MEMORANDUM

PORTMAN IRON ORE LIMITED'S COMMENTS ON WESTNET'S PROPOSED COSTING PRINCIPLES

1. In clause 1.2 of the proposed Costing Principles ("Principles") there is reference to WestNet being prepared to discuss access with interested parties separate to the Railways (Access) Code 2000 ("the Code"). The Code gives WestNet and interested parties rights to negotiate the terms and conditions of access and the tariffs for that access (so that the terms and conditions and tariffs can accommodate different access parties' different interests) but all access applications and grants of access should be dealt with consistently under the Code. This will ensure that there is compliance with train management guidelines, train path policy and with the Costing Principles in setting tariffs, for all access parties and will ensure that the master control diagram and the pooling diagrams operate effectively so that all parties' scheduled train paths are observed. Additionally, this will ensure that the principles of consistency in pricing, and the avoidance of pricing discrimination, required by paragraphs 13(a) and (b) of schedule 4 to the Code, are able to be applied properly to all access arrangements by WestNet. The Regulator must be in a position to express a view on price consistency under section 21 of the Code.

2. In clause 2.1 the reference to "Gross Replacement Cost" should be reference to "Gross Replacement Value" as this is the fundamental concept under the Code. By using the term "Gross Replacement Value" rather than the concept of cost, the Code is requiring the capital value of the network to be established by taking the cost of a modern equivalent asset and then taking account of the value which has already been extracted from that Network by reference to the time elapsed since the use of the Network commenced in relation to the expected total life of the Network. This is equivalent to the accounting concept of depreciation of capital assets. In other word the cost currently of establishing the Network with best industry practise, the most technologically advanced methods and components (ie the best steel rail and concrete sleepers) is established. This is then to be reduced by the proportion of value obtained from elapsed time of use of the Network as against its expected ultimate life from the time of commencement of operation. If this is what WestNet is proposing, then this is acceptable to Portman.

3. In clause 2.2 the stated determination that the existing Network infrastructure meets all current and reasonably projected demand for uses taken together is not correct. There is a requirement for WestNet to upgrade the Koolyanobbing to Esperance section of the Network in accordance with section 12(6) of the *Rail Freight System Act* 1999, which is important in meeting Portman's anticipated significantly increased demand for use.

4. In clause 2.3 the engineering and design overhead should be limited to 12.5% and not 16.5%, in accordance with standard industry practice.

5. Our previous comments in 2 above on how the value of modern equivalent assets should be used in setting the value of the capital base for the Network should be referred in the context of clause 2.3.

6. The financing charge during railway infrastructure construction should be exactly the same as the weighted average cost of capital approved by the Regulator which is a pre-tax real rate of return of 8.2%.

7. Concerning clause 2.6, as the annuity calculation is undertaken annually in arrears the charges resulting from that calculation must be paid by access parties annually in arrears.

8. The approach to operating costs appears to contain a fundamental misconception. The operating costs which WestNet can pass on to access parties under its track access charges must be only those operating and maintenance costs which would be incurred by a reasonable and prudent operator operating that Network in a reasonable manner. If WestNet has outsourced any part of the operation and maintenance of the Network those charges payable to the contractor can only be recoverable by WestNet if the Regulator is satisfied that they are "efficient costs" as this phrase is generally understood. This is an objective and theoretical test based upon the assumption required under the Code that the network is comprised of modern equivalent assets which have provided the value previously provided by those assets over their life to date. The actual operating costs of the network as it exists including liabilities to contractors providing operational and maintenance services are not relevant in determining the operating costs which can be passed through to access parties in WestNet's track access changes.

9. It must be clear in the Principles as to what aspects of maintenance are included in operating and maintenance costs and what are included in the value of the capital base of the Network. In other words if the capital base includes an allowance for future capital expenditure on improved rail, sleepers etc WestNet must not be able to include the cost of such improvements in the maintenance aspect of its operating costs. Capital works, even though it is done as part of a maintenance program, should properly be dealt with in establishing the capital value of the network (ie it should be included as forecast capital expenditure, and if reasonable, be included in the capital base). That forecast capital expenditure would then of course be excluded from non-capital operating costs.

10. Clause 3.3 underlines the misconception in WestNet's approach to operating costs.

Because the only costs recoverable by WestNet are the efficient costs of operating an assumed modern equivalent asset network its actual costs in operating the Network as currently configured are not relevant. The test must be that the operating costs which can be passed on through WestNet's track access charges are those that would be incurred by a reasonable and prudent operator operating in a reasonable manner a network comprised of modern equivalent assets. The actual costs of track maintenance which has been outsourced and the cost of managing those outsourced maintenance contracts are not relevant to the recoverable operating costs unless WestNet can demonstrate to the Regulator's satisfaction that those costs (and overheads allocation) would be incurred by a reasonable and prudent operator operating in a reasonable manner a network comprised of modern equivalent assets.

11. The actual capital base and the operating costs which are used to determine the floor price and ceiling price for the purposes of clause 9 of Schedule 4 to the Code will be considered in detail at the time they are published. It may be that the way in which the Principles are applied in the proposed calculation of the floor price and ceiling price will demonstrate other deficiencies in the Principles, which will be highlighted at that time.

12. Concerning clause 4.1 again WestNet's overhead costs must be those which are assessed as economically efficient and not those which WestNet simply incur in conducting its business. Further, the allocation of corporate overhead function by the Australian Railway Group can only be passed on to access parties if they are also the efficient costs of providing those overhead functions. The Regulator should assume because of the

relationship between the parties, that those costs are not efficient costs until it can be demonstrated that they are efficient costs. Further, it must be demonstrated that the allocation of the cost of corporate overhead functions accurately represents the proportion of those functions which relate to the activities of WestNet.

13. The escalation of the regulatory ceiling should be, at the highest, 67% of CPI only. All Regulators of infrastructure assets apply an efficiency incentive to the owners/operators of those assets in the form of a CPI minus X formula. In addition, only the operating and maintenance components (and the overheads allocated to those components) of the regulatory ceiling should be escalated.

14. In accordance with the Code there must be only one regulatory ceiling and one regulatory floor for the route required for the relevant access party (see clause 9 of Schedule 4). The costing principles are silent on the allocation of total revenue from the WestNet network to relevant routes on that network. This is of course is a critical part of any approach to regulatory tariff setting and the allocation of total revenue to the various route components which make up the Network must be established in these Principles and approved by the Regulator.

14.1 The economic life tables contained in clause 7.1 presumably designate the specific economic lives in years and this should be clarified. The economic lives appear to be reasonable for the different classes of railway infrastructure. The column with "km" contained in it must be completed if relevant, or deleted, if not. In addition, it is inconsistent for WestNet to assume, on the one hand, that its infrastructure is new and, on the other hand, suggest that it has a limited life.

15. In clause 4.2 and Table 7.2, the Costing Principles deal with the allocation of overheads. The Costing Principles also need to provide detail as to the principles, rules and practices that will be applied and followed in establishing the floor price and the ceiling price for particular routes and particular access parties. The total revenue received by WestNet derived from capital costs, operating costs and attributable overheads must be allocated between routes or parts of routes, and between access parties having access to that route or part of it. The principles, rules and practices that will be applied in this allocation must be fair and reasonable, and must be described in detail in the Principles. The Regulator must ensure the fairness and reasonableness of these principles, rules and practices before he approves the Principles.