

# ***AustralAsia Railway (Third Party Access) Act 1999***

## ***AustralAsia Railway (Third Party Access) Code***

### ***Review of revenues***

*April 2021*

#### *Introduction*

1. This advice is provided in connection with a review of revenues paid or payable by an access holder to access providers for railway infrastructure services using infrastructure comprising the railway between Tarcoola and Darwin where no sustainable competitive prices exist. A review is conducted under clause 50(4) of the *AustralAsia Railway (Third Party Access) Code* (the “**Access Code**”) by the Essential Services Commission of South Australia (the “**Commission**”).<sup>1</sup>
2. In particular, this advice relates to the methodology that is to be adopted for valuing capital assets for the purposes of the review. The question of the methodology to be adopted by the Commission relates to the fact that the pricing principles that apply in relation to an arbitration under the Access Code where no sustainable competitive prices exist prescribe the *Depreciated Optimised Replacement Cost* (the “**DORC**”) methodology for valuing capital assets. However, unlike the arbitration provisions, there is no clear statement in the Access Code about the methodology to be used by the Commission when undertaking a review under clause 50 of the Access Code noting, in particular, that the DORC approach is not referred to in clause 50.

#### *Focus of a review*

3. As provided by clause 50(4) of the Access Code, the purpose of a review is to determine whether the relevant revenues are “excessive”, having regard to the factors specified in clause 50. This is, from one perspective, a relatively straight-forward question, being whether the relevant revenues are excessive, and there is an argument that the assessment should not be constrained by any particular factor, other than as specified in subclause (5) of clause 50 (supported by subclauses (6) and (7)). Connected with this view, it could be said that there is no point in a review if the Commission cannot take steps to make or recommend improvements to the scheme set out in the Access Code as to the determination of price for gaining access to the

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<sup>1</sup> The Commission is the regulator under the Access Code. The last review under clause 50(4) was conducted in 2015 in relation to the period 15 January 2004 to 30 June 2013. The current review is the second review conducted by the Commission under clause 50 of the Access Code, and is in respect of the 5 year period that commences immediately after the end of the last review. Subsequent reviews are to be conducted in respect of successive five year periods. See clause 50(10) of the Access Code.

relevant railway infrastructure in order to ensure that these prices are not excessive.

4. As has been already stated, the DORC methodology for valuing capital assets applies in relation to an arbitration where there is no sustainable competitive price. However, the review is wider than assessing how the regime has performed when prices have been determined through arbitration; it is to determine whether prices have been excessive taking into account all cases where no sustainable competitive prices exist. These issues will be further explored in a later part of this advice.

#### *Essential features of review*

5. It is helpful to consider various matters associated with a review under clause 50(4) of the Access Code.
  - (1) The review relates to revenues derived from either: (1) awards by arbitrators to the extent the awards involve the application of section 2 of the pricing principles, which apply where there is no sustainable competitive prices; or (2) access contracts negotiated between parties to the extent that the regulator considers that sustainable competitive prices did not exist or do not exist in relation to the transportation of freight.
  - (2) The question is whether the relevant revenues paid or payable in these circumstances are *excessive*.
  - (3) Clause 50(5)(a) requires that the relevant revenues are measured against the *costs* associated with the required railway infrastructure, including an appropriate *commercial return* on the relevant required railway infrastructure.
  - (4) Clause 50(5)(b) requires the regulator to have regard to the investment in all railway infrastructure facilities and all revenues earned from the provision of railway infrastructure services including revenues at market rates in relation to those services.
  - (5) Clause 50(5)(c) requires the regulator to have regard to an appropriate commercial return on the relevant required railway infrastructure (determined having regard to specified factors).
  - (6) Clause 50(5)(d) refers to the subtraction of the aggregate of specified avoidable costs and a reasonable contribution to fixed costs of the relevant required railway infrastructure from all other access holders using that infrastructure.
  - (7) Clause 50(6) requires that costs applied under subclause (5) must be *efficient*.

