



**Public Submission by
Alcoa World Alumina Australia
on Draft Determination of the Costing Principles
to apply to WestNet Rail**

Prepared for:

Rail Access Regulator
Office of the Rail Access Regulator
Level 27, 197 St Georges Tce
PERTH WA 6000

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1. EXECUTIVE SUMMARY

The following recommendations have been extracted from the text of this submission:

Operating Costs

1. The Regulator should apply rigorous benchmarking and efficiency targets to ensure that the lowest possible Operating Costs are used in the modelling to calculate ceiling and floor prices on each route section.

Economic Life, MPM, Cyclical Maintenance Costs

2. Economic life should reflect the optimum life for each major asset type based on good maintenance practice and the expected traffic density on the network.
3. Some further clarification of the definitions of routine, cyclical and MPM maintenance is required as the definitions as applied to the theoretical GRV model are, and should be, different to those applied to the actual asset.
4. Maintenance costs in the model must reflect the MEA nature of the asset and should not include items required to maintain a depreciating asset - but should reflect Year 1 maintenance for a new asset.

Asset valuation

5. We recommend that perpetual track structures - such as the original earthworks including any embankments and cuttings required to establish the railway corridor - should be excluded from the GRV and hence from the annuity calculation.
6. We recommend that a more precise definition of earthworks be added to the Costing Principles to reflect this view.

7. The assertion¹ on page 21 Bullet 3 should be clarified to recognise that earthworks are land and therefore cannot be included in the GRV. Any maintenance required to maintain the earthworks over time will be included in routine or cyclical maintenance costs under bridge and culvert maintenance, drain clearing, access road maintenance etc.
8. The Costing Principles should include a section on Operator Contributed Assets and require WestNet to compensate operators either via a credit (preferably in the form of reduced access charges) or by a service level improvement for any direct investment by the operator in the railway infrastructure.

Design, construction and project management fees

9. Design, project management and construction risk fees should be below 20% and nearer to 15% if efficient practices are adopted throughout the build cycle.

Inclusion of interest costs during construction

10. Construction rates in excess of 1.5 km/day should be achievable for MEA infrastructure anywhere on the WestNet network.

Ceiling indexation

11. The indexation of the ceiling should be based on CPI-X where X is a productivity improvement factor for the following two years and is not a % of CPI.
12. The value for X should be set to reflect the ability of WestNet to achieve substantial productivity gains over the next three years.

¹ "...earthworks may be required as part of maintenance programs and the Regulator is of the view that inclusion of such costs, in these instances, in the GRV may be reasonable"

Service Quality

13. The Regulator should publish a series of KPIs to show the movement in costs and service levels by comparison with any benchmarks researched by ORAR or provided by other relevant jurisdictions.

2. INTRODUCTION

In accordance with the requirements of Section 46 of the Railways (Access) Code 2000, the Office of the Rail Access Regulator released a Draft Determination of the Costing Principles to Apply to WestNet Rail on 28 June 2002. Interested parties were invited to examine the document and provide comments to the Regulator by 26 July 2002. This submission is Alcoa's response to the Draft Determination.

References marked **[DD]** in the text are references to sections of the Draft Determination on the Costing Principles to apply to WestNet Rail issued by the Regulator on the 28 June 2002.

In our first submission in January 2002, we considered that the Costing Principles proposed by WestNet lacked any detail which would have indicated the operation and outcome of applying the principles to any route section on the Network. We consider that the Regulator has made significant progress in addressing many of the issues raised by Alcoa and the other respondents in the earlier public submissions. We are however concerned that the Regulator's additional comments and directions contained in the Draft Determination do not provide a basis for a rigorous implementation of the Costing Principles and there is too much flexibility and discretion in the hands of a monopoly provider. In particular, we are concerned about the confusion being generated over costing and pricing principles being related to routes - rather than route sections as this could potentially lead to price distortion in the market. This issue is further complicated by the revenue allocation principles which have been proposed in the Draft Determination on the Overpayment Rules.

The following section of this submission seeks to elaborate our concerns in these areas. It is obviously difficult to understand fully the implications of the Draft Determination as there is no corresponding redraft of the Costing Principles. The comments in this submission make certain assumptions about the interpretation of the Draft Determination. Where possible, we have sought clarification on specific issues from the Office of the Rail Access Regulator prior to submitting this response.

