REVIEW OF THE PILBARA INFRASTRUCTURE PTY LTD'S PART 5 INSTRUMENTS SEPTEMBER 2008

COSTING PRINCIPLES & OVERPAYMENT RULES

Background

The West Australian Economic Regulation Authority ("ERA") has sought submissions from interested parties with respect to The Pilbara Infrastructure Pty Ltd ("TPI") proposed Part 5 instruments. The instruments form Part 5 of the Railway (Access) Code 2000 ('Code').

In relation to this submission, the Part 5 Instruments under review are:

- Costing Principles; and
- Overpayment Rules.

This follows the request for submissions in August 2008 on TPI's other instruments:

- Segregation Arrangements;
- Train Management Guidelines; and
- Train Path Policy.

The WA Regime: ARTC's Previous Submissions

In line with its previous submissions to the ERA, and its previous involvement in the consultation processes conducted by the ERA (or its predecessor) and the NCC in relation to the WA Rail Access Regime, ARTC's positions and comments have largely been based around two broad themes, being,

- ARTC has consistently indicated that it considered it important that access regimes within each jurisdiction in Australia are consistent to the maximum extent possible, whilst recognizing structural differences between providers in each jurisdiction.
- The need for the WA Access Regime and regulatory supervision to ensure that adequate measures are put in place to provide the market with confidence that access to the WA network can be gained in a timely, fair and equitable way when the access provider is vertically integrated. One outcome of this is that ARTC has consistently argued that access regimes for vertically integrated operators need to be much more prescriptive in nature than regimes considered appropriate in a vertically separated environment.

ARTC's interest in the Part 5 Instruments is that they are consistent with these needs.

COSTING PRINCIPLES

TPI's Part 5 Instrument in relation to 'Costing Principles' is a statement of the principles, rules and practices that TPI will apply to determine the Floor and Ceiling costs as required to be established under the Code, and to define the manner in which TPI's accounts and financial records must be kept and presented so far as they relate to the determination of floor and ceiling costs.

ARTC has previously made submissions to the ERA in relation to Costing Principles for WestnetRail (WNR) which, in a general sense, would also apply in the case of TPI. In these submissions, the following main issues have been raised:

- ARTC supports the ability to apply market based pricing to below rail services, where costs represent only one input to the pricing decision. ARTC adopts a similar approach in its 2007 Interstate Access Undertaking.
- The Code incorporates floor and ceiling limits to pricing for any particular traffic. ARTC's 2007 Interstate Access Undertaking contemplates floor and ceiling revenue limits and undertakes that prices will be set such that revenue on any given segment falls between these limits. The limits are published and have been accepted by the ACCC. ARTC considers most of the WA rail network carries similar business and such an approach to pricing is warranted in this case.
- Given the nature of the rail infrastructure asset, there is usually a wide band between floor and ceiling limits. To aid negotiation, ARTC has published indicative pricing for each of its segments to be applied to any user seeking to operate an indicative service under indicative terms and conditions. Indicative services represent the majority of ARTC business. The indicative pricing is published and is accepted by the ACCC. Variations around the indicative price would be based on a range of parameters including the characteristics of the service, as well as logistical and commercial impacts on ARTC. ARTC will not differentiate based on the identity of the applicant, nor where the services to be operated are the same (including terms and conditions) and the services are operated in the same end market. Indicative access prices are market based. ARTC has previously indicated that indicative pricing on each segment could be approved by the ERA and published by track owners in a similar way.
- ARTC has commented on the need for key performance indicator (KPI) reporting. ARTC has provided for regular service quality KPI reporting in its undertaking, and specifically identifies indicators to be reported. In a vertically integrated environment the track owner can discriminate against third parties through the standards it chooses to maintain the network. This will impact the efficient cost of maintaining the network. Required network standards should be

incorporated in the Costing Principles and performance measures put in place to ensure compliance with these standards.

