RATE OF RETURN TO APPLY TO WESTNET RAIL
ARTC SUBMISSION

The Acting WA Independent Rail Access Regulator ("Regulator") has requested submissions from interested parties with regard to a review undertaken by Network Economics Consulting Group ("NECG") for the Regulator of the appropriate regulatory rate of return to apply to WestNet Rail ("WNR") and West Australian Government Railways ("WAGR") required under the Railways (Access) Code 2000 ("Code"). ARTC major interest is in regard to the terms and conditions of access of the freight network in WA, and, in particular, that part of the freight network forming part of the interstate rail network between Kalgoorlie and Perth and the ports of Kwinana and Fremantle. As such, ARTC's submission is limited only to aspects of the review pertaining to WNR.

A key issue for ARTC with respect to the regulatory rate of return to be applied to WNR is that it is applicable to revenue associated with 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 and revenue limits for access by interstate operators, or by access seekers, of services between the eastern states and Western Australia will be determined using the applicable regulatory rate of return. Revenue limits with respect to the network used by these services east of Kalgoorlie will be based on ARTC's regulatory rate of return, accepted the Australian Competition and Consumer Council, as part of ARTC's Access Undertaking in May 2002. A copy of ARTC's Access Undertaking, and the Commission's Final Decision 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 proposed rate of return calculation is to ensure reasonable consistency with any relevant terms 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.

ARTC has previously made submissions[1] to the Regulator in relation to the Costing Principles which detail how the rate of return is to be applied with respect to WNR revenue and pricing limits. ARTC has also made submission[2] to ceiling limit determinations with respect to certain routes in WA undertaken by the Regulator.

On ARTC's network, the level of ARTC's pricing is set so as to enable rail to be competitive with alternative modes of transport (particularly road) and to promote the use of rail for interstate freight movements, so increasing utilization of the network. At current levels of pricing, ARTC is unable to generate sufficient revenue to fully recover the economic cost of its network. It is ARTC's strategy, to grow utilization of the network so as to recover sufficient revenues to sustain the asset in the long term.

On those parts of the interstate network in WA (Kalgoorlie – Perth), the asset achieves a higher level of utilization because of substantial intrastate grain, iron ore, mining related freight and passenger volumes using significant parts of the network, supplementing interstate freight and passenger volumes. Whilst not certain, ARTC would expect that current volumes and reasonable pricing would still be insufficient to generate revenue at or above ceiling limits. Nevertheless, the ceiling revenue limit, and the rate of return, would still be relevant to the determination of a ceiling price applicable to a new access seeker. On the other hand, other major intrastate lines in WA, particularly those serving substantial bauxite and coal markets in the south of the state, may generate sufficient revenue for the regulatory rate of return to have an impact on pricing arrangements for existing users.

During the review of ARTC's Access Undertaking, ARTC provided to the ACCC, an independent assessment of component parameters and WACC for the company[3]. At the time, ARTC considered that the assessment resulted in a

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[1] Westnet Submissions to the Acting Rail Access Regulator, ARTC Submission, 24 Jan 2002, and ARTC Submission to the Draft Determination on WestNet Rail Costing Principles, 31 Jul 2002.
[2] Clause 9 – Floor Ceiling Determinations on Certain Routes, ARTC Submission, 6 Feb 2003.
[3] Equity & Advisory, Assessment of Weighted Average Cost of Capital, January 2001.

WACC that did not fully contemplate all of the commercial circumstances that ARTC was exposed to, relative to other track owners, and was low. The ACCC Final Decision resulted in an approved WACC that was fairly close to that originally provided by ARTC, although there was some variation in the assessment of specific components.

Below is a comparison of the parameters and WACC accepted by the ACCC, as part of ARTC's Access undertaking, and the same as proposed by NECG for WNR. Below are brief explanatory comments with regard to the parameters.

WACC Parameter	ARTC, as accepted by the ACCC (May 2002)	WNR, as proposed by NECG (April 2003)
Inflation rate	2.605%	2.001%
Debt	60%	50%
Equity	40%	50%
Nominal Risk Free Rate	5.90	5.25
Real Risk Free Rate	3.21%	3.19%
Australian Market Risk Premium	6.00	7.00
Asset Beta	0.58	0.45
Debt Beta	0.12	0.00
Equity Beta	1.27	0.90
Effective Tax Rate (debt)	30.00%	30.00%
Effective Tax Rate (Equity)	17.04%	30.00%
Debt Margin	1.20	1.11
Nominal Cost of Debt	7.10	6.48
Nominal post tax cost of debt	4.97	4.54
Franking Credit Utilisation-gamma	50.00%	50.00%
Post Tax Cost of Equity (CAPM)	**13.50%**	11.52%
Post tax equity (post imputation)	11.11%	9.49%
Pre Tax Cost of Equity	14.75%	13.55%
Post Tax Nominal WACC	7.88%	7.01%
Nominal Pre Tax WACC	10.16%	10.02%
Real Pre Tax WACC	7.36%	7.86%
Nominal-Post Tax Vanilla WACC	**9.66%**	9.00%
Real Vanilla WACC	6.87	6.86

