

# WestNet Rail's Part 5 Instruments Review

## Draft Determination on the Proposed Over-payment Rules

10 May 2006

Economic Regulation Authority



WESTERN AUSTRALIA

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## DRAFT DETERMINATION

1. On 15 December 2005, WestNet Rail Pty Ltd (**WNR**) submitted its proposed Over-payment Rules to the Economic Regulation Authority (**Authority**) for approval. The submission of the proposed Over-payment Rules resulted from a requirement for WNR to review the existing Over-payment Rules two years after approval by the Independent Rail Access Regulator (**IRAR**) in May 2003.
2. The Authority has considered the proposed Over-payment Rules in conjunction with comments made in submissions to the Authority by interested persons.
3. The draft determination of the Authority is to not approve the proposed Over-payment Rules on the ground that it does not represent a fair balance of interests between the railway owner, operators (operators and customers) and access seekers as required under Section 20(4) of the Railways (Access) Act 1998. The detailed reasons for this draft determination are set out in this document.
4. The five amendments to the proposed Over-payment Rules required by the Authority are listed below.

## Summary of Amendments

### Required Amendment 1

Section 1 of the proposed Over-payment Rules should be amended so that the word 'section' is included after the word 'route' in the first line of the paragraph under the first bullet point.

### Required Amendment 2

Section 2.7 of the proposed Over-payment Rules should provide for private and government contributions to be specified as an equivalent annual contribution for the purposes of the floor and ceiling calculations. The allocation process where contributed assets service more than one route section should also be specified in this section.

### Required Amendment 3

Note (b) of rule 6, Section 3 of the proposed Over-payment Rules, should include the condition that refunds can be made to non-Regime operators if this provision is included in commercially negotiated access agreements to ensure consistency with rule 13.

### Required Amendment 4

Section 2.8 of the proposed Over-payment Rules should be amended to delete items 1 and 2. Item 3 should be suitably amended such that the allocation process outlined under this item is used as the methodology for allocating all over-payments. Item 3 should also be amended to make it clear that the over-payment should only be reimbursed to the operators who have contributed to the over-payment on the route section where the over-payment occurs.

### Required Amendment 5

Rule 6, in Section 3 of the proposed Over-payment Rules, should include non-access revenue in the numerator and denominator as reflected in the existing Over-payment Rules.

## INTRODUCTION

### Background

5. WestNet Rail (**WNR**) is the principal provider of “below” rail freight infrastructure, covering approximately 5,000 kilometres of track, in the south-west of Western Australia. WNR is a subsidiary company owned by Babcock and Brown Ltd, a publicly listed Australian company.
6. Section 3 of the Western Australian *Railways (Access) Act 1998* (**Act**) defines a “railway owner” to mean the person having the management and control of the use of the railway infrastructure. Within this context, WNR is considered to be the railway owner for the freight rail infrastructure.
7. The Over-payment Rules is one of the four Part 5 Instruments set out in Section 40(3) of the *Railways (Access) Code 2000* (**Code**). Each of the Part 5 Instruments is currently being reviewed by the Authority.
8. The scope of the Part 5 Instrument reviews is limited to those matters specifically set out under Part 5 of the Code.
9. In the case of the Over-payment Rules, sections 47(1) and 47(2) of the Code set out the extent of the issues considered in this review, as follows:
  - (1) As soon as is practicable after the commencement of this Code each railway owner is to prepare and submit to the Regulator a statement of the rules (“the over-payment rules”) that are to apply where breaches of clause 8 of Schedule 4 occur on the part of that owner that could not be reasonably be avoided.
  - (2) The rules referred to in subsection (1) must give effect to the following basic requirements-
    - (a) The excess revenue referred to in clause 8(4) of Schedule 4 in respect of an operator or group of operators must be at all times be within a limit, being a percentage of the relevant costs, from time to time notified in writing to the railway owner by the Regulator;
    - (b) At the expiry of each successive period of three years from the commencement of access by an operator or group of operators there must be no such excess in respect of that operator or group of operators.
10. In May 2003, the Independent Rail Access Regulator (**IRAR**) approved the Over-payment Rules submitted by WNR following the introduction of the Code. The IRAR carried out a public consultation process during the course of its assessment in 2002. In its determination the IRAR stipulated the requirement for a review at the end of two years of operation of the Over-payment Rules.
11. Following a request from WNR, the Authority approved an extension of time to 15 December 2005 for WNR to submit its proposed revisions to its Over-payment Rules (proposed Over-payment Rules) for the purpose of the review.
12. Under Part 5 of the Code, the Authority is required to undertake public consultation prior to making determinations on two of the Part 5 Instruments (Train Management Guidelines and Statements of Policy) but not in relation to the other two Part 5 Instruments (Costing Principles and Over-payment Rules). However, the Authority decided that a consistent approach to public consultation should be followed and

invited public submissions on all four Part 5 Instruments. This approach is also consistent with the approach taken by the IRAR in 2002.