If any further explanation of any of the views expressed in this submission is required, please contact: Mr John Oliver, Transportation and Logistics Manager, Alcoa World Alumina Australia tel: 08 9316 5406, fax: 08 9316 5162

3. RESPONSE TO COSTING PRINCIPLES DRAFT DETERMINATION

In reading this response to the Draft Determination, it is important to understand the purpose of the Costing Principles as part of the operation of the Code in relation to how the limits on access charges - the ceiling and the floor prices - are to be calculated.

- The ceiling price should be based on the lowest current cost to replace the asset;
and
- The floor price should return the incremental cost of providing access to any one operator.

In this regard, Alcoa considers that the most important issues relate to the determination of ceiling prices on each route section of the four main lines of the network. This assessment is based on the reality that branch lines and other underutilised grain lines are unlikely to provide access revenue much above floor prices as there is a competitive road transport alternative to many of these remote branch lines.

It is also important to realise that many major users are captive users of rail with no alternative mode of transporting large quantities of raw material to port. For these users, Alcoa included, WestNet is a monopoly supplier and has significant market power. This market power must be controlled by the access regime and regulatory oversight. The Regulator is the users' representative in this area and is tasked with protecting the interests of all users. The Regulator must ensure that the track owner is able to operate a viable business with an acceptable rate of return without extracting monopoly profits from the operators using the network.

The key to the operation of the Code is a theoretical modelling of costs to arrive at a ceiling price for each route section which provides WestNet with sufficient revenue to be able to operate an efficient rail network and provide access at competitive rates to all users and at the same time prevents monopoly behaviour by WestNet.

As part of this process, it is important that there is a transparency to the process so that operators and end users understand the cost build up of the floor and ceiling prices for any route section and the combination of these prices where more than one operator is provided with access on a route or route section. Fair pricing at competitive rates will ensure the sustainability of the network where lines are economic and will also result in re-examination of uneconomic lines which may be required to close or be subsidised by government in the form of a Community Service Obligation (CSO). It is not for the

Regulator or the users to ensure that uneconomic lines are kept open especially if those lines are competing with road as an alternative means of transport. Cross-subsidies distort competitive behaviour and lead to further market distortions. Whilst road has many hidden subsidies, rail is typically transparent in its pricing mechanisms and this approach should be maintained in the Costing Principles proposed under the Code.

The following detailed responses are provided to each issue where we consider that further direction will be required from the Regulator to ensure that the Costing Principles provide the certainty and fairness required to ensure that both WestNet has a commercially viable business but at the same time, all users may gain access at the lowest possible price.

3.1. Route Sections [DD page 8]

Following discussions with WestNet, we believe the route sections on the South West mainline should be:

- Kwinana - Mundijong Junction
- Mundijong Junction - Pinjarra
- Pinjarra - Alumina Junction
- Alumina Junction - Pinjarra South
- Pinjarra - Wagerup
- Wagerup - Brunswick Junction
- Brunswick Junction - Picton Junction
- Picton Junction - Bunbury Inner Harbour

3.2. Operating Costs [DD 4.2]

We concur with the Regulator's view that the operating costs must be based on efficient costs associated with the theoretical model based on GRV and that there is no relationship between actual operating costs and the operating costs which would be required to operate and maintain the MEA in the model. Ultimately, the Regulator must be satisfied that the revenue permitted under the Code is not excessive as we consider that a GRV based model has the potential to overstate the revenues required to operate and maintain the existing network. Providing excess revenues based on the theoretical model could result in an inefficient approach to maintenance and would be as undesirable as providing insufficient revenue resulting in reducing maintenance and a deteriorating asset base.

In the interests of encouraging a track owner to adopt an efficient approach to operating costs, it would be preferable to set competitive access rates based on a lower ceiling price to force efficient behaviour rather than assuming that this will be achieved because of any commercial imperative from within the track owner's organisation.

It is important to remember that the approach as devised for the Code is a theoretical model based on GRV which is untried in a rail environment. Only time will tell if the approach provides users with competitive access rates.

With current access rates (i.e. rates prior to the determination of ceiling prices under Schedule 4 Clause 9 of the Code) set well above comparable access rates elsewhere in Australia, it must be assumed that benchmarking will play a significant role in the determination of access pricing on this network.

