Authority to constitute a material change.
- Section 45 should include the costing principles and over-payment rules in order to ensure consistency in the public consultation process across all Part 5 instruments.
- A new provision should be added to provide for the review of all Part 5 instruments every 5 years or as otherwise determined by the Authority.

Part 6 – General

Code Provisions

67. Part 6 of the Code deals with general matters including the issue of inquiries and reports by the Authority, obligations on the Authority with respect to confidential information and transitional provisions.

Draft Recommendation

68. Draft Recommendation 5 addressed the provisions of Part 6 of the Code.

Draft Recommendation 5

Section 52(1), 52(2), 52(3), 52(4) and 53 of the Code should be deleted as these transitional provisions are no longer relevant.

Public Submissions on Draft Recommendation

69. The submission provided by AMEC (page 2) supported Draft Recommendation 5.

Authority's Assessment

70. In the absence of any views opposing Draft Recommendation 5, the Authority upholds that recommendation.

Final Recommendation

Final Recommendation 5

Sections 52(1), 52(2), 52(3), 52(4) and 53 of the Code should be deleted as these transitional provisions are no longer relevant.

Schedules

Code Provisions

71. The Code contains five schedules, as follows:

- Schedule 1 – Routes to which the Code applies
- Schedule 2 – Information to be made available
- Schedule 3 – Matters for which provision is to be made in an access agreement
- Schedule 4 – Provisions relating to prices to be paid for access
- Schedule 5 – Relevant provisions of Competition Principles Agreement

Draft Recommendation 6 (Schedule 1)

72. Draft Recommendation 6 addressed the provisions of Schedule 1, in relation to the definition of the railway owned by The Pilbara Infrastructure (**TPI**), as follows:

Draft Recommendation 6 (element relating to Schedule 1)

Schedule 1 should be amended as follows

- *Item 52 should be amended by replacing the words "... the railway constructed pursuant to the TPI Railway and Port Agreement" with "... the railway constructed pursuant to the TPI Railway and Port Agreement and defined as 'Railway' in that Agreement".*

Public Submissions on Draft Recommendation

73. The submission provided by API (paragraph 2.9.3, page 6) supported this recommendation. In relation to this, API submitted that:

> *API recommends that that the amendment reflect, where possible, the defined term contained in the TPI Railway and Port Agreement.*

Authority's Assessment

74. The Authority notes that the API submission appears to suggest that the definition of the TPI railway which appears in the TPI Port and Railway Agreement be adopted verbatim. The Authority notes that the definition quoted in the API submission (paragraph 2.9.3, page 6) cites the initial configuration of the railway, being from the "vicinity of the Chichester Ranges". The Authority is aware that the TPI railway has been extended from its Cloubreak mine to its mine at Christmas Creek, and that further extensions (e.g to the Solomon precinct) are planned.

75. For this reason, the Authority does not propose that the actual current wording of the TPI Port and Railway Agreement be adopted in this regard, but that the Code refer to the definition of the Railway as it is cited in the Agreement, as it may be subject to change from time to time.

76. In the absence of any views opposing this element of Draft Recommendation 6, the Authority upholds that recommendation.

Draft Recommendation 6 (Schedule 2)

77. Draft Recommendation 6 addressed the provisions of Schedule 2, as follows:

Draft Recommendation 6 (element relating to Schedule 2)

Schedule 2 should be amended as follows:

- *Clause 4(g) "the running times of existing trains" should be replaced with "relevant running information for all current scheduled trains or cyclical train movements, as appropriate".*

Public Submissions on Draft Recommendation

78. The submission provided by NWI (page 3) supports the recommended amendment and further comments that the recommended amendment to Clause 4(g) would be improved by articulating that the relevant running information include departure and

arrival times, and should include information in relation to all existing and scheduled future train paths, whether established inside or outside the Code.

79. The submission provided by WNR (pages 10 and 11) strongly opposed this element of Recommendation 6. WNR has provided a comprehensive argument as background to its opposition. This argument relates to security of commercial information regarding its customers' particular train movements, and the inappropriateness of presuming that an access seeker may be able to construct a realistic operating plan without the assistance of the railway owner.

80. The submission provided by API (paragraphs 2.10.3 and 2.10.4, page 7) opposed this element of Recommendation 6. API argued that the items listed in Schedule 2 do not require further clarification, nor is there a need for any further information to be made available by a railway owner.

Authority's Assessment

81. The Authority notes that the Code was amended in June 2009, following the Authority's first review of the Code, to replace the requirement for railway owners to provide "working timetables for the route" with a requirement to provide the "running times of existing trains". This amendment was not recommended in the Authority's review reports, but was first raised following the finalisation of the Authority's final report to the Treasurer. The Authority does not have any background for the reason for the amendment.

82. In view of the currency of the June 2009 amendment, and the concerns raised by railway owners in relation to the security of commercial information relating to their customers train movements, the Authority has decided to no longer require this element of Draft Recommendation 6. The Authority accepts the WNR argument that it is not appropriate to presume that access seekers are able to formulate realistic operations plans autonomously and without the railway owner's input and advice.

Draft Recommendation 6 (Schedule 4)

83. Draft Recommendation 6 also addressed the provisions of Schedule 4. The elements of Draft Recommendation 6 which relate to Schedule 4 were presented under seven dot points, as follows:

Draft Recommendation 6 (elements relating to Schedule 4)

Schedule 4 should be amended as follows:

- *Item 50A of Schedule 1 should be added to clause 3(1)(a)(i) of Schedule 4.*
- *Clause 3(1)(a)(ii) should be amended by replacing the words "in the other items in that schedule" with "in items 1 to 48 in that Schedule".*
- *Clause 3(2) should be amended to ensure that the public consultation arrangements set out in sections 3(3) to 3(5) of Schedule 4 apply to the initial WACC determinations for any new railways which come under the Code.*
- *Unless it can be demonstrated that the Building Block approach could cause an inefficient calculation of ceiling costs, clause 2(4) should be amended to prescribe a Building Block approach to determining costs, in place of the current GRV-based approach.*
- *A definition of the land which is considered necessary to build and operate railway infrastructure under the Code should be added to Schedule 4. This definition should*

be consistent with the land requirements necessary to build and operate the railway infrastructures facilities set out in the definition of 'railway infrastructure' under Part 1 of the Code.

