

OVER-PAYMENT RULES TO APPLY TO WESTNET RAIL

DETERMINATION OF
THE WESTERN AUSTRALIAN
INDEPENDENT RAIL ACCESS REGULATOR

IN ACCORDANCE WITH THE REQUIREMENTS OF
SECTIONS 47 OF THE RAILWAYS (ACCESS) CODE 2000

27 SEPTEMBER 2002



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1. Introduction

Section 47(1) of the *Railways (Access) Code 2000* (“the Code”) requires each railway owner to prepare and submit to the Regulator a statement of rules (“the Over-payment Rules”) that are to apply where breaches of the ceiling price test occur on the part of that railway owner that could not reasonably be avoided.

The Over-payment Rules provides a mechanism in the WA Rail Access Regime to:

- Calculate the revenue that exceeds the total costs attributable to the route section and infrastructure; and
- Reimburse operators who are provided with access under the Code to that route section and infrastructure in the event of an excess.

In October 2001, WestNet Rail (WNR), the principal provider of “below” rail freight infrastructure in Western Australia, submitted a proposed set of Over-payment Rules to the Regulator. The State’s other railway owner, Western Australian Government Railways Commission has yet to submit its proposed Over-payment Rules.

The WNR submission is available on the Office of the Rail Access Regulator’s website (www.railaccess.wa.gov.au).

The Regulator has reviewed WNR’s Over-payment Rules and is of the view that the WNR proposal requires modification. Accordingly, the Regulator has determined a set of Over-payment Rules, as outlined in Sections 3 and 4 of this Determination, that will apply to WNR in accordance with Section 47(3) of the Code.

In developing the Over-payment Rules, the Regulator recognises that the need to ensure that operators are protected from WNR’s ability to attain monopoly rents must be balanced against ensuring that WNR is not prevented from making a fair and reasonable return on its overall rail investments.

On 28 June 2002, the Regulator released the Draft of the Determination on Over-payment Rules to apply to WNR and invited interested parties to provide comments on the draft by 26 July 2002. The submission deadline was extended by a week at the request of stakeholders.

Submissions on the Draft of the Determination were received from Alcoa World Alumina Australia, Australian Rail Track Corporation Ltd (ARTC), Pacific National and Worsley Alumina. Their submissions are available on the Office of the Rail Access Regulator’s website (www.railaccess.wa.gov.au).

In finalising the Determination on Over-payment Rules to apply to WNR, the Regulator has taken into consideration the comments provided by all stakeholders.

WNR was consulted in the development of the Over-payment Rules, and the Regulator understands that WNR is supportive of the recommended changes to the Over-payment Rules originally proposed by WNR.

2. The WA Legislative Over-payment Rules Requirements

The legislative requirements in relation to Over-payment Rules are provided for in Section 47 and Clause 8 of Schedule 4 of the Code.

Section 47 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 rules ("the over-payment rules") that are to apply where breaches of clause 8 of Schedule 4 occur on the part of that owner that could not be reasonably be avoided.*
- (2) The rules referred to in subsection (1) must give effect to the following basic requirements –*
 - (a) the excess referred to in clause 8(4) of Schedule 4 in respect of an operator or group of operators must at all times be within a limit, being a percentage of the relevant costs, from time to time notified in writing to the railway owner by the Regulator;*
 - (b) at the expiry of each successive period of 3 years from the commencement of access by an operator or group of operators there must be no such excess in respect of that operator or group of operators.*
- (3) The Regulator may –*
 - (a) approve the statement submitted by the railway owner either with or without amendments; or*
 - (b) if he or she is not willing to do so, determine what are to constitute the over-payment rules.*
- (4) The over-payment rules may be amended or replaced by the railway owner with the approval of the Regulator.*
- (5) The Regulator may, by written notice, direct the railway owner –*
 - (a) to amend the over-payment rules; or*
 - (b) to replace them with other over-payment rules determined by the Regulator,*

and the railway owner must comply with such a notice.

