30th April 2004

Mr Bruce Chan
Rail Division
Economic Regulation Authority
Level 27, 197 St Georges Terrace
PERTH WA 6000

Dear Bruce,

ESTIMATION OF CPI-X IN THE WA RAIL INDUSTRY

WestNet Rail is pleased to respond to the call for comment on the Draft Report prepared by IRIC and GHD concerning estimation of CPI-X in the WA Rail Industry.

It is hard to fault Total Factor Productivity analysis on theoretical grounds but generally the lack of available data makes its implementation in practice problematical.
In this case, having to effectively recreate data that forms one end of a time period (i.e. 2001) when the objective is to measure relative change over the period (2001-03) does raise some questions.
The wide variation of results, with some negatives, makes it difficult to assess the credibility of the analysis, whilst recognising that the intent of this process undertaken by the ERA was consideration of the methodology rather than calculating the factor of X in CPI - X

Regulators face a difficult task in determining regulated prices such that the outcome reflects a competitive market outcome and is free from monopoly rents. The regulatory process contains inherent uncertainties, both in terms of the correct methodologies to be applied and in terms of the information required to support a preferred methodology.
It is generally accepted that faced with these uncertainties, a Regulator should err on the side of higher revenues as understating revenues is the more serious error because it gives rise to under-investment. A recent report prepared by Associate Professor Martin Lally for the Queensland Competition Authority makes this very point[1].

---

[1] *Associate Professor Martin Lally, "The Cost of Capital for Regulated Entities",Report prepared for the Queensland Competition Authority, 26 February 2004.*

As acknowledged by IRIC, a competitive firm will be allowed to retain for some period of time the productivity benefits from its innovation before, in the face of competitive pressures, being forced to pass them onto consumers through lower prices.

It is also reasonable to assume that productivity improvements and innovation achieved on average throughout the economy will be reflected in the rate of change in the consumer price index with competition forcing such savings to be passed through to consumer prices. Adjusting prices by CPI therefore assumes an average level of productivity improvement and consequently a positive X implies better than average productivity improvement.

In WestNet's view, any suggestion that the rail infrastructure sector has the potential to provide dynamic productivity improvements greater than the economy on average needs to be treated with some caution. The sector is characterised by mature technology with limited opportunities for extraordinary productivity improvement. It is also important to recognise the distinction between permanent and temporary productivity gains. Temporary productivity gains achieved at the expense of a rundown in asset quality should not be reflected in prices as such gains are illusory. Only permanent productivity gains are relevant but it is often difficult to establish whether gains are permanent from observed data.

The central issue is the extent to which the Regulator should allow WestNet Rail's revenue caps to increase between regulatory re-sets - i.e. we are only concerned with the dynamic productivity element or the rate of change in productivity of an efficient firm over the regulatory period. The points set out in the preceding paragraphs suggest there is a reasonable case for arguing that the X should be zero and that CPI is the appropriate adjustment.

Any static productivity gaps that might emerge over time are dealt with at each regulatory re-set. So given:

- The uncertainties inherent in the methodologies to be applied in measuring dynamic productivity change;
- The lack of reliable data, particularly in the early stages of regulatory oversight of WestNet's rail infrastructure services;
- Uncertainty as to whether observed productivity gains are permanent or have been achieved from a rundown in asset quality;
- The commonly held view that a Regulator should err on the side of higher revenues faced with such uncertainties; and
- The lags between productivity change and price change inherent in a competitive market,

WestNet believes it is a reasonable proposition that X should be set at zero.

It would be of major concern to WestNet rail and investors in rail infrastructure generally if the Regulator slavishly followed an empirical process that has some questions over it - even the authors are concerned about the results and the argument that this is probably due to light traffic volumes on several lines is unconvincing.

In arguing for an X of zero, we are not suggesting that productivity change in railway infrastructure businesses will be zero into the future. Temporal changes in productivity will be picked up at each regulatory reset (every 3 years) but in the intervening period, it is important that the infrastructure provider has strong incentives to improve productivity and to continue to invest. In WestNet Rail's view it is these considerations that should dominate as the potential benefits to consumers in the medium to long term will likely far outweigh bringing forward any marginal real reductions in tariffs by one or two years.

Strictly applying a theoretically robust but practically difficult escalation formula is not likely to benefit either consumers of, or investors in, rail infrastructure services. Having regard to all of the relevant factors, WestNet believes CPI escalation is the most sensible approach.

Yours sincerely,

Tim Ryan
General Manager