13. On 15 December 2005, the Authority issued a notice calling for submissions from interested parties on WNR's proposed Over-payment Rules. Four public submissions were received from:

- Alcoa World Alumina Australia Pty Ltd.
- Australian Rail Track Corporation Ltd.
- Great Southern Railway Ltd.
- Pacific National Pty Ltd.

These submissions are available on the Authority's website ([www.era.wa.gov.au](http://www.era.wa.gov.au)).

14. In consideration of the Over-payment Rules, the Authority recognises the need to ensure that operators are protected from WNR's ability to attain monopoly rents balancing this against ensuring that WNR is not prevented from making a fair and reasonable return on its rail investments.
15. This draft determination makes reference to a number of acronyms which are identified in the Glossary in Appendix 1.
16. To assist the Authority in the review of the issues raised in the public submissions, the Authority engaged a consultant Strategic design and Development Pty Ltd (SdD) to review the submissions and provide independent comment to the Authority on the issues raised in these submissions. The SdD report is available on the Authority's website ([www.era.wa.gov.au](http://www.era.wa.gov.au)).

## Legislative Considerations

17. The key areas of the Code and the Act that have relevance to the formulation and application of the Over-payment Rules are as follows:

Section 47 of the Code states:

- (1) As soon as is practicable after the commencement of this Code each railway owner is to prepare and submit to the Regulator a statement of the rules ("the over-payment rules") that are to apply where breaches of clause 8 of Schedule 4 occur on the part of that owner that could not be reasonably be avoided.
- (2) The rules referred to in subsection (1) must give effect to the following basic requirements-
  - (a) the excess revenue referred to in clause 8(4) of Schedule 4 in respect of an operator or group of operators must at all times be within a limit, being a percentage of the relevant costs, from time to time notified in writing to the railway owner by the Regulator;
  - (b) at the expiry of each successive period of three years from the commencement of access by an operator or group of operators there must be no such excess in respect of that operator or group of operators.
- (3) The Regulator may-

- (a) approve the statement submitted by the railway owner either with or without amendments; or
    - (b) if he or she is not willing to do so, determine what are to constitute the over-payment rules.
  - (4) The over-payment rules may be amended or replaced by the railway owner with the approval of the Regulator.
  - (5) The Regulator may, by written notice, direct the railway owner-
    - (a) to amend the over-payment rules; or
    - (b) to replace them with other over-payment rules determined by the Regulator, and the railway owner must comply with such a notice.
18. Clause 8 of Schedule 4 of the Code states:
- (1) An operator that is provided with access to a route and associated railway infrastructure must pay for the access not more than the total costs attributable to that route and that infrastructure.
  - (2) For the avoidance of doubt it is declared that the calculation of total costs under subclause (1)-
    - (a) is for the whole of the route and associated railway infrastructure; and
    - (b) is to be the same for all operators,regardless of the extent of the operations or use of the route and infrastructure by any particular operator.
  - (3) The total of-
    - (a) The payments to the railway owner by-
      - (i) all operators; and
      - (ii) all other entities,that are provided with access to a route, or part of a route, and associated railway infrastructure (“the route”); and
    - (b) the revenue that the railway owner’s accounts and financial statements show as being attributable to its own operations on the route,must not be a sum that is more than the total costs attributable to the route.
  - (4) It is not a breach of this clause for-
    - (a) payments to the railway owner mentioned in subclause (1) to exceed the total costs referred to in that subclause; or
    - (b) the total sum mentioned in subclause (3) to exceed the total costs referred to in that subclause,if the over-payment rules approved or determined under section 47 are complied with.
19. The Act also provides a framework within which the Authority’s determination required under Section 47 of the Code is to be made. Section 20(4) states:
- In performing functions under the Act or Code, the Regulator is to take into account-
- (a) the railway owner’s legitimate business interests and investment in the railway infrastructure;
  - (b) 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;



- (c) the economic value to the railway owner of any additional investment that a person seeking access or the railway owner has agreed to undertake;
- (d) the interests of all persons holding contracts for the use of the railway infrastructure;
- (e) firm and binding contractual obligations of the railway owner and any other person already using the railway infrastructure;
- (f) the operational and technical requirements necessary for the safe and reliable use of the railway infrastructure;
- (g) the economically efficient use of the railway infrastructure; and
- (h) the benefits to the public from having competitive markets.

The nature of the decision-making power given to the Authority under Section 47 of the Code is mandatory in that the Authority must take into account all the factors listed in Section 20(4) of the Act. However, the Authority has discretion to allocate such weight to each of the factors listed in Section 20(4) of the Act as it considers appropriate for each particular case.

