Roy Hill Infrastructure Pty Ltd
Proposed Costing Principles

Final Decision

June 2017

Economic Regulation Authority
WESTERN AUSTRALIA

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Introduction

1. Sections of the *Railways (Access) Code 2000* (**Code**) that are relevant to the establishment of a railway owner's Costing Principles are:

   - Section 46 of the Code requires a railway owner to submit Costing Principles to the Regulator for approval. Section 46(1) indicates the purpose of the Costing Principles.[1]
   - Schedule 4 to the Code "Provisions relating to prices to be paid for access" relates to the establishment of costs, and is relevant to the Costing Principles. Division 1 of Schedule 4 contains definitions of terms describing the various components of total costs. The remainder of Schedule 4 relates to the various requirements of the Regulator and provisions relating to the prices to be paid for access, and these divisions are not relevant to the Costing Principles.

2. On 11 October 2016, Roy Hill Infrastructure (**RHI**) submitted Costing Principles for the Authority's approval. The Authority published a Draft Decision in respect of the proposed principles and called for submissions on 24 March 2017.

3. A submission was received from RHI. That submission has been published on the ERA website.

Final Decision

4. This document:

   - Summarises issues and required amendments identified by the Authority in each part of RHI's proposed Costing Principles;
   - Summarises responses from RHI to each of these issues, as laid out in RHI's submission; and
   - Specifies the Authority's final required amendments where appropriate.

[1] The costing principles that are to be applied and followed by the railway owner —

(a) in the determination of the costs referred to in clauses 7 and 8 of Schedule 4; and

(b) in the keeping and presentation of the railway owner's accounts and financial records so far as they relate to the determination of those costs.

Part 1 - Introduction

Reference to "additional costs and burdens" being imposed on RHI's parent company by the Act and the Code

5. Part 1(d) of RHI's proposed Costing Principles states:

> *To the extent that the Act and the Code impose additional costs and burdens on RHH and its subsidiary companies (either directly or indirectly), these Costing Principles permit the complete recovery of all of those costs*

6. In its Draft Decision, the Authority outlined that the costs caused by RHI being subject to the *Railways (Access) Act 1998* and Code are not "additional" costs but the normal costs of operating an open-access railway.[2] The Authority also highlighted that the incidence of costs on RHI's parent company are not relevant to RHI's costing principles except to the extent that they are represented in RHI's corporate overheads. Further, the Authority referred to an earlier Authority decision where this matter was discussed.[3]

7. In its Draft Decision, the Authority required the removal of Part 1(d) of RHI's proposed Costing Principles.

8. In its submission, RHI stated:

> *Part 1.1(d) merely makes the point that RHI intends to recover any costs from the third party which are incurred as a result of RHI providing third party access to RHI's railway.*

and suggested alternative text for Part 1.1(d), as follows:

> *To the extent that RHH and its subsidiary companies incur operating costs, capital costs and overheads attributable to the performance of RHI's access-related functions, as a consequence of providing access to third parties (either directly or indirectly), these Costing Principles permit the complete recovery of those costs.*

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[2] Paragraphs 16 – 19 of the Draft Decision

[3] Pages 6 and 67 of Authority decision in accordance with Section 10 of the Code relating to TPI's legitimate business interests: https://www.erawa.com.au/cproot/11565/2/20130830%20110918%20-%20TPI%20-%20Corrigenda%20Decision.pdf

Pursuant to section 20(4) of the Act, the Regulator is to take into account:

- the railway owner's legitimate business interests and investment in railway infrastructure; and
- the railway owner's costs of providing access, including any costs of extending or expanding the railway infrastructure, but not including costs associated with losses arising from increased competition in upstream or downstream markets.

The Authority acknowledges that there are real disadvantages that may result from third party access arrangements, to the effect that there are significant costs and risks to railway owners associated with third party access, arising from having to manage the displacement of alternative investment proposals, costs and delays associated with negotiations, potential disputes and operating allowances. These are unavoidable elements of any open-access railway, and are considered normal business costs associated with owning an open access railway.

The Authority is of the view that RHI's business interests must be considered in a context where RHI knew, at the time it decided to proceed with its investment in the railway infrastructure, that it would be subject to third party access proposals. In particular, in order to obtain the State's assistance with development of multi-use rail infrastructure, RHI made commitments to the State Government in Schedule 1 of the *Railway (Roy Hill Infrastructure Pty Ltd) Agreement Act 2010*, including a commitment to operate the railway under open third party access arrangements and to use all reasonable endeavours to promote access to, and attract above-rail customers for, the railway in accordance with the Act and the Code.

The Authority is of the view that, in circumstances where RHI owns a regulated railway, any adverse cost impacts to RHI, RHH or other interested users of the railway must be considered in the context of RHI having contractual obligations in relation to providing third party access.

9. The Authority considers that the objectives of railway owners' costing principles do not include permitting railway owners to recover costs. Cost recovery is assured by Clauses 7 and 8 of Schedule 4 to the Code which require that an operator provided with access must pay to the railway owner the costs commensurate with the appropriate operating, capital and overhead costs incurred by the railway owner resulting from provision of that access.

10. The objective of the costing principles is not to permit the recovery of those costs per se, but to determine those costs.

11. Further, and as outlined in the Draft Decision (see paragraph 6 of this decision) the incidence of costs on RHI's parent company is not relevant to RHI's costing principles except to the extent that they are represented in RHI's corporate overheads.

12. The Authority confirms its requirement that part 1.1(d) is deleted.

Costing principles are put in place to determine costs, not prices

13. Part 1.1(e) of RHI's proposed Costing Principles outlines the objectives of the Costing Principles. Part 1.1(e)(i) includes among the stated objectives "to provide the framework for the calculation and determination of the Floor Price and the Ceiling Price required under clause 9(1)(c)(i) if the Code".

