WestNet Rail's Part 5 Instruments Review

Draft Determination on the Proposed Costing Principles

10 May 2006

Economic Regulation Authority
WESTERN AUSTRALIA

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Economic Regulation Authority website at **www.era.wa.gov.au**.

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DRAFT DETERMINATION

1. On 15 December 2005, WestNet Rail Pty Ltd (**WNR**) submitted its proposed Costing Principles to the Economic Regulation Authority (**Authority**) for approval. The submission of the proposed Costing Principles resulted from a requirement for WNR to review the existing Costing Principles two years after approval by the Independent Rail Access Regulator (**IRAR**) in December 2002.

2. The Authority has considered the proposed Costing Principles 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 Costing Principles 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 four amendments to the proposed Costing Principles required by the Authority are listed below.

Summary of Amendments

Required Amendment 1

Sections 3.4 and 7.2 of the proposed Costing Principles should be amended to state that train control costs will be apportioned directly to rail routes.

Required Amendment 2

Section 7.2 of the proposed Costing Principles should be amended to delete reference to a specific proportion of GTK and train numbers to be used in allocating overhead costs and to note that this proportion will be determined by the Authority during future floor and ceiling cost determinations.

Required Amendment 3

Sections 3.4 and 4.2 of the proposed Costing Principles should be amended to state that the allocation methodologies proposed are intended to be used to allocate costs down to the route level and that the allocation of route costs down to the route section level will be determined by the Authority during future floor and ceiling cost determinations.

Required Amendment 4

Section 5.1 of the proposed Costing Principles should include a requirement for WNR to submit the annual inflation adjusted floor and ceiling costs for determined rail lines to the Authority for review and approval.

INTRODUCTION

Background

5. WestNet Rail Pty Ltd (**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 Costing Principles is one of four Part 5 Instruments set out in Section 40(3) of the *Railways (Access) Code 2000* (**Code**). Each of WNR's 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 Costing Principles, Section 46(1) of the Code sets out the extent of the issues considered in this review, as follows:

   Section 46(1) 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 principles, rules and practices ("the costing principles") that are to be applied and followed by the railway owner-

   (a) in the determination of the costs referred to in clauses 7 and 8 of Schedule 4; and

   (b) in the keeping and presentation of the railway owner's accounts and financial records so far as they relate to the determination of those costs.

10. In December 2002, the Independent Rail Access Regulator (**IRAR**) approved the Costing Principles 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 Costing Principles.

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 Costing Principles (proposed Costing Principles) 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 Costing Principles. 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).

14. The Authority's draft determination on WNR's proposed Costing Principles focuses on the elements within the scope of the Costing Principles review, as outlined under paragraph 9 above, being the establishment of principles, rules and practices that are to be applied by the railway owner to determine the floor and ceiling price tests, and to keep and present the railway owner's accounts and financial records pertaining to the determination of these costs. Quantification of the floor and ceiling costs and assessment of whether WNR's costs are appropriate are not part of this determination but will be addressed in future determinations on WNR's floor and ceiling rail line cost reviews.

15. The Authority has noted a number of comments in the public submissions received on WNR's proposed Costing Principles, such as comments on access charges and regulatory asset valuation, which fall outside of the scope of the Costing Principles review. The Authority's determination is limited to the scope of this review and consequently, comments from the public submissions which have been determined to fall outside this scope have not been taken into consideration by the Authority in making this draft determination.

16. This draft determination makes reference to a number of acronyms which are identified in the Glossary in Appendix 1.

17. 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 raise in these submissions. This SdD report is available on the Authority's website (www.era.wa.gov.au).

Legislative Considerations

18. The key areas of the Code and the Act that have relevance to the formulation and application of the Costing Principles are as follows:

a) *Costing Principles (Section 46 of the Code).*

The railway owner is to submit the Costing Principles to the Authority for approval as soon as possible. Section 46(5) of the Code specifies that the Costing Principles must be consistent with the Corporations Law relating to financial administration.

b) *Definition of Costs (Clauses 1 and 2, Schedule 4 of the Code)*

All costs referred to under the Code are those that would be incurred by adopting efficient practices in the provision and management of railway infrastructure including the practice of operating a particular route in combination with other routes for the achievement of efficiencies.