## Assessment Process

20. The Authority's draft determination provides the railway owner, operators and access seekers with the proposed outcome of the Authority's consideration of WNR's proposed Over-payment Rules. The draft determination also proposes amendments which are required to be made to WNR's proposed Over-payment Rules in order for the Authority to approve these rules.
21. The process for the review of the proposed Over-payment Rules that the Authority has adopted is as follows:
  - Public submissions on WNR's proposed Over-payment Rules. (January 2006)
  - Authority's draft determination published (May 2006).
  - Public submissions on draft determination (June 2006).
  - Authority's final determination published (June 2006).
  - Amended Over-payment Rules submitted by WNR (June 2006).
  - WNR's amended Over-payment Rules approved by the Authority (July 2006).

## REASONS FOR THE DRAFT DETERMINATION

### Discussion of Issues

22. Relevant issues raised in public submissions regarding WNR's proposed Over-payment Rules are discussed under the following headings:
- Defined terms.
  - Definition of access revenue.
  - Over-payments apply to all access seekers.
  - Over-payments and under-recoveries.
  - Allocation of access revenue/over-payment.
  - Over-payment rules.
23. The Authority has taken the view that those sections of WNR's proposed Over-payment Rules on which no comment has been made are acceptable to operators and access seekers. The proposed Over-payment Rules are largely the same as the Over-payment Rules approved by the IRAR in 2003 so operators and access seekers have had a considerable period to assess the effectiveness and suitability of these rules.
24. The discussion of each item below commences with a summary of WNR's position followed by an outline of relevant comments received in the public consultation process then the Authority's assessment and any amendments required.

### Defined Terms

#### WNR's Proposal

25. WNR has defined the Over-payment Rules as 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.

#### Interested Party Submissions

26. Alcoa has indicated<sup>1</sup> that the text in the first bullet point appears to be incorrect as it compares Total Revenue earned on a route to the Total Costs for the route section. This indicates that there is an inconsistency as the Total Revenue and Total Cost should be compared on a route section basis to be meaningful.

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<sup>1</sup> Alcoa, Submission on the Review of WestNet Rail's Part 5 Instruments, page 1.

## Authority's Assessment

27. The Authority agrees with Alcoa that there appears to be an inconsistency in the text in the first bullet point as the Total Revenue and Total Costs must be compared for the same length of distance. If a route section is the same as a route, as may exist in parts of the grain network which are lightly trafficked, then there would be no inconsistency. However, in heavily trafficked parts of the network a number of routes are split into route sections. Consequently, it is not appropriate to compare the revenues and costs between a route and route section. The comparison of revenues and costs on a route section basis is consistent with the intent of the over-payment rules as outlined in paragraph 18 above.

## Draft Determination

### Required Amendment 1

Section 1 of the proposed Over-payment Rules should be amended so that the word 'section' is included after the word 'route' in the first line of the paragraph under the first bullet point.

## Definition of Revenue

### WNR's Proposal

28. WNR has indicated that Total Revenue will comprise the sum of Access Revenue and Non-Access revenue for the purpose of defining revenue for the ceiling price test under Clause 8 of Schedule 4 of the Code. Access Revenue is all income received by WNR for the provision of track access to the network, whether the access agreements have been negotiated inside or outside the Code. Non-Access Revenue will be all third party revenue, including private and government contributions, in accordance with the provisions for contributed assets as outlined in the Costing Principles.

## Interested Party Submissions

29. ARTC has indicated<sup>2</sup> that in its Undertaking with the ACCC, private and government contributions are excluded from the regulatory asset base and hence excluded from the ceiling calculation. ARTC suggests that a similar approach be adopted by WNR for the freight network following clarification of the objectives of any government investment in the WNR freight network.
30. ARTC has also indicated that the proposed Over-payment Rules does not address the special arrangements in place for the wholesale access agreement between WNR and ARTC. The wholesale agreement allows for ARTC to act as the aggregator for track access on the Midland to Kalgoorlie rail line (**EGR**) for interstate train operators and it receives a fee for this service with the balance of revenue received from access charges sent to WNR. ARTC queries whether the ceiling price test should be considered from the perspective of total contributions

<sup>2</sup> ARTC, Submission on the Review of WestNet Rail's Part 5 Instruments, page 13.

from operators; direct revenue received by WNR for the provision of access services or consideration of ARTC's costs in providing the aggregation service to be included in the regulatory cost base. ARTC's preference is for access revenue to be defined as revenue received by WNR on a "wholesale" basis and included in the Over-payment Rules.