- *The definition of operating costs under clause 1 should be amended to include the costs associated with a railway owner acquiring the right to use land owned or controlled by another party for the purpose of building and operating railway infrastructure.*
- *The definition of capital costs under clause 2 should be amended to include land purchase costs for land acquired for the purpose of building and operating railway infrastructure. The equivalent annual cost, or annuity, for such capital costs should be calculated on the basis of providing a rate of return on such capital but no depreciation.*

84. The aim of the last three dot points above have been reflected in recent amendments to the Code which were formulated by the Department of Treasury and gazetted on 23 September 2011. These amendments broadly reflect the suggested wording provided by the Department of Treasury in its submission to the Issues Paper for this Code Review. Accordingly, the last three dot point elements above will not be discussed further in this report.

85. The fourth dot point above was subject to a large number of comments in public submissions received in response to the draft report. Consideration of issues related to the comments provided in submissions and other issues has resulted in the Authority deciding to no longer require this element of Draft Recommendation 6. The arguments presented in public submissions and other matters associated with administration of the Code in its current form are addressed in the Appendix to this final report, and are not referred to in this section.

86. Further discussion in relation to the Schedule 4 elements of Draft Recommendation 6 in this section of the final report will be confined to comments and issues raised in relation to the first three dot points above only.

Public Submissions on Draft Recommendation

87. The submission provided by API (paragraph 2.11.3, page 7) supported all proposed amendments to Schedule 4.

88. The submission provided by AMEC (page 2) supported all proposed amendments to Schedule 4.

89. There were no further comments received in submissions which addressed the first three dot points of the Schedule 4 elements of Draft Recommendation 6.

Authority's Assessment

90. In the absence of any views opposing the first three dot point elements of Draft Recommendation 6 which relate to Schedule 4, the Authority upholds those elements of Draft Recommendation 6.

Final Recommendation

Final Recommendation 6

Schedule 1 should be amended as follows:

- Item 52 should be amended by replacing the words "... the railway constructed pursuant to the TPI Railway and Port Agreement" with "... the railway constructed pursuant to the TPI Railway and Port Agreement and defined as 'Railway' in that Agreement".

Schedule 4 should be amended as follows:

- Item 50A of Schedule 1 should be added to clause 3(1)(a)(i) of Schedule 4.
- Clause 3(1)(a)(ii) should be amended by replacing the words "in the other items in that schedule" with "in items 1 to 48 in that Schedule".
- Clause 3(2) should be amended to ensure that the public consultation arrangements set out in sections 3(3) to 3(5) of Schedule 4 apply to the initial WACC determination for any new railway which comes under the Code.

ADDITIONAL ISSUES RAISED IN PUBLIC SUBMISSIONS

91. Some comments received in submissions to the draft report contain references to matters which were not raised in the draft report, or in submissions to the earlier issues paper.

92. The Authority notes these comments. However, the Authority considers that it is not appropriate to provide further opportunity for public comment on these issues for the purposes of this final report, in view of the consultation already undertaken in relation to the issues paper and the draft report.

93. The Authority recognises all issues raised in public submissions as important, and has addressed these issues in this final report. Where the Authority considers that further consultation would be useful in relation to any of these issues, a final recommendation is made to that effect.

94. It is anticipated that the Treasurer will note these comments and any related recommendations in this final report and that the Department of Treasury may call for further public comment in subsequent consultation undertaken for this review of the Code.

Clarification of the Term "Unfairly Discriminate"

Comments received in Submissions

95. API submitted (paragraph 2.3.4, page 4) that the term "unfairly discriminate" as referred to in section 16(1)(b) may need to be clarified, and that section 16(1)(b) should be expanded to allow railway owners some discretion in providing to capacity to one access seeker rather than another. API suggested that this section could be amended to include a non-exclusive list of the considerations a railway owner is allowed to take into account in determining whether to choose one access seeker over another.

96. RHI submitted (paragraph 2.1, page 1) that the term "unfairly discriminate" in section 16(2) must be clarified. RHI submitted that there are a number of instances in which a railway owner should be able to treat prospective users differently, and whether this is fair or unfair is an emotive issue calling for value judgement. RHI commented that this uncertainty should be replaced by a more developed test of what type of instances and reasons will give rise to permissible different treatment.

97. RHI referred (paragraph 2.2, page 1) to the definition of "discriminate" and regulation 23 of the *Gas Transmission Regulations 1994* (WA) (now repealed) for a well-constructed and well-drafted approach to the issue of permissible discrimination.

98. There were no comments received in submissions suggesting what particular considerations a railway owner should be allowed to take into account enabling permissible differential treatment of access seekers.

Authority's Assessment

99. The Authority has previously had cause to make confidential enquiries in relation to the implications of section 16 as it relates to the "fairness" of differential conduct by a railway owner in respect of alternative above-rail operations. The Authority therefore recognises the issue of adequately defining the term "unfairly discriminate" as a significant issue for the proper conduct of negotiations conducted under the Code.

100. The Authority notes the wording of regulation 23 of the *Gas Transmission Regulations 1994* (WA) and this wording is reproduced below:

> *Differential conduct towards 2 or more shippers or prospective shippers does not constitute discrimination if the material differences in conduct towards, or in terms, conditions and prices offered or granted to or negotiated by, the shippers or prospective shippers are attributable to one or more of:*
>
> > *(a) material differences in the nature of the shippers or prospective shippers, or of the shippers' or prospective shippers' respective requirements, services, physical conditions, geographical locations or conduct;*
> >
> > *(b) the operation on the corporation or a shipper of force majeure (but not the negotiation under regulation 91 of any term relating to force majeure);*
> >
> > *(c) changes of general application made from time to time in accordance with these regulations in the terms, conditions and prices for a grant of capacity or any other service;*

> *(ca) the fact that one person is a shipper or prospective shipper under a commissioning grant, and the other person is a shipper or prospective shipper under a grant of capacity which is not a commissioning grant;*
>
> *(d) to the extent that a person under an exempted contract is materially advantaged, differences between the terms of these regulations or a transmission contract, and the exempted contract; and*
>
> *(e) the operation of Part 11.*

101. The Authority acknowledges that the particular matters cited in regulation 23 of the *Gas Transmission Regulations 1994* as the basis for justifiable differential conduct are not relevant to railway operations. The Authority nonetheless agrees with RHI that regulation 23 is an example of a well-constructed and well-drafted approach to the issue of permissible discrimination, and is of the view that a similarly well constructed approach, were it incorporated as an amendment to the Code, would improve the operation of the Code.