14. The Authority, in its Draft Decision outlined that the purpose of the Costing Principles is to determine the costs referred to in clauses 7 and 8 of Schedule 4,[4] which are the Total and Incremental Costs. These costs are also referred to in section 9(1)(c)(ii) as the costs on which the floor and ceiling price are calculated.

15. In its Draft Decision, the Authority required that the words "Floor Price and Ceiling Price required under clause" in Part 1.1(e)(i) of RHI's proposed Costing Principles are replaced with "costs referred to in section".

16. In its submission, RHI agreed with this requirement.

17. The Authority confirms its requirement in relation to Part 1.1(e)(i) of RHI's proposed Costing Principles.

Establishing a framework for keeping and presenting accounts and financial records

18. Part 1.1(e) of RHI's proposed Costing Principles outlines the objectives of the Costing Principles. Part 1.1(e)(ii) includes in those objectives "to define the manner in which the keeping and presentation of the railway owner's accounts and records so far as they relate to the determination of the Floor Price and the Ceiling Price will occur".

19. The Authority, in its Draft Decision,[5] noted that the body of the proposed Costing Principles did not address that objective. The Authority required the removal of Part 1.1(e)(ii).

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[4] Consistent with the purpose of the Costing Principles as outlined in Section 46(1)(a)

[5] Paragraph 21.

20. In its submission, RHI pointed out that the TPI and BR Costing Principles contain a similar objective, and that Part 1.1(e)(ii) should be retained[6] so that RHI's Costing Principles are consistent with the Costing Principles accepted by the Authority for TPI and BR.

21. The Authority accepts that the objectives of the Costing Principles may include

> *A statement of the principles, rules and practices that are to be applied and followed by the railway owner in the keeping and presentation of the railway owner's accounts and records so far as they relate to the determination of (those) costs*[7]

22. As indicated in paragraph 19 above, the Authority has noted in its Draft Decision that RHI's proposed Costing Principles do not address the keeping of financial records.

23. The Authority has changed its required amendment in relation to Part 1(e)(ii) such that the words "the Floor Price and the Ceiling Price will occur" are replaced with "those costs", and that a new part be added to RHI's Costing Principles addressing the keeping of accounts and records for the purpose of determining costs.

24. The required new part will include, as a minimum, the identification of route sections for which costs will be determined, and for which the information referred to in Schedule 2 of the Code will be maintained. The new part will be equivalent to Appendix C of the TPI Costing Principles and Part 7.3 of Brookfield Rail's Costing Principles.

The Costing Principles are required by the Code not the ERA

25. At Part 1.1(h) of its proposed Costing Principles, RHI states that the Over-payment Rules are "required by the ERA" under section 47 of the Code. The requirement arises directly from the Code.

26. The Authority required the removal of the words "the ERA under" from Part 1.1(h). In its submission, RHI agreed with this requirement.

27. The Authority confirms its requirement that the words "the ERA under" are removed from Part 1.1(h).

Assurances about matters to which the Costing Principles do not apply

28. Part 1.3(d) of the proposed Costing Principles contains the statement:

> *RHI is prepared to discuss access with interested parties either within the requirements of the Code or outside the Code. The rights and protection offered under the Code are not extended to negotiations and agreements undertaken outside the Code.*

29. In its Draft Decision, the Authority required the deletion of Part 1.3(d) of RHI's proposed Costing Principles, as the statement in Part 1.3(d) refers to the provisions of section 4A of the Code.[8] Those provisions relate to negotiations and agreements

[6] RHI submitted that Part 1.1(e)(ii) should be retained, but with the words "Floor Price and Ceiling Price" replaced with "Floor and Ceiling Costs". The Authority notes that the costs on which Floor and Ceiling Prices are based are referred to in the Code as the Incremental Cost and the Total Cost.

[7] Paraphrased from section 46(1)(b) of the Code.

[8] Section 4A(c) of the Code includes "a Part 5 Instrument, as defined in section 40(3), is not to be taken into account in determining the rights, powers, duties and remedies of parties to negotiations carried out on or

made outside the Code, and so are not relevant to the Costing Principles, which are a Code instrument.

30. In its Draft Decision, the Authority required the removal of Part 1.3(d).

31. In its submission, RHI stated that the Authority should explain why it has required the deletion of Part 1.3, as a similar part is included in Brookfield Rail's Costing Principles.

32. The Authority is aware that the Brookfield Rail Costing Principles contain a part similar to Part 1.3(d) of RHI's proposed Costing Principles. There is not a similar part contained in TPI's Costing Principles.

33. In its submission, RHI stated that it is important that the principle of Part 4A is repeated in full in the Costing Principles.

34. The Authority does not agree that Section 4A of the Code should be repeated in full in a railway owner's costing principles, for the same reason as outlined in paragraph 23 of the Draft Decision. The Authority does not consider it relevant for the Costing Principles to provide statements relating to negotiations to which the Costing Principles do not apply, or to sections of the Code which do not relate to the negotiations for access under the Code. The Authority notes that RHI did not refer to section 4A of the Code in its proposed Part 1.3(d).

35. The Authority accepts RHI's submission that section 4A of the Code is relevant, but only to the extent that it relates to circumstances under which the Costing Principles apply, rather than circumstances under which they do not apply.

36. The Authority has revised its requirement in relation to Part 1.3(d) such that Part 1.3(d) may be retained and the second sentence of that part should read "RHI must apply these Costing Principles in the determination of costs in response only to an access proposal made under the Code".