31. Alcoa suggested<sup>3</sup> that Section 2.7, Allocation of Non-Access Revenue, of the proposed Over-payment Rules should be consistent with the Costing Principles to reflect that private and government contributions to the regulatory asset base is an annualised equivalent of a lump sum payment for the purposes of the floor and ceiling calculations. Alcoa has also suggested that the allocation to a route section should be based on a proportion of the contribution utilised in that route section in the event that the contributed asset services more than one route section.

### Authority's Assessment

32. The Authority considered the issue of contributed assets and the impact on the regulatory asset base during its review of the Code and enunciated its position in the final report on the review of the Code<sup>4</sup>. The Authority does not propose to outline in detail the issues considered in the report, but rather re-state its position that the issue of precluding the railway owner from earning a return on assets funded by government subsidies is better addressed by changes to the Over-payment Rules. The purpose of government subsidies are mainly for level crossings which are to improve the safety standards by enabling the railway owner to install safer protections (e.g. boom gates as well as flashing lights) rather than being a subsidy intended to enable lower freight rates.

Additionally, if operators provide the railway owner with a contribution to an upgrade, the Authority would anticipate that the value of such a contribution would be reflected in commercially negotiated pricing outcomes between these parties. The Authority also notes that the ceiling test is simply the upper limit reference point for commercial negotiations. Overall, given the light handed nature of the Regime, this issue can potentially be better addressed through changes to the Over-payment Rules so that subsidies and contributions are only allocated to the relevant upgraded route section.

33. The Authority has considered the issue regarding revenues and costs associated with the wholesale access agreement and understands that the costs incurred by ARTC in performing its aggregation services is met by the access fees charged to interstate operators on the EGR and none of the costs and revenues directly have an impact on the costs and revenues incurred by WNR for the provision of access services. Consequently, the Authority is of the view that the ceiling price test should be considered from the perspective of the impact on WNR of costs incurred and revenue received for the provision of access services.
34. SdD considers that the costs and fees associated with the wholesale agreement is a commercial matter best dealt with by the two parties involved in the agreement, WNR and ARTC and not be an issue dealt in the Over-payment Rules. SdD

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<sup>3</sup> Alcoa page 5.

<sup>4</sup> Economic Regulation Authority, Final Report on the Review of the Railways (Access) Code 2000, 23 September 2005, section 4.8.3, page 39.

suggests that ARTC could return any additional rebate it receives from WNR in accordance with its own over-payment rules.

35. The Authority supports Alcoa's contention that there should be some consistency between Section 2.7 of the proposed Over-payment Rules and the proposed Costing Principles for private and government contributions to be specified as an equivalent annual cost in the floor and ceiling calculations as this is consistent with clause 2, Schedule 4 of the Code. Also, the proposed Over-payment Rules does not indicate the allocation process where contributed assets transcend route sections which the Authority considers appropriate.

### Draft Determination

#### Required Amendment 2

Section 2.7 of the proposed Over-payment Rules should provide for private and government contributions to be specified as an equivalent annual contribution for the purposes of the floor and ceiling calculations. The allocation process where contributed assets service more than one route section should also be specified in this section.

## Over-payments Apply to all Access Seekers

### WNR's Proposal

36. Section 2.3 of the proposed Over-payment Rules specifies that any refund to operators resulting from an over-payment will only be paid to operators who negotiate an access agreement under the Code unless access agreements negotiated outside the Code specify that refunds will apply in the event of an over-payment.

### Interested Party Submissions

37. Alcoa seeks clarification<sup>5</sup> of note (b) in rule 6, section 3 of the Over-payment Rules, as note (b) indicates that only operators who negotiated inside the Regime are eligible for a share of the refund resulting from any over-payment. Alcoa suggests that this is incomplete as it should recognise that refunds can be made to non-Regime operators if this provision is included in access agreements. This is recognised by WNR in item 13.
38. Great Southern Railway (**GSR**) has stipulated<sup>6</sup> that WNR must refund any over-payments to all track users and access seekers whether they negotiated inside or outside the Regime and for WNR not to provide refunds to access seekers who negotiated outside the Code was in contravention of section 47.2(b) of the Code.

<sup>5</sup> Alcoa page 20.

<sup>6</sup> GSR, Submission on the WestNet Rail's Part 5 Instruments, page 20.

39. Pacific National (**PN**) has asserted<sup>7</sup> that over-payment reimbursements should be distributed to all operators, whether or not the access agreements are negotiated under the Code. It contends that failure to pass on reimbursements to non-Regime operators diminishes the incentive for operators to negotiate outside the Code, undermining the flexibility inherent in the Regime which permits negotiations inside or outside the Code. PN argues that by withholding reimbursements from non-Regime operators, the incentive is for WNR to charge a rate above the ceiling knowing it will keep all over-payments apportioned to operators who negotiate access outside the Code.