Recommendation

- 1. The Regulator should apply rigorous benchmarking and efficiency targets to ensure that the lowest possible Operating Costs are used in the modelling to calculate ceiling and floor prices on each route section.**

3.2.1. Economic Life, MPM, Cyclical Maintenance Costs [DD 4.2.2]

Economic Life

In considering economic life for the WestNet network, it is important to note that even on the most heavily trafficked line, between Pinjarra and Kwinana, tonnages are considerably lower than comparative operations in the Hunter Valley in NSW or the coal lines in Queensland. Queensland Rail provides track access for some 100 million tonnes of coal² over four major coal lines. Rail Infrastructure Corporation (RIC) in the Hunter Valley provides rail infrastructure support for 66 million tonnes of coal exported through the Port of Newcastle³. By comparison, Alcoa as the largest user on the WA network moves only 14 million tonnes from Pinjarra and Wagerup to Bunbury and Kwinana.

² QCA Draft Decision on QR's Draft Undertaking, Chapter 13 p167

³ FreightCorp Annual Report 1999 p22

On this basis, economic life comparisons with Eastern States operations should be carefully scaled to ensure like-for-like comparisons. Rail life in WA could be extended well beyond current life with a rigorous maintenance regime which included rail grinding to maintain the optimum rail profile. Taking a long-term view on rail maintenance can double the life of the rail.

In our previous submissions, we estimated the weighted average life for the railway infrastructure assets was 58.25 years. If earthworks (see comments in section 3.2.3) are to be included as part of the GRV, then they must also be included in the weighted average life. This results in an extension of the weighted average life to 68.94 years. The following table shows the comparison between WestNet's figures in Annexure 7.1 of the Costing Principles and the figures used by our consultants.

Economic Life in years for major asset types	WestNet Estimate	Indec Estimate	Indec Weighting
Rail	50	50	10.9%
Sleepers	50	50	13.0%
Ballast	25	30	3.5%
Track laying	50	50	10.9%
Turnouts	20	30	0.9%
Signalling	20	30	5.9%
Communications	20	20	0.4%
Bridges	100	100	19.6%
Culverts	50	100	1.2%
Earthworks*	100	100	20.9%
Other	50	50	13.0%
Weighted Average	N/A	68.94 years	

*Assumes all earthworks are included

Comparison of Economic Lives for various Asset Types

Alcoa maintains the view that earthworks must be excluded from the GRV calculation and therefore should be excluded from the economic life calculation.

If this view is upheld, then the weighted average life for the assets listed above (excluding earthworks) would be 61.16 years.

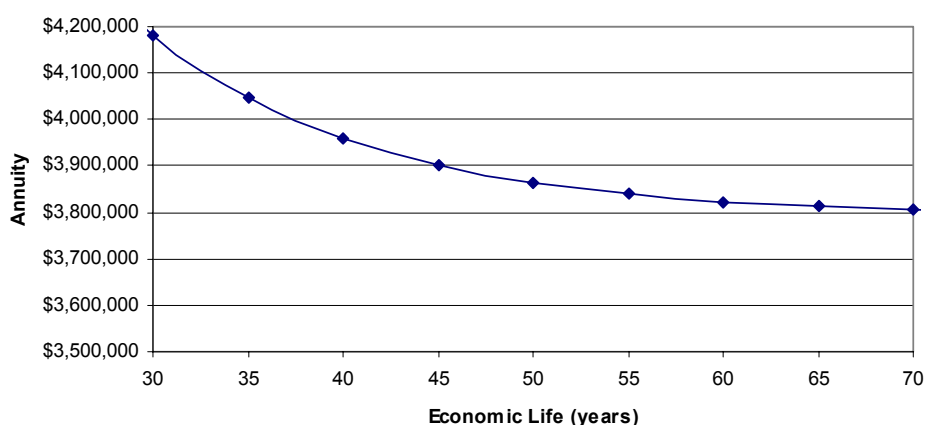
The Regulator has also expressed the view in the Draft Determination that *"after around 30 years of life for a given GRV the impact is small"*⁴ (see graph on Page 15 of the Draft Determination) however the following table shows that for the example shown in the Draft Determination (the same graph is reproduced in "magnified" form below) the economic life still has a significant impact on the final numbers.

