

WestNet Rail's Part 5 Instruments Review

Final Determination and Approval of the Proposed Costing Principles

28 August 2006

Economic Regulation Authority



WESTERN AUSTRALIA

Copies of this final determination and approval and WestNet Rail's approved revised Costing Principles are available from the Economic Regulation Authority website at www.era.wa.gov.au.

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EXECUTIVE SUMMARY

Final 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 was to not approve the proposed Costing Principles on the ground that it did 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 not accepting the proposed Costing Principles were outlined in the draft determination which was released for public consultation on 10 May 2006.
4. Following a period of further public consultation, the Authority considered issues raised in submissions and prepared its final determination. The four amendments to the proposed Costing Principles required by the Authority in its final determination 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.

Approval

5. WNR submitted a revised Costing Principles on 8 August 2006 which was in compliance with the Authority's final determination. The Authority has approved WNR's revised Costing Principles and this document has been placed on the Authority's website www.era.wa.gov.au.

INTRODUCTION

Background

6. 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.
7. 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.
8. 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.
9. The scope of the Part 5 Instrument reviews is limited to those matters specifically set out under Part 5 of the Code.
10. 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.
11. 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.
12. 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.
13. 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.

14. 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).

15. The Authority's draft determination on WNR's proposed Costing Principles focused on the elements within the scope of the Costing Principles review, as outlined under paragraph 10 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.
16. To assist the Authority in the review of the issues raised in the public submissions the Authority engaged a consultant, Strategic design and Development Pty Ltd (SdD) to review the submissions, prior to the release of the draft determination, and provide independent comment to the Authority on the issues raised in the submissions. This SdD report is available on the Authority's website (www.era.wa.gov.au).
17. The draft determination was released for public consultation on 10 May 2006.
18. Subsequent to the Authority issuing a notice on 10 May 2006 calling for submissions from interested parties on the draft determination, seven submissions were received as listed below.
- Alcoa World Alumina Australia.
 - Australian Rail Track Corporation Ltd (**ARTC**).
 - Department for Planning and Infrastructure (**DPI**).
 - Goldfields Esperance Development Commission.
 - Great Southern Railway Ltd.
 - WestNet Rail Pty Ltd.
 - Worsley Alumina Pty Ltd (**Worsley**).

These submissions are available on the Authority's website (www.era.wa.gov.au).

19. It should be noted that some of the comments in the public submissions received during the course of this review fall outside 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 considered by the Authority in making its determinations.

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

Legislative Considerations

21. 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 the 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 46 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

22. The process which has been followed for the review of WNR's proposed Costing Principles is outlined below:
- January 2006 - Public submissions received on WNR's proposed Costing Principles.
 - May 2006 - Authority's draft determination published.
 - June 2006 - Public submissions received on draft determination.
 - August 2006 - Authority's final determination and approval published.

REASONS FOR THE FINAL DETERMINATION

Discussion of Issues

23. Relevant issues raised in public submissions, during the second round of public consultation, on the Authority's draft determination are discussed below under the following headings:
- Capital, Operating and Overhead costs.
 - Total costs.
24. The discussion of each of these items commences with the draft determination's required amendments followed by an outline of relevant comments received in the public consultation process on each amendment then the Authority's assessment and final determination.
25. 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.
26. Some submissions contained comments which were within the scope of the review but which did not specifically address the amendments outlined in the draft determination. These comments are addressed at the end of this section under "Other Relevant Matters Raised in Submissions".
27. The Authority received seven submissions on the Authority's draft determination. However, there were only three submissions (from WNR, Alcoa and ARTC) that addressed the amendments in the draft determination. WNR indicated that it accepted all four amendments.¹

Capital/Operating/Overhead Costs

Allocation of Operating and Overhead Costs

Draft Determination Amendment

28. Three amendments were outlined in the draft determination relating to the allocation of operating and overhead costs, as listed below.

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.

¹ WNR, Part 5 Instruments- Submission on the draft determination of Costing Principles, page 1.

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.

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.

Interested Party Submissions

29. Two submissions were received (from Alcoa and WNR) on the three amendments.
30. Alcoa² has, in general, indicated its support for the three amendments subject to a more equitable allocation of overhead costs being made by the Authority, particularly for short route sections. In regard to Amendment 1, Alcoa supported the amendment that train control costs be apportioned directly to rail routes, but suggested that some guidance on the allocation of these costs down to the route section level would be of assistance.
31. In regard to Amendment 2, Alcoa has some concerns with the use of train numbers and GTK's as the methodology for allocating overhead costs. It suggests that the Code requires the railway owner to submit an initial determination of the costs prior to a determination by the Regulator. Consequently, it believes that Amendment 2 would require the railway owner to submit a partly completed price breakdown with the overhead allocation provided subsequently by the Regulator.
32. In relation to Amendment 3, Alcoa supports the amendment on the basis that a more equitable allocation of overhead costs is expected to result from the future floor and ceiling cost review, particularly for short route sections where the existing allocation methodology, in its view, has caused distortions.
33. WNR³ indicated that it accepted the above three amendments and would comply with these amendments by revising the proposed Costing Principles.

