REVIEW OF WESTNET RAIL'S PART 5 INSTRUMENTS

Background

The West Australian Economic Regulation Authority ("Authority") has sought submissions from interested parties with respect to WestNet Rail's ("WNR") proposed Part 5 instruments. The instruments form Part 5 of the Railway (Access) Code 2000 ('Code'). A separate review of the Code was recently undertaken by the Authority and ARTC presented submissions to the Authority as part of this review. The Authority's final report on the review of the Code was presented by the Authority to the market in September 2005.

In relation to the current process, the Part 5 Instruments under review are:

- Train Path policy ("TPP").
- Train Management Guidelines ("TMG").
- Costing Principles.
- Over-payment Rules.

The Independent Rail Access Regulator ("Regulator") approved the TPP and TMG in April 2003, the Costing Principles in December 2002 and the Over-Payment Rules in May 2003. A review by WNR for each of the documents was set for two years after the date of approval by the Regulator. ARTC notes that WNR requested an extension of time for the review of Part 5 instruments and the Authority granted an extension to December 2005

ARTC Interaction & Interest in WNR's Part 5 Instruments

In accordance with an Inter-Governmental Agreement (IGA) made in 1997 which brought about the incorporation of ARTC as the track manager of the interstate rail network, ARTC developed and executed with the Western Australian Government Railways Commission (Westrail) which was the owner of that part of the interstate rail network in WA, a wholesale agreement providing ARTC with the right to sell access for interstate train operations to that network.

Also under the IGA, ARTC submitted a voluntary access undertaking in accordance with Part IIIA of the Trade Practices Act (1974) ("TPA") to the Australian Competition and Consumer Commission (ACCC) in January 2002. The undertaking was approved by the ACCC in May 2002, and applies to the interstate network currently controlled by ARTC, and sets out the framework under which access to that network can be negotiated with ARTC in a fair and balanced way. In endorsing ARTC's access undertaking, the ACCC recognized that a large part of ARTC's revenue is derived from rail operations that compete in markets subject to strong intermodal competition, particularly road. The ACCC also indicated that it saw ARTC's access undertaking as laying a foundation for the development of a consistent 'national' rail access regime in conjunction with other state based jurisdictions.

This wholesale agreement was developed in accordance with the principles for access now incorporated in ARTC's Access Undertaking. WNR still effectively controls the maintenance, investment and operations between Kalgoorlie and Perth. The wholesale arrangements sought to facilitate voluntary novation of existing access agreements for interstate operations in WA to ARTC. To date, no incumbent operators have novated agreements largely resulting from a stated preference for a direct relationship with the party responsible for maintenance and control of the network, rather than an indirect relationship through ARTC. As yet, no operations are being conducted on this part of the network pursuant to an access agreement developed under the wholesale arrangements.

A key issue for ARTC with respect to the WNR's Part 5 Instruments is that they cover activities occurring on the WA rail network and associated infrastructure currently leased from the WA Government by WNR, which includes part of the interstate rail network between West Kalgoorlie and Perth. Management of access in WA, for interstate operators, of services between the eastern states and WA will be undertaken according to the Part 5 Instruments, as well as under ARTC's Access Undertaking (accepted by the Australian Competition and Consumer Council (ACCC) in May 2002) for any movement east of Kalgoorlie.

Greater consistency of the terms and conditions of access (including pricing) to the national interstate rail network is one of ARTC's, its shareholders', and the rail industry's key objectives

The WA Regime: ARTC's Previous Submissions

In its previous submission to the Authority, and its previous involvement in the consultation processes conducted by the Authority (or its predecessor) and the NCC in relation to the WA Rail Access Regime, ARTC's positions and comments have largely been based around two broad themes, being,

- The need for a consistent approach to access to the interstate network, including that part of the interstate network in WA. ARTC has consistently indicated that it considered it important that access regimes within each jurisdiction in Australia are consistent to the maximum extent possible, whilst recognizing structural differences between providers in each jurisdiction.
- The need for the WA Access Regime and regulatory supervision to ensure that adequate measures are put in place to provide the market with confidence that access to the WA network can be gained in a timely, fair and equitable way when the access provider is vertically integrated. One outcome of this is that ARTC has consistently argued that access

regimes for vertically integrated operators need to be much more prescriptive in nature than regimes considered appropriate in a vertically separated environment.

ARTC maintains an interest in the Part 5 Instruments that is consistent with these needs.

ARTC's supports the general view previously taken by the Authority that the Code and associated Part 5 Instruments could be improved by addressing the problems of transparency and information asymmetry that are inherent in attempting to introduce a contestable market in a monopoly industry. These problems are magnified where the access provider is vertically integrated, as they are two key areas in which an incumbent can seek to stifle third party entry to the network.

