ROY HILL INFRASTRUCTURE PTY LTD

SUBMISSION TO ECONOMIC REGULATION AUTHORITY

2015 REVIEW OF RAILWAYS (ACCESS) CODE 2000

1 INTRODUCTION

This submission is made by Roy Hill Infrastructure Pty Ltd (**Roy Hill**) in response to the invitation by the Economic Regulation Authority (**Authority**) for written submissions in relation to the Authority's proposed review of the Railways (Access) Code 2000 (**Code**).

2 SUMMARY

In summary, this submission recommends amendments to the Code which would provide as follows:

(a) all decisions by the Authority should be subject to a merits based review;
(b) railway owners should be permitted to require that the Authority retain the confidentiality of documents and information provided to the Authority in accordance with the Code;
(c) the extent to which the Authority may amend documents which reflect operational procedures of the railway should be limited to procedures which are inefficient, or discriminate against access holders. Otherwise, the Authority should not have power to amend operational procedure documents (such as Train Management Guidelines or Train Path Policies);
(d) all decisions of the Authority, and any arbitrator appointed to make a decision under the Code, should take into account the total supply chain of which the rail infrastructure forms part (in particular, decisions should take into account activities at the mine and at the port);
(e) the segregation arrangements required by the Authority must not increase costs or decrease productivity;
(f) in order to make a valid proposal for access, an access seeker should be required to establish that its management and staff have the necessary knowledge and experience to make a valid proposal, and that the access seeker has the financial resources to carry on the proposed railway operations and pay its share of the costs relating to any extension or expansion;
(g) the term"unfairly discriminate " in section 16(2) of the Code should be defined; and
(h) the owner of the railway should be provided with an opportunity to elect to use the depreciated optimised replacement cost method of depreciation.

3 MERITS BASED REVIEW

3.1 The Authority's Final Report on the Code issued in December 2011 rejected submissions that all regulatory decisions should be subject to a merits based review. Roy Hill submits that the previous rejection of this submission cannot now be sustained, in light of the Authority's unsuccessful attempt to protect incorrect decisions in the case *The Pilbara Infrastructure Pty Ltd v Economic Regulation Authority [2014] WASC 346 (the TPI/ERA case).*

3.2 `Roy Hill submits that the availability of a merits based review of a decision by the Authority is essential to ensure a balanced and fair regulatory system. The availability of a merits based review will assure or improve the quality of regulatory decision making. A merits based review will allow recourse to review the facts, law and policy of a decision in circumstances where the Regulator has made an error in its decision. This is necessary to satisfy potential infrastructure providers and their financiers that their legitimate business interests will be protected through recourse to a fair and equitable review process.

3.3 An administrative decision that is likely to affect the interests of a person should in the absence of good reason be subject to review (Commonwealth Administrative Review Council, What Decisions should be Subject to Merit Review? 1999 at para 2.4).Regulatory decisions under the WA Access Regime inevitably affect the interests of the infrastructure provider and their financiers as well as other stakeholders and so should be subject to a merits based review.

3.4 The recent decision of Edelman J in the TPI/ERA case highlights why a merits based review structure must be inserted into the Code. Put very simply, in the TPI/ERA case the Authority sought to prevent the review by the Supreme Court of its decisions regarding the calculation of the ceiling price on the basis that The Pilbara Infrastructure Pty Ltd (**TPI**) had to establish "… the category of inferred error involving a decision that is so unreasonable that an inference of some other error must be drawn (bias, no evidence, irrelevant factors)" (para 149 of decision). Edelman J rejected that claim by the Regulator, and agreed with the assertions by TPI that the Regulator had erred in its calculation of the ceiling price in two ways: (a) by excluding contingencies from its calculation and (b) in its approach to the economic life of the railway. Edelman J commented that "… the combined error alleged, assuming aggregation of the two classes of alleged error and an equal annuity over a 20 year period, would be in excess of $2 billion for a 20 year access agreement."

