



6 May 2004

Mr Lyndon Rowe
Chairman
Economic Regulation Authority
Level 6, Governor Stirling Tower
197 St Georges Terrace
Perth WA 6000.

Dear Mr Rowe,

ESTIMATION OF CPI-X IN THE WA RAIL INDUSTRY

Thank you for your letter of 29 March seeking stakeholder comments on the paper *Estimation of CPI-X in the WA Rail Industry* by the Institute for Research into International Competitiveness, March 2004.

This response is provided jointly by AWB Ltd and CBH Ltd, grain industry marketers who collectively are the largest customer for the Western Australia rail network.

AWB and CBH commissioned economic consultants ACIL Tasman to review the paper. The consultants note that the present price adjustment appears somewhat arbitrary, and is unsatisfactory in that it puts very little pressure on Westnet Rail to improve its efficiency. At Australia's current inflation rate of 2% p.a., WNR need only improve its costs per unit by 0.5% p.a. to maintain its profits under the regime, and could achieve this merely through volume growth (since many of its costs do not vary with volume) without any efficiency improvement.

However the consultants' advice to AWB and CBH is that we could not have confidence in the outcome of the new approach to price adjustment suggested in the IRIC paper. ACIL Tasman advises that, although the paper is professional and thoughtful, the proposed methodology is untested and has not produced robust results. There are inconsistent results for X for the four lines, inadequate data for the required cost allocations between cost categories and between routes, an assumption that the past is a guide to the future, judgements (to which X may be sensitive) about capacity, and an impractical approach to estimating revenue. The consultants say that total factor

productivity analysis, on which the IRIC paper is based, while theoretically appealing is in practice very sensitive to assumptions and can produce a wide range of answers.

The four lines studied in the IRIC paper are not grain lines and may have rather different cost characteristics compared with grain lines. The consultants tell us that there can be no confidence (for us or even for WNR) about what X would be for individual grain lines emerging from further development of the proposed methodology. There is the potential danger that if X is too low (i.e. prices rise too much) then WNR could extract monopoly rents from us and hence from WA grain farmers; if X is too high there could be inadequate rail infrastructure maintenance as has occurred in Tasmania.

In ACIL Tasman's view the best approach would be the more tested "building block" CPI-X methodology with some input from comparisons with other railways known for their efficiency.

AWB and CBH consider that whatever approach is adopted should be robust and meaningful to those affected, and that grain farmers should not be the "guinea pig" for a novel approach. We note that we had to hire specialist consultants to interpret what was a theoretical paper, and that if the proposed approach was applied the various stakeholders would have to continue hiring specialist help which would not be needed (or not as much) under a better-established approach.

The price adjustment regime chosen by the Regulator should place continuing disciplines and incentives on WNR to reduce its costs, as its natural monopoly shelters it from competitive pressures such as those AWB and CBH face in the international marketplace. A report by specialist consultants Rail Asset Management, recently commissioned by AWB, concluded that WNR construction costs for a selection of grain lines were at least 13 – 14.6% higher than they could have been. We are disturbed by the paper's assertion, with no supporting evidence, that WNR is efficient. It may be more efficient than some East Coast railways, but doubt that it is at "best practice" efficiency after allowance is made for its relatively benign operating conditions.

We hope these comments are helpful, and we are happy to discuss this further at a mutually convenient time.

Yours sincerely

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Co-operative Bulk Handling Limited