There are a number of components that vary largely because of different prevailing market factors compared at the time when the return is determined. These include inflation, risk free rate, and to a lesser extent, tax rate market risk premium, debt margin and franking credit. If the ARTC WACC were adjusted to incorporate the inflation rate and risk free rate used by NECG, then ARTC WACC would reduce to 9.01%.

As such, the combined impact of all assumptions made by NECG in determining parameters, and those made by the ACCC, results in almost identical outcomes. Given this, ARTC is of the view that the proposed WNR WACC may therefore be on the high side, given that ARTC's revenue base relies on a narrower spread of customers and markets, and the predominant ARTC market (intermodal freight) is considered higher risk than many of WNR's markets on the interstate network. This is confirmed by the beta estimates proposed by NECG for each market segment.

The following comparisons are made with respect to the respective methodologies for determining parameter values by NECG and the ACCC.

Parameter	NECG methodology	ACCC methodology	ARTC comment
Inflation rate	Difference between nominal and indexed bond rate. Using Fischer equation.	Difference between nominal and indexed bond rate. Using Fischer equation.	
Gearing	Benchmarked against other rail companies	Benchmarked against other regulated industries	ARTC considers that the rail industry operates in a more competitive environment than that experienced in other industries (eg pipelines, telecoms). As such, higher levels of debt cannot be tolerated. ARTC supports NECG's approach and lower level of gearing.
Nominal Risk Free Rate	10 year bond rate as at day of commencement	5 year bond rate averaged over 40 days prior to day of commencement.	ACCC prefer to use five year rate due to higher inflation risk premium embedded in the 10 year bond rate. Given the annual review of return provided for in the Code, long term inflation risk is ameliorated, so ARTC would consider a shorter term bond rate to that proposed as being appropriate. ARTC considers that averaging yields over a period before date of commencement is reasonable.
Real Risk Free Rate	10 year indexed linked Commonwealth bond rate	5-year-equivalent real bond rate.	See above.
Australian Market Risk Premium	Benchmark approach, forward looking MRP.	Standard used by ACCC for many assessments.	ARTC supports NECG's approach, and the use of a more longer term average, but considers NECG's proposal to be at the higher end of reasonable estimates.
Asset Beta	Weighted average of separate market risks, benchmarked by market and adjusted for local volatility.	Implied by Equity Beta and gearing.	ARTC has no concerns with NECG's approach and would expect WNR's betas to be lower than ARTC's given the different market mix.
Debt Beta	Considers systematic risk of the company's debt. WNR debt return contractually fixed and negligible risk of default assumed.	Not known	ARTC has no issue with NECG approach.
Equity Beta	Monkhouse equation to derive from Asset Beta.	Benchmarked nationally and internationally.	ARTC would expect a lower beta for WNR given the above and ARTC's higher assumed gearing.
Effective Tax Rate (debt)	Corporate Tax Rate	Effective Tax Rate	ARTC supports the use of a simple and transparent approach, and agrees that innovative tax approaches should be rewarded.
Effective Tax Rate (Equity)	Corporate Tax Rate	Effective based on cash flows	As above.

Debt Margin	Benchmarked against other Australian infrastructure companies. Credit rating A assumed. Also includes a debt issuance cost premium of 0.125%.	Benchmarked against other Australian infrastructure companies. No debt issuance cost premium assumed.	ARTC has no issue with the inclusion of a debt issuance cost premium.
Franking Credit Utilisation-gamma	Regulatory norm	Regulatory norm	

Framework Issues

For the sake of regulatory consistency, ARTC supports the use of a nominal post-tax framework, as has been used by the ACCC. The ACCC has stated, in its final decision on ARTC's Access Undertaking, a preference for the estimated impact of taxation on a company's required cash flows to be modeled explicitly in the cash flows themselves rather than expressed as an adjustment to the WACC formula.

ARTC also supports the use of the CAPM framework, as proposed by NECG, for the determination of equity capital costs, again for consistency as well as for simplicity and transparency.