OVER-PAYMENT RULES TO APPLY TO WESTNET RAIL ARTC SUBMISSION

The Acting WA Independent Rail Access Regulator ("Regulator") has requested submissions from interested parties with regard to the draft determination made in relation to WestNet's ("WNR") Over-Payment Rules required under the Railways (Access) Code 2000 ("Code"). WNR's proposed overpayment rules were proposed to the Regulator in October 2001. The Regulator's draft determination is that WNR's proposed rules are not approved, and that WNR is required to adopt rules as detailed in the draft determination.

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

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

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

Neither the wholesale agreement or ARTC's Access Undertaking explicitly address the issue of overpayment rules to come into play when ceiling revenue limits are breached. This is largely because it is widely considered most unlikely that any reasonable ceiling revenue limit would be breached on the interstate network within the foreseeable future. Nevertheless, ARTC did informally indicate to the ACCC, during the consultation process, that should such a breach ever occur, it would be ARTC intention to rebate any annual excess back to operators at the end of each year. Rebates are likely to be proportioned to each operator to the extent that an operator contributed to the revenue. As such, having over-payment rules would not, in principle, be inconsistent to that which ARTC might propose on the interstate, should the need arise.

Within the context of the WA interstate network and the wholesale agreement, any over-payment rules may have an impact to the extent that any revenue received from operators under access contracts would probably enter the ceiling test as normal operator revenue. Essentially, the pricing principles under the wholesale agreement provide for ARTC to retain a share of access revenue it charges under access agreement between it and the operator, depending on market growth achieved on the WA interstate network. The remainder of the revenue is passed through to WNR. ARTC is unclear as to whether the revenue it receives from operators should enter the ceiling test or whether it is the share of revenue received by WNR that should enter the test. The treatment can be viewed from several directions:

- From the **operator's** perspective, the total charges paid for access should enter the test.

- From **WNR's** perspective, it can only apply the revenue it receives to the recovery of the cost of service provision, and it is this revenue that should be incorporated in the ceiling test.

- From **ARTC's** perspective, it is effectively a wholesale customer of WNR, and hence the wholesale charge it returns to WNR should be applied in the ceiling test. If the revenue received from the operator is included in the test, then ARTC's reasonable costs of providing it's service to the operator should be included in the regulatory cost base.

ARTC believes that these issues should be considered by the Regulator and resolved by recognizing access revenue received by WNR on a 'wholesale' basis in the rules.

For the remainder of the submission, ARTC will endeavour to identify, and comment on, specific aspects of the Over-Payment Rules as detailed by the Regulator in the draft determination.

<u>Over-payments and under-recoveries</u>

ARTC notes that the Code is silent on how under-recoveries are to be treated in the Over-Payment Rules, and that the Regulator has defined the approach to be adopted.

The Regulator has determined that over-payments can be used by the railway owner to offset against under-recoveries over a three year period (being the period over which any net surplus in the over-payment account must be rebated to operators). This is in addition to annual rebates of surplus revenue in any year greater than 10% over the ceiling limit.

ARTC also notes that the regulator may allow a carryover of a net under-recovery to the next three year period if because annual rebates (surplus over 10% in any year) mean that there is insufficient finds in the over-payment account to recoup a significant under-recovery in the three year period. The amount of carryover would only be to the extent of the annual rebates paid.

This treatment could be likened to the taxation treatment of capital gains and losses, where net capital gains must be paid in a current tax period, whilst net capital losses may be rolled forward for a certain period.

The Regulator has made it quite clear in its determination that 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.

ARTC considers that this view taken by the regulator weighted too heavily in the direction of the interests of operators (and insufficiently addresses the reasonable commercial interests of the track owner). Reasons for this are:

- ARTC considers that an efficient access regime should seek to allocate risk to the parties best able to manage those risks. Whilst clear separations are not necessarily practical, the **balance** should be such that the users of the rail network bear more market risk (which operators are best to manage) and the track owner bear more cost risk (which it can best manage). As such, any over-payment rules should, at least to some extent, seek to mitigate the track-owner's risk to market fluctuations and forecasting risk.

- ARTC, and other track owners in Australia, already take on significant market risk by virtue of the access pricing structure employed in many cases, particularly on the interstate network. That is, two part pricing, where the larger part of revenue is derived from the variable (GTK) component of the charge. On the ARTC network, the variable component of two-part pricing represents around 70% of revenue. This is slightly lower on the WA part of the interstate network (interstate operations) and slightly higher in NSW. In any case, given the volumes on may parts of the rail network in Australia (outside coal and private iron ore networks) it is generally accepted that around 30% of infrastructure costs is variable. Even the flagfall component of revenue is only 'fixed' to the extent that the path entitlement is not cancelled. As such the revenue of many track owners in Australia can vary more with volume than costs and, as such, profitability is sensitive to market risk.