### Authority's Assessment

40. The Code was originally designed to form an optional 'safety net' regulatory framework. That is a negotiating framework (Parts 2-3 of the Code) of minimum rights that access seekers can elect to utilise for the purchase of rail access. Alternatively, consistent with the principles of commercial negotiations contained in the Competition Principles Agreement, access seekers and railway owners are free to pursue different negotiation processes with pricing and terms and conditions which can be different to those defined in the Code.
41. The Regime does not mandate provisions in the Code on operators and access seekers who are content to negotiate their access arrangements outside the Regime. Consequently, the Over-payment Rules, as one of the Part 5 Instrument requirements of the Code, can only apply to operators and access seekers who negotiate within the Code. WNR has indicated in the Over-payment Rules (page 3), that while it is not obligated to reimburse operators who negotiated outside the Regime, non-Regime operators can seek to have this provision included in their commercially negotiated access agreements. On this basis, the Authority considers there is enough flexibility for non-Regime operators to obtain reimbursements through including this provision in commercially negotiated access agreements.
42. The Authority considers that the inconsistency that Alcoa has identified in section 3, item 6 of the Over-payment Rules should be rectified to recognise that refunds can be made to non-Regime operators, if this provision is included in commercially negotiated access agreements.

### Draft Determination

#### Required Amendment 3

Note (b) of rule 6, Section 3 of the proposed Over-payment Rules, should include the condition that refunds can be made to non-Regime operators if this provision is included in commercially negotiated access agreements to ensure consistency with rule 13.

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<sup>7</sup> PN, Submission on the Review of WestNet Rail's Part 5 Instruments, page 8.

## Over-payments and Under-recoveries

### WNR's Proposal

43. In its proposed Over-payment Rules, WNR has defined over-payment to be where total revenue received for a route section exceeds the total cost for that route section for a twelve month period. Under-recovery is defined where the total revenue in a route section is less than total cost attributed to that route section over the twelve-month period. Net over-payments are to be assessed over a successive three-year period with over-payments in a particular year balanced by under-recoveries in a subsequent year. Net over-payment, in a three year period, will be paid back to operators according to the Over-payment Rules.
44. In the event of under-recovery, the operators are not required to compensate WNR for that under-recovery. However, where a net under-recovery occurs in a particular three-year period, there are circumstances under which WNR will be allowed to carry-over this net under-recovery as an "accounting balance" into the subsequent three year period. These circumstances relate to the situation where WNR is required to reimburse operators during the three-year period because the breach of the ceiling is greater than 10 percent and there are insufficient funds in the interest bearing account for WNR to recoup an under-recovery that has occurred during the same three-year period. In this instance, WNR will seek approval from the Authority to carry forward the under-recovery to the next three years up to the amount WNR has been required to refund to track users as a result of exceeding the 10 percent limit. If approved by the Authority, the carry forward will only apply for one additional successive three-year period.

### Interested Party Submissions

45. ARTC, in its submission,<sup>8</sup> considers the rules associated with the offsetting of over-payments with under-recoveries is weighted too heavily in the direction of operators and insufficiently addresses the reasonable commercial risks of the railway owner. ARTC has identified these commercial risks to be the railway owner's risk to market fluctuations and forecasting risk. ARTC considers that operators should bear more market risk (as they are considered the best party to manage this) and the railway owner bear more cost risk (which it can best manage).

ARTC suggests that railway owners accept a greater market risk through inappropriate pricing mechanisms where the fixed price element in the access charge is considerably lower than the fixed cost component. Therefore, it is argued that the revenue of the railway owner can vary more with volume than costs, hence, profitability is sensitive to market risk. It is also argued that the cost of access to a track user is more variable than volume. It is contended that current access arrangements do not contain "take or pay" provisions and measures to include this would be resisted by track users.

If pricing were based on overstated volumes and in the absence of volume "take or pay" arrangements, the railway owner faces the risk of under-recovery of revenue. If, on the other hand, pricing was based on an understated task, the additional revenue must be refunded if the ceiling limit is breached. ARTC asserts that this results in an inadequate risk profile for the railway owner where the upside is limited

<sup>8</sup> ARTC page 13.



by the over-payment rules and there is little downside protection except where there is some netting of over and under-recoveries where both occur. ARTC contend that if the risk profile for railway owners is subsequently altered by regulation, such that downside exposure is retained but upside is constrained, then this should be accommodated with a higher allowed rate of return. On the other hand, the operator has the benefit of the reverse profile where the cost of access is capped when volumes are higher than anticipated but “fall in line” when lower volumes are experienced.

To offset this inequity, ARTC suggests that an “unders and overs” account arrangement (as exists in New South Wales) be established to allow access pricing to be adjusted each year to reflect prior year under and over-recoveries which would minimise the effect of volume fluctuation on revenue. This approach, it is suggested, mitigates the risk of operators over-compensating the railway owner when volumes are higher, and also mitigates the risk to the railway owner of under-recovery of cost when volumes are lower.