TRAIN MANAGEMENT GUIDELINES (TMG)

The TMG operated by WNR is designed to be "...a statement of principles, rules and practices to be applied in the real time management of services." (WNR's TMG page 4).

In principle, WNR's approach with respect to the use of the network in accordance with scheduled train paths, dealing with network blockage and recovery, consultation between itself and operators and prioritization of train paths in the event of out-of-course running is largely consistent with ARTC's approach. A copy of ARTC's Network Management Principles included in ARTC's Indicative Access Agreement, forming part of ARTC's Access Undertaking, can be located at the ACCC's website www.accc.gov.au.

With respect to the sections contained in WNR's TMG, ARTC provides the following specific comments.

'Infrastructure Issues' and 'Operations Conflict Resolution Procedures & Protocols'

In these sections of the TMG WNR:

- outlines the requirements an Operator must meet in order to operate on WNR's network
- determines the instructions and processes that WNR must work within when disrupting, varying or ceasing train paths. This includes situation that are inside (eg. maintenance) and outside (eg. train failures, emergencies) the control of WNR.
- proposes a set of principles and rules (including a management matrix) to be referred to in the management of trains and associated operational conflict.

ARTC’s overarching objectives with regard to network management, within safety constraints, are:

1. A train that enters the network on-time (with agreed tolerance usually 15”) and suffering no significant enroute delay brought about by above rail causes will exit the network on time (15” tolerance). Train considered to be healthy.
2. A train which enters the network late or suffers a significant enroute delay brought about by above rail causes will exit the network no later than the total of the late entry delay and enroute delay (notwithstanding any delays incurred in managing healthy trains). That is, ARTC will not add to the above rail delay.
3. ARTC will use best endeavours to exit a train on-time where the train has entered late or suffers an enroute delay brought about by above rail causes (notwithstanding any delays incurred in managing healthy trains).

The first and last objectives are similar to those proposed by WNR. In relation to objective 2 above, WNR commit to using “best endeavours to recover lost time”. However, in practice it will be difficult to determine the use of ‘best endeavours’ and there would appear to be no objective proposed by WNR not to ‘deteriorate’ unhealthy trains.

It should be noted that ARTC’s principles differentiate between different types of services (Premium, High, Standard). This differentiation is dependent upon the speed and axle loading of the train and results in different pricing for these types of train. The different train types are largely recognized in the planning of a timetable more so than in the treatment during train running. Careful inspection of ARTC’s principles will reveal that the prioritization during train running is still largely dependent upon the position of the train with respect to its scheduled path. Having said this, it is generally regarded that a higher speed, lighter train is more able to hold gains made when given preference. As such, these types of trains often have inherent priority on the network when all other things are equal. Combined with the priority afforded to these types of services during planning, there is some justification for the higher access charge generally paid for these services.

Nevertheless, separation of the train management principles into these types of services would not be considered mandatory given the underlying priority as described above.

It should be noted that, unlike ARTC, WNR is a vertically integrated access provider. In previous submissions to the NCC, ARTC has suggested that a vertically integrated provider has different commercial motivations to that of a vertically separated provider. This different motivation is manifested in how a vertically integrated provider manages third party trains with respect to its own above rail provider. Whilst the regulatory regime seeks to prohibit anticompetitive behaviours, it is only able to do so where such behaviours are observed and at the time such behaviours are observed. ARTC has expressed concern that day-to-day network management is an area where anti-competitive activity could be difficult to observe given that there is some subjectivity inherent in management decisions.

ARTC is not aware of any third party competition on the WNR network outside of the interstate network   On the interstate network in WA, WNR's related above rail provider does not directly compete in interstate markets. As such, evidence of the veracity of the TMG in a directly competitive environment is not available. However, the relative treatment of third party trains (compared to WNR related trains) can impact on rails performance in interstate markets and the operation of the TMG on the interstate network should be explored by the Authority. Comments from the third party interstate operators would be useful in this regard.

The use of a decision matrix as proposed can provide a framework for some equity and transparency in this management process, but it is the specific application of the matrix where anti-competitive behaviour can arise but is generally only observable following obvious or continual behaviour.

ARTC requests that the Authority consider this in assessing WNR's approach, particularly with respect to the need for performance indicators covering the network management activity.

"Disputes & Performance Monitoring" and "Consultation & Review"

In these sections of the TMG, WNR details the disputes and performance management guidelines by which WNR operates. There is a requirement for WNR and operators to develop Key Performance Indicators (KPI's) and agree on the consequences of not meeting those KPI's. WNR and respective operators must meet at least quarterly to discuss and determine actual performance against the KPI's.