Provisions relating to the content of access agreements

37. Part 1.4 of the proposed Costing Principles provides service quality commitments and refers to the negotiation of key performance indicators, and the potential for related incentives and penalties.

38. In its Draft Decision, the Authority required the removal of Part 1.4, as the actual service standards and efficient practices of the railway owner are not relevant to the valuation or costing of the railway infrastructure.[9] Although the costs to be included in the determination of Total and Incremental costs would be those of an efficient service provider/railway owner providing services to a prescribed quality standard there is no place in the costing principles for the prescription of KPI and incentives/penalties that may arise in the negotiation of access.

39. In its submission, RHI stated that the Authority should explain why it has required the deletion of Part 1.4, as a similar part is included in Brookfield Rail's Costing Principles.

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an agreement made otherwise than under this Code, except to the extent that the parties concerned agree otherwise".

[9] Paragraph 24 of the Draft Decision.

40. The Authority's reasoning for the required deletion of Part 1.4 was provided in paragraph 24 of the Draft Decision (as indicated in paragraph 38 above). RHI did not address the Authority's concerns in relation to Part 1.4.

41. The Authority notes that although Brookfield Rail's Costing Principles contain a part (Part 1.5 – Service Quality Principles) identical to Part 1.4 of RHI's proposed Costing Principles, TPI's Costing Principles, which were approved more recently, do not contain an equivalent Part.

42. The Authority confirms its requirement that Part 1.4 be removed from RHI's Costing Principles.

Required Amendment 1

Part 1 of RHI's proposed Costing Principles should be amended such that:

- Part 1.1(d) is deleted
- The words "Floor Price and the Ceiling Price required under clause" are replaced with "costs referred to in section" in 1.1(e)(i)
- The words "the Floor Price and the Ceiling Price will occur" are replaced with "those costs" in Part1.1(e)(ii), and a new Part is inserted to address the keeping of accounts and records for the purpose of determining costs
- The words "the ERA under" are removed from 1.1(h)
- The second sentence of Part 1.3(d) is replaced with "RHI must apply these Costing Principles in the determination of costs in response only to an access proposal made under the Code"
- Part 1.4 is deleted

Part 2 – Determination of Capital Costs

Inclusion of capital costs of expansions as incremental costs

43. Part 2.1(b) of RHI's proposed Costing Principles requires that incremental costs will include a capital charge where RHI agrees that capital expenditure is necessary to provide the service, either because of the need to expand capacity or because of the characteristic of the service requested. Part 2.1 goes on to propose that any capital expenditure associated with a required expansion will be included as an incremental cost, and that the funding of a required capital expansion will be completely at RHI's discretion.

44. In its Draft Decision, the Authority did not accept the propositions contained in part 2.1(b). Capital expenditure associated with capacity expansions is not an incremental cost. The Code anticipates that the costs of providing extensions and expansions will be dealt with separately to establishing the replacement cost of

existing infrastructure.[10] The Authority has previously accepted capital expenditure of the type described in Part 2.3(c) as operational costs.[11] Consequently, these may be accepted as incremental costs.[12] This reasoning was provided at paragraph 38 of the Draft Decision.

45. In its Draft Decision, the Authority required that Part 2.1(b) be replaced with "Incremental costs will include capital costs only where RHI assesses that it is necessary to make capital expenditure (of the type referred to in 2.3(c) of these Costing Principles) to provide the proposed access".

46. In its submission, RHI argued that Part 2.1(b) should be retained, as that part is very similar to corresponding statements in Brookfield Rail's Costing Principles. RHI did not address the Authority's reasoning at paragraph 38 of the Draft Decision.

47. The Authority notes that there is no part of the TPI Costing Principles which is similar to Part 2.1(b) of RHI's Costing Principles. The significance of whether another railway owner's Costing Principles reflect the same or different wording does not automatically infer that compliance is required. The circumstances of different railways may dictate a different approach or the position of the Authority may have moved in light of past experience with the implementation of other railway owners' instruments.

48. The Authority confirms its requirement that Part 2.1(b) be replaced with "Incremental costs will include capital costs only where RHI assesses that it is necessary to make capital expenditure (of the type referred to in 2.3(c) of these Costing Principles) to provide the proposed access".

Proponent to demonstrate commitment to a proposal requiring expansion of a railway owner's infrastructure

49. At Part 2.4(a)(i) of its proposed Costing Principles, RHI states:

> RHI believes the existing network can meet the reasonably projected demand by RHI. If RHI received a request for access from a third party, the capacity of the existing network would have to be increased. RHI would include the costs of the additional infrastructure required to meet the projected demand from the third party, and that third party would need to demonstrate: (A) the basis for the demand projection; and (B) a commitment to the capital expenditure.

50. This statement paraphrases similar statements in BR's and TPI's Costing Principles.[13] In BR's and TPI's costing principles, the statement provides that the railway owner will not claim 'spare capacity' as required for 'own use' unless the railway owner can substantiate that claim.

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[10] The Code defines GRV at Clause 2(4)(c) of Schedule 4 as being "the lowest current cost to replace existing assets". At Section 9(2), the Code outlines that if an expansion is specified, then the sums notified to the proponent under 9(1)(c) are for the infrastructure as it exists and not for any proposed extension or expansion. Section 9(2)(b) outlines the process for a railway owner to "quote" for an extension or expansion.

[11] For example, capital expenditure on the following items has been considered eligible as operational/incremental costs for other railway owners: motor vehicles, computers, printers, facsimile machines, photocopiers, system hardware and software, mobile and fixed communications, office furniture and equipment.

[12] The Code allows for the inclusion of capital costs as incremental costs at Schedule 4 1(b)(i).

[13] At Part 2.3 and Part 3.2.1 respectively.