46. GSR has expressed a concern that operators receiving the benefit arising when WNR under-recovers will not be the same operators that are disadvantaged by any offsetting against over-recoveries<sup>9</sup>. Consequently, GSR suggests that offsetting should only occur where the same operators are involved and no one operator is disadvantaged.
47. PN has asserted<sup>10</sup> that the use of the Gross Replacement Value as the regulatory asset value leads to higher ceiling costs than the use of Depreciated Optimised Replacement Cost approach for the asset value and the use of the under-recovery concept allows for access rates to be established at even higher levels than the ceiling.

### **Authority’s Assessment**

48. The fundamental principles of the Over-payment Rules are that there is only one regulatory ceiling which incorporates all access payments received from operators who have negotiated access “inside” and “outside” the Code. The ceiling includes revenue from government and third party contributed assets. Any breaches to the ceiling price test are to be temporary due to unforeseen circumstances with permanent breaches, due to volume growth, to result in renegotiation of access charges for all operators on that route that is subject to the permanent breach. These principles are consistent with Clause 8, Schedule 4 of the Code.
49. The Over-payment Rules provide the mechanism to calculate whether revenue from access agreements exceeds the total ceiling cost attributable to a route section, in order to reimburse operators who access that route section. Consequently, any over-payment in a route section occurring after WNR allocates the excess revenue in that route section using the allocation rules outlined in Section 2.6 of the Over-payment Rules will only apply to operators in that route section. Hence, it is only the operators in that route section that triggered the over-payment who will be reimbursed.

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<sup>9</sup> GSR page 20.

<sup>10</sup> PN page 8.



50. SdD considers the “unders and overs” arrangement, as proposed by ARTC, adds a significant complication to the process of setting annual access prices and would effectively supersede the CPI-based escalation built into the Costing Principles. While the arguments supporting the proposition appear to be sound, the remedy proposed may not be practicable as it would require substantial annual recalculation and administration with considerable potential for disputation between the railway owner and operators. There are also many route sections where the under-recovery was a permanent condition (eg. grain lines), leading to annual price increases that would be unaffordable to the operators using those sections.
51. The Authority has considered the issue of commercial risk of the railway owner, as raised by ARTC, and believes the best way to mitigate this risk is for the railway owner to apply more appropriate access pricing mechanisms to bring the fixed proportion of revenue and costs more into line. This is an issue best addressed by commercial negotiation rather than policy determination by the Authority which is consistent with the intent of the Regime to be light handed. Consequently, the Authority does not consider any changes to the Over-payment Rules are necessary to address this issue.

## ***Allocation of Access Revenue/Over-payment***

### *Allocation of Access Revenue*

#### **WNR’s Proposal**

52. Under Section 9(1)(c) part (i) of the Code, a railway owner is required to provide one floor and one ceiling price for access to a route, although the access proposal may traverse a number of route sections in the route.
53. In section 2.6 of the proposed Over-payment Rules, WNR has stipulated that access charges are determined on a route or multiple route basis. However, as total costs are required to be determined (Section 9(1)(c)(ii) of the Code), there is a requirement to distribute access revenue earned over a particular route, or routes, to individual route sections. The distribution of the access revenue will be done on the following basis:
- 1) Access revenue derived from a route can only be allocated to the route sections on that route.
  - 2) WNR will allocate access revenue to cover the costs attributed to the applicable route sections in the following order:
    - (a) Incremental costs against all applicable route sections;
    - (b) Up to the ceiling on all applicable branch or feeder (dedicated) route sections; and
    - (c) Up to the ceiling on all applicable shared route sections.
54. WNR’s justification for the order of the allocation process is based on the following principles:
- a) To avoid cross subsidisation between route sections, the access revenue allocated to each route section must cover the incremental cost.
  - b) Recovery of capital costs on branch or feeder lines ranks above shared lines on the basis that there is no other traffic on these lines to fund the dedicated infrastructure and unless those costs are covered, the line may close.

55. Where WNR and track users have reached agreement on a different access revenue allocation arrangement, that arrangement would prevail.

### **Interested Party Submissions**

56. ARTC has expressed some concern<sup>11</sup> that with the above allocation process there is potential for operators of shared infrastructure to pay higher access charges than normal to “subsidise” the lower revenue attributed to shared infrastructure for other operators whose revenue has been allocated to branch lines up to the ceiling limits. ARTC considers that this would result in a loss of network efficiency associated with keeping a non-commercial branch line open. ARTC believes that the objective of keeping un-economic branch lines open should be dealt with in more transparent ways, rather than through cross subsidisation.