ARTC has previously indicated to the Authority that it considers that KPI reporting by WNR, being vertically integrated, should be separated to associated party and third party use of the network respectively. ARTC has also advocated consistency of reporting and measurement on the interstate network (for interstate services where appropriate).

ARTC requires that significant reporting to the Authority and publicly of performance relating to the negotiation framework, segregation arrangements, train path policies and management guidelines and service quality is necessary to adequately promote market confidence in fair and equitable treatment in a vertically integrated environment.   In most of these areas, ARTC, being vertically separated, has no incentive to discriminate between users and, as such, extensive reporting in these areas is not required by the ACCC.

ARTC's Access Undertaking provides for public reporting, on a quarterly basis, of KPI's in the areas of service reliability, transit time, track quality and unit costs. ARTC notes that public reporting of WNR KPI's is only required annually. ARTC considers that reporting on a quarterly basis would be more timely and meaningful. The market is likely to consider that receiving evidence of a deterioration in performance up to twelve months after it occurs as being too late in most cases.

With regard to the types of indicators used, ARTC makes the following comments in the context of meaningful reporting on the interstate network:

- service reliability – measures do not seem to recognize that a train can become unhealthy enroute, even though on time entry may have been achieved. This is not consistent with ARTC reporting if it was intended to be.
- No transit time indicators are reported
- TQI is not reported
- Speed restrictions – reporting only the change in number of restrictions is not particularly meaningful. The length of the restriction and the restricted speed are also important to train operations as these impact on resulting delays. As a minimum, the length of track under restriction should be publicly reported. This is a standard railway measure.
- Unit cost is not reported

In total, ARTC does not consider the public reporting in these areas as sufficient or particular meaningful for users of the interstate network.

"Annexures"

In relation to section 6.1.6 of the TMG, ARTC has previously indicated that WNR's provisions in relation to "Obligations of Operators" are largely consistent with those in ARTC's Indicative Access Agreement. However, ARTC again points out that there appears to be no obligation requiring operator compliance with the Code of Practice in the TMG. It is not clear to ARTC why WNR continues to omit this provision.

TRAIN PATH POLICY (TPP)

The TPP operated by WNR is designed to "…ensure that the allocation of Train Paths is undertaken in a manner that ensures fairness of treatment between Operators, acknowledges existing contractual rights and any new contractual rights created under Access Agreements entered into under the Code" (TPP p 2). The TPP defines:

- that WNR must maintain a Master Control Diagram and the guidelines for receiving and assessing new Train Path requests,
- the process and instructions required of WNR in relation to varying (temporarily or permanently) or removing Train Paths,
- the rights of an operator to sell a Train Path,
- the process for determining who is allocated a Train Path where more than 1 operator request the same path and
- outlines the Dispute Resolution and TPP Consultation & Review process.

ARTC has previously made submissions to the Authority in relation to the TPP in which it stated that its main concern is to ensure reasonable consistency between the relevant aspects of the TPP and the terms and conditions of the wholesale agreement and, therefore, the principles endorsed by the ACCC in ARTC's Access Undertaking. Once again, ARTC seeks the Authority's consideration of the issue of consistency of conditions of access to the interstate rail network for interstate users in its deliberations.

Third party rail access regimes in Australia (in a vertically integrated industry structure) have generally not been successful in bringing about healthy and sustainable above rail competition on the network. ARTC has previously argued that this has been the case in WA as well. Such regimes in Australia range considerably in the degree of prescription provided. In order to minimize the opportunities for the vertically integrated access provider to undertake anti-competitive activities, a greater deal of prescription, enforcement and stronger remedies are warranted.

To this end, ARTC would encourage the Authority, in its contemplation of the balance between transparency and availability of third party access on fair and reasonable terms, and the administrative and regulatory impost on the access provider, to fall on the side of greater transparency to the market in pricing and non-pricing matters, including capacity management and allocation, and day-to-day network management activities.

ARTC has previously stated that, by and large, WestNet's approach to establishing and allocating train path entitlements, and managing the utilization and variation of those entitlements is largely consistent with ARTC's approach. ARTC's approach is detailed in the provisions of ARTC's Indicative Access Agreement (IAA), forming part of ARTC's Access Undertaking, as well as the Undertaking itself.

Without diminishing the need for consistency, ARTC recognizes that the Authority may see the need for greater prescription in some of the provisions of the TPP in order to address issues relating to WNR's vertical integration with an above rail operator.

With respect to relevant sections in WNR's TPP, ARTC provides specific comments on the following sections:

Management of Train Paths

- **Master Train Plan**

ARTC notes that WNR will maintain a Master Control Diagram for those routes under its control that are subject to the Code.

