



MEMORANDUM OF SUBMISSIONS

PORTMAN IRON ORE LIMITED'S COMMENTS ON WESTNET'S PROPOSED CEILING AND FLOOR PRICES

GENERAL

1. The *Railway (Access) Code 2000* ("**Code**") requires "Ceiling Price" and the "Floor Price" for access to be determined by reference to:
 - (a) capital costs ("**Capital Costs**");
 - (b) operating costs ("**Operating Costs**"); and
 - (c) overheads attributable to the performance of the railway owner's access-related functions ("**Overhead Costs**"),in each 12 month period following the commencement of the proposed access arrangement.

CAPITAL COSTS

2. The Code requires "Capital Costs" to be calculated by applying:
 - (a) the "Gross Replacement Value" ("**GRV**") of the railway infrastructure as the principal;
 - (b) the "Weighted Average Cost of Capital" ("**WACC**") as the interest rate; and
 - (c) the economic life which is consistent with the basis for the Gross Replacement Value of the railway infrastructure.
3. The GRV calculated in the initial determination of costs provided by WestNet Rail Pty Ltd (**WestNet**) under clause 9 of Schedule 4 to the Code ("**WNR Determination**") appears to be set at the *actual* cost of constructing the railway infrastructure (as modern equivalent assets or "MEA") and does not allow for the depreciation that has already occurred in respect of the railway infrastructure during its operation to date. This is critical because if there is no allowance for depreciation on the railway infrastructure to date, then the capital cost must be calculated by allowing depreciation over the entire economic life of the assets determined in accordance with the Costing Principles which were approved by the Independent Rail Access Regulator on 23 December 2003 ("**Costing Principles**"), not on the considerably shorter remaining economic life of the existing railway infrastructure. The entire economic life of a significant portion of the assets comprising the existing railway infrastructure, is the life of the lease period as the maintenance programs and budgets will ensure that these assets are kept in good serviceable condition for that period. Examples are signs, fences, ballast, concrete sleepers and formations. The lease period is the period of 99 years, the term of the lease of railway infrastructure to WestNet by the Government of Western Australia ("**Government Lease**").

Further, the WNR Determination does not identify in its supporting material the actual economic life used in the calculation for each relevant group of assets, other than to say that the calculation is made in accordance with the Costing Principles. In this regard, we submit that WestNet must be required to provide a detailed explanation for the

calculation. This must include an analysis of the relationship between the capital refurbishment program and budget on the one hand and the operating and maintenance program and budget on the other hand, to provide details for each key asset or groups of assets of the point in time at which it is estimated that the costs of operating those assets would actually exceed the total of the annual cost of the capital expenditure to replace or refurbish those assets, plus the consequential lower costs of operating those replacement assets. The analysis would then go on to detail that these assets are replaced or refurbished at that time with the consequent capital expenditure increasing capital costs recoveries, but reducing operating costs recoveries. This analysis and planning is consistent with clause 4 of Schedule 4 of the Code which requires the relevant costs to be calculated as those that would be incurred by a body managing the railways network and adopting "efficient practices".