51. In BR's and TPI's costing principles, the statement refers to the railway owner – not the proponent – demonstrating a commitment to expanding its own use on its railway. The requirement for a proponent to demonstrate that its proposed operations may be accommodated on a route or an expanded route that is the basis for capacity extensions arises at section 15 of the Code.

52. In its Draft Decision,[14] the Authority required that the second paragraph of Part 2.4(a)(i) of RHI's proposed Costing Principles is replaced with "RHI considers that the network as constructed can meet the reasonably projected demand for all users taken together. If RHI requires additional infrastructure to meet its own projected demand in conjunction with an access proposal, then it will demonstrate the basis of and financial commitment to the demand projection".

53. In its submission, RHI agreed with this requirement. The Authority confirms the requirement in this Final Decision.

Inclusion of the costs of surface diversion works within a "greenfields" assumption

54. Part 2.4(a)(iv), which proposes that the GRV calculations "assume a Greenfields site", but that costs relating to surface diversions be included, is not accepted. The proposition that the costs of surface diversions would be included in a greenfields costing is not consistent with a greenfields assumption. Brookfield Rail's and TPI's Costing Principles explicitly exclude these costs on the basis of the greenfields assumption.[15]

55. In its Draft Decision, the Authority required that – in Part 2.4(a)(iv) of RHI's proposed Costing Principles – the word "However" is deleted and the word "included" is replaced with "excluded".

56. In its submission, RHI did not agree with this requirement, and stated that the Authority should explain where the costs of diversions would be included. RHI did not address the Authority's reasoning at footnote 12 of the Draft Decision, including the observation that both BR and TPI's Costing Principles exclude consideration of the costs of surface diversions.

57. The Authority confirms its requirement that – in Part 2.4(a)(iv) of RHI's proposed Costing Principles – the word "However" is deleted and the word "included" is replaced with "excluded".

Economic lives

58. The second paragraph of Part 2.4(a)(ix) states that RHI's evaluation of the economic lives of assets is based on generally accepted industry lives and RHI's own experience, and that the economic life of assets adopted by RHI are generally consistent with those accepted in other regimes. RHI has proposed economic lives

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[14] Paragraphs 37-42.

[15] A 'greenfields' assumption is an assumption that the GRV of an asset is established on the basis that there is no other infrastructure in place which the replacement asset must build around or divert from. This assumption is used in both the Brookfield Rail and TPI costing principles on the basis that the third party operator should contribute, by way of payment to the railway owner, its share of the current value of the network. Alternative valuations (such as Depreciated Optimised Replacement Value) contemplate the operator remunerating the railway owner for actual depreciated expense incurred in establishing the asset (not its gross replacement value).

which are significantly shorter than those approved for inclusion in the Brookfield Rail and TPI Costing Principles.

59. In its Draft Decision,[16] the Authority considered that, in determining appropriate economic lives of assets, the experience of other railways in the Pilbara is at least as significant as the experience of RHI as a railway owner. The experience of other railways in the Pilbara is also more significant than the experience of railway owners subject to other regimes, as these regimes do not cater for heavy haul railways of the type owned by RHI. The Authority required that Part 2.4(a)(ix) be removed.

60. In its submission, RHI stated that:

> *The financial modelling of the Roy Hill mine is based on an expected mine life of 16 years and that only those assets which have an expected life of less than 16 years are allocated an economic life of less than 16 years.*

61. This statement is not consistent with the statement in the proposed Costing Principles:

> *This evaluation is based on generally accepted industry lives and RHI's own experience. The economic life of assets are generally consistent with those accepted in other regimes*

62. In its submission, RHI noted that the above statement is very similar to the equivalent statement in BR's costing principles. The Authority notes that a similar statement does not appear in TPI's Costing Principles, and that the heavy haul railways owned by TPI and RHI are not similar to the railway owned by BR, and are not subject to the "other regimes" referred to in BR's Costing Principles.

63. In its submission, RHI stated that Part 2.4(a)(ix) should be retained because it provides an explanation as to how the economic life of the infrastructure has been assessed. This view is not consistent with the statement referred to in paragraph 60 of this decision.

64. In its submission, RHI suggested that the statement referred to in paragraph 61 be amended to read (emphasis added):

> *This evaluation is based on generally accepted industry lives, <u>the experience of other railways in the Pilbara</u>, and RHI's own experience. The economic life of assets are generally consistent with those accepted in other regimes*

65. The Authority notes that the economic lives proposed by RHI are not consistent with those specified in the TPI Costing Principles.

66. The Authority does not consider that the economic life of the railway should be constrained by the economic life of the Roy Hill mine, as the railway may be used for other more long-lived projects. Also, it is not unusual for mines to be operated for longer than expected when they begin operation. The Authority has noted the term of the State Agreement for operation of the railway, which is at least 27 years.

67. The Authority has noted that the RHI proposed Costing Principles already include provision for truncating the economic life of assets consistent with time-constrained

[16] Paragraph 45.

projects. The Authority has accepted these provisions, which appear at the last paragraph of 2.4(a)(ix) and in the definition of "Nper" at 2.6(c).

68. The Authority confirms its requirement that Part 2.4(a)(ix) is removed. The Authority also requires that Annexure A 'Economic Life of Assets 'is amended such that the economic lives shown are consistent with those shown in Annexure A of TPI's Costing Principles.

The ERA to determine a nominal pre-tax WACC

69. Part 2.5 of RHI's proposed Costing Principles says that it is a Code requirement that the ERA determine a nominal pre-tax WACC each year for the RHI railway. This is not correct, as the Code requires only that an annual WACC be determined. The Code does not prescribe that the WACC should be real or nominal, post- or pre-tax. For practical reasons,[17] the ERA determines the annual WACC on a real pre-tax basis.