ARTC has undertaken to make significant plan and capacity information available on its website (Master Train Plan, route standards, running times) in order to enable prospective users to make a reasonable assessment as to available capacity prior to an application for access. Further, ARTC has undertaken to provide even more specific and detailed information available to an applicant through the provision of an Indicative Access Proposal, so as to assist with the balance of the ensuing negotiation process.

Given WestNet's vertically integrated structure, ARTC considers it appropriate that similar information should be made available to potential third party users. ARTC notes that the Code provides for WestNet to provide an initial indication of available capacity on a route but ARTC is concerned that this may not provide sufficient transparency to the user by itself.

Under the wholesale agreement, WestNet has committed significant available capacity to ARTC for the purpose of making access available to interstate users. ARTC considers that WestNet's Train Path Policy should recognise this commitment.

- **Allocation, Variation, Removal and Review of Train Paths**

WNR indicates in the TPP that it will manage the TPP in such a way as to maximize use of the network. ARTC's notes the Authority's requirement that, in doing so, WNR will need to ensure that its allocation of train paths are undertaken in a manner that does not unfairly discriminate between operators.

Where the access provider is vertically integrated, the process involved with allocation and management of capacity, as well as the day-to-day management of services provides the owner with the most significant opportunity to hinder third party access in the least detectable way. ARTC is of the view that the most effective means of limiting undesirable activities in this area is:

- Prescriptive process for dealing with competing interests
- A high degree of transparency
- Extensive use of comparative performance measurement.

ARTC notes that the Authority has taken steps in previous reviews to make processes more prescriptive however ARTC still considers that the policy amendments do not go far enough in the areas of providing capacity information to seekers, or in providing for consultation with seekers in the allocation process.

Specific comments are:

- ARTC suggests greater detail is required as to how the allocation of train paths is to occur.
- With the introduction of a wider array of train paths, it would be appropriate in the TPP to specify how it intends to deal with the issue of under-utilisation with respect to non-fixed schedule paths. Applicable provisions in ARTC's Indicative Access Agreement deal with scheduled train paths only, and so leave the treatment of adhoc services for individual negotiation. However, ARTC would publish the outcome of such negotiations and the negotiated terms would be available for other parties.
- In relation to the '3-month history' for 'reviewing' a train path, ARTC notes that WNR does not proposes to apply this in assessing under-utilisation. ARTC notes that the '3-month history' requirement only relates to a review of paths where actual train performance is measured against the schedule, as is the case in ARTC's Indicative Access Agreement. The process for 'removal' of train paths is based on:
  - Firstly, WNR issuing a notice to an operator that they failed to utilise a path for 3 consecutive weeks.
  - Then, after that notice has been issued, if the Operator fails to utilise the path for more than 6 weeks in aggregate in the period of 6 months then WNR can issue a notice of withdrawal.

  If a path is rescheduled under the '3-month history' criteria, does this make it difficult to assess the level of utilisation to determine if a path is not utilised as per the removal criteria (ie. removal requires 6-months monitoring of services which may coincide with a period where paths are rescheduled)?
- ARTC agrees with the requirement that WNR's entitlement to cancel a path should only apply if there is a reasonable indication that the train path is sought and will be allocated to another operator. In a

vertically separated environment, the provider would have no commercial incentive to resume a path unless there was another demand. A vertically integrated provider would have other incentives.

Rights of an Operator to Sell a Train Path

WNR's TPP is very specific in that an Operator must not sell the rights to use a Train Path to another Operator. The only exception to this rule is for Train Paths that are granted to ARTC under the Wholesale Access Agreement. Under this exception, ARTC is permitted to sell the ownership of Train Paths from one Operator to another.

ARTC has previously indicated that it saw no reason why WNR could not provide for the selling or trading of paths. ARTC's Indicative Access Agreement forming part of the Access Undertaking specifically provides for a path to be on-sold providing the related 'trade agreement' satisfies certain criteria.

ARTC continues to finds the position taken by WNR on the issue of on selling of train paths disappointing and request the Authority consider the relative benefits of the ability of operators to on-sell paths. ARTC sees benefits on on-selling include maximizing utilisation of the network and reducing barriers to entry for competition.

Competition for the Same Train Path

WNR's TPP describes that where more than one Operator requests the same Train Path and the requests demonstrate a requirement for the Train Path, the path will be allocated on a 'first come-first served' basis.