ARTC recognises that in the case of TPI, the traffics are different, and the approach here will be more around cost recovery and cost based pricing. TPI should be required to report KPI's, however KPI's take on lesser importance in this instance as long as traffics are restricted to iron ore. It is assumed that TPI will be maintaining the infrastructure to the required standards for this purpose and this will be sufficient for any operator wishing to transport iron ore.

With respect to relevant sections in TPI's Costing Principles, ARTC provides specific comments on the following sections:

Determination of Capital Costs

In determining the capital charge considered appropriate by TPI, the 5 key elements adopted are:

- Infrastructure included
- Gross Replacement Value
- Economic life of the asset
- Rate of return
- Annuity calculation

Infrastructure Included

TPI's costing principles apply to "…all of the railway infrastructure owned by TPI that is covered by the WA Rail Access regime or is otherwise required to provide access under the TPI Railway and Port Agreement." All other assets which support operating functions are to be included in the operating cost or overhead cost calculations.

It is ARTC's view that TPI, being a vertically integrated entity, should be required to provide detailed information in its Costing Principles in relation to determination of capital costs.

Gross Replacement Values

TPI's approach to determining GRV seems reasonable, however, ARTC is concerned that the valuation is not proposed to be independently assessed. An independently determined or assessed valuation is important to establish market confidence in the limits around access pricing. The ACCC conducted an independent assessment of ARTC proposed DORC value (and floor and ceiling limits) before approving ARTC Access Undertaking (including the pricing principles).

TPI states that in terms of route optimisation, "As a greenfields development, TPI does not consider that any optimisation should occur on its network". ARTC would not expect TPI to over-engineer its assets, and it would not make good commercial sense to do so, however, it would be prudent to have an independent assessment made to ensure that this is not the case. It could be that TPI may have a particular standard of track for its own business which may not be a 'standard' track in relation to other above rail operators.

ARTC recognises that it is the ERA's position to be satisfied that capital costs are determined appropriately and the underlying assumptions and data (for example in relation to unit rate calculations, economic life assumptions, independent reports) are appropriate. ARTC notes that the ERA has in the past sought independent advice in regard to these issues in making determination on floor and ceiling limits. ARTC supports the continued use of independent advice in this regard.

TPI states that "For the purposes of calculating ceiling costs, the value of the assets will be increased by the GRV of each additional investment in covered infrastructure made by TPI." ARTC finds this reasonable as long as any additional infrastructure built is necessary given reasonably anticipated expectations of future volumes on the network and not simply for TPI's purposes. Also, any investment needs to be considered prudent by the ERA.

Economic Life

There should be transparency around the basis for determining asset lives assumed, and the methodology and assumptions used should therefore be clearly outlined by TPI.

Rate of Return

TPI has included "…an allowance for asymmetric risk will be estimated for inclusion as an increment to the WACC. In the event that the ERA does not allow an adjustment to the WACC to account for asymmetric risk, the fair value of the impact of asymmetric risk be included in the operating costs for the purposes of calculating floor and ceiling costs."

If this is to be acceptable to the ERA, ARTC suggests that the method for estimating the allowance for asymmetric risk be transparent and independently assessed. ARTC notes that the method used by IPART in NSW is to select a rate of return towards the upper end to what might be a reasonable rate.

ARTC agrees that where asymmetric risks are real they should be accounted for in the rate of return but on a transparent and independently assessed basis. Alternatively, the value of such risk should be quantified, e.g. insurance, and be an allowable inclusion in operating costs.

Annuity

It is ARTC's view that there needs to be transparency around the approach for the annuity calculation and any methodology should be clearly outlined.

Determination of Operating Costs

TPI advises that it prepares its operating costs based on the efficient cost of maintaining the MEA network. TPI will consider the following factors: the definition of operating costs; "Efficient Cost Test"; and allocation of operating costs.

Efficient Cost Tests

Where actual costs are used, TPI states that a "…robust tendering process will provide the regulator with some comfort that the resulting price reflects an efficient market price." In line with transparency, such a process should be clearly outlined and agreed with the ERA.