### **Authority’s Assessment**

57. The Authority considers there is merit in providing WNR with some degree of discretion to allocate revenues for a route back to the individual route section to ensure the efficient and economic use of the railway infrastructure.
58. Given that the ceiling price reflects the full economic cost of the infrastructure being provided, the Authority considers that WNR’s proposal that branch or feeder infrastructure should rank ahead of shared infrastructure is reasonable on the basis that there is no other traffic to fund the dedicated infrastructure and unless those costs are recovered, the branch line may close.
59. The Authority monitors the manner in which WNR allocates its revenue to determine whether WNR is “gaming” in a manner that does more than recover its legitimate costs and maximise the efficient and economic use of the railway infrastructure. In particular, the Authority will be monitoring any adjustments to access rates by WNR which favour one track user over another to avoid breaching the ceiling. The Authority has mandated that WNR undertake independent annual audits to ensure its compliance with the Over-payment Rules. There have been two audits completed in which the independent auditor has certified that WNR has complied with the Over-payment Rules.
60. The Authority considers that where track users do not wish the proposed revenue allocation methodology to apply, they have the option of fixing revenue allocation on a route section basis in their access agreements. In this case, these alternative revenue allocation arrangements would prevail as outlined in the proposed Over-payment Rules. Alternatively, operators can negotiate access prices on a route section basis which would alleviate the problem of allocating revenue to route sections.

### *Allocation of Over-payment*

#### **WNR’s Proposal**

61. In section 2.8 of the proposed Over-payment Rules, WNR has outlined the process it will apply in the allocation of an over-payment on a route section as:
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<sup>11</sup> ARTC page 16.

- 1) If an operator can be identified as being responsible for triggering the over-payment, then the over-payment will be allocated back to all operators on the entire route of that operator.
- 2) If more than one operator can be identified as being responsible for triggering the over-payment, then the over-payment will be allocated back to all operators on all of the routes of those operators.
- 3) If it is not possible to single out the operators responsible, then an assumption will be made that the over-payments are the result of all operators' payments on that route section. In such cases, the over-payment will be allocated back to all operators on all of the route sections of those operators that share that route section.

The repayment will be apportioned based on the total annual access revenue received above the floor for access by each operator on the route section as a proportion of the total access revenue above the floor for the route section. An operator paying only the incremental cost on the route section will not be considered for any refund as this would compromise the floor price test in the Code.

### Interested Party Submissions

62. Two submissions were received on this issue from GSR and Alcoa. GSR<sup>12</sup> has expressed concern that WNR has the discretion to identify the operator that triggers the over-payment. It suggests that the trigger is the result of the total use of the route section rather than by a single operator. GSR contends that it would be more appropriate to identify the route section on which the over-payment is made and apportion the repayment on the basis of each operator's access revenue paid to use that route section.
63. Alcoa contends<sup>13</sup> the particular route section that causes the over-payment should be the only route section used in calculating the quantum of the over-payment and the allocation of that over-payment to the track users using that route section.
64. Alcoa, in its assessment of the allocation methodology outlined above, suggests that it is unclear how the trigger event is identified by a single track user who causes the trigger (item 1 in paragraph 61 above) for the over-payment. There is no explanation in the section on how WNR is going to identify the track user who triggers this event. Alcoa also suggests that it is unclear how in item 2 above, WNR is able to identify more than one track user which trigger the over-payment and questions the fair allocation of the over-payment to any of the operators who are not the trigger operators.
65. Alcoa is supportive of item 3 as it is based on the inability of identifying the operator which triggers the over-payment. Hence, all the operators' access revenue is considered to result in the over-payment which is consistent with its contention as identified in paragraph 63 above. However, Alcoa has expressed a concern that the use of all the routes of all the track users gives an unfair outcome as the length of each of the routes of each track user will determine the amount of the revenue which determines the percentage allocation of the over-payment. This provides an advantage to the longer distance track user whose revenue contribution along the route may be much higher. Alcoa's preference is that only revenue on the route section which caused the over-payment should be used as the measure of the allocation.

<sup>12</sup> GSR page 21.

<sup>13</sup> Alcoa page 5.

