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14 November 2008

Mr Russell Dumas
Director, Gas and Rail Access
Economic Regulation Authority
Level 6, Governor Stirling Tower
197 St George's Terrace
PERTH WA 6000

Dear Russell

**RAILWAYS (ACCESS) CODE 2000 – THE PILBARA INFRASTRUCTURE PTY LTD**

On 24 July and 15 August 2008, The Pilbara Infrastructure Pty Ltd (TPI) submitted to the ERA, its Overpayment Rules and Costing Principles, required under Sections 47 and 46 respectively of the above Code. The ERA released the submissions for public comment with 4 parties making comments.

The ERA has since agreed to TPI providing a response to the public comments.

Please find attached TPI's response to selected issues raised in public comments.

If you require additional information or clarification of comments, please do not hesitate to contact me.

Yours sincerely

**FORTESCUE METALS GROUP LTD**

**GREG DELLAR**
for
The Pilbara Infrastructure Pty Ltd

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**Response to Selected Comments**

**Costing Principles S 46 Railways (Access) Code 2000**

**Overpayment Rules S 47 Railways (Access) Code 2000**

**The Pilbara Infrastructure Pty Ltd**

In accordance with its obligations under Clause 16(8) of the Railway and Port (The Pilbara Infrastructure Pty Ltd) Agreement, The Pilbara Infrastructure Pty Ltd (TPI) submitted its proposed costing principles and overpayment rules to the Economic Regulation Authority (ERA) for approval. The ERA subsequently released TPI's documents for public comment.

The ERA website indicated that four public submissions were made in response to the proposed costing principles and overpayment rules, by the following organisations:

- Australian Rail Track Corporation (ARTC)
- Hancock Prospecting (HP)
- North West Iron Ore Alliance (NWIOA)
- United Minerals Corporation NL (UMC).[1]

Having reviewing the submissions made by these organisations, TPI has summarised some key issues raised and commented accordingly in this paper.

## Capital costs

Comments received have focussed on:

- Gross Replacement Values
- Asset Stranding Risk
- Asset Lives
- Route Sections

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*TPI's Response*

Gross Replacement Values

Contrary to impressions created by commenting parties, TPI's railway will be treated as a standalone railway for cost allocation purposes under the Code. Moreover, as a greenfields railway, it is difficult for anyone to credibly argue that it has not been built with modern equivalent assets.

The building block approach is not a theoretical construct as suggested. Rather, Australian regulators use the regulated businesses' actual costs as a starting point and test the reasonableness of these actual costs in establishing the capital and operating cost building blocks.

Regardless, the Code requires railway managers like TPI to use the gross replacement valuation approach to establish capital costs not the building block approach used in other Australian rail access regimes. The Code clarifies that floor and ceiling costs are intended to be those that would be incurred by an entity managing the network and adopting efficient practices.

TPI also clarifies that the initial capacity of the railway was 70 Mt/a, as required under the Railway and Port (The Pilbara Infrastructure Pty Ltd) Agreement. Given that the scale of production by the foundation customer, FMG Chichester Pty Ltd from its initial project was 45 Mt/a, there can be argument about a lack of capacity for parties other than FMG when the railway was commissioned.

Some comments sought that TPI be required to provide greater detail on current and spare capacity on the railway and on what basis the need for capacity enhancements will be assessed by TPI. The Code does not require that TPI provide such detail and basis. Rather, TPI is obliged to provide information to an access seeker regarding available capacity on the route to which it seeks access. The complexities associated with estimating the capacity of a multiple user network, including differences between operator's train configurations and axle loadings, require the adoption of evolving and iterative methodologies. The outputs of such estimates are heavily dependent upon future and unknown operator preferences, many of which cannot be mandated by the railway owner.

Asset Stranding Risk

This issue is a secondary issue for the costing principles and TPI expects will be addressed as part of ERA's consideration of an appropriate WACC for the railway. However, it is worth noting that comments made regarding the ability of TPI to lease track is irrelevant – it would have been impossible for TPI to raise finance for the track without FMG's commitment. Adopting a lease approach given the risk profile of TPI's infrastructure is likely to be perceived by financiers

as a higher risk investment, and as a consequence, involve a higher cost of capital.