70. In its Draft Decision, the Authority required that the words "nominal pre-tax" are replaced with "annual" in Part 2.5. In its submission, RHI agreed with the requirement. The Authority confirms the requirement in this Final Decision.

The proposed Costing Principles includes references to accrual of charges and payments of accounts

71. Part 2.6 outlines the specific form of the annuity calculation proposed to annualise capital costs. The requirement for an annuity calculation is outlined in Clause 2(3) and 2(4) of Schedule 4 to the Code, however, the specific form of the calculation is not prescribed. RHI has proposed an MS Excel-based formulation of the annuity calculation which is identical to that approved in the BR and TPI Costing Principles.

72. At 2.6(d), RHI introduces the concepts of under- and over-payments, and relates the timing of the calculation of capital charges and payment to the inclusion of working capital amounts in the operating costs calculation.

73. In its Draft Decision, the Authority required the replacement of 2.6(d) and 2.6(e) with "This formula calculates the costs at the beginning of the period. Provisions for the calculation of working capital amounts based on consideration of the mid-point of the annuity period are made at Part 3.3(c)(v)".

74. In its submission, RHI stated that Parts 2.6(d) and 2.6(e) should be retained in the Costing Principles as they describe more fully how the calculation of the annuity will work.

75. The Authority considers that Parts 2.6(d) and 2.6(e) do not describe more fully how the calculation of the annuity will work, and that the calculation of the annuity is fully described in 2.6(c). The Authority considers that 2.6(d) and 2.6(e) provide a justification for the consideration of working capital – which is an operating cost and covered in Part 3.3(c)(v) - and statements positing alternative accounts payable

[17] The ERA calculates a pre-tax WACC to avoid the need for the railway owner to produce comprehensive nominal tax accounts. The ERA publishes both real and nominal WACCs for all railways; however, a nominal (dollar of the day) annuity is generally calculated for the purposes of railway owners' negotiations.

scenarios. This consideration was provided at paragraphs 48 and 49 of the Authority's Draft Decision.

76. In its submission, RHI stated that both BR and TPI Costing Principles include paragraphs similar to 2.6(d) and 2.6(e). While both the TPI and BR documents refer to the calculation of working capital, neither refers to scenarios for the payment of accounts or the crediting of over-payments.

77. RHI did not address the reasoning of the Authority in its Draft Decision. The Costing Principles are used to determine costs. The Costing Principles should not be used to prescribe means of establishing prices or the payments to be made by an operator, which are determined by negotiation between the railway owner and the operator and which are outlined in an access agreement between those two parties.

78. The Authority confirms its requirement that the 2.6(d) and 2.6(e) be replaced with "This formula calculates the costs at the beginning of the period. Provisions for the calculation of working capital amounts based on consideration of the mid-point of the annuity period are made at Part 3.3(c)(v)".

Required Amendment 2

Part 2 of RHI's proposed Costing Principles rules should be amended such that:

- 2.1(b) is replaced with "Incremental costs will include capital costs only where RHI assesses that it is necessary to make capital expenditure (of the type referred to in 2.3(c) of these Costing Principles) to provide the proposed access".

- The second paragraph of 2.4(a)(i) is replaced with "RHI considers that the network as constructed can meet current and reasonably projected demand for all users taken together. If RHI requires additional infrastructure to meet its own projected demand in conjunction with an access proposal, then it will demonstrate the basis of and financial commitment to the demand projection."

- In Part 2.4(a)(iv), the word "However" is deleted, and the word "included" is replaced with "excluded".

- In Part 2.4(a)(ix), the second paragraph is removed.

- The words "nominal pre-tax" are replaced with "annual" in Part 2.5.

- Parts 2.6(d) and 2.6(e) are replaced with "This formula calculates the costs at the beginning of the period. Provisions for the calculation of working capital amounts based on consideration of the mid-point of the annuity period are made at Part 3.3(c)(v).

Part 3 – Determination of Operating Costs

Determination of Operating Costs in the past tense

79. Part 3.1 of RHI's proposed Costing Principles refers to the determination of operating costs in the past tense, and the Authority required, in its Draft Decision, that this part should be altered to indicate that operating costs will be determined on the basis of efficient costs at the time of receipt of a proposal.

80. In its submission, RHI agreed with this requirement. The Authority confirms this requirement in this Final Decision.

Determining operating costs on the basis of actual or expected operating costs

81. In its Draft Decision, the Authority required the removal of the last paragraph of Part 3.3(c)(iii).[18] This is because operating costs do not necessarily relate to the expected actual costs,[19] but to efficient operating costs, including the efficient costs of managing the network for the purposes of third party access. This consideration was provided at paragraphs 58 and 59 of the Authority's Draft Decision.

82. In its submission, RHI stated that the last paragraph of Part 3.3(c)(iii) should not be removed, as third parties will pay the entire cost of additional staff required as a consequence of the provision of third party access.

83. The Authority considers that RHI has not addressed the Authority's concerns as shown in its Draft Decision. The Authority confirms its requirement that the last paragraph of Part 3.3(c)(iii) is removed.

Inclusion of Insurances as an operating cost

84. In its proposed Costing Principles, RHI has proposed the inclusion of insurances as an operating cost at 3.3(c)(vi). Given the corporate structure of RHH, it will procure and manage insurances for the group, including for RHI. The management of insurances for RHI by RHH would be similar to the arrangement indicated in TPI's costing principles (Appendix B) whereby FMG provides these services to TPI, and where TPI includes the cost of these services as a corporate overhead.