6. In considering these matters, a number of related points may be made.
7. Firstly, it is possible that a review may determine that one or more awards made as a result of arbitration are excessive, which may indicate that the application of the DORC methodology has been a contributing factor to such an outcome.
8. Secondly, some of the matters referred to in clause 50(5) are similar to, but not identical to, factors and principles that must be applied by an arbitrator under the pricing principles to determine a ceiling price and a floor price, and this may contribute to a divergence between the outcome of a review and prices determined as a result of arbitration.
9. Thirdly, some of the concepts in clause 50(5) are not included in the pricing principles and this may further contribute to a divergence between the outcome of a review and prices determined as a result of arbitration.
10. Finally, clause 50(6) requires that the costs to be applied under clause 50(5) must be efficient costs. Efficient costs are influenced by the capital valuation of the relevant railway infrastructure, and this value is used for the purpose of determining an appropriate commercial return on, and the depreciation of, the railway infrastructure. For the purposes of a review, this must be an objective determination and must use the most appropriate methodology in the circumstances. From an economic perspective, the most efficient costs are the costs determined by cost or market value.

### *Contrasting different approaches*

#### *Comparing arbitration provisions with negotiated access arrangements*

11. It is helpful to consider the situation applying to arbitrations and to compare this to negotiated access arrangements.
12. With an arbitration, the Access Code adopts a highly prescriptive approach in relation price determination. From one perspective, the Access Code essentially seeks to achieve a balance between ensuring that a railway infrastructure service provider receives reasonable remuneration for the provision of those services, including a reasonable return on capital assets, and ensuring that access seekers are not charged excessive prices.
13. This prescriptive approach provided a degree of certainty for Governments in seeking to promote investment in the railway, and has provided a degree of certainty for access providers as to their returns in the event of an arbitration. The approach also provides a level of transparency for access seekers.

14. This may be compared to the situation applying where a price is negotiated, which is effectively unregulated<sup>2</sup>, subject to the extent to which a party takes into account the rules and principles that would be applied under the Access Code if an access proposal were to be referred to arbitration.<sup>3</sup>
15. In relation to the issue of the methodology to be applied to valuing capital assets, by not prescribing the use of DORC where a price is to be determined by negotiation appears to indicate that the DORC methodology does not necessarily need to be a factor in determining price. Rather, market and commercial forces and factors may prevail, subject to periodic reviews to ensure that prices where no sustainable competitive prices exist have not been excessive, and subject to the impact of a determination on a review that prices are found to be excessive<sup>4</sup>.

*Considering a different approach to the DORC methodology*

16. As with negotiated access contracts, and as stated earlier, there is no statement of the methodology to be used by the Commission for the valuation of capital assets when the Commission is undertaking a review.
17. While it might therefore be thought that the Commission may adopt any methodology that it thinks appropriate, which may not be the DORC methodology, it is necessary to consider the effect of a position that the Commission is entitled to adopt a different methodology.
18. In this regard, to use a methodology other than DORC for the purposes of a review would create a degree of inconsistency between the concept of “excessive” for the purposes of a review and the actual outcomes derived from the substantive operation of the arbitration process.
19. Furthermore, in the last review conducted by the Commission, it was put to the Commission that the initial value of capital to be returned, as calculated by the DORC valuation, should be revisited, and should be based upon a condition-based assessment of the asset.<sup>5</sup>
20. However, the Commission decided at the time not to revisit the DORC for three specific reasons<sup>6</sup>, which may be summarised as follows:

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<sup>2</sup> This is subject to such requirements as the duty to negotiate in good faith to endeavour to reach agreement on access and any terms or conditions for the provision of access – see clause 11 of the Access Code.

<sup>3</sup> As stated by the National Competition Council *AustralAsia Railway Access Regime – Final Recommendation February 2000* (at page 34), the pricing approach taken in arbitration will strongly influence the approach taken in negotiation.

<sup>4</sup> See especially clause 50(8) and (9) of the Access Code.

<sup>5</sup> See Essential Services Commission of South Australia *Tarcoola-Darwin Railway: 10-Year Review of Revenues Final Report August 2015* at page 36.

<sup>6</sup> See page 36 of the Commission’s 2015 report.