Incremental costs are the operating costs and, where applicable, capital costs and overheads that the rail owner would be able to avoid in respect of the 12 months following the proposed access.

Operating costs are the train control, signalling and communications, infrastructure maintenance, train scheduling, emergency management and information reporting costs. The cost of maintaining the railway infrastructure is to be calculated on the basis that cyclical maintenance costs are evenly spread over the maintenance cycle. All cost items are to be based on the costs that would be incurred if the infrastructure were replaced using modern equivalent assets (**MEA**).

Capital costs are the costs comprising both the depreciation and risk-adjusted return on the relevant railway infrastructure. It is to be determined using an annuity formula by applying the Gross Replacement Value (**GRV**) of the infrastructure as the principal, the Weighted Average Cost of Capital (WACC as the rate of return and the economic life of the asset in years. The GRV of the rail infrastructure is calculated as the lowest current cost to replace existing assets that have the capacity to provide the level of service that meets the actual and reasonable projected demand and are if appropriate, MEA.

Total costs include the total of all operating and capital costs and overheads attributable to the performance of the access-related functions of the railway owner.

c) Determination of the WACC (Clause 3, Schedule 4 of the Code).

The Authority is required to determine, as at 30 June each year, the WACC for the rail infrastructure associated with the non-urban network. In 2003 and every five years thereafter, the Authority is to publicly consult when determining the WACC.

d) *Nature of costs (Clause 4, Schedule 4 of the Code).*

All costs are to be those that would be incurred by adopting efficient practices for the provision of rail infrastructure, including the practice of operating a particular route in combination with other routes to achieve efficiencies.

e) *Allocation of costs to determine the floor (Clause 7, Schedule 4 of the Code).*

The floor price of a route and associated railway infrastructure is the incremental costs resulting from the combined operations of all operators and other entities on that route and use of that infrastructure.

f) *Allocation of costs to determine the ceiling (Clause 8, Schedule 4 of the Code).*

The ceiling price of a route and associated railway infrastructure is the total cost attributable to that route and infrastructure.

g) *Determination of the floor and ceiling costs on routes for which access proposals are likely to be made (Clause 9, Schedule 4 of the Code).*

The Authority is required to nominate the routes which it considers that proposals for access are likely to be made, and ask the railway owner to propose floor and ceiling costs of these routes. The Authority will make a determination on these costs and will seek public comment before making the determination.

h) *Determination of the floor and ceiling costs on routes which have not been assessed under Clause 9 (Clause 10, Schedule 4 of the Code)*.

When a proposal is made on a route where the floor and ceiling costs have not previously been determined by the Authority, the railway owner will be required to notify the Authority of its costs. The Authority will either approve the railway owner's proposed costs or make an appropriate determination of the costs. In both instances, the Authority may seek public comment on the determination, as long as the time limit imposed on the railway owner to present to the operator a draft access agreement for consideration is not breached. This time constraint can be waived by the operator who is seeking access.

i) *Competition Principles (Section 20(4) of the Act).*

The Act also provides a framework within which the Authority's determination required under Section 46 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

19. 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 Costing Principles. The draft determination also proposes

amendments which are required to be made to WNR's proposed Costing Principles in order for the Authority to approve these principles.

20. The process for the review of the proposed Costing Principles that the Authority has adopted is as follows:

- Public submissions on WNR's proposed Costing Principles (January 2006).
- Authority's draft determination published (May 2006).
- Public submissions on draft determination (June 2006).
- Authority's final determination published (June 2006).
- Amended Costing Principles submitted by WNR (June 2006).
- WNR's amended Costing Principles approved by the Authority (July 2006).

REASONS FOR THE DRAFT DETERMINATION

Discussion of Issues

21. Relevant issues raised in public submissions on WNR's proposed Costing Principles are discussed below under the following headings:

- Required network standards.
- Capital, Operating and Overhead costs.
- Total costs.