85. The inclusion of insurances as an operating cost is not accepted, as the definition of operating costs in Clause 1 of Schedule 4 to the Code refers only to (a) train control, signalling costs, (b) cyclical maintenance costs, (c) payments in respect of land leases. Additional insurances required in respect of third party access may be included as an incremental overhead cost.

[18] Part 3.3(c)(iii) states:

> "These costs include the whole of any additional costs incurred by RHI resulting from the provision of access to another Operator in managing the network (including the entire cost of employing or engaging any additional persons required as a consequence of complying with RHI's obligations to provide access under the Act and the Code)."

[19] The actual cost of accommodating third party access will, of course, not be known with certainty prior to access commencing.

86. In its Draft Decision, the Authority required the removal of Part 3.3(c)(vi). In its submission, RHI agreed with the requirement. The Authority confirms the requirement in this Final Decision.

Stipulating payment regimes

87. Part 3.5 of RHI's proposed Costing Principles proposes a regime for the payment of Operating Costs, including that "amounts payable for operating costs will be paid annually in advance, based on budgeted costs".

88. It is not the function of Costing Principles to prescribe the terms and conditions normally found in access agreements. The object of the Costing Principles is to determine cost boundaries for price negotiation, not to prescribe the manner in which those costs might be recovered. This consideration was provided at paragraph 62 of the Authority's Draft Decision. In its Draft Decision, the Authority required the removal of Part 3.5.

89. In its submission, RHI stated "the Authority considers that the payment mechanisms should be included in the access agreement between the third party and RHI, rather than in the Costing Principles", and that RHI considers that it is appropriate that the payment mechanisms be included in the Costing Principles. RHI went further in its submission, suggesting that compensation would be payable to RHI for any deviations from the payment mechanisms set out in the Costing Principles.

90. RHI's submission has not demonstrated that its proposed wording at Part 3.5 is consistent with purpose of Costing Principles under the Code, which does not include prescribing the manner in which payment mechanisms may be negotiated (refer to paragraph 88 above).

91. The Authority confirms its requirement that Part 3.5 be removed from RHI's proposed Costing Principles.

Required Amendment 3

Part 3 of RHI's proposed Costing Principles should be amended such that:

- In part 3.1 the words "has determined" are replaced with "will determine"
- The last paragraph of Part 3.3(c)(iii) is deleted
- Part 3.3(c)(vi) is deleted
- Part 3.5 is deleted

Part 4 – Overhead Costs

Overhead costs are related to the Code's definition of "Railway Infrastructure" and not to the performance of the railway owner's access-related functions

92. Part 4 of RHI's proposed Costing Principles defines overhead costs and describes the means by which RHI proposes to allocate these costs across route sections of the

railway. The Code does not provide guidance on overhead costs, except to prescribe their inclusion in total costs at clause 1(c) of Schedule 4 to the Code. In this subclause, overhead costs are referred to as "the overheads attributable to the performance of the railway owner's access-related functions whether by the railway owner or an associate".

93. At Part 4.1, RHI lays out that RHI is a "separate legal entity" with an overhead structure which relates to its business of access provision, and that it sources corporate and related functions from RHH. Part 4.1 outlines that only those overhead costs attributable to the Code's definition of "railway infrastructure" will be included in costs.

94. In referring to overhead costs, RHI's statement that "only those costs attributable to activities related to the Code definition of 'railway infrastructure' will be included" does not reflect the description in the Code of overhead costs as being those attributable to access-related functions.[20]

95. This consideration was provided at paragraph 69 of the Authority's Draft Decision. In its Draft Decision, the Authority required that RHI amend Part 4.1 such that the words "railway infrastructure" are replaced with "access-related functions".

96. In its submission, RHI stated "the reference to "railway infrastructure" is consistent with the terminology used in both the BR and TPI Costing Principles. It argues that for the sake of consistency, it would be best if the term 'railway infrastructure' was retained in the RHI Costing Principles".

97. RHI did not acknowledge the Authority's concerns in relation to the Code definition of overhead costs. The Authority considers that consistency with the Code is more important than consistency with other railway owners' Costing Principles.

98. The Authority notes that the TPI Costing Principles includes the appropriate reference to "access-related functions" in its description of overheads costs.

99. The Authority has amended its requirement in respect of Part 4.1, such that Part 4.1 is prefaced by the statement "RHI's overheads are those overhead costs attributable to the performance of RHI's access-related functions whether by RHI or by an associate".

Requiring the Regulator to determine the allocation of overhead costs

100. Part 4.2 of RHI's proposed Costing Principles refers to the allocation of overhead costs, and indicates an allocation method at Annexure B. Part 4.2 proposes that overhead costs will be allocated to route section in the first instance, and that "subsequent allocation to the Route Section level will be determined by the ERA".

101. RHI's Costing Principles must not relieve RHI from its responsibility to provide a complete determination of costs in the first instance, nor seek to make the Regulator responsible for determining the allocation of overhead costs to the route section level.[21]

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[20] Notwithstanding the use of "separate" and "railway infrastructure" in both BR's and TPI's costing principles.

[21] In the corresponding part, BR's costing principles indicate that the route section allocation will be "determined by the ERA". TPI's costing principles indicate that the allocation will be "reviewed by the ERA".

102. In its Draft Decision, the Authority required that the following text in Part 4.2:

> *The allocation of Overhead Costs will, in the first instance, be apportioned to a Route Section and subsequent allocation to the Route Section level will be determined by the ERA as part of the calculation of incremental and total costs. Details of Overhead Costs included are set out in Annexure B.*

be amended to read:

> *The allocation of Overhead Costs will, in the first instance, be apportioned to a Route Section and subsequent allocation to the Route Section level will be reviewed by the ERA as part of the calculation of incremental and total costs. Allocation criteria for Overhead Costs are set out in Annexure B.*

103. In its submission, RHI agreed with this requirement. The Authority confirms the requirement in this Final Decision.

Stipulation of payment regimes

104. Part 4.3 of RHI's proposed Costing Principles "Payment of Overhead Costs" stipulates rules for the payment of overhead costs by operators, including that "amounts payable for overhead costs will be paid annually in advance, based on budgeted costs".