With regard to the treatment of competing claims to a path, where neither party has executed an agreement, ARTC has previously stated that its approach is to advise parties concerned. ARTC would have the right to finalise an agreement with the applicant with whom ARTC can agree terms and conditions most favourable to it. Such a decision would ordinarily be based on a 'highest NPV' test, but it should be noted that the test is not limited to price alone. The test would incorporate the relative risk and opportunity profile of the respective proposals. ARTC's approach has been accepted by the ACCC.

ARTC considers the 'first come – first serve' approach as proposed, whilst offering a degree of inherent transparency and fairness, does not adequately recognize the reasonable commercial interests of the access provider, nor does it represent what might occur in normal competitive business circumstances. As long as adequate controls are in place to ensure that a vertically integrated provider cannot unreasonably delay negotiations, the provider should have the opportunity to accept a more favourable opportunity, if such an opportunity presents before agreement with the original, less favourable proposal occurs. ARTC would consider this to be normal commercial practice. Given the wide array of proposals (path types) that have been specified, it would appear unreasonable that the access provider might have to accept a proposal of a 6 month, conditional path instead of a ten year fixed path commitment merely because the conditional path proposal might have been received (but not agreed) say one week earlier.

On the other hand, where the access provider is vertically integrated, the evaluation process will need adequate prescription and transparency and non-discriminatory.

It is becoming more apparent to ARTC (and other jurisdictions) that the ability for paths to be reserved for a period of time (say up to 2 years) between the execution of an access agreement an the commencement of operations may reduce a significant barrier to entry faced by third parties. ARTC has experienced evidence of this in its markets. The 2005 QR Access Undertaking currently being developed has also introduced provisions dealing with capacity reservation (although ARTC is not entirely supportive of the approach taken in this regard).

ARTC can see merit in introducing provisions to allow for an access seeker to be able to reserve capacity for a period of time following execution of an access agreement before commencement of operations. Of course, there would need to be a range of rules placed around capacity reservation in this manner and, most importantly, the pricing of capacity reservation over extended periods would need to recognize the opportunity cost of that capacity to the access provider.

OVERPAYMENT RULES

The Code requires Railway Owners to submit to the Authority a statement of rules that are to apply when breaches of the Ceiling Price Test occur on the part of that railway owner that could not reasonably be avoided. The Overpayment Rules document describes the rules which will apply to WNR and provides a mechanism to:

- calculate the amount by which Total Revenue Earned on a particular route exceeds the total costs attributable to the route section and infrastructure, and
- reimburse Operators who are provided with access under the Code to that route section in the event of an over-payment.

'Overpayment Rules' and the Wholes Agreement between ARTC and WNR

Neither the wholesale agreement or ARTC's Access Undertaking explicitly address the issue of overpayment rules to come into play when ceiling revenue limits are breached. This is largely because it is widely considered most unlikely that any reasonable ceiling revenue limit would be breached on the interstate network within the foreseeable future. Nevertheless, ARTC did informally indicate to the ACCC, during the consultation process, that should such a breach ever occur, it would be ARTC's intention to rebate any annual excess back to operators at the end of each year. Rebates are likely to be proportioned to each operator to the extent that an operator contributed to the revenue. As such, having over-payment rules would not, in principle, be inconsistent to that which ARTC might propose on the interstate, should the need arise.

Within the context of the WA interstate network and the wholesale agreement, any over-payment rules may have an impact to the extent that any revenue received from operators under access contracts would probably enter the ceiling test as normal operator revenue. Essentially, the pricing principles under the wholesale agreement provide for ARTC to retain a share of access revenue it charges under access agreement between it and the operator, depending on market growth achieved on the WA interstate network. The remainder of the revenue is passed through to WNR. ARTC is unclear as to whether the revenue it receives from operators should enter the ceiling test or whether it is the share of revenue received by WNR that should enter the test. The treatment can be viewed from several directions:

- From the **operator's** perspective, the total charges paid for access should enter the test.
- From **WNR's** perspective, it can only apply the revenue it receives to the recovery of the cost of service provision, and it is this revenue that should be incorporated in the ceiling test.
- From **ARTC's** perspective, it is effectively a wholesale customer of WNR, and hence the wholesale charge it returns to WNR should be applied in the ceiling test. If the revenue received from the operator is included in the test, then ARTC's reasonable costs of providing it's service to the operator should be included in the regulatory cost base.

ARTC believes that these issues should be considered by the Authority and resolved by recognizing access revenue received by WNR on a 'wholesale' basis in the rules.

For the remainder of the submission, ARTC will endeavour to identify, and comment on, specific aspects of the Over-Payment Rules as detailed by WNR.

Basis of the Overpayment Rules

- **Revenue for the purpose of the ceiling test**

ARTC notes that the ceiling test provides for the inclusion of 'private and government contributions' as revenue and, presumably the inclusion of investment arising from the contribution in the regulatory asset base.