- (1) A revenue review is backward looking, with the DORC methodology to be applied being clearly set out in the Guidelines. Investments had been made within the framework of the Code and the Guidelines and it would not be appropriate to change them ex-post as they relate to the review. Regulated entities have a right to expect regulatory consistency if they are to have confidence in making investments. This principle is generally adopted by the Commission, unless there is sufficient evidence to warrant a change.
- (2) The Commission had previously considered this issue in an earlier review of the Guidelines and decided to adopt the roll-forward approach rather than a DORC revaluation.
- (3) The process of revisiting the DORC is costly, yet was unlikely to change the outcome of the relevant review. Any revision of DORC would also result in an adjustment to allowed depreciation, which would have an off-setting impact on total capital costs.

21. It is also noted that the Commission made the point, in considering the fact that GWA (North) Pty. Limited (GWAN) purchased the railway in 2010 for \$334m (nominal), that it would not be appropriate to adopt this amount for the purposes of the review, as the guidelines for the Assess Code specified that the asset base should be valued using the DORC methodology. The Commission then said that to adopt GWAN's purchase price for a retrospective review that covers a lengthy antecedent period would not be appropriate. Finally, it was said that the price GWA paid in 2010 reflected a regulatory regime which had committed to a DORC-based value in the event of an access price dispute, and for settling ceiling prices.<sup>7</sup>

22. It is also the case that it may become apparent that the actual value of the relevant assets differs in a material way from the value applying under the DORC methodology and, indeed, as has already been said, the Commission adopted a DORC roll-forward methodology in its review of the Guidelines in 2008.<sup>8</sup> This roll-forward approach has allowed the Commission to update the initial DORC valuation without a full DORC revaluation.

23. Furthermore, it is possible that there might become a stage where the DORC methodology is considered to be no longer appropriate during the "life" of the railway under this access regime. In such a case, it

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<sup>7</sup> See pages 34 – 35 of the Commission's 2015 report.

<sup>8</sup> See page 35 of the Commission's 2015 report and the reference to the Guideline Review, Final Decision, from September 2008. Essentially, a roll-forward arrangement allows commencing asset values to be adjusted from year to year to take into account annual depreciation, annual additions of assets (including through the renewal, rehabilitation and replacement of existing assets), annual disposal of assets, and annual inflation.

would appear to unduly restrain a review to take the view that the Commission is unable to adopt the correct or preferable value of capital assets because of a methodology that is only referred to in the pricing principles to be applied in an arbitration.

### *Interpretation principles and analysis*

#### *Consideration of legislative scheme*

24. In providing advice in a case such as this, it is important to consider the legislative scheme reflected in the Access Code and its Schedule. The whole code needs to be considered and analysed in order to fully understand any part of it. Essentially, it is not possible to arrive at the appropriate construction of a legislative scheme by simply looking at individual sections, but rather it is important to consider all parts together and to consider their relation to the objects to be achieved by the scheme.

25. This is essentially based on the significance of *context* in understanding a set of legislative provisions, as reflected in the joint judgment of Brennan CJ, Dawson, Toohey and Gummow JJ in *CIC v Bankstown Football Club Ltd* where the following was said:

Moreover, the modern approach to statutory interpretation (a) insists that the context be considered in the first instance, not merely at some later stage when ambiguity might be thought to arise, and (b) uses “context” in its widest sense to include such things as the existing state of the laws and the mischief ... one may discern the statute was intended to remedy.<sup>9</sup>

26. It is on this basis that it is significant that reference is not made to the DORC methodology in clause 50 of the Access Code. If it was thought to be a key principle that should be applied for the life of the code, despite the purposes, processes and outcomes associated with periodic reviews under clause 50, it is unusual that its on-going significance and application were not mentioned in clause 50. In other words, if this methodology was so important, the question may be asked why it was not prescribed in clause 50 for the purposes of any review.

#### *Purpose of provisions*

27. As a matter of statutory interpretation, it is also important to consider the purpose of a relevant provision or set of provisions.

28. In relation to clause 50 and as indicated earlier, the purpose of a review is to determine whether revenues paid or payable by access holders to the access provider for railway infrastructure services where

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<sup>9</sup> (1997) 187 CLR 384 at 408.

no sustainable competitive prices exist are excessive, having regard to factors specified in clause 50. This includes prices that are determined under the pricing principles by an arbitrator.