105. This statement is substantially identical to the statement at Part 3.5 "Payment of Operating Costs".

106. It is not the function of Costing Principles to prescribe the terms and conditions normally found in access agreements. In particular, the object of the Costing Principles is to determine cost boundaries for price negotiation, not to prescribe the manner in which those costs might be recovered. This consideration was provided at paragraph 72 of the Authority's Draft Decision. In its Draft Decision, the Authority required the removal of Part 4.3.

107. In its submission, RHI stated "the Authority considers that the payment mechanisms should be included in the access agreement between the third party and RHI, rather than in the Costing Principles", and that RHI considers that it is appropriate that the payment mechanisms be included in the Costing Principles. RHI went further in its submission, to suggest that compensation would be payable to RHI for any deviations from the payment mechanisms set out in the Costing Principles.

108. RHI's submission has not demonstrated that its proposed wording at Part 4.3 is consistent with purpose of Costing Principles under the Code, which does not include prescribing the manner in which costs might be recovered (refer to paragraph 106).

109. The Authority confirms its requirement that Part 4.3 is removed from RHI's proposed Costing Principles.

Required Amendment 4

Part 4 of RHI's proposed Costing Principles should be amended such that:

- Part 4.1 is prefaced by an additional sentence reading ""RHI's overheads are those overhead costs attributable to the performance of RHI's access-related functions whether by RHI or by an associate".
- In Part 4.2, the words "determined" and "Details of" are replaced with "reviewed" and "Allocation criteria for" respectively, and the word "included" is removed.
- Part 4.3 is removed.

Part 5 – Other Matters

Costs may be "re-determined" not "pre-determined"

110. Part 5.1(a) of RHI's proposed Costing Principles includes the words:

> *Following any determination of incremental costs and total costs, the costs may be indexed annually for a period of up to five years. The purpose of the indexation is to enable the administration of the Over-payment Rules in relation to revenues received under Access Agreements and to enable total costs to reflect a reasonable return to RHI over the five year period without requiring RHI or the ERA to predetermine costs over that period.*

111. RHI has used the word "predetermine" in the last sentence of 5.1(a), where the word "re-determine" would be appropriate.

112. In its Draft Decision, the Authority required that the word "predetermine" in the last sentence of 5.1(a) be replaced with "re-determine". RHI agreed to this requirement in its submission. The Authority confirms the requirement in this Final Decision.

Indexation scheme

113. Part 5.1 of RHI's proposed Costing Principles provides for the indexation of costs for the purposes of administration of the over-payment accounts. RHI has proposed that determined costs will be indexed for a period of five years, and will remain unadjusted over any period beyond five years.

114. These matters are not contemplated by the Code, but have been addressed by the Authority in a decision published in 2011.[22]

115. In Part 5.1(c), RHI proposes to index determined costs on the basis of actual cost increases, or a CPI applicable to the Pilbara region of Western Australia. Other railway owners' costing principles provide for indexation on the basis of an

[22] https://www.erawa.com.au/cproot/9819/2/20110825%20Final%20Decision%20-%20Review%20of%20the%20Requirements%20for%20Railway%20Owners%20to%20Submit%20Floor%20and%20Ceiling%20Costs.pdf paragraphs 133-135.

efficiency-discounted “CPI-X” method. Apart from this difference, RHI’s proposal is equivalent to the provisions in TPI’s costing principles. BR’s costing principles provide for indefinite indexation of costs.[23]

116. RHI’s proposal to index costs on the basis of actual cost movements (including movements resulting from changes in law) is not accepted. Cost shifts resulting from actual movements in costs would require a re-determination of costs, consistent with the provisions of Clause 12 of Schedule 4 to the Code. Clause 12 provides for a re-determination of costs if the Regulator considers that there has been a material change in any of the circumstances that existed at the time when costs were determined under Clause 9 or 10 of Schedule 4 to the Code in respect of a proposal.

117. Further, the use of a price index applicable specifically to the Pilbara region of Western Australia is not accepted for the purpose of indexing costs. The Australian Bureau of Statistics does not produce regional prices indexes. The Western Australian Department of Regional Development does produce regional price estimates, but it updates them infrequently. Moreover, many of the costs of constructing a railway are established outside the Pilbara region, in particular where rail or other components are manufactured.

118. The inclusion of a negative “X” factor of 25 per cent of the annual movement in CPI is required as an efficiency factor for cost indexation purposes, and should be applied consistently to all railway owners.[24] The appropriate value of the “X-factor” was established by the Authority in conjunction with the approval of Costing Principles for WestNet Rail in 2002.[25]

119. In its Draft Decision, the Authority required that Part 5.1(c) be deleted and replaced with:

> *RHI will index Incremental and Total Costs based on CPI minus the “X” factor. The “X” factor will be set at one quarter of CPI. In determining CPI, the Australian Bureau of Statistics Weighted Average of Eight Capital Cities All Groups CPI index will be used. The annual change will be calculated as the percentage change in the average of the four quarters to March of each year from the average of the previous four quarters.*

120. In its submission RHI stated that the purpose of nominating actual costs and a Pilbara CPI index is to ensure that the indexation is as accurate as possible. RHI did not address the Authority’s concerns in the Draft Decision,[26] in particular:

- That available Pilbara specific CPI indices,[27] are not updated regularly, and would not necessarily relate to costs incurred outside the Pilbara region, and

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[23] BR’s costing principles were last approved in 2010, prior to the Authority’s decision referred to in paragraph 114.