ARTC has advised the ACCC that any investment in the infrastructure received from its shareholder, the terms of which require no return will not be included in its asset base for ceiling purposes.

The terms of any government payment made to WNR would need to be clear in order to establish appropriate treatment in the ceiling test. It may be that the subsidy is in infrastructure that would not form part of the MEA asset base. If this were the case, then an annualized form of the investment should not be included in revenue compared to the ceiling limit.

- **Over-payments and under-recoveries**

ARTC notes that the Code is silent on how under-recoveries are to be treated in the Over-Payment Rules, and that the Overpayment Rules in Instrument 5 has defined the approach to be adopted by WNR.

These rules determine that over-payments can be used by the railway owner to offset against under-recoveries over a three year period (being the period over which any net surplus in the over-payment account must be rebated to operators). This is in addition to annual rebates of surplus revenue in any year greater than 10% over the ceiling limit.

ARTC also notes that the rules may allow a carryover of a net under-recovery to the next three year period if because annual rebates (surplus over 10% in any year) mean that there is insufficient finds in the over-payment account to recoup a significant under-recovery in the three year period. The amount of carryover would only be to the extent of the annual rebates paid.

This treatment could be likened to the taxation treatment of capital gains and losses, where net capital gains must be paid in a current tax period, whilst net capital losses may be rolled forward for a certain period.

The Authority has made it clear in previous determinations that a net under-recovery over the three year period does not mean that operators will be required to make up the railway owner's revenue to the ceiling.

In previous submissions, ARTC has advised that it considers these rules are weighted too heavily in the direction of the interests of operators (and insufficiently addresses the reasonable commercial interests of the track owner). ARTC maintains this view and the reasons for this are:

- ARTC considers that an efficient access regime should seek to allocate risk to the parties best able to manage those risks. Whilst clear separations are not necessarily practical, the **balance** should be such that the users of the rail network bear more market risk (which operators are best to manage) and the track owner bear more cost risk (which it can best manage). As such, any over-payment rules should, at least to some extent, seek to mitigate the track-owner's risk to market fluctuations and forecasting risk.

- ARTC, and other track owners in Australia, already take on significant market risk by virtue of the access pricing structure employed in many cases, particularly on the interstate network. That is, two part pricing, where the larger part of revenue is derived from the variable (GTK) component of the charge.

  On the ARTC network, the variable component of two-part pricing represents around 70% of revenue. This is slightly lower on the WA part of the interstate network (interstate operations) and slightly higher in NSW. In any case, given the volumes on many parts of the rail network in Australia (outside coal and private iron ore networks) it is generally accepted that around 30% of infrastructure costs is variable.

  Even the flagfall component of revenue is only 'fixed' to the extent that the path entitlement is not cancelled. As such the revenue of many track owners in Australia can vary more with volume than costs and, as such, profitability is sensitive to market risk.

  On the other hand, the cost of access to the infrastructure to an above rail only entity is more variable with volume. One could argue that the cost of the infrastructure asset would be more 'fixed' in nature if the infrastructure were owned by the operator and, as such, the operator (vertically integrated) profits would be more sensitive to market risk.

  It could be argued that a track owner could seek to move this market risk to the operator by seeking 'take-or-pay' arrangements based on a minimum volume. This is not all that common in current access arrangements and, outside of some mining industries (where volume risk is relatively low), would not be overly palatable to operators.

- Generally when access is negotiated, the track owner seeks volume forecasts from the operator (or end customer), upon which to base the pricing calculation. Clearly the operator/end customer is in a better position to make such forecasts, and the track owner would place some credence in those forecasts. If pricing were based on overstated volumes and in the absence of volume 'take or pay' arrangements (which is equivalent to the top-up not incorporated in the rules), the track owner faces the risk of under-recovery of revenue.

On the other hand, an understated task may result in additional revenue that, if breaching a revenue limit, must be refunded. This results in a lopsided volume risk profile for the track owner (that is, upside could be limited by overpayment rules) but there is little downside protection (except for some netting of over and under-recoveries, where both occur). Where there is longer term volume discrepancy, the rules explicitly require WNR to renegotiate pricing but only if revenues will be consistently above the ceiling.

- Finally, it could be argued that the rate of return allowed to the track owner may take some consideration of market risk surrounding the businesses utilizing the network. Generally, though, such analysis considers upside and downside risks around expected volumes.

  If the risk profile is subsequently altered by regulation such that downside exposure is retained but upside is constrained, then this should be reconciled with a higher allowed return. Conversely, the operator have the benefit of the reverse profile, where cost of access is capped when volumes are higher than anticipated, but fall in line with lower volumes.