Annuity v life	30 yrs	40 yrs	50 yrs	60 yrs	68.94 yrs	100 yrs
Annuity Payment \$ millions	\$4.18m	\$3.96m	\$3.86m	\$3.82m	\$3.81m	\$3.79m
% reduction	0%				9.0%	

Annuity Payments for varying asset life between 30 and 100 years.

The table above shows that if the weighted average life of the infrastructure was 69 years, there would be a further reduction in the annuity of 9.0% compared to a 30 year cut-off - hardly a small impact. Using a 30 year life in this case would overstate the ceiling by 7.4%⁵.

Annuity pa with GRV of \$50M @ 8.2% WACC



⁴ Draft Determination p15 first bullet

⁵ Based on our estimate that capital costs represent approximately 82% of the total costs in the ceiling calculation.

Economic lives greater than 30 years do make a difference and it is important to accurately estimate the varying lives of the different asset types to ensure that the annuity is accurate. It might be more acceptable to argue that economic lives over 100 years have little effect on the outcome.

Major Planned Maintenance (MPM)

Following the clarification that all MPM is to be excluded, we have aligned our model with this new definition in the Draft Determination. This has involved removing the following items from our original cost estimates:

- Surfacing (included tamping, ballast regulating and consolidation)
- Rerailing (included an allowance of 2% of rail to be replaced every five years)
- Ballast cleaning every 20 years

The effect of these changes in definition is shown below.

Routine Maintenance

Whilst we would agree that the general definition provided by the Regulator's independent engineer applies to normal track, we disagree with the inclusion of general fettling in the definition given that the track is MEA and would therefore consist of continuously welded track, concrete sleepers and elastic fastenings. Routine maintenance in Year 1 of a new track would not require any sleeper replacement or fastening maintenance. The extent of maintenance on sleepers and fastenings should be limited to inspection only, as there should be no requirement to tighten fastenings or replace sleepers for rot or failure.

Cyclical Maintenance

In our model, we have included a significant allowance for cyclical maintenance of turnouts including point motors and for other mechanical devices such as level crossing boom gates which are part of the track configuration. We have also included weed control, boghole treatment, level crossing pavements, drain cleaning and structure (bridges and culverts) maintenance activities as cyclical

maintenance. It is not clear how these items are treated under the definitions in the Draft Determination.

These inclusions result in an average cost for routine inspections and cyclical maintenance on the South West mainline of \$5,453/km/yr and an average cost of \$5,745/km/yr if branch lines to Alumina Junction are included. This figure is based on replacing the existing track with MEA track based on 50 kg rail and concrete sleepers. It also includes the additional routine inspections required for daily passenger services to operate between Perth and Bunbury at up to 110 km/h on the mainline.

Recommendations

- 2. Economic life should reflect the optimum life for each major asset type based on good maintenance practice and the expected traffic density on the network.**
- 3. Some further clarification of the definitions of routine, cyclical and MPM maintenance is required as the definitions as applied to the theoretical GRV model are, and should be, different to those applied to the actual asset.**
- 4. Maintenance costs in the model must reflect the MEA nature of the asset and should not include items required to maintain a depreciating asset - but should reflect Year 1 maintenance for a new asset.**

3.3. Asset valuation [DD 4.3]

3.3.1. Gross Replacement Value [DD 4.3.1]

Alcoa believes that Gross Replacement Value (GRV) for each route section of line should be based on:

- The track standard agreed between all existing operators and WestNet in their respective Access Agreements;
- Best Practice efficient costs to lay track to the agreed standard based on unit rates per kilometre (for a minimum replacement of at least 200 km) for formation, rail, sleepers and ballast;

- Actual numbers of bridges, turnouts, signals, level crossings⁶ and crossing loops based on an ideal MEA track layout where, for example, costs of turnouts and signalling are attributed or apportioned to relevant line sections based on an agreed protocol established in the Costing Principles.
- Common network wide systems (e.g. one train control centre) are allocated to each route section on a basis of an agreed and declared cost driver (e.g. train movements)

We consider that all these rates should be benchmarked and approved by the Regulator to establish efficient costs prior to each GRV reset and then published by WestNet as part of the Costing Principles.

