

## **COSTING PRINCIPLES TO APPLY TO WESTNET RAIL ARTC SUBMISSION**

The Acting WA Independent Rail Access Regulator (“Regulator”) has requested submissions from interested parties with regard to the draft determination made in relation to WestNet’s (“WNR”) Costing Principles required under the Railways (Access) Code 2000 (“Code”).

A key issue for ARTC with respect to the WNR’s Costing Principles is that they cover activities occurring on the WA rail network and associated infrastructure currently leased from the WA Government by WNR, which includes part of the interstate rail network between West Kalgoorlie and Perth. Pricing of access for interstate operators, or access seekers, of services between the eastern states and Western Australia will be determined following the Costing Principles, as well as under ARTC’s Access Undertaking (accepted by the Australian Competition and Consumer Council (ACCC) in May 2002) for any movement east of Kalgoorlie. A copy of ARTC’s Access Undertaking can be located at the ACCC’s website [www.accc.gov.au](http://www.accc.gov.au).

ARTC notes that the WA Government applied for certification of the Code from the National Competition Council (NCC) in February 1999, and subsequently withdrew the application in late 2000. As such, the Code, as applied to either interstate or interstate services on the WA rail network leased by WNR is not a certified regime.

In accordance with an Inter-Governmental Agreement made in 1997 which brought about the incorporation of ARTC as the track manager of the interstate rail network, ARTC developed and executed with the Western Australian Government Railways Commission (Westrail) which was the owner of that part of the interstate rail network in WA, a wholesale agreement providing ARTC with the exclusive right to sell access for interstate train operations to that network. The agreement was developed in accordance with the principles for access now incorporated in ARTC’s Access Undertaking. The agreement provides for the purchaser of the Westrail rail freight network (Australian Railroad Group) to assume Westrail’s role following the sale. As such, ARTC’s main interest in the Costing Principles proposed to the Regulator is to ensure reasonable consistency between the relevant aspects of the Costing Principles and the terms and conditions of the wholesale agreement and, therefore, the principles endorsed by the ACCC in ARTC’s Access Undertaking. ARTC seeks the Regulator’s consideration of the issue of consistency of conditions of access to the interstate rail network for interstate users in its deliberations.

ARTC has previously made a submission<sup>1</sup> to the Regulator in relation to the Costing Principles, among other things.

With regard to the Costing Principles, ARTC raised three main issues in relation to the Costing Principles, broadly outlined as follows:

- ARTC supports WNR being able to apply market based pricing to below rail services, where costs represent only one input to the pricing decision. ARTC adopts a similar approach in its undertaking.
- The Code incorporates floor and ceiling limits to pricing for any particular traffic. ARTC's access undertaking contemplates floor and ceiling revenue limits and undertakes that prices will be set such that revenue on any given segment falls between these limits. The limits are published and have been accepted by the ACCC. ARTC considers most of the WA rail network carries similar business and such an approach to pricing could be warranted in this case.
- Given the nature of the rail infrastructure asset, there is usually a wide band between floor and ceiling limits. To aid negotiation, ARTC has published indicative pricing for each of its segments to be applied to any user seeking to operate an indicative service under indicative terms and conditions. Indicative services represent the majority of ARTC business. The indicative pricing is published and is accepted by the ACCC. Variations around the indicative price would be based on a range of parameters including the characteristics of the service, as well as logistical and commercial impacts on ARTC. ARTC will not differentiate based on the identity of the applicant, nor where the services to be operated are the same (including terms and conditions) and the services are operated in the same end market. Indicative access prices are market based. ARTC considers that indicative pricing on each segment could be approved by the Regulator and published by WNR in a similar way.

For the remainder of the submission, ARTC will endeavour to identify specific aspects of the Costing Principles and make comment on the Regulators draft determination. In the main, ARTC supports the Regulator's position with regard to most of these issues. The Regulator has recognized a call for greater prescription of the rules and practices to be followed by WNR in the light of its vertical association with an above rail service provider.

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<sup>1</sup> Westnet Submissions to the Acting Rail Access Regulator, ARTC Submission, 24 Jan 2002

ARTC would like to make a general comment regarding the process for approving the Costing Principles in relation to the wider regulatory supervision of the Code. ARTC notes that the Regulator is intending to determine ceiling prices on a number of routes (advertised 17 November 2001), and will be addressed in an upcoming determination. If the Regulator is to determine ceiling prices, and it presumably has discretion (following public consultation) in interpreting the Costing Principles in order to do so, ARTC is unclear as to why certain requirements for more detail are being made following the draft decision. For example, the Regulator requires WNR to identify (give examples) of the type of assets supporting operating functions that are to be included in the GRV. Such examples would limit the Regulator's discretion in determining ceilings, and would presumably be included in the Costing Principles without further public consultation. There are a number of change requirements that are similar.

ARTC also notes a number of other documents on the Regulator's website relating to a review of WNR pricing models in preparation for this determination. ARTC is unclear as to their status in this process.

#### Relevance of the Costing Principles

WNR has interpreted the Code as allowing it to apply market based pricing to below rail services, and as such costs are only one input to pricing decisions. In its original submission, ARTC supported this position. ARTC notes that the Regulator requires WNR to replace this interpretation with:

'The Code allows WNR to negotiate prices between the floor and ceiling prices and as such the costs within the floor and ceiling only provide the lower and upper bound to potential final prices.'