22. It should be noted that, as outlined under paragraph 15, those matters raised in submissions which were considered to be outside the scope of the Costing Principles review were not taken into account in this draft determination.

23. There were some minor issues, related to definitional errors, raised in submissions which are being directly addressed with WNR and do not form part of this draft determination.

24. The Authority has taken the view that those sections of WNR's proposed Costing Principles on which no comment has been made are acceptable to track users and access seekers. The proposed Costing Principles are largely the same as the Costing Principles approved by the IRAR in 2002 so operators and access seekers have had a considerable period to assess the effectiveness and suitability of these principles.

25. 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.

Required Network Standards

WNR's Proposal

26. WNR has not published any network standards or provided key performance indicators (**KPI**) on the network standards. However, WNR has indicated, in Section 1.5, that it will adopt economically and technically efficient practices to provide a network which maintains service quality at the specified operational levels for the network. The Costing Principles state that WNR will report on specific service quality KPI's as are agreed between WNR and the Authority. The Costing Principles also indicate that WNR will negotiate specific KPI's, covering WNR's and train operators performance, in its access agreements to measure operational performance of WNR and operators which may provide for financial incentives and penalties.

Interested Party Submissions

27. The ARTC submission indicated:[1]

> "In a vertically integrated environment the railway owner can discriminate against third party access seekers through standards it chooses to maintain the network which would impact on the efficient cost of maintaining the network. Consequently, it seeks to have network standards incorporated in the Costing Principles and KPI's put in place to ensure compliance with the standards."

Authority's Assessment

28. The Authority is aware that under the terms of WNR's lease agreement with the WA Government, the Government has powers to assess the performance of WNR and to require remedial work to be undertaken, if required, to lift WNR's performance to agreed standards.

29. Clauses 9 and 10, Schedule 4 of the Code stipulate that the railway owners must develop floor and ceiling costs for determination and approval by the Authority. To date, the Authority has made three determinations on floor and ceiling costs on various rail lines in the freight network. The floor and ceiling cost calculations necessitate the establishment of modern equivalent asset (MEA) standards in each of the determinations. There is no single network standard with MEA standards varying for different rail lines.[2] The Authority monitors the performance of railway owners through the requirement to provide KPI's on a quarterly and annual basis with the annual KPI report made available to the public via the Authority's website.

30. SdD considers that ARTC's comments regarding KPI reporting and the publication of track standards in the Costing Principles is out of place as WNR is accountable for the track standard under rail safety legislation and periodic track audits under its lease agreements with the WA Government. SdD also suggests that WNR should not be directly accountable to access seekers and train operators for the standards to which the network is maintained because the condition of a given track section, from time to time, is rather fluid and it would be impractical to publish detail of this condition in a meaningful way in the proposed Costing Principles. Consequently, SdD considers the commercial interest of the railway owner in maintaining the track to a standard that maximises traffic can be relied on.

31. The Authority considers that the approach to monitoring the railway owners performance is satisfactory but has recently indicated[3] a willingness to review the content of the KPI's being reported. As there is no single network standard, the Authority considers it more appropriate for MEA standards for individual lines to be determined as part of the determination of the floor and ceiling costs as they form the basis of the floor and ceiling calculations rather than publish the standards in the Costing Principles.

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[1] ARTC, Submission on the Review of WestNet Rail's Part 5 Instruments, page 17.

[2] Determination of the Independent Rail Access Regulator, Floor and Ceiling Costs to Apply to WestNet Rail, September 2003, page 18.

[3] Economic Regulation Authority, Final Report on the Review of the Railways (Access) Code 2000, September 2005, section 5.4, page 53.

Capital/Operating/Overhead Costs

Asset Valuation

WNR's Proposal

32. In its proposed Costing Principles, WNR has indicated that assets will be valued using GRV of the MEA of the infrastructure where appropriate in accordance with the requirements of the Code. This lends itself to the valuation being based on "fit for purpose", with the more heavily trafficked parts of the network valued on the basis of an optimised replacement cost and the less trafficked routes (i.e. regional lines in the grain network) based on a least cost-less optimal approach.