We submit the following sample table of linear asset costs as indicative benchmarks provided by our consulting engineers.

Item	Unit Cost	Cost per km
50 kg/m rail	\$1000/tonne	\$100,000/km
Concrete sleepers	\$80 each	\$119,200/km
Fastenings	\$15 per sleeper	\$22,350/km
Track formation (base capping layer)	\$17.40/m ²	\$104,000/km
Ballast inc cartage	\$23.10/tonne	\$32,340/km
Track laying	N/A	\$100,000/km

Sample of unit costs for linear assets on Narrow Gauge Track

3.3.2. Definition of MEA [DD Page 19 Bullet 5]

We consider that the definition of MEA should be altered to reflect only a three year period of projected demand growth rather than five years. Reducing the period would align the review of projected growth with the GRV reset.

For the same reasons, any major expansion of the network to meet an increase in capacity (for example as a result of refinery expansion by Alcoa) should be

⁶ Net of any subsidy or capital cost sharing with Main Roads WA or Local Government Authorities.

excluded from the projected growth definition as these expansions would be subject to a separate review of capacity issues and pricing arrangements by the affected parties and, if necessary, by the Regulator.

3.3.3. Earthworks [DD page 21]

It is not clear from the Draft Determination if earthworks are still considered part of the GRV calculation. It is our legal advice that earthworks and for that matter all other improvements affixed to the land become part of the land. In the Code "railway infrastructure" (which would normally be considered part of the land) is redefined and valued separately from the corridor land for the purposes of the Code.

Since earthworks are not included in the definition of "railway infrastructure" and are not "fixtures" to the land they must be considered to be land and therefore are excluded from the definition of capital costs as stated in Schedule 4 Clause 2(2) Definition of capital costs:

"For the purposes of this clause, railway infrastructure does not include the land on which the infrastructure is situated or of which it forms part."

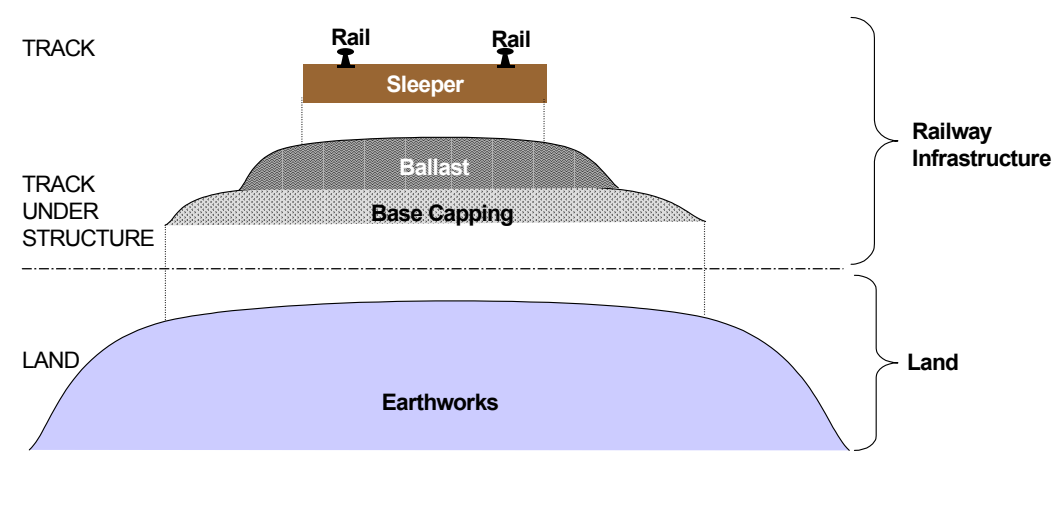
This view is consistent with the views expressed by Professor Ergas as consultant to the NCC when he stated that the use of GRV as a valuation methodology could be acceptable if *"perpetual structures were not included in the evaluation;"*⁷.

We also believe that this definition of railway infrastructure is consistent with the fact that WestNet enjoys the right to use and occupy the railway corridor but only holds a lease for the defined "railway infrastructure".

⁷ National Competition Council Draft Recommendation September 1999 p48

What are earthworks?