ARTC does not consider these two interpretations to be at odds with one another. In the ARTC undertaking, price differentiation is based on a range of factors including cost and risk differentials as well as markets. The Code also limits differentiation in a similar way. It is unclear as to why the Regulator has chosen to remove WNR's explicit recognition of the Code's requirements in regard to the role of costs in price differentiation from the Costing Principles.

## Service Quality Commitment

ARTC notes that the Regulator requires a new section outlining:

- A general service quality commitment from WNR to adopt industry best practice and to provide an efficient network
- Commitment to report service quality KPI's
- Commitment to negotiate specific KPI's (covering both operator and WNR performance) within the access agreement which may be linked to a system of financial incentives/penalties.

ARTC makes a service quality commitment in its access undertaking. In the absence of any independent benchmarking of WNR's cost structure during the assessment, it is probably reasonable for WNR to commit to adopt industry best practice/efficient network in the Costing Principles.

ARTC has provided for regular service quality KPI reporting in its undertaking, and specifically identifies indicators to be reported. The Costing Principles should include specific definition of the KPI's to be reported.

The indicative access agreement forming part of ARTC's undertaking provides for the consultative development of ARTC and operator KPI's over time. This period of development recognizes the infancy and consequent lack of such reporting in the industry, as well as the difficulty in separating out respective track owner and operator responsibility for service quality. The use of financial incentives/penalties are also provided for after sufficient time is allowed for parties to fully understand the implications of such a system.

## Capital Costs

ARTC notes that WNR's floor price and, indeed, the Code allows for the inclusion of a capital charge in floor price limits. ARTC's precludes the inclusion of capital charges in its floor calculation.

ARTC notes that the Regulator requires WNR to provide examples in the Costing Principles as to when it considers capital costs are avoidable and need to be included in the floor. ARTC finds it difficult to imagine how sunk investment in track assets could be avoidable with respect to the usage of the asset by an access seeker. In any event, there is likely to be limited public consultation surrounding the appropriateness of WNR's examples, prior to finalisation of the Costing Principles. Inclusion of examples in the principles will limit Regulator discretion when determining segment ceilings.

### Asset Value

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

In its draft decision, the Regulator requires WNR to provide significantly more information about what assets should be included, what WNR considers to be Modern Equivalent Assets (MEA), and what unit rates apply. Whilst ARTC agrees with this requirement, it is not clear as to whether the Regulator intends to undertake an independent assessment of WNR's valuation, or the inputs to it, prior to approval of the Costing Principles. Once again, there is likely to be limited public consultation around WNR's response prior to finalisation of the Costing Principles.

Presumably an independent assessment of GRV will be undertaken as part of the ceiling determinations yet to be carried out, but the Regulator's discretion may be limited by already approved principles.

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

### Operating Costs

#### Efficient costs

ARTC notes that the Regulator requires WNR to provide significantly more detail in order to establish whether it is operating efficiently. It is presumed that the Regulator is intending to undertake an independent assessment of WNR's unit maintenance and network control costs in order to establish that WNR is operating efficiently during later ceiling price determinations. ARTC has previously suggested that WNR's maintenance costs on the Kwinana-Kalgoorlie segment are higher than the unit costs that apply on most of ARTC's network (after consideration of the different conditions involved). An assessment of ARTC's unit costs was carried out by the ACCC during its assessment of ARTC's Access Undertaking.

### Cyclical Maintenance Costs

ARTC notes that the Regulator requires WNR to provide significantly more detail in order to establish annualized cyclic maintenance costs. Once again, it is presumed that the Regulator is intending to undertake an independent assessment as to whether the costs are reasonable during ceiling determinations. WNR has indicated that it has conducted an analysis of ARG's overheads, which have then been allocated based on the usage by WNR as a proportion of all other users in the ARG group. Whilst ARTC has no problem with such an allocation being made, it is important that such an allocation is carried out appropriately, as the resultant cost of access to third party users can be affected.

### Overhead Costs

ARTC supports the need for more information to be provided as to how WNR proposes to allocate costs from ARG. Any cost allocation should be independently assessed.

### Floor/Ceiling

ARTC has previously indicated that annual ceiling escalation by full CPI could be over-allowing for the impact of inflation on costs. ARTC has published on its website, segment floor and ceiling limits. These limits have been specified over the full term of the Access Undertaking, but will annually be updated with updated cost and volume forecasts. The movement in ARTC's limits does not reflect full CPI. Movements CPI escalation of ARTC DORC value, and CPI-X escalation of operating costs, where X is a productivity allowance.

In order to provide price certainty to users, ARTC has undertaken to review prices annually but has capped any price increase that it may apply to the greater of 2/3rds CPI or CPI-2%.

ARTC suggests that annual ceiling movements should be reflective of annual cost and asset valuation movements, incorporating an allowance for ongoing productivity improvement where appropriate.

ARTC notes that the regulator requires WNR to provide indicative floor and ceiling cost calculations for high volume multi-user sections and for low volume lines. In its application to the ACCC, ARTC provided proposed floor and

ceiling calculations for each of its pricing segments to the ACCC. ARTC's intention was to have the floor and ceiling limits independently assessed and endorsed by the ACCC, in order to satisfy the market and access seekers that these limits were reasonable. This avoided the need to have highly prescriptive costing principles and public availability of detailed costing information so that access seekers could determine floor and ceiling limits for themselves.

ARTC recommends a similar approach to the Regulator, requiring independent assessment of WNR's floor and ceiling calculations (including asset valuation, cost efficiency and cost allocation as described earlier).

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