**Authority’s Assessment**

- 66. SdD considers there is no significance in the order in which operators introduce their traffic to a route section for the purposes of reimbursement. The decision to allocate over-payment rebates to the operators based on the ‘triggering’ operator’s route characteristics seems arbitrary and overly complex. SdD supports the allocation based on item 3 on the basis that no single operator can be said to have triggered the over-payment under any scenario. It supports over-payments being made to all operators on the route section on the basis of their use of that route section, rather than the differing routes of each of the operators. SdD contends that simplicity and clarity should be the aim of this exercise.
- 67. The Authority has considered the views of Alcoa, GSR and SdD and agrees that the allocation mechanisms outlined in the first two items in paragraph 61 do cause some confusion in how WNR is going to identify the operator or operators who trigger the over-payment and believes that the allocation process identified in item 3 is more appropriate. Consequently, the Authority considers that in the absence of WNR’s rationale for determining the operator or operators who trigger the over-payment, that the allocation process identified in item 3 is the most appropriate methodology. The Authority also considers that the over-payment should only be reimbursed to the operators who have contributed to the over-payment in the route section where the over-payment occurs rather than have the over-payment allocated back to all operators on all of the route sections as is contended in item 3.Draft Determination

**Required Amendment 4**

Section 2.8 of the proposed Over-payment Rules should be amended to delete items 1 and 2. Item 3 should be suitably amended such that the allocation process outlined under this item is used as the methodology for allocating all over-payments. Item 3 should also be amended to make it clear that the over-payment should only be reimbursed to the operators who have contributed to the over-payment on the route section where the over-payment occurs.

**The Over-payment Rules**

**WNR’s Proposal**

- 68. In section 3 of the proposed Over-payment Rules, WNR has proposed the over-payment rules that will apply to the rail freight network. In rule 6, WNR has indicated that reimbursements to operators (who have negotiated access inside the Code) will be apportioned, based on the total annual access revenue above the floor by each track user on the route section. The formula to be applied will be:

A track users(b) annual Access Revenue above the Floor	×	Amount of net over-payment
Total annual Access Revenue(a) above the Floor		

Where (b) represents the operators who have negotiated inside the Code, as they are the only ones eligible for a share of the net over-payment and (a) represents the total access revenue from both non-Regime and Regime operators.

69. WNR has advised that for operators who have negotiated access outside the Code and who have included in their commercially negotiated access agreements the provision for reimbursement of over-payment, the same formula will apply to calculate each operator's reimbursement.

### Interested Party Submissions

70. Alcoa notes<sup>14</sup> that the calculation now excludes non-access revenue, where non-access revenue includes government and private contributions. Alcoa contends that excluding non-access revenue would be acceptable if the contributed asset generating the non-access revenue does not result in a change to the access revenue. However, it considers that in a number of cases there will be a resulting change to the access revenue which would result in an incorrect allocation where an operator who makes the contribution would negotiate a discounted access charge equivalent to its contribution. As a consequence, the numerator in the equation would be lower and the allocation to the operator would be unfairly reduced. Alcoa considers that non-access revenue should be included in the calculation.

### Authority's Assessment

71. The Authority notes that there are seventeen over-payment rules proposed by WNR and that all but rule 6, as indicated above in paragraph 68, are unchanged. There has been no comment by interested parties other than by Alcoa who have commented on the change to the equation apportioning the reimbursement of the over-payment to individual operators as indicated in rule 6. The Authority notes that the amended formula used to calculate the reimbursement for operator omits non-access revenue from the numerator and denominator of the equation. However, WNR has not provided any justification and reasoning for the change.
72. The Authority notes Alcoa's comments in regard to the omission of non-access revenue from the formula and the potential negative impact this would have on operators who were providers of contributed assets, this impact is expected to be relatively small. Operators may be able to reflect any negative impact resulting from the proposed formula in revised access pricing for contributed assets. However, these access price negotiations are done ex-ante where the quantum of the over-payment may not be known for a period of three years after the revised access price deliberations have been completed.
73. The Authority considers that the revised formula does not represent an equitable distribution of the over-payment between operators as it discriminates against operators who provide contributed assets. On this basis, and in the absence of any justification why the formula was revised to exclude non-access revenue, the Authority will require an amendment to the formula.

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<sup>14</sup> Alcoa page 8.

**Draft Determination**

**Required Amendment 5**

Rule 6, in Section 3 of the proposed Over-payment Rules, should include non-access revenue in the numerator and denominator as reflected in the existing Over-payment Rules.

# APPENDICES

## Appendix 1 Glossary

Act	Railways (Access) Act 1998
Alcoa	Alcoa World Alumina Australia Pty Ltd
ARTC	Australian Rail Track Corporation Ltd
Authority	Economic Regulation Authority
ARG	Australian Railroad Group Pty Ltd
Code	Railways (Access) Code 2000
CPI	Consumer Price Index
DORC	Depreciated Optimised Replacement Cost
GRV	Gross Replacement Value
GSR	Great Southern Railway Ltd
GTK	Gross Tonne Kilometres
KPI	Key Performance Indicator
MEA	Modern Equivalent Asset
Operator	Train Operators and end user customer
PN	Pacific National Pty Ltd
PTA	Public Transport Authority
SdD	Strategic design and Development Pty Ltd
WACC	Weighted Average Cost of Capital
WNR	WestNet Rail Pty Ltd