33. The infrastructure is required to be optimised to meet current and reasonably projected demand. The GRV valuation will not distinguish between the type of funding of the assets as it is based on calculating the capital cost of the entire network. Recognition of contributed assets will be made via the Over-payment Rules which is the subject of a separate determination by the Authority.

34. In the Costing Principles, WNR has proposed that unit rates for capital equipment will be based on:

    - An independent engineering firm's report.
    - Tendered rates that WNR has tested in the market.
    - Direct quotation from suppliers.

    WNR has indicated that where unit rates are adjusted for scale or the impact of location, these assumptions will be included in the costing model to be audited by the Authority. The costing model is used to calculate the floor and ceiling costs for the rail network.

Interested Party Submissions

35. ARTC, in its submission,[4] accepts the GRV asset valuation in the Costing Principles as it is the prescribed methodology in the Code. ARTC, however, suggests that any GRV valuation be independently assessed to establish market confidence in the limits around access pricing. Further, ARTC supports the use of independent advice by the Authority to verify the MEA standards, unit rate calculations and economic life assumptions on which the capital cost is based.

Authority's Assessment

36. The Authority is aware that WNR has, in the past, used the services of an independent consultant to provide cost estimates in its calculations for the floor and ceiling costs for rail lines. The Authority has, in its past floor and ceiling cost determinations, also used an independent consultant to verify the costs proposed by railway owners and will continue to do so in future floor and ceiling cost determinations.

[4] ARTC page 18.

Operating and Maintenance Costs

WNR's Proposal

37. In section 3 of the proposed Costing Principles, WNR outlines the elements of operating and maintenance costs. In particular, the Costing Principles, in section 3.2, outline the process by which WNR will test whether the operating costs used in determining the floor and ceiling costs are efficient, as follows:

- Benchmarking will be used where the information is available and comparable;
- For certain processes and activities, unit costs from competitive tendering may be used;
- If the maintenance programs are based on accepted industry standards for maintenance which describe the scope and frequency of the activity, then this may be considered to be efficient;
- Actual costs may be used where the consumption and scope are efficient (eg. Train controllers' salaries, if the number of controllers and their range of duties are efficient by benchmarking);
- Actual costs may also be used where the costs:
  - come from a competitive market such as insurance; or
  - are regulatory costs (such as the cost of rail safety accreditation).

In measuring efficiency, WNR recognises that these costs change over time especially as a result of innovation and technological change. WNR will also report against efficiency KPI's to the Authority.

Interested Party Submissions

38. Great Southern Railways (**GSR**) indicated[5] that under a MEA approach efficient costs need to be estimated for the operating and maintenance task and cautions that the accuracy of these estimates has an impact on the floor and ceiling cost levels. GSR suggests that the Authority closely scrutinise the accuracy of WNR's efficient cost estimates.

Authority's Assessment

39. The Authority recognises the importance of confirming the accuracy of efficient cost estimates in the calculation of floor and ceiling costs. In the three previous determinations on the floor and ceiling costs for rail lines, the Authority has used an independent consultant to confirm the accuracy of efficient cost estimates and where appropriate changes have been made to the floor and ceiling cost estimates to reflect the consultant's recommendations. The Authority will continue to use the services of independent consultants in future floor and ceiling cost determinations.

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[5] GSR, Submission on the WestNet Rail's Part 5 Instruments, page 20.

Allocation of Operating and Overhead Costs

WNR's Proposal

40. In section 3.4 of the Costing Principles, WNR defines the allocation of non-sector specific operating costs in accordance with allocation rules using GTK or train numbers. Infrastructure management costs, which incorporate maintenance management and engineering support, are allocated by region and then by GTK's within the region. Network management costs, the other component of operating costs which incorporate access management, train scheduling, train management and operations planning are allocated using train numbers because it is argued that these functions are used to support train movements.