It is ARTC's view that TPI should be required to report against agreed efficiency KPI's to the ERA.

Allocation of Operating Costs

ARTC is of the view, consistent with previous submissions, that any cost allocation should be independently assessed. ARTC recognises that it is the ERA's position to be satisfied that operating costs are efficient and allocated appropriately.

Overhead Costs

ARTC suggests that TPI should specify that overhead costs are defined in the Code, and such TPI overhead costs should be specified.

It should also be specified that only those overhead costs attributed to activities related to the Code's definition of railway infrastructure will be included in the Floor and Ceiling Price Tests.

It is ARTC's view that the ERA would need to confirm reasonableness of TPI's position in terms of allocation of overheads and that any cost allocation should be independently assessed. ARTC recognises that it is the ERA's position to be satisfied that overhead costs are efficient and allocated appropriately, and the basis of sharing costs should be in accordance with normally accepted practices for railways, and benchmarked against other rail access providers around the country.

Other Matters

Indexation of Floor and Ceiling

TPI states: "TPI will develop an index to be applied for operating costs that reflects the underlying regional cost drivers. Before developing it, TPI seeks to gain an understanding of the changes in its costs over time. TPI will consult with the ERA before submitting its proposed index to the ERA for its consideration." ARTC's view is that this is a reasonable approach however the process for ERA's approval should be conducted through a public consultation process.

OVERPAYMENT RULES

The Code requires Railway Owners to submit to the ERA a statement of rules that are to apply when breaches of the Ceiling Price Test occur on the part of that railway owner that could not reasonably be avoided. The Overpayment Rules document describes the rules which will apply to TPI and provides a mechanism to:

- calculate the amount by which Total Revenue Earned on a particular route section 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 in the event of an over-payment.

Basis of the Overpayment Rules

Over-payments and under-recoveries

ARTC notes that the Code is silent on how under-recoveries are to be treated in the Over-Payment Rules, and that the Overpayment Rules in Instrument 5 has defined the approach to be adopted by TPI.

These rules determine 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 rules may allow a carryover of a net under-recovery to the next three year period if annual rebates (surplus over 10% in any year) mean that there is insufficient funds in the over-payment account to recoup a significant under-recovery in the three year period.

The ERA has stated in previous determinations 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.

In previous submissions, ARTC has advised that it considers these rules are weighted too heavily in the direction of the interests of operators (and insufficiently addresses the reasonable commercial interests of the track owner). ARTC maintains this view and the 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 bears 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.
- 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 overpayment 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 TPI to renegotiate 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 surrounding 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 retained but upside is constrained, then this should be reconciled with a higher allowed return. Conversely, the operators 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. This view is also held by IPART.

Allocation of Access Revenue

This section should make mention of where TPI has entered into an Access Agreement with an Operator which stipulates a different arrangement for the allocation of access revenue, then that arrangement would prevail.

Allocation of an overpayment

TPI should specify that the proportion of overpayment to be paid to each Operator will be determined by each Operator's annual Access Revenue and Non-Access Revenue above the floor recorded on the Route Section *divided by the aggregate of all operators access and non-access revenue above the floor for the route section* over the preceding 12 month period from July to June.

Overpayment Rules

Clause 3

In ARTC's view the formula for calculation of payments to Operators should be clarified further through some additional notes. For example, does Total Annual Access Revenue include both Regime and non-Regime operators, are only Operators negotiated inside the Code eligible for a share of the overpayment, and what is the case for Operators who have negotiated outside the Regime.

Clause 7

TPI states it will credit interest to the Overpayment account, calculated daily on the balance in the account using a rate equal to the 10 year long term bond rate as at June 30 each year. TPI should make it clear around what happens if June 30 falls on a non-business day.

ARTC also suggests that to ensure clarity as to how the Overpayment rules are to be applied, some illustrative examples be included.

Compliance

ARTC suggests that TPI be required to review the Overpayment Rules every three years after approval, and also make it clear that Access Seekers and Operators can at any time request the ERA to consider amendments.