ARTC notes that the 'unders-and-overs' account arrangements recommended by the Independent Pricing and Regulatory Tribunal of NSW ("IPART") appears to allow access pricing to be adjusted each year to reflect prior year under and over-recoveries, and minimizing the ongoing effect of volume fluctuation on revenue. This approach mitigates the risk of operators overcompensating the track owner when volumes are higher (as does the WA regime), but also mitigates the risk to the track owner of under-recovery of cost when volumes are lower.

ARTC considers this approach represents a fairer balance between the management of respective risk of the parties involved. This view is also held by IPART.

Allocation of access revenue

ARTC notes that the Overpayment Rules, in determining the approach to distribute the revenue over a particular route against the costs of individual route sections allocates:

- to incremental costs against all applicable route sections, then
- up to ceiling costs on applicable branch or feeder sections, then

- up to ceiling costs on applicable 'shared route' sections.

The Authority has agreed to rank branch or feeder sections ahead of shared infrastructure because these branch or feeder lines may close in the absence of other traffic to fund these dedicated lines.

Presumably the potential would then arise for users of shared infrastructure to pay higher charges than might otherwise have been the case to effectively 'subsidise' the lower revenue attributed to shared infrastructure for other users whose revenue has been allocated to branchlines up to ceiling limits.

ARTC is concerned that there would be loss of overall efficiency of the network usage, which would fund a non-commercial objective (that is ensuring that a branchline that is otherwise non-commercial could remain open). ARTC is of the view that such objectives should be dealt with in other more direct and transparent ways, rather than via some form of cross-subsidisation.

COSTING PRINCIPLES

WNR's Part 5 Instrument in relation to 'Costing Principles' are a statement of the principles, rules and practices that WNR will apply to calculate the Floor and Ceiling costs on a route section basis, as required to be established under the Code. The Costing Principles detail:

- The determination of capital costs - including defining the infrastructure to be included, assumptions for gross replacement value & economic life and definitions of the allowable return & annuity calculation.
- The determination of Operating Costs – including definition of the 'efficient cost test' and definition & allocation of operating costs.
- Definition and allocation of 'Overhead Costs'.
- Definition and detail relating to variation & calculation of the 'Ceiling' and 'Floor'.

ARTC has previously made submissions to the Authority in relation to WNR's Costing Principles and has consistently raised four main issues, broadly outlined as follows:

- ARTC supports WNR being able to apply market based pricing to below rail services, where costs represent only one input to the pricing decision. ARTC adopts a similar approach in its undertaking.
- The Code incorporates floor and ceiling limits to pricing for any particular traffic. ARTC's access undertaking contemplates floor and ceiling revenue limits and undertakes that prices will be set such that revenue on any given segment falls between these limits. The limits are published and have been accepted by the ACCC. ARTC considers most

of the WA rail network carries similar business and such an approach to pricing is warranted in this case.

- Given the nature of the rail infrastructure asset, there is usually a wide band between floor and ceiling limits. To aid negotiation, ARTC has published indicative pricing for each of its segments to be applied to any user seeking to operate an indicative service under indicative terms and conditions. Indicative services represent the majority of ARTC business. The indicative pricing is published and is accepted by the ACCC. Variations around the indicative price would be based on a range of parameters including the characteristics of the service, as well as logistical and commercial impacts on ARTC. ARTC will not differentiate based on the identity of the applicant, nor where the services to be operated are the same (including terms and conditions) and the services are operated in the same end market. Indicative access prices are market based. ARTC has previously indicated that indicative pricing on each segment could be approved by the Authority and published by WNR in a similar way.
- ARTC has commented on the need for KPI reporting to be provided by WNR. ARTC has provided for regular service quality KPI reporting in its undertaking, and specifically identifies indicators to be reported. In a vertically integrated environment the track owner can discriminate against third parties through the standards it chooses to maintain the network. This will impact the efficient cost of maintaining the network. Required network standards should be incorporated in the Costing Principles and performance measures put in place to ensure compliance with these standards.

ARTC believes these issues remain of relevance. With respect to relevant sections in WNR's Costing Principles, ARTC provides specific comments on the following sections:

Determination of Capital Costs

In determining the capital charge considered appropriate by WNR, the 5 key elements adopted are:

- Infrastructure to be included
- Gross Replacement Value
- Economic life of the asset
- Allowable return
- Annuity calculation

WNR defines 'infrastructure to be included' as only assets that are directly engaged in the provision of rail infrastructure services, as defined by the Code. ARTC reads that assets that provide 'support services' are included in operating cost allocations and not capital costs calculations.