Clause 8 of Schedule 4 states:

- (1) An operator that is provided with access to a route and associated railway infrastructure must pay for the access not more than the total costs attributable to that route and that infrastructure.*
- (2) The calculation of costs under subclause (1) is to be made on the basis that the access is provided to the operator in isolation.*
- (3) The total of –*
 - (a) the payments to the railway owner by –*
 - (i) all operators; and*
 - (ii) all other entities,**that are provided with access to a route, or part of a route, and associated railway infrastructure (“the route”); and*
 - (b) the revenue that the railway owner’s accounts and financial statements show as being attributable to its own operations on the route,**must not be a sum that is more than the total costs attributable to the route.*
- (4) It is not a breach of this clause for –*
 - (a) payments to the railway owner mentioned in subclause (1) to exceed the total costs referred to in that subclause; or*
 - (b) the total sum mentioned in subclause (3) to exceed the total costs referred to in that subclause,**if the over-payment rules approved or determined under section 47 are complied with.*

As with other Determinations, Section 20(4) of the *Railways (Access) Act 1998* (“the Act”) provides the framework within which the Regulator’s determination required under Section 47 of the Code is to be made.

The application of Section 20(4) is discretionary in so far as the Regulator may allocate such weight to each of the factors listed in Section 20(4) in a manner that the Regulator considers appropriate to ensure a balancing of competing and sometimes conflicting interests for the railway owner, access seekers and the community.

3. Basis Of The Over-payment Rules

- (1) Definition of a route and a route section*

The Code defines a “route” to mean those parts of the railways network and associated infrastructure to which this Code applies (ie. as listed in Schedule 1 of the Code), and includes part of a route. As pointed out by WNR in its Costing Principles Proposal, the Code also uses the term in a slightly different context when describing the floor and ceiling price tests in Clauses 7 and 8 of Schedule 4 in the Code. In this instance, a “route” is defined as the route or parts of a route, and associated railway infrastructure, relevant to the access proposal.

For the purpose of this Determination, which is to develop a statement of rules that are to apply where breaches of Clause 8 of Schedule 4 occur, the Regulator has adopted the meaning used in Clause 8 of Schedule 4.

Schedule 2 of the Code also defines a “route section” as sections of the railway network that has been divided for management and costing purposes. The route section is the basic unit to which the Over-payment Rules will apply. Each route section contains its own derived ceiling and floor costs and it is from these costs that access prices will be negotiated. A negotiated route therefore could equate to a route section (or part thereof) or be a combination of several route sections.

WNR has proposed that the freight network be defined into the following route sections based on differences in track characteristics and traffic densities.

Midland to Kalgoorlie (seven route sections)

- Midland - Millendon Junction
- Millendon Junction - Toodyay West
- Toodyay West - Avon Yard
- Avon Yard - West Merredin
- West Merredin - Koolyanobbing
- Koolyanobbing - West Kalgoorlie
- West Kalgoorlie - Kalgoorlie

Kalgoorlie to Esperance (four route sections)

- West Kalgoorlie - Hampton
- Hampton - Kambalda
- Kambalda - Salmon Gums

- Salmon Gums - Esperance

Kalgoorlie to Leonora (two route sections)

- Kalgoorlie - Malcolm
- Malcolm - Leonora

Kwinana to Bunbury Inner Harbour (eight route sections)

- 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

The Regulator agrees to the above division of the Network which may be refined over time as required.

(2) One regulatory ceiling

There has been some confusion among access seekers as to the meaning of Clause 8, Schedule 4 of the Code. One interpretation is that different ceiling levels can exist between different operators. Another is that the route section has only one ceiling and that it applies to all operators regardless of their access needs.

It is understood that the intent of the Regime is for only one ceiling to apply to all operators for each route section and for operator differences to be reflected in the price being negotiated (refer to Clause 13(c), Schedule 4 of the Code). Indeed, it would be problematic to apply the combinatorial test as set out in Clause 8(3) of Schedule 4 on multiple ceilings for each route section.

The Regulator has received legal advice that Clause 8 of Schedule 4 does not provide for multiple ceilings for each route section. However, to remove the potential for any possible mis-interpretation, an amendment to Clause 8 has been drafted and will be introduced as a change to the Code.

(3) *What constitutes revenue in the Ceiling Price Test under Clause 8 of Schedule 4 in the Code*

In assessing the extent of over-payments under Section 47 and Clause 3(a), Schedule 4 of the Code, all access and non-access payments and revenues received by WNR for a route section, or part of a route section, and associated railway infrastructure will be included to calculate the quantum of any refunds to Regime operators for that route section of the network.

Non-access revenue includes private contributions and government subsidies targeted to track improvements. These are converted to equivalent annual costs or annuities and included in the over-payment determination.

