

Pacific National

Costing Principles

Comments on the

Draft of the

**Determination of the Western Australian
Independent Rail Access Regulator**

in accordance with the requirements of

**section 46 of the Railways (Access) Code
2000**

Introduction

1. Pacific National welcomes the opportunity to comment on the draft determination on costing principles. Pacific National is a major above rail train operator in Australia which incorporates the businesses previously conducted as Freight Rail Corporation, National Rail Corporation Limited, Toll Rail and Patrick Rail. As such, it currently provides interstate services using the WestNet track that is the subject of the access regime and is a potential provider of other above rail services within Western Australia.
2. In this submission, Pacific National does not seek to comment in detail on each of the matters identified in the draft determination but rather to focus on what it considers key aspects which arise from the draft determination. Those matters focus on:
 - (a) the need for greater transparency and detail in the asset valuation approach which has been used by WestNet in determining both the floor and ceiling prices;
 - (b) transparency and further detail in relation to the operating costs and maintenance costs of WestNet;
 - (c) the need for service quality standards to be included and explicitly linked with pricing.
 - (d) the inappropriateness of CPI linked escalation of rates.

Transparency in capital cost components

3. Pacific National supports the introduction of a new section 1.1 to the proposed costing principles as set out in section 5 of the draft determination. The inclusion of this new section better reflects the objectives which the costing principles are designed to achieve and, in particular, clarifies that it is an important part of the objectives of the costing principles to ensure that there is proper data provision to assist in the transparency of underlying cost information.
4. The draft determination noted that a significant part of the request in submissions was for far greater detail on the rules and practices that WestNet utilised to calculate floor and ceiling costs. In Pacific National's submission, the lack of transparency in the cost calculations used in the GRV approach is a significant issue which needs to be addressed.

5. The draft determination recommends that for those routes with potential to breach the ceiling, there is merit in having WestNet's GRV independently reviewed by a railway engineering expert. For others, benchmarking costs against best practice capital cost unit rates is appropriate.
6. In Pacific National's submission, there is merit in having WestNet's GRV independently reviewed by a railway engineering expert for all routes. As is implicit in the draft determination, there is no clarity in WestNet's assertion that there is full optimisation to achieve a modern equivalent asset comparison. Given the inherent information asymmetry which exists between the track provider and an access seeker, much greater transparency on this issue should be required. In addition to the information which the regulator has foreshadowed he will ask WestNet to produce (see page 21) of the draft determination, the regulator's independent railway engineer should be asked to review the capital cost drivers used by WestNet against best practice. Those key cost drivers are identified at page 20 of the draft determination and are key issues in determining the appropriate capital base. Given the significance of these and the relatively limited number of key cost drivers identified, this would be a reasonable requirement to be imposed on WestNet.

Transparency in operating costs

7. The costing principles are designed to demonstrate that efficient costs are being achieved. In essence, WestNet relies on outsourcing as a demonstration of efficient costs.
8. In addition, this appears to be based on a misconceived notion given a GRV and MEA assumptions are the basis of costing in the regime. Some recognition of this appears to have been accepted by WestNet in that it will treat MPM as zero. However, given the lack of detail it is not clear that this issue will be adequately addressed based upon the current information available. If the hypothetical GRV of a MEA is assumed then the infrastructure is as new. Therefore the scope of maintenance that is required is less than the actual maintenance performed. It is therefore Pacific National's view that for pricing purposes the assumed maintenance scope should be the hypothetical maintenance scope required for new infrastructure.
9. It is Pacific National's recommendation that the criteria on weather WNR is operating at efficient levels (which are outlined on pages 12 and 13 in the draft determination) should be expressly incorporated into the costing principles. This will increase transparency and certainty in the pricing of access for both WNR and access seekers.

10. Pacific National is generally supportive of the changes required to section 3.1 of the costing principles. In addition, however, an audit of the operating costs is required to determine whether they are efficient operating costs.

Service quality standards

11. As the draft determination notes, service quality is inextricably linked with price. However, service quality is not covered by the costing principles. This needs to be rectified and a direct link between service quality and price should be included. The need for this has been recognised by the Australian Competition and Consumer Commission. For example, see its decision on the ARTC access undertaking where it said:

"A related issue is whether there exists an appropriate relationship between price and quality of service. That is, in a situation where an access provider has market power there may be an incentive to increase profitability by reducing quality of service."