Final Recommendation

Final Recommendation 7

The Department of Treasury undertake further consultation in relation to the specific considerations a railway owner should be allowed to take into account when providing differential treatment to prospective operators, and Section 16 of the Code should be amended to provide a non-exclusive list of those considerations.

The Application of Part 5 Instruments to Greenfields Railway Owners

Comments received in Submissions

102. API submitted (paragraph 2.7.3, page 6) that it does not consider that all of the provisions relating to Part 5 Instruments can be applied to greenfields railway owners. In particular, API argued that it is difficult to see how a greenfields railway owner would be in a position to prepare train management guidelines, costing principles and over-payment rules.

103. API, from paragraph 4.1.3, page 9, commented that:

> *the Act and the Code were drafted on the basis that they applied to a railway network consisting of:*
>
> *a) the government railways*
> *b) the railways that are on land that is corridor land as defined in the Rail Freight System Act 2000*
> *c) the railway constructed pursuant to the TPI Railway and Port Agreement; and*
> *d) any new railway declared to be a part of the railways network*

API commented that the current provisions of the Code provide a regulatory regime suitable for existing brownfields railways only. API argued that consequently, it is difficult to reconcile the existing provisions of the Code in relation to a greenfields

railway operation, and that it would be difficult for a greenfields railway owner to provide technical information about any aspect of the railway owner's infrastructure that affects the design of rolling stock, or to respond to an access proposal with the information required under Section 9 of the Code.

Authority's Assessment

104. The Authority does not agree with the API submission in respect of the applicability of Part 5 instruments to greenfields railway owners. The experience of the Authority in making determinations of Part 5 instruments for the railway owned and operated by TPI has informed the Authority that there are no impediments to greenfields railway owners having a full and comprehensive understanding of operating procedures and costing principles for their railways.

105. Further, the Authority is of the view that operating principles and costing principles are required to be well understood by prospective railway owners in order to provide feasibility assurances for the development of their projects.

106. The Authority notes that costing principles for new railways under the current valuation method prescribed by the Code should be easily assimilated by greenfields railway owners, as the Code requires asset valuation on a Gross Replacement Value basis. In the case of a new railway built on a best practice and efficient cost basis, replacement cost is equivalent in the first instance to the build cost of the railway.

107. The Authority does not recommend that further consultation be undertaken on this issue.

Timeframe for Submission of Part 5 Instruments

Comments received in Submissions

108. NWI submitted (page 8) that the Code does not specify a definitive timeframe for the submission or approval of Part 5 instruments and, rather, that the Code requires that the information be provided to the ERA "*as soon as is practicable after the commencement*" of the Code.

109. NWI argued that the lack of a definitive timeframe hampers the objective of the Code to provide timely access to prescribed railways and therefore undermines the effectiveness of the Code.

110. NWI also commented that the provisions of Schedule 4 are not sufficiently determinative as to the correct process or specific timetables for the determination of floor and ceiling costs, and to put a railway owner in a position to enable it to comply with the provisions of section 9(c)(1).

111. OPR submitted, at page 31, that specific express provision should be made for greenfields projects. OPRs view is that the Code should be amended to provide for greenfields projects through:

- *A light handed regulation option allowing greater upside returns in exchange for taking greater risks*

- *Less invasive functional segregation requirements to allow for the legitimate benefits of vertical integration to be realised in the critical early years of construction and operation*
- *A 9 month delay in requiring Costing principles to be provided to the ERA following commissioning to allow the operator to gain experience of actual costs and what drives these costs*
- *A longer carry-over period for the over-payment rules to address uncertainty for a greenfields operator in its costs and revenues in the early years of operation due to lack of practical experience of the operation*

Authority's Assessment

112. The Authority agrees that the lack of definitive timeframes for the submission of Part 5 instruments by greenfields railway owners hampers the objective of the Code to provide timely access to prescribed railways, and therefore undermines the effectiveness of the Code.

113. The Authority does not agree that there are impediments to greenfields railway owners having a full and comprehensive understanding of operating procedures and costing principles for their railways.

114. The Authority notes that the provisions of the Part 5 instruments approved for the TPI railway are not differentiable from those which apply to Brookfield Rail (formerly WNR) in any significant commercial respect, except for the inclusion of cyclic train paths in operators' service entitlements. This was allowed in order to enable operators to take advantage of unscheduled opportunities to use port facilities.

115. The Authority notes that the Code allows for the resubmission of Part 5 instruments by railway owners for approval of variations at any time.

116. The Authority notes that the provisions of Part 5 of the Code currently enable the Authority to direct the railway owner to amend any of the Part 5 instruments at any time.

117. The Authority considers, in view of the above two points, that timely application of Part 5 Code provisions to new railways would be achieved if a model set of Part 5 instruments were applied to all new railways from a date six months prior to the commencement of operations of the railway. This would enable the railway owner to propose amendments to that model set of Part 5 instruments, for the Authority's approval, in adequate time for those amendments to be approved prior to commencement of the operations of the railway.

118. It is envisaged that the model set of Part 5 instruments would be based on the current approved Part 5 instruments for TPI, as a workable set of Part 5 instruments suitable for a greenfields railway[1]. It is a consideration for the Treasurer as to whether the Authority or the policy agencies of Government should be responsible for developing any such model set of regulatory instruments. The Authority considers that a model set of instruments should be maintained as a standing set of documents available for the information of prospective railway owners and access seekers. .

[1] . As at the date of release of this report, TPI has not proposed amendments to its Costing Principles to allow the recovery of land related costs, enabled by amendments to the Code gazetted in September 2011.

119. The Authority notes that the WA Government has undertaken to amend the Code to make provision for statutory timelines for the approval of Part 5 instruments. This undertaking is detailed at clause 2.6 of the Competition and Infrastructure Reform Agreement (CIRA 2006). The Authority endorses this undertaking.

Final Recommendation

Final Recommendation 8

The Department of Treasury undertake further consultation in relation to the desirability of requiring a standing set of model Part 5 instruments to be maintained by the Authority, and if desirable, that these model Part 5 instruments should apply to all new railways from a date six months prior to the commencement of the operations of the railway.

Merits Review

Comments received in Submissions

120. OPR commented in its submission (section 9 page 25) that the Code should be amended to provide for all regulatory decisions to be subject to merits review.

Authority's Assessment

121. The Authority's view is that it would be unusual, in the context of the 'light-handed negotiate-arbitrate' nature of the WA Rail Access Regime, for a merits review process to apply to Authority decisions, as the instruments subject to Authority determinations provide only a framework within which the terms of access must be negotiated.