If Government makes an unspecified contribution to WNR to achieve a desired policy outcome, the Regulator will determine how the Government contribution should be reflected in the calculation of the floor and ceiling of the route sections in question. If Government contributes to infrastructure that falls outside the Code's definition of "railway infrastructure", those contributions would not be considered in the floor and ceiling calculations.

Payments from operators with access agreements negotiated outside the Regime ("non-Regime operators") will also be assessed in evaluating compliance with the maximum and minimum combinatorial revenue limits of the Code. Furthermore, in assessing the extent of over-payment under Section 47 of the Code, payments from non-Regime operators are included in assessing the quantum of refunds to Regime operators.

However, the Code does not provide non-Regime operators a legal entitlement to any refund for any over-payment. These over-payments will be returned to WNR but it is the Regulator's intention to publish this information whenever such payments are returned as part of his general responsibility to encourage the efficient use of, and investment in, railway facilities by ensuring a contestable market for rail operations.

(4) *Breaches of the ceiling price test*

Section 47(1) of the Code states that the Over-payment Rules are to apply where breaches occur on the part of that owner that "could not reasonably be avoided".

In attempting to define what could or could not reasonably be avoided, WNR will be required to identify the reasons for breaching the Ceiling Price Test. If WNR has breached the Ceiling Price Test because of temporary or short-term breaches that are of an unavoidable nature, then the over-payments will be subject to the Over-payment Rules described in this Determination.

If, on the other hand, the movement in revenues above the ceiling is considered to be permanent, such as due to the result of long-term factors, WNR will need to immediately negotiate a new access price with all affected parties using the route section in order to bring the total revenue for the route section back down to the ceiling.

(5) Over-payments and under-recoveries

In this Determination, “over-payment” is defined as the amount of revenue received by the railway owner for a route section that exceeds the total costs attributed to the route section for a one-year period. Conversely, “under-recovery” in the Determination refers to a situation where the total payments to the railway owner on a route section for a one-year period is less than the total costs attributed to that route section.

Some stakeholders have expressed the view that “under-recoveries” should not be considered by the Regulator as total payments to WNR may be under the ceiling for a variety of reasons, some of which may be due to WNR’s own actions.

Equally, concerns have also been expressed about whether it is appropriate to translate “average” returns observed for particular companies into a “maximum” return to be applied to a railway owner. This is because the Code requires that a Weighted Average Cost of Capital (WACC) be set that will allow the railway owner to achieve a reasonable rate of return, while charging efficient prices for access, and will be motivated and able to maintain long term investment in the infrastructure sufficient to provide services at levels required by the market.

The complexity inherent in the WA Regime is that the Code’s ceiling test constrains the maximum revenue receivable by a route section to its total cost and it does not allow WNR to cross subsidise under-performing infrastructure by over-recovery of costs on well-utilised sections of track. Therefore, it would be appropriate to allow WNR to achieve the ceiling on those routes in which the ceiling can be achieved.

Determination of the WACC using capital pricing model theory is an empirical and partially subjective process. The Regulator is aware of the view by some stakeholders that “high-end parameter values” to reflect the level of risk have already been used in determining the WACC for WNR, and therefore no additional allowance should be entertained. This is a matter that will be included in the review of the WACC, scheduled to commence later this year. In the meantime, the Regulator considers that it is appropriate to allow some balancing mechanism in the regulatory framework.

The Code is silent on how under-recoveries are to be treated. As the make-up of the Over-payment Rules will depend on the consideration given to under-recoveries, the Regulator will need to define the approach to be adopted.

Section 47 of the Code:

- permits railway owners to average out the net of any over-payments and under-recoveries over 3 years with a refund of a net over-payment to operators, but no claw back of any net under-recovery; or
- requires railway owners to refund every three years all over-payments and disregard any under-recoveries.

The Regulator is of the view that the Code's specification of a "successive period of three years" may be interpreted that refunds are based on the net result of over-payments and under-recoveries. In other words, over-payments can be used by the railway owner to offset against under-recoveries over that three-year period. However, a net under-recovery over the three-year period does not mean that operators will be required to make up the railway owner's revenue to the ceiling.

In arriving at this decision, the Regulator has taken into account all the factors listed under Section 20(4) of the Act.

WNR has approached the Regulator regarding a longer time horizon when considering under-recoveries. WNR has argued that it should be allowed to carry-over any under-recoveries beyond the three-year time horizon as WNR experiences temporary variations in traffic flow even on its most stable routes.