41. The Costing Principles, in sections 4.2 and 7.2, have identified overhead costs to be a combination of WNR overheads, which cover compliance, office equipment and furniture and WNR management costs, and corporate overheads which principally cover information systems, human resource management and finance costs. WNR proposes to use an equal combination of GTK and train numbers for allocating these overhead costs.

42. The Costing Principles are silent on whether these allocation methodologies are to be applied at the route or route section basis. However, as the floor and ceiling costs are calculated on a route section basis, it can be implied that these allocation methodologies are to apply on a route section basis.

Interested Party Submissions

43. Two submissions were received on this issue from ARTC and Alcoa. ARTC[6] had no concerns with the allocation methodologies proposed for the operating and overhead costs but suggested that the cost allocations should be independently assessed and that the Authority confirm the reasonableness of the equal split by GTK and train numbers for overhead costs as proposed by WNR.

44. Alcoa[7] has expressed concerns at the use of only train movements in the allocation of common operating costs at the route section level. Its concerns relate to allocating train numbers to the number of route sections in a route, and demonstrates by a worked example the impact on the allocation of costs if the number of route sections were re-defined.

45. Alcoa has also indicated that this method of allocation does not give consideration to the length of route sections within a route, resulting in a disproportionately high operating cost allocation to short route sections compared to other costs. As a result of this disproportionate allocation, Alcoa believes that operators using short route sections are unfairly treated. While it conceded that the number of trains on a route may provide a fair indication of the intensity of resources needed, it does not translate to a fair allocation at the route section level because it does not consider the number and length of route sections in a route.

[6] ARTC page 19.

[7] Alcoa, Submission on the Review of WestNet Rail's Part 5 Instruments, page 2.

Authority's Assessment

46. The Authority has made, to date, three determinations on floor and ceiling costs for various rail lines. In each of the determinations, the Authority has used train movements as the basis for allocating common operating costs and an equal combination of GTK and train movements for the allocation of overhead costs in the floor and ceiling determinations down to the route section level. In each of the determinations, the Authority obtained independent advice on the merits of the allocators before making its decision and will continue to do so for future floor and ceiling cost determinations.

47. Following these determinations, the Authority established a working group, consisting of WNR and customers, to assess the methodologies for the allocation of common operating and overhead costs. The outcome of this assessment was to agree the apportionment of some costs directly to rail lines. Where these costs could not be apportioned an appropriate allocation methodology was identified.

    The working group agreed that train control costs could be directly apportioned to rail lines and that the allocation of the balance of network management costs should be done using train numbers. The working group agreed that for infrastructure management costs that the approach taken in the Costing Principles was reasonable. However, the working group could not agree on a methodology for the allocation of overhead costs. The working group only considered cost allocation methodologies at the route level and agreed that the allocation methodologies for the route section level should be left to the Authority's discretion when it makes future determinations on the floor and ceiling costs.

48. The Authority considers that, following the review of the working group, train control costs should be apportioned directly to rail routes and not be allocated using train numbers. In addition, the Authority supports the use of train numbers for allocating the balance of network management costs and the methodology proposed in the Costing Principles for the allocation of infrastructure management costs.

49. The Authority considers that the allocation methodology for overheads, using an equal combination of GTK and train numbers, may be too prescriptive. The Authority also acknowledges the concerns expressed by Alcoa in regard to the potential impact of the proposed allocation methodologies, for the allocation of both overhead and operating costs, at the route section level. The Authority believes that these matters are best addressed during its future reviews of floor and ceiling costs.

Draft Determination

> **Required Amendment 1**
>
> Sections 3.4 and 7.2 of the proposed Costing Principles should be amended to state that train control costs will be apportioned directly to rail routes.
>
> **Required Amendment 2**
>
> Section 7.2 of the proposed Costing Principles should be amended to delete reference to a specific proportion of GTK and train numbers to be used in allocating overhead costs and to note that this proportion will be determined by the Authority during future floor and ceiling cost determinations.
>
> **Required Amendment 3**
>
> Sections 3.4 and 4.2 of the proposed Costing Principles should be amended to state that the allocation methodologies proposed are intended to be used to allocate costs down to the route level and that the allocation of route costs down to the route section level will be determined by the Authority during future floor and ceiling cost determinations.