122. The Authority also notes that the WA Rail Access Regime does not share any significant regulatory characteristics with the regimes which apply to other railways in Australia and that it would not be appropriate to compare the Authority's decisions in respect of the WA Rail Access Regime with decisions made by rail regulators in other jurisdictions.

123. The Authority notes that an institutionalised merits review process would add to regulatory costs.

Supply Chain Issues

Comments received in Submissions

124. OPR submitted (paragraph 2.1.2, page 4) that the Code should recognise the supply chain context, in particular in determining the Part 5 Instruments such as the Train Path Policy or Train Management Guidelines.

125. OPR submitted (paragraph 4.6, page 9) that the Code should be amended to require the ERA to consider supply chain issues.

126. OPR acknowledged (footnote 8, page 9) that the recognition of and provision for a railway under the Code being part of an integrated supply chain is not expressly provided for in the Code and that an amendment to the Code is required to clarify this position.

127. RHI supports (from paragraph 3.1, page 2) the position of OPR and argues that the over-riding objective of the Code, as set out in section 4(1) of the Act requires that the Code is established to give effect to the CPA, and that the CPA provides that an access regime should promote the economically efficient use of, operation and investment in, significant infrastructure thereby promoting effective competition in upstream or downstream markets.

128. RHI refers to paragraph 131 of the Authority's draft report which reflects the view that considerations outside of rail network priorities may not guide the application of the Code. RHI argues that this view, which it describes as "limiting and constraining" does not promote effective competition in upstream or downstream markets and therefore does not comply with the CPA.

129. RHI (paragraph 3.5, page 2) argues that:

> *The plain economic reality is that these railway facilities will not be built unless they are part of a vertically integrated operation. It is not economically efficient for a new mine of any significant size to rely on a separate, non-integrated "take your chances when available" railway operation.*

Authority's Assessment

130. Both RHI and OPR refer to paragraph 131 of the Authority's Draft Report. That paragraph acknowledges the commercial imperatives in operating a logistics chain and the potential for operational efficiency gains resulting from co-ordination of its various elements. The Authority has previously made specific consideration of this issue (in the case of the TPI railway network) by allowing the use of cyclic train paths in an operator's service entitlements, in addition to timetabled train paths, in order to allow operators to take advantage of opportunities to use port facilities.

131. Paragraph 131 of the Authority's Draft Report concludes with a statement that it is not appropriate under the current rail legislation for any considerations outside of the rail network priorities to guide the application of the Code, and that this is particularly the case where a third party user wishes to gain access to the railway only and not to any associated downstream facilities, such as port facilities.

132. It is on the basis of this point that the Authority does not accept that limiting the operation of the Code to railway operation imperatives inhibits competition in downstream markets and that, in fact, constraining the operations of an open access railway to the imperatives of an associated downstream infrastructure facility such as a port facility would inhibit the efficient allocation of resources between competing port facilities.

133. The Authority notes that railway owners' own above-rail operations are not required to be subject to Code arrangements whereby the Part 5 instruments must apply, and that these instruments are not required to apply to third party access agreements made outside the Code. The operation of the Code therefore does not necessarily impede the efficient operation of the railway owner's above-rail operations in the context of its own logistics chain.

134. If the Code were amended to require that the imperatives of the logistics chain were recognised in all Code instruments, then there may be a case for the above-rail operation of the railway owner to be required to comply with the full range of Part 5 instruments, such that all above-rail operations are treated equally.

135. Further, the Authority does not accept that railway facilities will not be built if they are not part of a vertically integrated operation. The Authority is aware of the potential feasibility of haulage-only railway operations in the Pilbara.

136. The Authority is mindful that the operation of the Code is not intended to accommodate the integrated rail operations of large mining companies only, but must also be in the best interests of below-rail only operators (such as Brookfield Rail), potential haulage network operators (who may be indifferent to imperatives outside the operation of the railway network) and in the interests of small potential access seekers.

137. The Authority is not aware of any instance where the operation of the Code has worked against the logistics interest of Fortescue Metals Group which to date is the only mining company which owns a vertically integrated railway operation (TPI) which is subject to the WA Rail Access Regime.

138. The Authority accepts that large mining companies will seek to lower costs by operating their logistics chains in the most economically efficient manner. The Authority is also cognisant of the difficulties faced by smaller miners in gaining access to vertically integrated facilities and seeks to ensure that access to railway facilities by smaller miners is not hampered by the operation of the Code, and that competition in related markets is not diminished.

139. The Authority has not made a recommendation in relation to this issue, and maintains its position as stated in paragraph 131 of the draft report.

APPENDIX – The Valuation Method

140. The matter which is the subject of this Appendix is the valuation method prescribed in Schedule 4 of the Code. This matter was flagged in paragraph 162 of the draft report, as below:

> *The Authority considers there may be merit in a change in the cost determination method from a GRV-based approach. This could be beneficial on two accounts:*
>
> *i) a Building Block approach allows forecast capital expenditure to be incorporated into a cost determination; and*
>
> *ii) administrative improvements by unifying the Authority's approach under the Code with that applied to other railway networks in Australia.*

141. The draft report contained a recommendation in relation to the valuation method prescribed in Schedule 4 of the Code. This recommendation was a component of Draft Recommendation 6, at page 29 of the draft report, and is reproduced below:

> *Unless it can be demonstrated that the Building Block approach could cause an inefficient calculation of ceiling costs, clause 2(4) should be amended to prescribe a Building Block approach to determining costs, in place of the current GRV-based approach.*

142. The Authority is not upholding this component of Draft Recommendation 6 in this final report.

COMMENTS RECEIVED IN SUBMISSIONS

143. Five of the seven submissions received in response to the draft report addressed the valuation element of Draft Recommendation 6, with two of these submissions providing arguments in some detail. All comments received are addressed separately in this Appendix, due to the range of issues raised.

Roy Hill Infrastructure Submission

144. RHI submitted (paragraph 2.4 page 2) that it supports an amendment prescribing a building block approach. RHI indicated that it considers that in most cases a GRV plus anticipated capital expenditure method would be appropriate, but also indicated that it would support a depreciated optimised replacement value method. RHI argued that Authority should seek submissions on the selection of the method which most appropriately reflects railway owners' true capital costs.