The Regulator accepts that WNR is not proposing to recover under-recoveries from its clients but only want an accounting balance to allow WNR to carry over under-recovery credits. The Regulator has also noted that Section 47(2)(b) of the Code requires that there be no excess (ie. over-payments) at the expiry of each successful period of 3 years, but it does not preclude the carry-over of under-recoveries.

The Regulator is only prepared to consider a carry over beyond the three years in one instance (refer to Example 4 in the Application of the Over-payment Rules section). WNR would be allowed to carry forward under-recoveries where, as a result of having to reimburse operators during the three-year period because the breach is greater than 10 percent of the ceiling (refer to the Over-payment Rule #3 in Section 4), there is insufficient funds in the trust account for WNR to recoup an under-recovery that has occurred during the same three-year period.

In this instance, WNR will need to put a case to the Regulator to carry the under-recovery credits over to the next three years up to the amount WNR has been required to refund to operators as a result of exceeding the 10 percent limit. If allowed, the carry forward will only apply for that one additional period.

The 10 percent limit is based on a historical analysis of WNR's cash flow, and in any event, interest accruing in the trust account will go back to the operators.

(6) *Allocation of access revenue*

Under Section 9(1)(c)(i) of the Code, WNR is only required to provide one floor and one ceiling price for a proposed access to a route (ie. from origin to destination) even though the access proposal could transverse over multiple route sections as defined in the Code.

The Regulator has determined the following approach to distribute the revenue over a particular route against the costs of individual route sections:

- Revenue derived from a route can only be allocated to the route sections on that route;
- WNR will allocate revenue to cover the costs attributed to the applicable route sections in the following order:
 - (i) Incremental costs against all applicable route sections;
 - (ii) Up to the ceiling costs on all applicable branch or feeder (dedicated) route sections;
 - (iii) Up to the ceiling costs on all applicable shared route sections.

The Regulator believes that there is merit in providing WNR with a degree of discretion to allocate revenues for a route back to the individual route section to ensure the efficient and economic use of the railway infrastructure.

Given that the ceiling price reflects the full economic cost of the infrastructure being provided, the Regulator has agreed to WNR's request that branch or feeder infrastructure should rank ahead of shared infrastructure. This is on the basis that there is no other traffic to fund the dedicated infrastructure and unless those costs are covered the line may close.

For those operators who do not wish the above revenue allocation methodology to apply, they have the option to fix revenue allocation, for example, on a route section by route section basis, in their access agreement with WNR. Where there is a different revenue allocation arrangement agreed to in an access agreement, that arrangement would prevail.

The following process will apply in the allocation of an over-payment on a route section:

- If an operator can be identified as being responsible for triggering the over-payment, then the excess revenue will be allocated back to all operators on the entire route of that operator;

- If more than one operator can be identified as being responsible for triggering the over-payment, then the excess revenue will be allocated back to all operators on all of the routes of those operators;
- If it is not possible to single out the operators responsible, then an assumption will be made that the over-payments are the result of all operators' payments on that route section, and the excess revenue will be allocated back to all operators on all of the routes of all those operators.

The repayment will be apportioned based on the total annual payments above the floor for access by each operator on the route. An operator paying only the floor price on the route will not be considered for any refund as this would compromise the Floor Price Test in the Code.

The Regulator will monitor the manner in which WNR allocates its revenue to determine whether WNR is "gaming" in a manner that does more than simply recover its legitimate costs and maximise the efficient and economic use of the railway infrastructure. In particular, the Regulator will be monitoring any adjustments of access rates which favours one operator over another by WNR to avoid breaching the ceiling.

4 The Over-payment Rules

Commencing 1 July 2002 (or as soon as they are approved thereafter), the following rules will apply where breaches of the ceiling could not reasonably be avoided:

- (1) WNR is to account for any over-payment of revenue by each route section;
- (2) The over-payment should be calculated by 31 July of each year, with full settlement as agreed to by the Regulator by 30 September;
- (3) For any breach of the ceiling greater than 10 percent, WNR must reimburse to operators on that route section any over-payment that is greater than the 10 percent ceiling level for that year. Full repayment using the pro-rata formula in Item (8) is required by 30 September of the following financial year;
- (4) WNR is to establish a trust account for the annual deposit of all payments that are equal to or less than the 10 percent amount allowable for breaches of the ceiling level for that year;
- (5) The trust account is to be cleared every three years and WNR will not access the funds in the trust account until the end of the three-year term;
- (6) All interest which accrues in the trust account will be distributed to operators except for those instances referred to in Item (7);