3.5 Therefore, in the TPI/ERA case, the Authority sought to deny TPI an amount in excess of $2 billion, to which the Supreme Court ultimately decided that TPI was legally entitled, on the ground that the Authority's decision, although it might be incorrect, could not be reviewed by a Court because the legislation did not permit a merits based review.

3.6 Roy Hill's view is that the TPI/ ERA case highlights, in the most obvious way, that the Code must be amended to deprive the Authority of the ability to seek to protect its erroneous decisions on the basis that the decisions are only subject to a very limited narrow form of review.

4 IMPACT ON OPERATIONS

4.1 A railway owner is required to prepare Train Management Guidelines (**TMG**) and have them approved by the Regulator under section 43 of the Code. A railway owner is also required to prepare a Train Path Policy (**TPP**) and have it approved by the Regulator under section 44 of the Code. The matters addressed in the TMG and the TPP are day to day operational principles and rules that the railway owner must comply with in performing its functions in relation to the railway and providing access.

4.2 In approving or determining a TMG or a TPP the Authority is required to take into account the matters at section 20(4) of the Act which include the economically efficient use of the railway infrastructure (section 20(4)(g)). In its 2009 report prepared for the Authority, Price Waterhouse Coopers recommended a number of changes to TPI's TMG so that they were consistent with and facilitated effective and efficient real time management of the services provided to access holders. The Authority accepted these recommendations.

4.3 Roy Hill considers that the development of, and ongoing adjustment to, effective and efficient operational principles and rules for a railway or supply chain is best left in the hands of supply chain specialists. Roy Hill therefore proposes that the Authority should be required to accept the operating procedures developed or amended by a rail owner as set out in the TMG or TPP unless the operating procedures are clearly shown:

(a) to be inefficient; or
(b) to have a purpose of discriminating against access holders.

5 SUPPLY CHAIN CONTEXT

5.1 Roy Hill considers that the Authority and any arbitrator required to make a decision under the Code should consider the rail infrastructure in the context of the supply chain of which it forms part. The Code should be amended to expressly require the Authority and an arbitrator to consider and give significant weight to supply chain issues generally in their functions under the Code and in particular in approving or determining a TPP or a TMG.

5.2 The Authority has previously stated that a TPP should only address the railway component of an integrated supply chain and should make no reference to other elements of the supply chain, in particular the port (*ERA, TPI Final Determination on TPI's Proposed (Revised) Train Path Policy* 18 August 2009 at Amendment 1). The Authority has taken a similar position in assessing a TMG that all references to the provider's port or supply chain should be removed from the TMG *(ERA, TPI, Final Determination on the Proposed (Revised) Train Management Guidelines,* 18 September 2009 at required Amendment 1).

5.3 However the efficient operation of the integrated supply chain depends on the operation of all supply chain components. The Australian Competition Tribunal (**Tribunal**) in *In the matter of Fortescue Metals* [2010] ACompT 2 paras 227 – 234) found that end effects, including

operations at the port and mine terminal facilities, cannot be ignored in assessing rail capacity for purposes of third party access.

5.4 Therefore Roy Hill submits that the Code should be amended to require the Authority to consider and give weight to supply chain issues generally in its function under the Code and in particular in approving or determining a TMG or a TPP.

5.5 For the same reasons of efficient use of infrastructure Roy Hill submits that an arbitrator should also be required to consider and give weight to supply chain issues in a determination under the Code.

6 SEGREGATION ARRANGEMENTS

6.1 The competition principles set out in the Competition Principles Agreement (CPA), which provide the framework for the requirements of the Code, recognise the legitimate benefits that can be achieved through a vertically integrated access provider. The existing functional segregation requirements (which are to be set out in the Segregation Arrangements required by the Access Regime) go well beyond the requirements under the CPA for separate accounting arrangements for the elements of the business which are covered by the Access Regime.

6.2 The functional separation of an integrated organisation will result in significant additional costs and operational inefficiencies. This is in direct conflict with the principles for regulation of access prices which:

(a) are to provide incentives to reduce cost and improve productivity;

(b) acknowledge that concepts such as multi part pricing and price discrimination are allowable when they aid efficiency; and

(c) envisage the existence of vertically integrated service providers while also being able to prevent discrimination in favour of their upstream or downstream operations.