  On the other hand, the cost of access to the infrastructure to an above rail only entity is more variable with volume. One could argue that the cost of the infrastructure asset would be more 'fixed' in nature if the infrastructure were owned by the operator and, as such, the operator (vertically integrated) profits would be more sensitive to market risk.

  It could be argued that a track owner could seek to move this market risk to the operator by seeking 'take-or-pay' arrangements based on a minimum volume. This is not all that common in current access arrangements and, outside of some mining industries (where volume risk is relatively low), would not be overly palatable to operators.

- Generally when access is negotiated, the track owner seeks volume forecasts from the operator (or end customer), upon which to base the pricing calculation. Clearly the operator/end customer is in a better position to make such forecasts, and the track owner would place some credence in those forecasts. If pricing were based on overstated volumes and in the absence of volume 'take or pay' arrangements (which is equivalent to the top-up not incorporated in the rules), the track owner faces the risk of under-recovery of revenue. On the other hand, an understated task may result in additional revenue that, if breaching a revenue limit, must be refunded. This results in a lopsided volume risk profile for the track owner (that is, upside could be limited by over-payment rules) but there is little downside protection (except for some netting of over and under-recoveries, where both occur). Where there is longer term volume discrepancy, the rules explicitly require WNR to re-negotiate pricing but only if revenues will be consistently above the ceiling.

- Finally, it could be argued that the rate of return allowed to the track owner may take some consideration of market risk surround the businesses utilizing the network. Generally, though, such analysis considers upside and downside risks around expected volumes. If the risk profile is subsequently altered by regulation such that downside exposure is retain but upside is constrained, then this should be reconciled with a higher allowed return. Conversely, operator have the benefit of the reverse profile, where cost of access is capped when volumes are higher than anticipated, but fall in line with lower volumes.

ARTC notes that the 'unders-and-overs' account arrangements recommended by the Independent Pricing and Regulatory Tribunal of NSW ("IPART") appears to allow access pricing to be adjusted each year to reflect prior year under and over-recoveries, and minimizing the ongoing effect of volume fluctuation on revenue. This approach mitigates the risk of operators overcompensating the track owner when volumes are higher (as does the WA regime), but also mitigates the risk to the track owner of under-recovery of cost when volumes are lower. ARTC considers this approach represents a fairer balance between the management of respective risk of the parties involved.

Allocation of access revenue

ARTC notes that the Regulator, in determining the approach to distribute the revenue over a particular route against the costs of individual route sections allocates:

- To incremental costs against all route sections, then
- Up to ceiling costs on branch or feeder sections, then
- Up to ceiling costs on 'shared route' sections.

The Regulator has agreed to rank branch or feeder sections ahead of shared infrastructure because these lines may close in the absence of other traffic to fund these dedicated lines.

Presumably the potential would then arise for users of shared infrastructure to pay higher charges than might otherwise have been the case to effectively 'subsidise' the lower revenue attributed to shared infrastructure for other users whose revenue has been allocated to branchlines up to ceiling limits. ARTC is concerned that there would be loss of overall efficiency of the network usage, which would fund a non-commercial objective (that is ensuring that a branchline that is otherwise non-commercial could remain open. ARTC is of the view that such objectives should be dealt with in other more direct and transparent ways, rather than via some form of cross-subsidisation.

<u>Revenue for the purpose of the ceiling test</u>

ARTC notes that the ceiling test provides for the inclusion of annualized 'government subsidies' as revenue and, presumably the inclusion of investment arising from the subsidy in the regulatory asset base. ARTC has advised the ACCC that any investment in the infrastructure received from its shareholder, the terms of which require no return will not be included in its asset base for ceiling purposes.

The terms of any government payment made to WNR would need to be clear in order to establish appropriate treatment in the ceiling test. It may be that the subsidy is in infrastructure that would not form part of the MEA asset base. If this were the case, then an annualized form of the investment should not be included in revenue compared to the ceiling limit.

<u>Treatment of revenue associated with non-Regime operators</u>

ARTC notes that the Code does not provide for non-Regime operators with any legal entitlement to a refund for over-repayment. Such over-payments will be returned to WNR, but the Regulator has signaled an intention to publish this information whenever such payments are returned.

ARTC is not sure as to the purpose for publishing this information. If it were for the purpose of displaying that the distribution of over-payment funds is appropriate and consistent with the rules, then ARTC would have thought that the proposed independent audit of the distribution would be sufficient.