Co-operative Bulk Handling submission

145. The CBH submission (paragraph 2.1, page 7 – paragraph 2.3, page 14) concludes that the WA Rail Access Regime is deficient in encouraging the efficient use of and investment in rail infrastructure because:

- it adds complexity to the calculation of costs;
- it does not efficiently encourage replacement investment. In relation to this, CBH commented:

  > *why would you bother to incur the cost of investment in new infrastructure if you could be compensated for making such an investment even if you don't make it?;*

- it does not send better economic signals to access seekers than could be achieved via alternative costing methodologies. In particular, CBH argued that the "build or buy" signals sent by a GRV cost are not appropriate to below-rail

assets, as it is unlikely that access seekers would choose to build rather than buy access to below rail infrastructure;

- the GRV methodology is currently being implemented in a way that has the potential to enable WestNet Rail to more than recover its efficient costs. In its submission, CBH comments that:

  > *in highly simplified settings, it is easy to show that GRV can be consistent with recovery of efficient costs. But, as we move into the realm of the real world, we can encounter problems associated with how it is implemented over time when there are changes in replacement costs,*

  and,

  > *if the annuity is not applied consistently throughout the cost recovery period, over- or under-recovery can occur.*

146. The Authority notes that the CBH submission does not specify in which way the WA Rail Access Regime adds complexity to the calculation of replacement costs.

147. The Authority notes that WNR has invested significantly in the WA rail network since 2001, and that this investment appears not to have been impeded by the operation of the WA Rail Access Regime over that period.

148. The Authority also notes that the replacement cost approach, which CBH correctly identifies as a "build or buy" (or 'bypass') cost, is not consistent with an approach based on the recovery of historical costs and is not applied over a 'cost recovery period'.

149. The Authority notes that CBH does not assert that WNR is recovering more than efficient costs, only that the implementation of the GRV methodology provides potential for this to occur.

150. In its submission, CBH provided an argument aiming to justify the application of a 'tilted annuity' in the WA rail regime GRV-based scheme. A tilted annuity refers to a discounting (or 'backloading') of a 'flat' annuity to correct for returns on replacement costs which are expected to increase over time.

151. CBH's submission appears to imply that the annuity calculated as prescribed in the Code is rising over time. CBH then argues that if Modern Equivalent Asset (MEA) costs are increasing over time, and these are reflected in the annuity calculation, that this will create revaluation gains for WNR.

152. The Authority notes that the annuity calculations prescribed in the Code result in a flat annuity based on a single replacement cost at current prices and that increasing replacement costs over time are not reflected in this calculation. Railway assets are revalued periodically, or on an as-and-when required basis, when access proposals are received.

153. Subclause 4 of Schedule 4 clause 2(4) refers to the 'annuity' as an 'equivalent annual cost' and clearly describes the principal component of the 'equivalent annual cost' calculation as being a Gross Replacement Value amount, which by definition excludes any consideration of replacement investment (as the asset is always valued as new).

154. CBH submitted that the opening asset base in a building block approach should be depreciated, and that capital expenditure should only be rolled into a depreciated asset base.

155. CBH submitted that, to the extent that WNR is not required to pay back any funding it receives from federal or state governments, such payments should be treated as a subsidy and not used to increase the capital base on which WNR estimates ceiling prices. CBH submitted that any such payments should 'come out of the GRV', and that to do otherwise would enable WNR to earn a higher rate of return than it should.

156. The Authority notes that Section 2.3 of the WNR costing principles indicates that all government contributions are converted to an annuity and treated as revenue for the purposes of testing for overpayments, as per the requirements of Clause 8 Schedule 4 of the Code.

157. CBH submitted that the 'difference between ceilings and floors is too large' and refers to floors being as little as 4 per cent of ceilings. CBH argues that this provides scope for unjustified increases in prices.

158. CBH submitted that the Authority is not given any guidance in the Code as to how to "give an opinion" on access prices, except that the price must be below the ceiling test and must meet the requirements of Clause 13 of Schedule 4.

159. The Authority notes the provisions of Clause 13 of Schedule 4, which include the following requirements:

- Consistency in the application of pricing principles between all users of the railway
- Prices should reflect the standard of the infrastructure and relevant market conditions
- Any apportionment of costs should be reasonable

160. CBH makes references throughout its submission to the GRV valuation method as a "pricing methodology", and to the Authority determining prices and commenting that the Authority has no guidance on how to monitor prices. The Authority notes that the Code does not require that railway owners provide access prices for review, or that the Regulator make determinations on floor and ceiling prices.

161. CBH submitted that the GRV valuation method is invalidated by:

- The assumption of an efficient railway alignment in the Modern Equivalent Asset (**MEA**) specification. CBH argues that if a railway were to be replaced, that the pre-existing alignment of the railway might not represent the most efficient route.
- the inclusion of design construction and project management fees at 20 per cent of total infrastructure costs, and the inclusion of financing costs.

162. The Authority notes that none of these provisions are essential elements of the GRV approach, and none are mandated in the Code. Accordingly, the appropriateness of these provisions is a matter to be considered as part of any review of railway owners' Part 5 instruments rather than as a part of the Code review process.

Oakajee Port and Rail submission

163. OPR (paragraph 10.3, page 29) submitted that a DORC valuation with straight line depreciation should be available to railway owners as it is the common method for regulating infrastructure in Australia.

164. OPR submitted that "the ERA considered there was merit in adopting a different valuation methodology", and that a "DORC methodology is favoured by the ERA".

165. OPR submits that a DORC method with straight line depreciation should be 'available' to railway owners. The Authority takes this to mean that railway owners should be given the option to choose a valuation method, as OPR has suggested in earlier submissions to the Authority.

166. OPR's comments in paragraph 10.3 do not accurately reflect the true text of the Authority's Draft Report. The Draft Report (paragraph 162) states "The Authority considers that there may be merit in a change to the cost determination method" (emphasis added). The Draft Report does not nominate the adoption of a DORC method as an Authority-preferred outcome.

WestNet Rail submission

167. WNR submitted that the purpose of any Review of the Access Code undertaken by the Regulator (as outlined in clause 12(2) Part 2 of the Act) is to assess how effective the Code has been in meeting the objectives of the CPA. WNR argues that changes should only be made to the Code where there is "compelling evidence that the existing provisions are not effective in meeting CPA objectives". WNR argues that the proposed changes are not fully explained or their ramifications assessed, and it is not demonstrated how they will improve the effectiveness of the Code in meeting the CPA objectives.

168. WNR submitted that a change in valuation is prejudicial to WNRs interests, and refers to Section 20(4) of the Act which requires that ERA must consider the railway owner's legitimate business interests, and investment in railway infrastructure.