29. As stated by the National Competition Council in its Final Recommendations on the access regime in 2000, this is intended to be a comprehensive review of all elements of the regime<sup>10</sup>, and if an excessive is identified, steps are to be taken under clause 50(8) and (9) of the Access Code so that anticipated revenues from all users of the assets over the next ensuing period are not excessive, having regard to the matters referred to in clause 50(5).
30. Furthermore, if necessary, the Commission may in the circumstances applying under clause 50(9) make its own determination so as to ensure that prices are not excessive, including by mandating its own pricing principles under clause 50(9)(d).
31. In undertaking the review process, and in considering the best approach to determining whether prices are excessive and, if so, an appropriate remediation plan including the most appropriate methodology to value capital assets, there is no suggestion in the drafting of clause 50 that the Commission is constrained as to the methodology to be adopted.<sup>11</sup>
32. In relation to an arbitration, the purpose of the pricing principles is to set out principles and rules that are to be applied by arbitrators and that have the effect of setting parameters on determinations and outcomes if the parties to an access proposal end up on this path.
33. The DORC methodology was the methodology put forward for arbitrations during the development of the regime. It was noted by the National Competition Council in its 2000 Report that by mandating a DORC valuation methodology, the access provider was guaranteed certainty although, as stated by an adviser to the National Competition Council at the time, there may be a range of interpretations of the DORC concepts, with different interpretations being capable of yielding substantially different results.<sup>12</sup>
34. Furthermore, the National Competition Council reported that it had received advice that the theory of regulatory asset valuation is an evolving science and that the approaches taken to DORC will continue to differ. It was considered that there were risks in prescribing a DORC methodology for such a long period. It was reported that the adviser considered that, given the range of interpretations of DORC, the

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<sup>10</sup> See National Competition Council *AustralAsia Railway Access Regime – Final Recommendation February 2000* at page 71.

<sup>11</sup> In addition, as said before, the DORC methodology is not prescribed in clause 50 (especially clause 50(5)).

<sup>12</sup> National Competition Council *AustralAsia Railway Access Regime – Final Recommendation February 2000* at page 41.

Governments could not be certain that they would achieve the outcome they anticipated.<sup>13</sup>

35. The provisions for periodic reviews allow a determination to be made as to whether the provisions finally adopted as the pricing principles on an arbitration are appropriate in the longer term.
36. It would also appear to be logical to conclude that the Commission would determine the best possible approaches and methodologies to avoid excessive prices going forward, including in connection with arbitrations and on account of the fact that the policy appearing to underpin clause 50 is that action is to be taken if prices are determined to be excessive.

#### *Consequences of a particular interpretation*

37. It is also appropriate to consider the consequences of a particular interpretation.
38. This may lead to an “implication” that additional words or material were intended to be included in a particular provision, or that a particular outcome was not intended because it would lead to an absurd outcome.<sup>14</sup>
39. Taking this principle into account, there is an implication that the Commission should adopt the DORC methodology when undertaking a review under clause 50(4), as to do otherwise could lead to an inconsistency as to what is determined to be “excessive” as a result of a review and what is within acceptable parameters in the context of an arbitration. Furthermore, as outlined in an earlier part of this advice, the Commission has previously determined that there were good reasons not to depart from the DORC methodology when undertaking a review.
40. However, there is still the argument that the Commission is not constrained to being able only to apply the DORC methodology on a review if it concludes at the end of a review that this methodology has finally become inappropriate.

#### *Related matters*

41. It could also be argued that limitations on the ability of the Commission to adjust DORC by guidelines under section 2(8) of the pricing principles set out in the Schedule to the Access Code impose a limit on the ability to move away from the DORC methodology. However, I still

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<sup>13</sup> National Competition Council *AustralAsia Railway Access Regime – Final Recommendation February 2000* at page 43.

<sup>14</sup> See *F, BV v Magistrates Court of South Australia & Anor* [2013] SASCFC 1 and *Springall v Police* (2007) 98 SASR 493.



query whether this is an appropriate constraint on what may be considered appropriate by the Commission in the context of a review.