[24] ACIL for Hancock Prospecting, in response to TPI’s proposed costing principles in 2008, submitted (page 17) “TPI’s .costs should be indexed by CPI-X with ERA setting an appropriate X factor in the light of its consideration of future cost movements” http://www.erawa.com.au/cproot/7022/2/20081015%20Public%20Submission%20-%20Hancock%20Prospecting%20Pty%20Ltd.pdf

[25] https://www.erawa.com.au/cproot/3218/2/finalcost_prin.pdf page 38. The document refers to X as one quarter of CPI, whereas it should properly refer to one-quarter of *the change in* CPI.

[26] Paragraphs 78 and 79.

[27] The ABS does not produce a Pilbara region CPI.

- Any changes in actual costs – including as a result of government policy changes – would require a re-determination of costs under clause 12 of Schedule 4 to the Code.

121. RHI acknowledged the 25 per cent "X" efficiency factor which is included in both BR's and TPI's Costing Principles. However, RHI submitted that its own Costing Principles should not be consistent with the other railway owners' – in this instance - and that any indexation should be the full CPI amount. RHI stated "RHI is not aware of any reason why a reduction is appropriate".

122. The CPI-X method is a well documented regulatory means of providing an "efficiency incentive". In general terms, the X-factor performs two key roles. Firstly, it ensures that, while regulated firms are not locked into a nominal price schedule, which erodes real terms in line with inflation, they are not unduly benefitted through being able to appropriate all of the returns from productivity improvements, which would be passed onto consumers through lower prices in the case of a competitive industry. Secondly, the X-factor provides incentives for the regulated firm to engage in cost-reducing productivity improvements in the future.

123. The Authority confirms its requirement as outlined in paragraph 119 of this document, although it has clarified the wording in the second sentence of the required amendment replacing the words "one quarter of CPI" with "one quarter of the annual change in CPI".

Allowance for asymmetric risk as an operating cost

124. Part 5.2 of RHI's proposed Costing Principles allows for the consideration of asymmetric risk in the determination of operating cost.

125. The proposal at Part 5.2, that an allowance for asymmetric risk is considered on a case-by-case basis, was accepted by the Authority in its Draft Decision. However, the Authority required that such an allowance not be included as an operating cost, but may be considered for incorporation into the capital cost calculation[28] on a case-by-case basis.[29] This is because the definition of operating cost in Clause 1 of Schedule 4 to the Code includes only: (a) train control and signalling costs; (b) cyclical maintenance costs; and (c) payments in respect of land leases. This consideration was provided at paragraph 81 of the Authority's Draft Decision.

126. In its submission, RHI stated "RHI notes that the TPI Costing Principles include the allowance of asymmetric risk as an annual operating cost". The Authority should explain why it has taken a different view in relation to the RHI Costing Principles".

127. RHI did not acknowledge the definitional issue highlighted by the Authority in its Draft Decision (outlined in paragraph 125 above) by way of a reason for this requirement.

[28] Either by way of an adjustment to the return on equity component of the WACC calculation, or the economic lives used in an annuity calculation.

[29] ACIL for Hancock Prospecting, in response to TPI proposed costing principles in 2008, submitted (page 13) "TPI needs to provide a strong justification for any premium on costs (such as a self-insurance premium) or any premium on the WACC to allow for asymmetric risk. Such an allowance should not be given "blanket" approval within the Costing Principles".

128. The Authority requires that the words ”as an annual operating” is replaced with “in its determination of Capital” in Part 5.2. The Authority has amended the wording of this requirement as the draft decision erroneously referred to the inclusion of asymmetric risk as an overhead cost.

Required Amendment 5

Part 5 of RHI’s proposed Costing Principles should be amended such that:

- the words “predetermined” is replaced with “re-determined” in 5.1(a)
- Part 5.1(c) is deleted and replaced with “RHI will index Incremental and Total Costs based on CPI minus the “X” factor. The “X” factor will be set at one quarter of the annual change in CPI. In determining CPI, the Australian Bureau of Statistics Weighted Average of Eight Capital Cities All Groups CPI index will be used. The annual change will be calculated as the percentage change in the average of the four quarters to March of each year from the average of the previous four quarters.”
- The words “as an annual Operating” are replaced with “in its determination of Capital” in Part 5.2.

Part 7 – Definitions

Lack of Clarity in definitions

129. The Authority considers that there is a lack of clarity in RHI’s use of the term “RHI Railway”. The definition provided by RHI for “RHI Railway” does not refer to the definition of railway infrastructure in section 3 of the Code.

130. RHI also refers to “the rail network” in Part 2.4(a)(i) and 2.4(a)(iii) of its proposed Costing Principles. The Code defines “railways network” to mean all railways subject to the Act and the Code, including the BR and TPI railways. “Network” is not defined in Part 6 of RHI’s proposed Costing Principles.

131. The Authority requires RHI to replace “network” with “RHI Railway” in Parts 2.4(a)(i) and 2.4(a)(iii) of its proposed Costing Principles.

132. The Authority requires RHI to provide a definition of “RHI Railway” which refers to the definition of “railway infrastructure” in the Code.

Required Amendment 6

- Parts 2.4(a)(i) and 2.4(a)(iii) of RHI’s proposed Costing Principles should be amended such that the word “Network” is replaced with “RHI Railway”.

- Part 6 of RHI's proposed Train Management Guidelines should be amended such that a definition of "RHI Railway" is provided which refers to the definition of "railway infrastructure" in the Code.