Asset Lives

Under Clause 2 of Schedule 4 of the Code, capital costs of railway infrastructure must be calculated using the application of economic lives consistent with the basis for the gross replacement value of the railway infrastructure.

Contrary to comments received, the inclusion of contractors' margins and overheads, engineering and contract management and interest on construction is not irrelevant to the economic lives of assets. The inclusion of such costs has not been contentious in regulatory processes. TPI's approach is consistent with that adopted by WestNet.

Route Sections

TPI has considered how best to define route sections for the railway. It has become clear that any separation of the current railway into route sections is an arbitrary process given the uncertainties of access points by potential operators. An arbitrary definition of routes would doubtless draw the same degree of criticism from potential operators.

Further, no clarity on this matter has emerged since TPI submitted its proposed costing principles and overpayment rules to the ERA in July 2008, with only some general approaches having been made by possible operators. In the absence of the certainty required, TPI prefers to define route sections on the basis of existing rail usage. There are future opportunities for route sections to be re-defined as the situation changes.

**Operating costs**

Comments received have focussed on:

- Allocation of corporate overheads
- Major periodic maintenance (MPM)
- Use of train kilometres (TKM) verses gross tonne kilometres (GTK); and
- Land costs

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*TPI's response*

Corporate overheads

TPI notes that Westnet's approved costing principles do not specify the basis upon which the owner's corporate overheads are allocated to Westnet. The cost allocators will be included in the costing model which will be assessed by ERA.

MPM

This has been recognised by Australian rail regulators as a legitimate cost that must be incurred to achieve the economic life of the assets. They are appropriate for inclusion in operating costs if targeted at achieving asset life rather than asset renewal. TPI views MPM as a maintenance activity (and therefore cost) rather than an improvement to the network.

TKM and GTK

TPI prefers the use of TKM as it simplifies the cost allocator methodology. TPI is aware of a preference by operators for the use of GTK however that approach very poorly addresses the complex cost relationships that are influenced by factors such as traffic levels, speed, axle load and a fixed component of expenditure unrelated to traffic.

Land costs

Consistent with the Westnet precedent, TPI considers that the initial capital value should include the value of all earthworks, including cuttings and embankments, but should exclude the value of the land of which they form part. We believe that the costs associated with assembling land for a corridor and associated costs should be recoverable. Leasing costs for corridor land should also be recoverable as an operating cost. It is incorrect to state that regulators generally exclude land costs - rather, Australian rail regulatory precedent is uneven.

**Costing model**

Comments received have:

- Questioned the timetable for delivery of a model;
- Suggested a shorter period is possible if a standalone building block approach is used; and
- Suggested an indexing mechanism be used between GRV recalculations.

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*TPI's response*

Timetable

TPI's railway has only been in operations since May 2008. While the railway has been built to carry up to 70 Mt/a of products, the ramp up to such scale of operations will be gradual. The company is progressively developing real experience in operating and maintaining the railway, significantly including an understanding of associated costs. The 18 month timetable will be coincidental to a far more mature rail network.

Stand Alone Building Block Approach

The standalone building block approach applied across energy and transport infrastructure sectors in Australia is based on actual costs, so the suggestion that its application provides scope for a shorter period to develop a costing model is not valid.

TPI notes also that the previous WestNet costing reviews have been marked by debate over asset valuation approaches. While, on the surface, there may be merit in arguing the reasonableness of GRV (which assumes a new asset) in regard to the mature assets operated by Westnet, there can be no such debate in TPI's case as it operates a greenfields railway.

Indexing

TPI would argue that there should be no adjustment for productivity in the absence of evidence that TPI is inefficient. This is on the grounds that for new infrastructure, it is likely to be very difficult to accurately estimate achievable productivity gains over the initial price setting period.