12. Contrary to the comment made in the draft determination, it is Pacific National's experience that service quality standards are not frequently dealt with in access agreements and access seekers have enormous difficulty in obtaining any commitment to service quality levels from the access provider. Given the fundamental relationship between service quality and price, it is Pacific National's view that rather than simply monitoring WestNet's service quality standards, explicit service quality standards should be incorporated in the costing principles. This should be along the lines of the KPI reporting system which the regulator has proposed.
13. Pacific National supports the inclusion of a new service quality commitment section in the costing principles. Pacific National supports the service quality commitment sought by the regulator in the draft determination and specifically, the commitment to negotiate specific KPIs (covering both WestNet and operator performance) within the access agreement which is linked to a system of financial incentives.

In terms of service quality it is the recommendation that the following items or indicies be used as KPIs:-

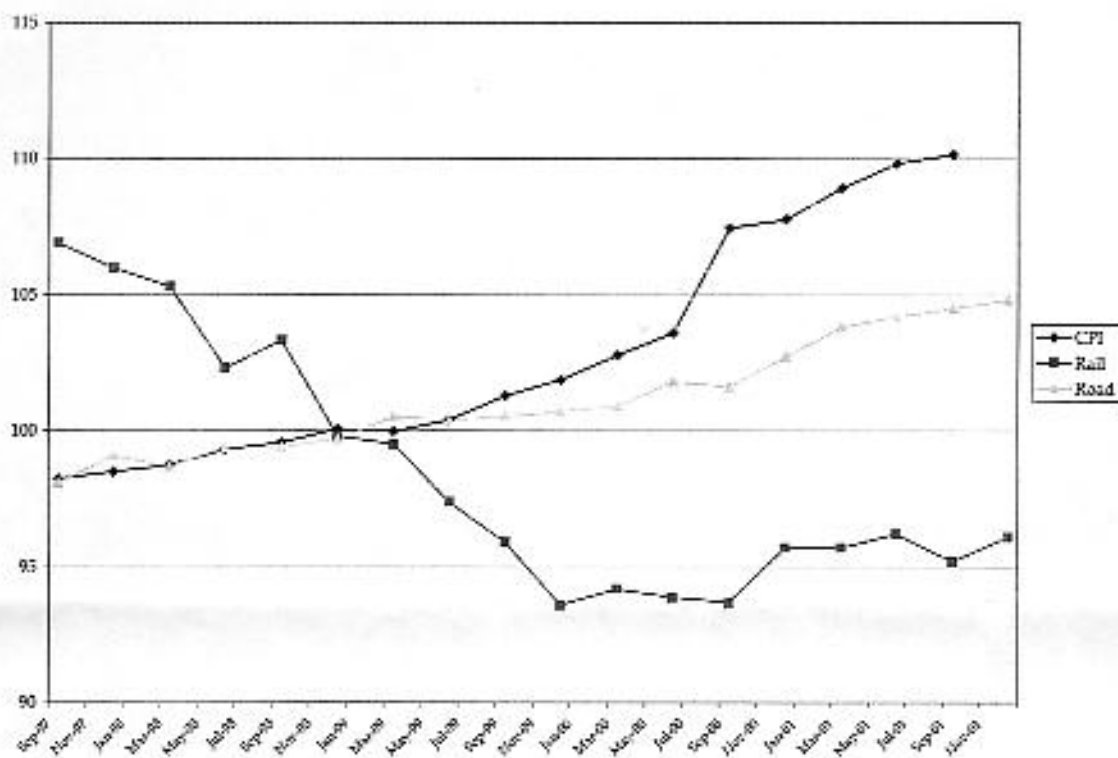
- Track Condition Index (TCI)
- Signal failures

- Minutes delayed due to speed restrictions
- Average transit times

Appropriateness of CPI – X escalation of rates

15. The draft determination allows WNR to raise their rates each year. This is despite the fact that as a business with a high fixed cost base WNR benefits greatly by operator's increase of volume hauled on the network. This increase is largely exogenous to any actions by WNR and is basically a windfall for the access provider.

End customer expectations are diametrically opposed to this "price up" mindset. It is widely recognised that rail costs have fallen dramatically in the post-Hilmer era. Road freight prices have also increased at rates that are significantly lower than CPI. The chart below illustrates how road and rail price trends have differed from CPI in recent times.



Source: ABS data.

To give these trends a more specific orientation, Toll Rail has been forced to negotiate lower nominal freight prices on the East-West corridor for nine major customers, for two of whom the business was entirely lost by rail. Patrick has experienced a four year declining trend in nominal container freight rates between Melbourne and Adelaide. These have averaged 1.3% decline per annum over that period. Pacific National reiterates its view that CPI linked rate increases are inappropriate.

Conclusion

15. Overall, Pacific National sees the draft determination as providing an important step towards achieving a satisfactory set of costing principles. It is imperative in Pacific National's view that each of the recommendations made in the draft determination is reflected in the final decision as it provides the minimum level of certainty about the costing principles which in their present form are clearly inadequate and lack transparency.