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Ms Meg Jones
Rail Division
Economic Regulation Authority
Level 27, 197 St George's Terrace
Perth WA 6000

RE: Estimation of CPI-X in the WA Rail Industry

Dear Meg,

Thank you for the opportunity to comment on the draft report on the Estimation of CPI-X in the WA Rail Industry.

Whilst recognising that the IRIC methodology is still in its infancy (even IRIC describe it as "novel"), we are nevertheless concerned with a number of statements made within the report, and also with the calculated outputs, particularly as they relate to an apparent negative bias toward the South West Main and Eastern Goldfields Railway.

As a general comment, we found the report difficult to read and understand. We appreciate that the subject is complex and largely theoretical, however the difficulty the authors have in conveying their logic to major stakeholders such as Alcoa would indicate that the transition from novel methodology to an accepted calculation of the X Factor, still has some way to go.

The existing CPI-X method, where X is 0.25 of the CPI, is certainly somewhat subjective. It is, however, easy to understand and, despite its potential flaws, is without doubt no less subjective than the IRIC methodology.

Consequently, our view is that the current CPI-X approach adopted by the ERA should remain in force until a proven, accurate and reliable alternative methodology is developed and accepted.

Draft IRIC Report Comments

Findings

We question the accuracy of the report methodology, given the apparent penalties suffered by the EGR and SWM. Even the authors comment that the Total Factor Productivity changes and the changes in Input Prices, which based upon the methodology appear to skew the results against the higher tonnage lines, are "troubling" and "counter intuitive".

Overview of IRIC Methodology

The authors make a number of comments concerning competitive markets and the need to provide an incentive to the regulated firm to pursue technological improvements. We fundamentally disagree with this view. The regulated below rail environment in Western Australia is not a competitive market. The below rail owner should at all times be providing best practice operations to consumers, and should not be able to increase profits as new technology improvements are “shared” with consumers, as suggested in the IRIC report.

The existing CPI-X escalator is designed to motivate the rail owner to move towards best practice – if it doesn’t, its profits will decline.

Temporary Shocks and Changing the X Factor

We agree that temporary shocks can significantly complicate any attempt by the regulatory authority to accurately adjust the X factor under the IRIC methodology. As suggested by the authors, adopting a position where the X factor is only changed once it can be justified that a change is necessary, is a pragmatic approach that has our support.

Capital, Maintenance, Operational Expenditures and Overheads

The authors make a number of references to the fact that professional/ independent engineering advice indicates that the MEA for 2003 is at World’s Best Practice (“WBP”). Alcoa does not believe this to be the case, and in fact our numerous independent submissions to the ERA, as part of the ceiling price determinations, suggest that the MEA ultimately allowed by the ERA to the rail owner falls well short of WBP. We have no doubt that every stakeholder has its own view of WBP and where the MEA currently sits compared to that. Whilst we realise that the authors have used the information available to them, and have had to make numerous assumptions in extrapolating data, it does highlight further possible inconsistency in output using the IRIC methodology.

We look forward to being able to make further comment on the IRIC methodology as it develops into a more robust X factor calculation.

Yours faithfully

John Oliver
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