Total Costs

Variation of Floor and Ceiling Costs

WNR's Proposal

50. The proposed Costing Principles, in section 5.1, indicate that WNR will escalate the floor and ceiling costs based on the consumer price index (**CPI**) less an "X" factor where the CPI is the Australian Bureau of Statistics Weighted Average of Eight Capital Cities All Groups CPI index calculated for the March quarter each year.

51. The "X" factor represents a productivity calculation for an MEA with the CPI-X escalation to be applied in between resets to the floor and ceiling costs only. The "X" factor is estimated at one quarter of CPI and applied to escalate the floor and ceiling costs for the second and third years following a floor and ceiling cost determination. The estimate for the "X" factor is the same as that approved for the current Costing Principles.

    WNR has proposed that the Authority monitor and assess the movement in costs to determine an appropriate "X" factor for the years after a floor and ceiling cost reset.

Interested Party Submissions

52. Two submissions were received from ARTC and Alcoa. ARTC has outlined[8] the annual cost escalation in its Undertaking which was approved by the ACCC. This consists of the operating costs being escalated by CPI less a productivity allowance

[8] ARTC page 19.

which is one third of CPI. The regulatory asset base is also adjusted annually by CPI less annual depreciation. These annual floor and ceiling cost escalations are reviewed and approved by the ACCC. ARTC suggests that a similar approach be adopted by WNR in the proposed Costing Principles so as to give comfort to access seekers that the escalation has been done correctly.

53. Alcoa has suggested[9] that the indexation of ceiling costs should be based on CPI-X with the X factor representing productivity improvements for the following two years and not a defined percentage of CPI. The value of X should reflect the ability of WNR to achieve substantial gains over the three years following a price reset.

Alcoa suggests that the Costing Principles should not indicate a figure until a new "X" factor is calculated by the Authority following the next review of the floor and ceiling costs for the mainlines. This Authority calculated "X" factor should then be included in the next review of the Costing Principles.

Authority's Assessment

54. The calculation of the "X" factor in the existing Costing Principles was estimated on the basis that the productivity benefits resulting from operating an MEA was likely to be lower than the productivity benefits arising from aged assets. The ACCC approved the ARTC Undertaking which stipulated that the "X" factor should be one third of CPI, based on the ARTC network having a regulatory asset value as determined through a DORC calculation which depreciates the assets over their economic lives. As a consequence, the Authority decided on a lower "X" factor, of one quarter of CPI, as the WNR rail network regulatory asset value was based on using an MEA approach with a GRV valuation which does not take depreciation of the assets into account.

55. The Authority's determination of the floor and ceiling costs for the mainlines was released in September 2003 which incorporated the CPI-X escalation of costs based on the "X" factor in the existing Costing Principles. Following the September 2003 determination, the Authority, in recognition of the uncertainty in the calculation of the "X" factor commissioned a study to calculate the productivity benefits resulting from the operation of a MEA. The study used a total factor productivity approach to estimate productivity benefits. However, due to data deficiencies the study was inconclusive and recommended a further study be undertaken following the review of the floor and ceiling costs for the mainlines to be undertaken in 2006.

The Authority recognised the deficiencies outlined in the study and proposed to assess the development of CPI-X regulation in Australia at the next reset of the floor and ceiling costs. The Authority is aware that no definitive methodology has currently been established to calculate the "X" factor in Australia and accordingly will undertake a further review of CPI-X methodologies following the completion of the next round of the floor and ceiling cost reviews. Until these reviews have been completed, the Authority is of the view that the "X" factor should remain as one quarter of CPI.

56. The Authority considers there is merit in the suggestion by ARTC and Alcoa that the Authority review and approve the annual inflation adjustment of the floor and ceiling costs.

[9] Alcoa page 4.

Draft Determination

Required Amendment 4

Section 5.1 of the proposed Costing Principles should include a requirement for WNR to submit the annual inflation adjusted floor and ceiling costs for determined rail lines to the Authority for review and approval.

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