The Authority has in previous reviews required WNR to provide detailed information in its Costing Principles in relation to determination of capital costs. ARTC recognises the need for detailed information to be provided on capital costs for a vertically integrated entity such as WNR.

In previous submissions, ARTC indicated that it considered WNR's approach to determining GRV was reasonable, but was concerned that the valuation was not proposed to be independently assessed.

ARTC believes an independently determined or assessed valuation is important to establish market confidence in the limits around access pricing. The ACCC conducted an independent assessment of ARTC proposed DORC value (and floor and ceiling limits) before approving ARTC Access Undertaking (including the pricing principles).

ARTC recognises that it is the Authorities position to be satisfied that capital costs are determined appropriately and the underlying assumptions and data (for example in relation to unit rate calculations, economic life assumptions, independent reports) are appropriate. ARTC notes that the Authority has in the past sought independent advice in regard to these issues in making determination on floor and ceiling limits. ARTC supports the continued use of independent advice in this regard.

Determination of Operating Costs

WNR advise that it prepares its operating costs based on the efficient cost of maintaining the network. WNR provides for a set of "Efficient Cost Tests" such as Benchmarking, competitive tender outcomes etc. In defining Operating Costs, WNR provides detailed information on the maintenance (routine and cyclical), network management costs and working capital.

WNR is explicit that Major Periodic Maintenance (MPM) is not included. ARTC takes a similar approach where, in recognising the life extending benefits of MPM (where an asset may be maintained in perpetuity through application of MPM) ARTC does not apply a depreciation charge in its ceiling calculation but includes MPM in operating costs.

In allocating non-specific segment costs, WNR's allocation method is based on either GTK or train numbers (as per WNR's 'Operating and Overhead Allocation Table'). ARTC allocates non-specific costs based on:

- GTK with respect to 60% on costs associated with track maintenance
- Track kilometres with respect to 40% of costs associated to track maintenance
- Train kilometres with non-specific costs not associated with track maintenance.

ARTC's view is that the allocation method (either GTK, number of trains or track kilometres) is somewhat arbitrary and the outcome is not sufficiently different to suggest that there is a preferred approach.

ARTC is of the view, consistent with previous submissions, that any cost allocation should be independently assessed. ARTC recognises that it is the Authorities position to be satisfied that operating costs are efficient and allocated appropriately.

Overhead Costs

Overhead costs are defined by WNR as WNR Overheads plus Corporate Overheads. Corporate Overheads is as an allocation of Australian Railroad Group Pty Limited Group (WNR's parent company) costs.

WNR allocates overhead costs (WNR and parent company) based on a 50/50 split between GTK and Train numbers. ARTC's split of overhead costs is as per the non-specific cost allocation described above. ARTC does not have a requirement to allocate Corporate Costs (ie. ARTC does not have a parent company). WNR appears to adopt this simpler approach as a proxy for allocation of specific costs on the basis of causality. The Authority would need to confirm reasonableness of WNR's position in this regard.

ARTC is of the view, consistent with previous submissions, that any cost allocation should be independently assessed. ARTC recognises that it is the Authorities position to be satisfied that overhead costs are efficient and allocated appropriately.

Other Matters – Floor and Ceiling Limits & Variation

Operating costs are reviewed every three years and Floor and Ceiling limits reset accordingly. In years 2 and 3, WNR indexes Floor and Ceiling limits based on CPS less the "X" factor, where the "X" factor is one quarter CPI. Indexing is not applied in the year that operating costs are reset. ARTC is aware of the significant work carried out by the Authority to estimate and set an appropriate X factor with respect to key rates and has made comment on this in previous submissions.

ARTC's approach to determining 'economic cost' for calculating Ceiling limits incorporates an annual adjustment of operating costs by CPI less a productivity allowance as well annual adjustment of the regulatory asset base by CPS less annual depreciation.

ARTC provides floor and ceiling calculations for each of its pricing segments to the ACCC and these limits have been endorsed by the ACCC. This information is available on ARTC's website. This avoids the need to have highly public availability of detailed costing information so that access seekers could determine floor and ceiling limits for themselves. ARTC recommends a similar approach could be adopted by WNR and there be a requirement for independent assessment of WNR's floor and ceiling calculations (including asset valuation, cost efficiency and cost allocation).

ARTC also provided to the ACCC, indicative access pricing (market based) for each pricing segment. ACCC endorsement was similarly sought so as to provide market confidence and certainty around pricing for the majority of users. ARTC is of the view that most of the WNR network (particularly the interstate mainline) lends itself to the use of indicative pricing, to avoid much of the uncertainty associated with wide floor/ceiling bands.