42. It is also important to “stand back” from the relevant provisions and to avoid adopting a strict interpretation of provisions in all situations. So, for example, while it might be considered that clause 50(5)(b) of the Access Code requires the adoption of a methodology that will take into account all Government contributions made with respect to asset values, this provision is essentially indicating the need to consider all railway infrastructure facilities no matter how, or by whom, they have been provided. In other words, the requirement under this provision is for the regulator to take into account all railway infrastructure facilities under paragraph (b). Once all such facilities have been identified, then the regulator will apply any relevant principle or methodology as the regulator thinks fit (and not so as to restrict the regulator in a particular way).

### *Final outcome*

43. I consider that it is inappropriate to place implied restraints on the Commission when undertaking a review under clause 50, as indicated above (subject to the actual provisions of clause 50). I have come to this conclusion looking at the overall scheme set out in the access regime, especially clause 50 and the relevant sections of the pricing principles.
44. As previously noted, a review is examining how the regime has performed, both as to outcomes of arbitrations and as to negotiated prices. In addition, a “fix” that will be applied under clause 50(8) and (9) includes prices that may have been determined by arbitration.
45. From another perspective, the determination to be made by the Commission as to whether or not the relevant revenues are excessive is not simply based on applying the pricing principles set out in the Schedule to the Access Code.
46. In particular, I think that the overriding “principle” is that a review must be meaningful in all respects, including as to the possibility that the DORC methodology is found to be no longer appropriate as part of the processes and conclusions associated with the conduct of a review under clause 50(4) of the Access Code. This appears to be a necessary implication.
47. This would especially be the case if the Commission concludes that the DORC methodology is no longer a valid methodology to determine efficient costs.<sup>15</sup>

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<sup>15</sup> As provided by clause 50(6) of the Access Code, the costs to be applied under clause 50(5) must be efficient costs.

48. Obviously it always remains open to the Commission, as it reviews the application of the DORC methodology, to determine that, on balance, the preferable outcome is to continue to adjust DORC according to an appropriate, transparent and recognised method to deal with changes in values, additions to the assets that make up the railway, and other factors. The Commission may decide to retain the DORC methodology but move to adopting a new set of values.
49. The disadvantages to parties in moving away from DORC, even in a forward-looking sense, may outweigh any advantages in making a fundamental change to the methodology to be adopted for valuing capital assets. This is a judgment to be made by the Commission after taking into account all relevant factors.

#### *Answers to specific questions*

50. In connection with providing this advice, I have been asked a series of specific questions. My specific responses to these questions follow.

##### *Question 1*

51. *Is the Commission bound to adopt the Depreciated Optimised Replacement Cost for relevant capital assets (as set out for use in the setting of floor and ceiling prices in the event of a dispute as prescribed in the mandatory guidelines issued by the Commission – see clause 2(7)(a) of the Schedule to the Code)?* Answer: No. The Commission may adopt another methodology if the Commission concludes, on a review, that the DORC methodology is no longer a valid methodology to determine efficient costs.

##### *Question 2*

52. *Is the Commission otherwise required (for example, to ensure internal consistency within the scheme of the Code) to use that Depreciated Optimised Replacement Cost referred to above?* Answer: There are other considerations that may apply. While parties will obviously expect consistency in the application of the Access Code, and the methodology to be applied in an arbitration will influence the approach taken in any negotiation, there may come a time when the Commission, on a five-year review under clause 50 of the Access Code, concludes that the DORC methodology is no longer appropriate for the purpose of determining whether relevant revenues paid by access holders for railway infrastructure services where no sustainable competitive prices exist are excessive having regard to the relevant factors set out in clause 50.

*Question 3*

53. *Is the Commission given discretion to develop its own value for relevant capital assets, notwithstanding that the Depreciated Optimised Replacement Cost methodology must be used in the setting of floor and ceiling prices as defined by the Commission's guideline under clause 2(7)(a)?* Answer: Yes, if the Commission considers it appropriate to do so, the Commission may, on a review, develop its own value for relevant capital assets.

*Question 4*

54. *Is the Commission bound by any other constraints in terms of the scheme of the Code (ie., does it have a complete freedom to develop its own method)?* Answer: The only constraints are as set out in clause 50(4) to (9) of the Access Code.

*Recommendations for changes to access regime*

55. Finally, it is always open to the Commission to recommend to the Ministers for the relevant jurisdictions that steps be taken to amend the Access Code to specify a different methodology and/or to clarify the Commission's options on a review.

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