To further assist with the definition of "railway infrastructure", we provide the following diagram which illustrates the "boundary" between track related assets and land. This definition is consistent with the view that all the items included as "railway infrastructure" require replacement as they all have a finite life whereas the land and the associated earthworks are perpetual assets which do not require replacement over the life of the network. The following diagram illustrates this definition:



In further support of this view, we would refer to the regulatory decisions in NSW and Queensland. As noted by the Regulator, the QCA in its Draft Decision on Queensland Rail's Draft Undertaking⁸ noted that:

"QR's assets fall into two categories:

- *those that will need to be replaced in the future, such as track; and*
- *those that are unlikely to ever require replacement, such as land and earthworks"*

The QCA went on to define⁹ the assets not requiring renewal as:

- *"Land;*
- *Transaction costs associated with land acquisition, including injurious affection compensation payments, legal fees etc; and*

⁸ QCA Draft Decision on QR's Draft Undertaking Chapter 13 p141

⁹ QCA Draft Decision on QR Draft Undertaking, Chapter 13 p142

- *Earthworks, such as creating cuttings and embankments."*

The QCA allowed QR to include some of these costs as QR had incurred costs in relation to land purchases, clearing and earthworks which could be legitimately included in a DORC valuation.

By way of contrast, IPART excluded the corridor formation¹⁰ from its valuation. As part of its definition, cuttings, embankments and tunnels were excluded as these assets were not owned by Rail Access Corporation (RAC) and they represented assets which would not require future expenditure to maintain the current network capacity. IPART did, however, concede that any land purchased subsequently by RAC and any resulting new corridor formations created as a result should be included at actual cost and indexed for inflation.

We would suggest that WestNet is in a very similar position to RAC. It does not own the land, earthworks or track but it is responsible for the on-going maintenance and renewal as required. Whilst all parties would acknowledge that the track and the formation have a finite life, the original earthworks will not deteriorate with time. As stated by IPART¹¹, *"The rail corridor will only be acquired once and hence is not usually replaced"*.

We consider that there should be only one exception to this definition where WestNet contributes to the construction of new earthworks on a particular route section as part of an upgrade to the existing network. In these instances, we support the views taken by IPART and QCA that future capital expenditure by the track owner on earthworks may be a valid inclusion in the GRV.

3.3.4. Operator Contributed Assets [DD page 22]

Following our discussions with ORAR since the release of the Draft Determination, we understand the Regulator's view on operator contributed assets to be:

¹⁰ IPART Final Report Aspects of the NSW Access Regime April 1999 Section 5.2 p29

¹¹ IPART Final Report Aspects of the NSW Access Regime April 1999 Section 5.2 p30

- That individual operators will negotiate reduced access charges or service level enhancements which suitably compensate the operator for the investment;
- The Regulator will increase the GRV to include all expansions to the network as if these expansions had been funded by WestNet; *and*
- On the assumption that all negotiations with WestNet will result in a reduction in access charges, the Regulator has modified the overpayment formula to reflect the contribution made in the form of an equivalent annual amount (annuity) for the GRV of the additional assets such that that operator is not disadvantaged by the use of a discounted access charge in establishing their share of the overpayment refund.

We believe that this approach could provide an acceptable outcome provided that WestNet negotiates in good faith and does provide a real reduction in access charges to compensate for the investment by the operator. To this end, we would suggest that the Costing Principles must require WestNet to compensate operators for any investment in infrastructure.

Recommendations

- 5. We recommend that perpetual track structures - such as the original earthworks including any embankments and cuttings required to establish the railway corridor - should be excluded from the GRV and hence from the annuity calculation.**
- 6. We recommend that a more precise definition of earthworks be added to the Costing Principles to reflect this view.**
- 7. The assertion¹² on page 21 Bullet 3 should be clarified to recognise that earthworks are land and therefore cannot be included in the GRV. Any maintenance required to maintain the earthworks over time will be included in routine or cyclical maintenance costs under**

¹² "...earthworks may be required as part of maintenance programs and the Regulator is of the view that inclusion of such costs, in these instances, in the GRV may be reasonable"

bridge and culvert maintenance, drain clearing, access road maintenance etc.

- 8. The Costing Principles should include a section on Operator Contributed Assets and require WestNet to compensate operators either via a credit (preferably in the form of reduced access charges) or by a service level improvement for any direct investment by the operator in the railway infrastructure.**

3.4. Design, construction and project management fees [DD 4.3.2 Page 23]

The Regulator has stated that WestNet is to revise its proposed design, construction and project management fee of 34% to a rate closer to 20%.