169. The Authority notes that section 20(4) of the Code applies in the context of assessing Part 5 instruments and does not apply to the Code Review Process.

170. WNR submitted that the consistency of the WA Rail Access Regime with the CPA objectives has been accepted by the NCC recommendation that the WA Rail Access Regime be certified in accordance with the Trade Practices Act.

171. The Authority notes that it was the NCC's draft decision that recommended that the WA rail access regime should be certified as effective, and that the final NCC recommendation was that the WA rail access regime should not be certified as effective. This final recommendation was due to concerns in relation to possible inconsistencies in application of the regime within WA. Notwithstanding the final NCC recommendation, the Parliamentary Secretary to the Treasurer certified the WA Rail Access Regime as effective on 11 February 2011.

172. WNR submitted that the regime has not proven materially deficient as evidenced by the substantial growth in freight volumes and WNR's ongoing investment in the network.

173. WNR made the following further comments in its submission:

- A change in valuation method is likely to have serious adverse effects on WNR's financial interests.
- The Authority is supposed to seek public comment on proposed amendments, and that the proposal to amend the valuation method was not canvassed in the issues paper. The detail and content of the 'building block' methodology is not described in the draft report.

- The Authority has proposed that a building block approach be adopted unless it can be shown to result in an inefficient calculation of ceiling costs. WNR argues that this incorrectly attempts to reverse the onus for justifying the proposal, and that it is the responsibility of the Authority to justify why a change is required.
- There is no indication in the draft report of the unsuitability of the present GRV provisions to give effect to the Competition Principles Agreement.
- WNR says that it cannot assess the implication of the Authority's proposal for its business, because of a lack of detail on the particular form of the 'building block approach' proposed to be adopted.

174. The Authority notes that it has proposed that a building block approach should be considered only if it can be shown to result in an appropriate calculation of ceiling costs, in a manner which is consistent with the nature of the regulatory framework.

175. The Authority states in the draft report (paragraph 165) that

> *the Authority is not aware of any reason in theory why a Building Block approach would disadvantage any railway owner in comparison to the GRV methodology.*

176. WNR submitted that the following were likely impacts on WNR of the adoption of a building block approach in place of a GRV approach:

- A substantial reduction in the valuation of WNR's infrastructure assets for purposes of assessing ceiling costs. In WNR's view, this would substantially reduce the business value determinations made by shareholders and the WA Government at the time of the sale of the Westrail business in 2000.

- Any change in valuation basis would require WNR to compile new asset registers, costing models, and financial reconciliation tools. Any fundamental change to the regulatory regime with limited consultation will increase the regulatory risk of WNR's business. Increased regulatory risk will undermine WNR's confidence to further invest in the WA rail network.

177. WNR submitted that the Authority needs a specific detailed consultation process in order to progress this issue. WNR requested that the Authority revoke its recommendation in its final report on the Code Review. WNR declared that it remained open to engage with the Authority on improving the GRV-based regime, and that this would require the Authority to:

- explain why the GRV method is not suitable to give effect to the CPA.
- analyse options for addressing identified concerns, such as forecast capital expenditure.
- explain what is meant by 'Building Block' approach, and why a Building Block approach is the most suitable option.
- explain how this addresses factors detailed in section 20(4) of the Act and, specifically, how the legitimate business interests of railway owners have been taken into account.
- grant WNR a sufficient right to be heard in relation to detailed content of any future proposal.

178. WNR submitted that unless such a process is followed, WNR would be unable to support any changes to the GRV process on the basis that it is unable to assess the effect of any change.

North West Infrastructure submission

179. NWI (page 7) submitted that the Code review mechanism should not be used to change the provisions of the Code without sufficient evidence that existing arrangements are not effective. NWI did not express a preference for or against any change to the GRV approach, but notes that such change would not appear to disadvantage any railway owner and may lead to a methodology more in line with other regulatory regimes.

180. The Authority notes that NWI does not consider a change in valuation method would disadvantage any railway owner. The Authority notes NWI's reference to Clause 12(2) Part 2 of the Act that states that the purpose of any review of the Code should be to assess the suitability of the Code to give effect to the Competition Principles Agreement.

AUTHORITY'S ASSESSMENT

The potential for railway owners to recover more than efficient costs

181. The Authority notes the CBH argument that the GRV-based 'equivalent annual cost' mandated in the Code as the basis for the ceiling cost calculation, should be discounted or 'backward tilted' to allow for increasing replacement costs over time.

182. The Authority acknowledges that any revaluation of assets will result in the asset owner generating revenues which are greater than the amount paid for the asset, if the replacement cost of the asset increases greater than inflation over the period.

183. The Authority nonetheless considers that the 'equivalent annual cost' as prescribed in the Code is calculated appropriately for its purpose, which is to send a signal to prospective access seekers indicating the cost of bypassing the service, and building their own infrastructure.

184. In relation to the CBH argument that the GRV method is being implemented in a way which has the potential to enable WestNet Rail to recover more than its efficient costs, the Authority considers that this argument can only be construed to apply to the grain line network. This is because the grain lines are the only part of the network that WNR has not invested heavily in such that they are close to the Modern Equivalent Asset specification.

185. The Authority considers that any under-investment in the grain line network is not necessarily a product of the operation of the WA Rail Access Regime, but may be due to provisions relating to maintenance of those railway lines contained in the WNR lease agreement with the Government.

186. In relation to the CBH argument that the 'difference between ceilings and floors is too large', and that this provides scope for unjustified increases in prices, the Authority notes that the differences between ceiling and floor costs are much larger in the case of grain lines than for the remainder of the WNR network and this appropriately reflects the poor condition of these lines.

187. The 'large difference' between ceiling and floor costs for grain lines is characterised by a lowering of floor costs rather than a raising of ceiling costs, thereby providing scope for lower prices to be negotiated, rather than necessarily providing scope for unjustified increases in prices as argued by CBH.

188. CBH submitted that ERA is not given any guidance in the Code as to how to "give an opinion" on access prices, except that the price must be below the ceiling test and must meet the requirements of Clause 13 of Schedule 4. The Authority considers that the provisions of the Code in this respect (at Schedule 4 Clause 13) are adequate and that more detailed guidance for an assessment of 'reasonableness' by the Regulator might not be appropriate in the context of the negotiate-arbitrate nature of the regime.