Authority's View on Comments in Submissions

34. The Authority has considered the issue raised by Alcoa in paragraph 30, and believes that it is more appropriate for the allocation of train control costs from the route to the route section level to be undertaken during the Authority's future review of the floor and ceiling costs rather than through the Costing Principles review as train control costs are part of operating costs which together with overhead costs will be assessed in the future floor and ceiling cost review.

² Alcoa, Submission on the draft determination on WNR's Part 5 Instruments, page 2.

³ WNR page 1.

35. In regard to Alcoa's comment on Amendment 2, the Authority considered in its draft determination that the allocation methodology for overheads, using an equal combination of GTK and train numbers, may be too prescriptive and acknowledged 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 draft determination indicated that these matters were best addressed during the Authority's future review of floor and ceiling costs.
36. In previous determinations of floor and ceiling costs, the Authority observed that GTK's, train numbers and train kilometres were allocators used in the rail industry. However, due to large distances and low volume of traffic in the grain network, it was inappropriate to use the measure of train kilometres in the freight network. Consequently, a combination of GTK's and train numbers were used to allocate common overhead costs. Therefore, the Authority is of the view that GTK's and train numbers should remain as the allocators for overhead costs as these are standard rail industry allocators for distributing common costs.
37. Alcoa has also suggested that Amendment 2 would require the railway owner to submit a partly completed price breakdown with the overhead allocation provided subsequently by the Authority. The Authority considers that this view is not correct as WNR's proposed floor and ceiling costs would include its proposed combination of GTK's and train numbers as the allocators for overhead costs at both the route and route section level. The Authority, in its review of the proposed floor and ceiling costs, would then consider the proposed combination of both measures in its determination of the floor and ceiling costs taking into account its reasonableness. Alcoa should be aware that during public consultation in the floor and ceiling reviews, it would be able to provide comment on WNR's proposed allocation methodology of overhead costs for consideration by the Authority.
38. The Authority is aware of Alcoa's concerns outlined in response to Amendment 3 and will determine an appropriate allocation of overhead costs for short route sections in its future review of floor and ceiling costs.
39. The Authority notes that WNR has accepted Amendments 1 to 3.
40. Based on the above discussion of comments raised in submissions on Amendments 1 to 3, the Authority does not consider that any changes are necessary to these amendments in the final determination.

Final Determination 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.

Total Costs

Variation of Floor and Ceiling Costs

Draft Determination Amendment

41. One amendment was outlined in the draft determination relating to the variation of floor and ceiling costs, as listed below.

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.

Interested Party Submissions

42. Three submissions were received (from Alcoa, ARTC and WNR) in regard to this amendment. Alcoa indicated⁴ its support for the amendment. ARTC also indicated⁵ its support for this amendment.
43. WNR⁶ indicated that it accepted the amendment and would comply with the requirement by revising the proposed Costing Principles.

⁴ Alcoa page 3.

⁵ ARTC, Submission on the draft determination on WestNet Rail's Part 5 Instruments, page 4.

Authority's View on Comments in Submissions

44. The Authority notes that the submissions all support the amendment.
45. Consequently, the Authority does not see a need for any change to Amendment 4 resulting from the submissions.

Final Determination Amendment

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.

Other Relevant Matters Raised in Submissions

46. In its submission on the draft determination, ARTC has indicated its support for an independent assessment of the GRV. ARTC notes that WNR has in the past used an independent engineer to provide cost estimates but suggests that including a specific requirement for WNR to carry out an independent assessment in the Costing Principles would formalise the requirement and ensure future compliance.
47. The Authority notes that in section 2.3 of the proposed Costing Principles, WNR has undertaken an independent assessment of cost inputs into the GRV calculation and this independent assessment will be made available to the Authority in its future reviews of the floor and ceiling costs for rail lines. The Authority, therefore, considers the provision for an independent assessment of GRV in WNR's proposed Costing Principles is satisfactory. It should be noted that the Authority has undertaken an independent assessment of WNR's proposed floor and ceiling costs during previous reviews and will do so in the floor and ceiling cost review due to commence in the near future.

⁶ WNR page 1.

APPROVAL OF WNR'S REVISED COSTING PRINCIPLES

48. Subsequent to release of the draft determination and receipt of WNR's submission on this determination, representatives of the Authority held discussions with WNR in relation to the amendments required by the Authority. On 8 August 2006, WNR submitted a further submission containing revised Costing Principles.
49. The Authority has reviewed the revised Costing Principles and is satisfied that the changes made by WNR meet the requirements of this final determination.
50. The Authority, consequently, approves the revised Costing Principles as submitted by WNR on 8 August 2006.
51. WNR's approved revised Costing Principles has been placed on the Authority's website www.era.wa.gov.au.

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