We consider that a figure closer to 15% would more accurately reflect WestNet's costs in relation to these fees. This figure consists of:

- Project management Fee 8%
- Planning and design 5% to 7 %

We have not included any contractor's risk contingency as we can see no justification for including an allowance for contractor's risk or overheads in the costing model. All contractors will quote fully inclusive prices and any contingency which they, the contractors, decide is required will be included in their price.

Recommendation

- 9. Design, project management and construction risk fees should be below 20% and nearer to 15% if efficient practices are adopted throughout the build cycle.**

3.5. Inclusion of interest costs during construction [DD Section 4.3.3 Page 24]

We would advise that the current construction rate for the Alice Springs to Darwin rail line is progressing at between 1.8 and 2 km per day as advised by an ADrail representative in July 2002.

Recommendation

10. Construction rates in excess of 1.5 km/day should be achievable for MEA infrastructure anywhere on the WestNet network.

3.6. Indexation of Ceiling Costs [DD Section 4.4.4 Page 29]

3.6.1. CPI-X

CPI-X can be expressed in two ways, where X is a percentage of CPI (as suggested in the Draft Determination) or as a reduction from CPI of X%. Alcoa believes that the Regulator should consider the Draft Decision by the QCA in this regard where it is argued that X as a percentage of CPI is not appropriate:

"...The productivity factor [X] is independent of the inflation rate, not a function of it. In addition, with low inflation, setting X as a percentage of the CPI limits possible real price reductions to a very low level. It would also rule out reductions in nominal prices"¹³

Alcoa believes that if any indexation is to be allowed between reviews, then it should be on the basis of X as a productivity percentage where X is unrelated to movements in CPI. The index could then take account of any real reduction in costs resulting from industry wide productivity improvements.

3.6.2. Ceiling Indexation

In its response to the submissions on escalation of ceiling costs, WestNet has suggested that:

"not allowing escalation of ceiling prices will adversely impact on it, particularly on those routes near the ceiling where escalation clauses are contained in the access agreements"¹⁴.

This comment suggests that WestNet are concerned that total income from existing agreements may exceed regulated ceilings due to indexation clauses in

¹³ QCA Draft Decision on Queensland Rail Draft Undertaking Chapter 16 Incentive Regulation p248

¹⁴ Draft Determination item (iii) p29

those contracts. Whilst this may be the effect of fixing the ceiling, it is not a justification for lifting the ceiling. Allowing any indexation of the ceiling must be justified by a movement in costs - not a change in revenue. The ceiling is designed to limit the ability of WestNet to earn monopoly profits. If the indexation clauses in the existing contract result in an overpayment then the ceiling is working as it is capping revenue and hence profit in relation to a given cost base.

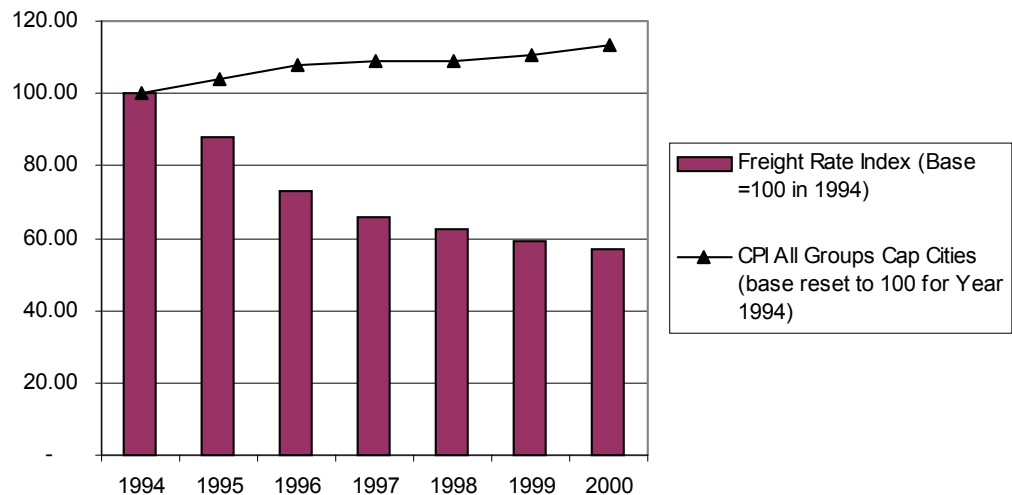
There would only be an adverse impact on WestNet if it was unable to contain costs (for example because of a real increase in wages or raw material costs). Allowing an automatic indexation of the ceiling (ie all costs) could still result in increasing profit margins for WestNet. We would make the following two observations in this regard:

- A significant portion of WestNet's actual cost base - its amortised lease payment to government - is not affected by CPI movements.
- WestNet, as the new "track owner" is in a good position to achieve major productivity gains in the years immediately following the purchase of the business.

The significance of on-going productivity gains cannot be underestimated. Westrail, in its Annual Report for the Year 2000, reported that the long term trend in Freight Rates was the best performance indicator to show that efficiency improvements were being passed on to its customers. The rates (price charges per net tonne kilometre) referenced to a base of 100 in 1994 showed the following downward trend:

Year	1994	1995	1996	1997	1998	1999	2000
Freight Rate Index	100	88.2	73.1	65.9	62.7	59.3	57.2

Freight Rates - Westrail Annual Reports 1999 & 2000 - Performance Indicators



Graph of Westrail Freight Rate Index versus CPI from 1994 to 2000

As shown above, during this same period, CPI showed an average increase of 2% per annum. Between 1994 and 1999, Westrail would have had to set X at 11% each year in a CPI-X formula ($CPI-X = 2\% - 11\%$) that is -9% to achieve the same savings reported by Westrail over the six year period.

There is also anecdotal evidence that the cost of construction of track is falling in real terms as a result of the extensive automation of track laying machinery and the use of pre-fitted fastenings on concrete sleepers. Continuous innovation in this area would appear to be either containing or reducing costs.

Based on the two issues raised, we would suggest that indexation based on CPI-X should reflect the potential for WestNet to achieve further significant productivity gains.

This would suggest that for the next three years, if CPI continues to be around 2.5% to 3%, that any indexation of the ceiling should be close to zero. This outcome would be consistent with recent regulatory decisions in electricity, gas and airport determinations where X has been set at 3% to 5.5% and would be comparable with the QCA decision to set X to 1.5% for QR pending a full review in three years.

We would therefore suggest that the Regulator's approach to "...monitor WNR's MEA network over the three years to determine an appropriate X factor for the second three-year period."¹⁵, should be reviewed and the Regulator should instead set an aggressive but achievable target and observe WestNet's ability to meet that target over the first three years where productivity gains should be more easily achieved.

Recommendations

- 11. The indexation of the ceiling should be based on CPI-X where X is a productivity improvement factor for the following two years and is not a % of CPI.**
- 12. The value for X should be set to reflect the ability of WestNet to achieve substantial productivity gains over the next three years.**

3.7. Service Quality [DD 4.4.5 Page 31]

There are two main aspects to service quality which need to be addressed:

- An agreed service level for each route section - based on axle load, speed, adequacy of crossing loops, overall line capacity, number of speed restrictions etc.
- Level of maintenance and renewal insufficient to maintain the service level over time (is the asset deteriorating over time). This is particularly critical towards the end of a franchise or lease period where renewal is less likely to occur.

We are in the process of adopting KPI's within our access agreement which look at availability and reliability of the network and particularly focus on temporary speed restrictions which adversely impact on our cycle times. We would suggest that KPI's to monitor the effectiveness of the Costing Principles would include:

- Benchmarking of average access rates against other jurisdictions in Australia with comparable asset base;

¹⁵ Draft Determination Costing Principles Bullet 4 p30

- Benchmarking of corporate and other overhead costs with other jurisdictions.
- Monitor cost drivers for the allocation of overheads and compare with actual costs;
- Compare Total Costs calculated in the theoretical model v actual total costs for each route section;
- Number of occurrences and size of overpayments (both within the % band and over the % band);
- Number of non-conformances from the Audit Report.

Recommendation

- 13. The Regulator should publish a series of KPIs to show the movement in costs and service levels by comparison with any benchmarks researched by ORAR or provided by other relevant jurisdictions.**

