

Determination on the 2014 Weighted Average Cost of Capital for the Freight and Urban Railway Networks

24 October 2014

Economic Regulation Authority

WESTERN AUSTRALIA

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Determination

1. The Economic Regulation Authority (**Authority**) administers the Western Australian railways access regime. The regime consists of the *Railways (Access) Act 1998* (**Act**) and the *Railways (Access) Code 2000* (**Code**). The rail network and types of infrastructure subject to the regime are defined in this legislation. The Authority's role is to administer the Act and the Code.

Requirements of the Code

2. Schedule 4, Clause 3(1) of the Code requires the Authority to make an annual calculation, as at 30 June, of the Weighted Average Cost of Capital (**WACC**) to be applied in determining the costs for each of the rail networks covered under Schedule 1 of the Code.¹ The Authority must then publish its determination of the WACC for each rail network in the Government Gazette as soon as practicable after it is made (Schedule 4, Clause 3(1)(b)).
3. The Code also requires the Authority, from 2003, to undertake public consultation every fifth year before determining the WACC values for that year (Schedule 4, Clause 3(2)). Consequently, the Authority was required to undertake a public consultation process prior to making its WACC determination for 30 June 2013.

The 2013 rail WACC review

4. The Authority undertook a public consultation program prior to making its annual WACC determination for the regulatory year commencing 1 July 2013, with a view to also undertaking a review of the rail WACC method at that time. The 2013 Issues Paper, and submissions from stakeholders, can be found on the Authority's website.
5. However, the Authority chose to defer finalisation of the rail WACC method review at the time, because it was undertaking a review of its approach to determining the rate of return for gas networks under the National Gas Rules, which involved common issues. The Authority subsequently released the rate of return guidelines for gas transmission and distribution networks pursuant to the National Gas Rules in December 2013. In the interim, the Authority updated the rail WACC for the 2013 regulatory year, based on the method determined during the previous 2008 method review.
6. The Authority released a draft decision in relation to the rail WACC method review on 5 June 2014.²
7. The Authority's rate of return approach has undergone further development during the course of the Authority's deliberations in developing the draft decision on the proposed revisions to ATCO's gas distribution system (**GDS**) access arrangement.³ Again, there is an overlap of issues with the proposed rail WACC method, with attendant conflicts, which needs to be addressed.
8. To accommodate the changes required to address the conflicts, as well as to allow due process in terms of consultation with rail stakeholders, the Authority has decided to revise and re-issue the rail WACC method review draft decision that it previously released, referred to above.
9. The Authority intends to release a final rail WACC method review decision later in 2014 or early in 2015, with the resulting updated rail WACC method to apply for the determination

¹ *Railways (Access) Code 2000*, Schedule 4.

² Economic Regulation Authority, *Review of the method for estimating the Weighted Average Cost of Capital for the Freight and Urban Railway Networks: Draft Determination*, 5 June 2014.

³ Economic Regulation Authority, *Draft Decision on Proposed Revisions to the Access Arrangement for the Mid-West and South-West Gas Distribution System*, 14 October 2014.

of the rail WACC for the Freight and Urban Railway Networks for the regulatory year commencing 1 July 2015, as well as for subsequent years.

The 2014 rail WACC

10. The Authority will base the 2014 rail WACC estimates on the 2008 method, as amended through to 2013, and the associated parameters. The 2014 rail WACC – to apply for the regulated railway networks from 1 July 2014 to 30 June 2015 – uses the method that was applied for the determination of the 2013 rail WACC, but updates the parameters based on observable market variables (that is, the risk free rate, inflation and the debt risk premium using 20 trading days). All other parameters remain unchanged from the 2013 rail WACC determination.

11. The Authority has determined the following real pre-tax 2014 rail WACC values, to apply for the 2014 regulatory year, from 1 July 2014 to 30 June 2015 (Table 1):
 - Public Transport Authority: 4.52 per cent
 - Brookfield Rail: 7.31 per cent
 - The Pilbara Infrastructure: 10.14 per cent

Table 1 Determination on 2014 rail WACC values

Determination	Public Transport Authority	Brookfield Rail	The Pilbara Infrastructure
Nominal Risk Free Rate (10 year term)	3.75%	3.75%	3.75%
Real Risk Free Rate	1.19%	1.19%	1.19%
Inflation Rate	2.52%	2.52%	2.52%
Gearing	35%	35%	30%
Debt Risk Premium	0.971%	1.388%	2.084%
Debt Issuing Cost	0.125%	0.125%	0.125%
Australian Market Risk Premium	6.00%	6.00%	6.00%
Equity Beta	0.46	1.00	1.43
Asset Beta	0.36	0.74	1.11
Corporate Tax Rate	30%	30%	30%
Franking Credit	25%	25%	25%
Nominal Cost of Debt	4.845%	5.263%	5.958%
Real Cost of Debt	2.263%	2.671%	3.349%
Real After Tax Cost of Equity	3.89%	7.05%	9.56%
Nominal Pre Tax Cost of Equity	8.40%	12.58%	15.91%
Real Pre Tax Cost of Equity	5.73%	9.81%	13.05%
Nominal Pre Tax WACC	7.15%	10.02%	12.92%
Real Pre Tax WACC	4.52%	7.31%	10.14%
Nominal After Tax WACC	5.93%	8.18%	10.42%
Real After Tax WACC	3.32%	5.52%	7.70%