7 VALIDITY OF PROPOSAL

7.1 Section 8(1) of the Code provides that an entity may make an access proposal to the railway owner. Section 8(3) provides that the proposal must specify the route, including the railway infrastructure to which access is sought, indicate the times when the access is required, and set out the nature of the proposed rail operations. Within 7 days of receipt of the proposal the railway owner must comply with section 9 of the Code – the railway owner may require the proponent to show that its management and staff have the necessary knowledge and experience to carry on the proposed rail operations (section 14 (1)(a)) and that it has the necessary financial resources to carry on the proposed rail operations (section 14(1)(b)).

7.2 The effect of the decision in *TPI v Brockman Iron Pty Ltd (No 2)* [2014] WASC 345 is that a proposal will be valid, and require attention by the rail owner, although the applicant may have no realistic likelihood of being able to obtain finance to proceed with the access requested. The railway owner will be put to the unnecessary expense of responding to the access proposal as required by the Code, before the applicant is required to establish a capability to proceed with the access applied for. In that case, Edelman J concluded at para 267:

"From the perspective of Brockman Iron, although it had a legal entitlement to make a proposal, and although I have concluded that its proposal was valid, this costly litigation might have been avoided by the withdrawal of its proposal and submission of a new proposal if and when finance for the project was obtained. … it is sufficient to observe that Brockman's desire for negotiations could turn out to be entirely futile if it is unable to show that it has the managerial and financial ability to carry on the proposed rail operations to which TPI's duty to negotiate is subject."

7.3 Accordingly, Roy Hill submits that section 8 of the Code should be amended so that an applicant cannot make a valid access proposal, and thereby put the railway owner to the time and expense of having to respond to the proposal, unless the access seeker can first satisfy the requirements of section 14 of the Code. That is, before an entity may make a valid access proposal, the access seeker must show that its management and staff have the necessary knowledge and experience to carry on the proposed rail operations, and it has the necessary financial resources to carry on the proposed rail operations and pay its share of the costs of any extension or expansion. Roy Hill notes that this amendment would be consistent with the existing two Part 111A undertakings, in which at any time before or during negotiations the railway owner may require the access seeker to establish appropriate prudential requirements.

8 SECTION 16 (2) - UNFAIRLY DISCRIMINATE

8.1 Roy Hill submits that the term "unfairly discriminate" in section 16(2) of the Code must be clarified. There are a number of instances in which, and a number of reasons why, a railway owner should be able to treat prospective users or users differently. Whether this is fair or unfair is an emotive issue calling for a value judgment. This uncertainty should be replaced by a more developed test of what type of instances and reasons will give rise to permissible differential treatment.

8.2 Roy Hill refers the Authority to the definition of "discriminate" in 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.

9 ASSET VALUATION, DEPRECIATION

9.1 Roy Hill considers that the Depreciated Optimised Replacement Cost (**DORC**) and straight line depreciation should be available to infrastructure owners as it is the common methodology used for regulated infrastructure around Australia. The asset valuation methodology used in WA in the WA Access Regime is Gross Replacement Value (**GRV**). DORC provides for a more accurate representation of the infrastructure owner's actual costs. Roy Hill considers that the possibility of using historical costs, rather than replacement costs, may have merit for greenfields projects given the greater likelihood of partial asset stranding of such assets.

9.2 A GRV calculation creates a risk of asset write downs in the event that construction occurs at the peak of a construction cycle or financing cycle. With the delays associated with a return

of capital under GRV, annuity based depreciation heightens stranding risk due to the length of time to recover capital. In principle, the ability to revisit the economic life of the infrastructure with the resubmission of the Costing Principles may reduce some of the stranding risk. Nevertheless, where the lives of time limited customer projects are known at the outset to be less than the rail asset life, a GRV approach increases the stranded asset risk.

9.3 Roy Hill considers that consideration should be given to accommodating either GRV or DORC approaches to be adopted by infrastructure owners.

Roy Hill Infrastructure Pty Ltd

23 March 2015