189. In relation to OPR's suggestion that a building block method should be 'available' to new railway owners, the Authority considers that it would not be practical to amend the Code to enable both a GRV method and a building block valuation method to be applied. This is because of the different levels of detail involved in reviews, negotiations, determinations and arbitration timelines associated with these two approaches.

190. In relation to WNR's views on the possible impacts on its business of a change in regulatory valuation method, the Authority does not consider that the GRV-based asset value determined for the purposes of administering the WA rail access regime would currently be used as a direct measure of the value of the railway owner's infrastructure assets. However, the Authority does understand that the regulatory valuation may contribute to any assessment of business value of WNR as a going concern.

191. Overall, the Authority does not consider that the Code in its current form provides systematic leeway for railway owners to recover more than efficient costs, on a "build or buy" basis, for access to below-rail infrastructure.

192. The Authority has identified further considerations which have a bearing on the appropriateness of amending the Code to prescribe a building block valuation method in place of the current GRV approach. These were not raised directly in submissions, but may be related to those issues. These further considerations are outlined below.

Preserving the "negotiate-arbitrate" nature of the Code.

193. The WA Rail Access Regime provides for transparency in costs and does not set regulated prices for provision of access to rail infrastructure. The negotiation framework prescribed in Part 2 of the Code enables access seekers and railway owners to negotiate terms and conditions for access which must comply with the railway owner's Part 5 instruments.

194. There are no limitations on the price that may be negotiated between the railway owner and the above rail operator, except that the railway owner is able to recover from all operators on a route section no more than its ceiling cost for the route section if that route section is subject to an access agreement.

195. The Code provides for the appointment of an arbitrator under the *Commercial Arbitration Act 1985.*

196. The GRV approach on which the WA Rail Access Regime is based may be considered a 'forward-looking' approach, where railway owners are able to recover costs from operators commensurate with the 'bypass' cost to the operator of building an equivalent portion of the railway owner's existing assets for their own use.

197. A building block approach is a 'backwards-looking' historical cost-recovery approach. Accordingly, if a building block valuation method were mandated in the Code, significant changes would be required to the Code in order to enable effective regulation of negotiations and, in particular, expansion of the timelines required to enable a more detailed examination of financial records and projections of operating and maintenance costs.

198. A building block approach might be incorporated into the Code in two ways. The first option would be to adopt a "price-setting" historic cost-based approach. This would require the calculation of reference tariffs in a similar way to other rail jurisdictions, and regulation of other industries, in Australia. Such an approach would represent a move away from the "negotiate-arbitrate" nature of the Code, and would require detailed examination of depreciation and capital works schedules and operating cost projections on a regular basis.

199. The second option for incorporating a building block approach into the Code would be to employ the building block methodology to establish an asset value on a historic cost basis, incorporating depreciation and capital expenditure projections. This asset value would be used, in place of the GRV value currently prescribed in the Code, as a basis for calculating floor and ceiling costs.

200. The "negotiate-arbitrate" nature of the Code would be preserved under the second approach above; however both approaches would require regular periodic examination of historic cost schedules and schedules for planned capital expenditure and forecasts for operations and maintenance costs. Both approaches would therefore introduce considerable complexity into the regulatory regime, especially in view of the requirements to make these calculations on a route section basis for all railways.

201. The Code does not mandate periodic determinations of floor and ceiling costs by railway owners. The Code requires only that floor and ceiling costs are determined when an access proposal is received, or is expected to be received. A GRV approach is well suited to this purpose, as it posits a hypothetical new 'modern equivalent asset' as the basis for a bypass valuation.

202. Incorporation of a building block valuation approach would likely require regular re-determination of costs in the absence of new access proposals in order to preserve continuity of historic capital and operating cost schedules.

203. The Authority considers that a building block approach to valuation would therefore result in more regulatory complexity relative to the existing GRV approach. A building block approach would also be open to contest on a much wider range of outcomes, in the event of a dispute.

204. A more detailed determination process would be required in the event of a move to a building block approach, as the level of cost transparency currently enabled by the Code could not be maintained unless the level of scrutiny of railway owners records and frequency of cost determinations were increased. In particular, sections of Part 2 of the Code "Proposals for access", where certain timelines for the provision of information are set out, would require amendment if the level of detail required to be provided is increased.

205. Particular sections in Part 2 which would require amendment in the event of a move to a building block approach would include:

Section 7 – Preliminary information:

- Subsection 7(1)(ii) - within 14 days after the request is received, the railway owner has to provide to an access seeker an indication of the price the access seeker might pay for access;

Section 9 – Railway owner's obligations on receipt of proposal:

- Subsection 9(1)(c) – within 7 days after the proposal is received, the railway owner must provide the access seeker with floor and ceiling price for access and with the costs on which those prices have been calculated;
- Subsection 9(2)(b) **–** within 30 days after the proposal is received, the railway owner must provide the access seeker with an estimate of the costs relating to any expansion or extension specified in the proposal and with an opinion as to the share of those costs likely to be borne by the access seeker;
- Subsection 9(3) – timeline for the railway owner to provide the access seeker with a draft access agreement;

206. The timelines for determinations to be made by the Authority as outlined in Schedule 4 would require alteration in line with any change in the level of review detail associated with an amended valuation method.

207. Requirements for the maintenance of financial records and mandatory periodic determinations of historic cost would be required in place of the "as and when required" provisions currently prescribed in Schedule 4.

208. Under the current negotiate-arbitrate provisions, the Regulator has an overseeing role in the initiation of arbitration processes, as described in section 24 of the Code. Section 30 of the Code requires the Regulator to provide on request advice and opinions on any matters before the arbitrator. The only timelines attached to arbitration processes are outlined in section 28 which describes the scheduling of a preliminary conference between the railway owner, the access seeker and the arbitrator. The timelines for concluding arbitration are settled in the preliminary conference.

209. In the event of a move away from a 'negotiate-arbitrate' regime, or in the event of a more detailed valuation process being prescribed within the 'negotiate-arbitrate' regime, it may be necessary to amend Part 3 of the Code to change the Regulator's role in the arbitration process, or to tighten the timeline provisions relating to arbitration.

210. Overall, the Authority considers that a change in the valuation approach to a building block method would necessitate a move away from the "arms-length" regulatory approach currently mandated in the Code, and would require amendments to those sections of the Code (in addition to Schedule 4) which describe the negotiation and arbitration procedures mandated in the Code.

The assessment of costs associated with forecast capital works

211. The issue of the most appropriate valuation method was first raised due to a perceived inability of the current regime to incorporate annuities associated with forecast capital expenditure into a valuation under a GRV approach, and the perception that this inability precludes an access agreement requiring capital works to be negotiated.