- (7) Any payments to non-Regime operators calculated in Item (8) will be returned to the WNR for its discretionary application as the Code does not apply;
- (8) Payments to operators will be apportioned, based on the total annual payments for access above the floor by each operator on the route. The following formula is to apply:

$$\frac{\text{An operator's ① annual payments above the floor + contributions}}{\text{Total annual payments above the floor + contributions received by railway owner ②}} \times (\text{Amount of net over-payment and interest for the route}) ③$$

Notes

①: *Includes Regime and non-Regime operators.*

②: *Government subsidies are not included.*

③: *Government subsidies are included when calculating the amount of net over-payments. These will be offset by a corresponding increase in the ceiling.*

- (9) The accounts will be independently audited to ensure that accurate over-payments are made into the trust account, and that the proposed distribution of any funds are appropriate and consistent with the Over-payment Rules;
- (10) The independent audit report will be provided to the Regulator. The Regulator will not sign off to the audit report until the Regulator is satisfied with the information provided. The Regulator will respond on the audit by 31 August each year, and if the Regulator is unsatisfied will provide a revised timetable for response.

5 Application Of The Over-payment Rules

The examples below should provide WNR and operators a guide as to how these rules apply. Years 1, 2 and 3 show over-payments and under-recoveries (denoted by a minus sign) for a route section. All operators are also assumed to be in the Regime and have met their floor costs.

The annual interest rate assumed is 5% compounded, which given the deposit occurs annually would only apply to year one and two deposits. It is also assumed that the ceiling cost for the route section in the examples below is \$100,000, and over-payments in excess of \$10,000 are reimbursed immediately.

Example 4 refers to the one exception in which the Regulator may be prepared to consider the carrying over of under-recovery credits to the next three-year period. In this example, the railway owner incurred a breach of 20 percent above the ceiling in year 1. At the end of year 1, it has to reimburse operators \$10,000 and deposit \$10,000 into the trust account.

However, in year 2, the railway owner incurred an under-recovery of 15 percent. Assuming that the revenue from access is exactly at the ceiling in year 3, there are now insufficient funds to compensate the railway owner in the trust account for the three-year period. In this example, the Regulator may approve a carry-over in under-recovery credits of \$5,000.

	<i>Example 1</i>	<i>Example 2</i>	<i>Example 3</i>	<i>Example 4</i>
Year 1	\$10,000	\$10,000	\$10,000	\$20,000
Year 2	-\$10,000	-\$30,000	\$5,000	-\$15,000
Year 3	\$0	\$0	-\$10,000	\$0
<i>Total of the 3 year period</i>	\$0	-\$20,000	\$5,000	\$5,000
<i>Reimbursed to operators</i>	N/A	N/A	N/A	\$10,000
<i>Accrued Principal in Trust</i>	\$10,000	\$10,000	\$15,000	\$10,000
<i>Accrued Interest in Trust</i>	\$1,025	\$1,025	\$1,275	\$1,025
<i>Refund to WNR</i>	\$10,000	\$10,000	\$10,000	\$10,000
<i>Refund to operators</i>	\$1,025	\$1,025	\$6,275	\$1,025
<i>Carry forward of credits</i>	N/A	N/A	N/A	\$5,000

N/A = Not applicable

If an operator has negotiated access outside the Regime then its share of the over-payments would go to the railway owner. For instance, if in Example 3 that route section comprised only non-Regime operators then the total accrued principal in the trust, ie. \$15,000, and interest earned, ie. \$1,275, would go to WNR.

6 Determination

The proposed Over-payment Rules submitted by WNR dated October 2001 are not approved. WNR is required under Section 47(3)(a) of the Code to amend its Over-payment Rules (by including the basis of the Over-payment Rules in Sections 3, the Over-payment Rules in Section 4, and, if appropriate, examples in Section 5 of this Determination) and resubmit them for the Regulator's consideration within 30 days of the receipt of the Determination. In the event that WNR is not willing to do so, the Regulator may give directions to effect the necessary changes under Section 47(3)(b) of the Code.

Ken Michael

ACTING INDEPENDENT RAIL ACCESS REGULATOR

27 September 2002