212. The Code precludes a ceiling cost for an expanded or extended route section being calculated prior to the expansion or extension being completed. Clause 2(4)(c) of the Code (Schedule 4) defines GRV as:

> *The gross replacement value of the railway infrastructure, calculated as the lowest current cost to replace existing assets.*

213. This has resulted in some criticism of the GRV based method on the basis of a perception that it does not enable negotiations which require route expansions. This issue was addressed in 2004 when the Code was amended to incorporate an explicit description of how railway owners and access seekers may negotiate on the basis of the projected cost of assets yet to be built.

214. Section 9(2) (Part 2) of the Code outlines the manner in which a railway owner may quote a price which is based on the GRV of the route section as it exists at the time and also quote an additional price commensurate with the access seekers' share of costs associated with any required expansion.

215. An agreement may then be reached under the Code between a railway owner and an access seeker on the basis of the replacement cost of the existing assets and the projected cost of the expansion or extension, and the access seeker's share of those additional costs.

216. Under these circumstances, following the making of an access proposal and prior to an access agreement being reached, the Authority is required to make a determination of replacement costs for the route section as it stands. If an access agreement is subsequently made, it is in the railway owner's interests to ensure that a determination be made of the replacement cost of the expanded route section, in order to enable the railway owner to recover appropriate costs in relation to that route section.

217. Because it is not possible to know in advance the exact cost of any capital expansion, alternative valuation methods do not provide an advantage over the GRV method for this purpose. The 'ex poste' (after it is built) approach stipulated in the Code is the only means by which expansion costs may be assessed accurately via any valuation method.

218. Any move to incorporate a cost determination for proposed capital expansions prior to the signing of an access agreement would require that Section 9 (Part 2) of the Code be re-written, regardless of the valuation method used. It would remain appropriate for the Authority to make an additional determination of costs following completion of the expansion works.

219. Overall, the Authority considers that the adoption of a building block approach would not improve the ability of the Code to accommodate negotiations requiring expansion or extensions of the railway infrastructure.

The applicability of the Modern Equivalent Asset (MEA) standard

220. CBH has criticised the GRV approach as requiring a MEA specification and therefore presenting the railway owner with an opportunity to recover more than efficient costs if the railway is not at that standard when replacement costs are calculated.

221. Schedule 4 of the Code provides for a MEA asset specification to be adopted as the basis for valuation, if this is considered by the Regulator to be an appropriate specification. Clause 2(4)(c) states that GRV is calculated as:

> *... the lowest current cost to replace existing assets with assets that –*
>
> *(i) have the capacity to provide a level of service that meets the actual and reasonably projected demand, and*
>
> *(ii) are, if appropriate, modern equivalent assets.*

222. The Code does not stipulate the specification of assets to be used as the basis for valuation in the event that a modern equivalent asset is not appropriate.

223. At present, the only significant route sections nominated in Schedule 1 of the Code (i.e. under coverage of the Code) to which a MEA specification is arguably not appropriate are the grain line route sections owned by WNR. These route sections, although a significant component of the WNR network from a route-kilometre perspective, carry only a very small proportion of WNR's annual tonne-kilometre freight task.

224. The Authority is of the view that the GRV-based approach has not driven inadequate maintenance of the grain lines, as suggested by CBH in its submission to the draft report, but that any such inadequacies have been caused at least in part by other commercial considerations which are not transparent and may relate to the lease agreement between WNR and the Government.

225. The Authority notes that the grain line network carries approximately 10 per cent of WNR's freight task. The remainder of the network, carrying 90 per cent of WNR's freight task, is close to the MEA standard specified in the most recent floor and ceiling determination for the WNR network.

226. In light of the observations above in relation to the grain line network and the remainder of the network, the Authority does not agree with the view that the existence of the GRV-based regime has discouraged investment by WNR in the network.

227. CBH has submitted that the GRV method provides potential for WNR to recover more than efficient costs (on grain line routes). The Authority notes that the Code provides for railway owners to recover costs anywhere between the floor cost and the ceiling cost calculated for any route section. The floor cost excludes the capital annuity components of the ceiling cost and reflects only the operating costs associated with providing access to a route section with zero capital cost.

228. The Authority is not aware that WNR recovers revenue commensurate with the ceiling cost determined for these route sections. In practice, the price that WNR charges for access to the grain lines would be limited to an extent by the threat of competition to rail services offered by road transport.

229. The Authority agrees that in the absence of effective competition to rail services over these routes, a potential for recovery in excess of efficient costs for these route sections may exist.

230. Under such circumstances, the Authority considers that it would be appropriate to 'discount' the GRV of a MEA route section where the actual capacity of the route section is significantly less than the hypothetical MEA. This is considered an

appropriate approach where the actual capacity of a route section is less than the lowest feasible build capacity.

231. For example, consider a hypothetical route section which enables a maximum freight task of 100 tonne-kilometres, where that route section was originally built to deliver 1000 tonne-kilometres, and the lowest-capacity construction specification possible over that route would be for a railway with a 500 tonne-kilometre capacity. It would be impractical to contemplate the specification of a 100 tonne-kilometre MEA as the basis for the valuation (as it would not be possible to accurately cost a railway build with such a low capacity). Under these circumstances it may be appropriate to calculate replacement costs on the basis of a GRV estimated as one-fifth of the GRV of a 500 tonne-kilometre MEA.

Appendix Conclusion

232. The Authority has decided not to uphold the recommendation which was a component of Draft Recommendation 6 recommending the amendment of Schedule 4 of the Code to prescribe a building block method for asset valuation as a basis for establishing floor and ceiling costs.

233. There are a number of considerations which have resulted in this decision, and these are outlined above. These considerations do not relate exclusively to arguments raised in submissions, and include:

- the Code in its current form does not provide scope for railway owners to recover more than efficient costs, on a “build or buy” basis, for access to below-rail infrastructure.
- a change in the valuation approach to a building block method would require amendments to those sections of the Code which prescribe negotiation and arbitration procedures.
- the adoption of a building block approach would not improve the ability of the Code to accommodate negotiations requiring expansion or extensions of the railway infrastructure.

234. Some of the matters which informed this decision, including the assessment of railway owners’ costs for the purposes of negotiations which require route expansions, and the required frequency of cost determinations, were clarified in the Authority’s decision document titled “Review of the Requirements for Railway Owners to submit Floor and Ceiling Costs” (August 2011).