4. The WNR Determination also fails to detail the level of service to which the railway infrastructure has been assumed to have been constructed as MEA (ie to carry what axle weight at what speed on the standard gauge branch lines, etc.) although this is clearly of relevance to the calculation of the GRV under the calculation in paragraph (4) of the definition of Capital Costs in section 2 of Schedule 4 to the Code. Any discrepancy between the service level that could derive from the Capital Costs which WestNet is allowed, and the actual service provided to operators results in a windfall gain to WestNet. Portman's best estimate from the material provided as to the Capital Costs is that the level of service that should derive from the Capital Costs claimed by WestNet is 23 tonne axle weight at 80 kph for the whole of the routes from Koolyanobbing to Esperance. If the Regulator allows these Capital Costs he must extract a covenant from WestNet that trains will be able to operate at these levels of service over every section of the Koolyanobbing to Esperance route because that is what operators are in fact paying for. To the extent that trains cannot operate at that level of service, the Regulator must allow an appropriate discount until the time when WestNet can provide the level of service that its allowed Capital Costs reflect. In terms of allowed axle weight it is axiomatic that the lowest axle weight for any section of rail on the entire Koolyanobbing to Esperance route (and the allowed discount) must take into account that the axle weight restriction will apply to the whole of the route even if a higher axle weight could be accommodated over certain other sections of the route.
5. The WestNet Costing Principles, approved by the Regulator on 23 December 2002, specify that WestNet is required to maintain the tracks to the operating service levels in accordance with the lease obligations entered into under the Government Lease. As Portman has previously submitted, the Regulator must obtain all relevant documents relating to the sale of the rail freight business and the lease of the rail infrastructure to ascertain the obligations imposed upon WestNet to improve and maintain the rail track, and the commercial arrangements relating to that improvement and maintenance. In particular, the Regulator must assure himself that the purchase price was not based on, and allowed a deduction for, WestNet's future obligations to expend capital to provide an operating service at a level specified in section 12(6) of the *Rail Freight System Act 2000* for the Koolyanobbing to Esperance route. The Regulator cannot approve the floor and ceiling prices for the WestNet railway system until he has fully understood and taken into account these matters, and can explain to operators how these matters have been taken into account in his decision.
6. Capital Costs include the costs of "earthworks", which does not fall within the definition of "railway infrastructure" under the Code. Clause 2(2) of the Code indicates that land of

which railway infrastructure forms part, as well as land on which the railway infrastructure is situated, is not to be included within railway infrastructure. Accordingly, all costs of earthworks must be excluded from the Capital Costs. Portman notes that WestNet assumes that an embankment height of 1.5 m has been allowed by the Regulator. Portman has not been provided with any information concerning this decision. Portman submits that all earthworks both before and after the commencement of the Rail Access Regime must be excluded from the Capital Costs allowed to WestNet.

7. We refer to the approved Costing Principles which state that the annuity is calculated at the beginning of each period as a requirement of the Code, although this is not the appropriate methodology. The Regulator has approved the inclusion in WestNet's operating costs, of a proxy for the working capital required because of the effects of the formula. This charge is calculated by multiplying half of the WACC by the annuity. Portman does not consider the Code does either directly or indirectly require the Capital Costs to be calculated at the beginning of the period. Portman suggests that normal Capital Cost calculation methodologies which operate in arrears can be applied which will accommodate the actual payment cycle for access charges. In this case there will be no need for the inclusion of a proxy for working capital requirement in WestNet's operating costs.
8. WestNet has included a construction and engineering overhead in its calculation which has been set at 20%. Portman considers this overhead to be excessive in light of advice received from its consultants that, based on industry experience for the construction of similar railway infrastructure, an appropriate overhead would be in the range of 6% to 9%.
9. WestNet should be required to demonstrate that the 5% allowance for wastage in track capital is reasonable.
10. Generally, we are unable to verify the content of the WNR Determination because the capital costs model used by WestNet (which is part of the WestNet Costing Model) has not been made available for review by Portman Iron Ore Limited ("**Portman**") and other third parties, even though the regulator has invited public submissions in accordance with clause 9(3) of Schedule 4. For example, WestNet's capital costs model would assist third parties in understanding the following items in the WNR Determination:
 - (a) why concrete sleepers and 60 kg rail are the MEA for the Koolyanobbing - Kalgoorlie route section, yet timber and steel sleepers and 50 kg rail are the MEA for the Kalgoorlie - Esperance route section;
 - (b) why the MEA ballast depth is assumed to be 300 mm for the Koolyanobbing - Kalgoorlie route section (as set out in the report prepared by WestNet's consultants, GHD Pty Ltd ("**GHD**") while the proposed Australian Standard only requires a ballast depth of 250 mm (see the "Draft Code of Practice for the Defined Interstate Rail Network, Vol 4: Track, Civil and Electrical Infrastructure Table 4.7); and
 - (c) why WestNet assumes that 60 kg rail is cheaper than 50 kg rail (as set out in the report prepared by GHD). Having regard to the superior performance and lower maintenance cost associated with the heavier rail, it seems illogical to adopt the light rail as the MEA for the Kalgoorlie - Esperance route section.



11. Concerning transportation costs generally, we also make the following points:
 - (a) the costs for transportation of ballast are about 20% higher than the estimates provided to Portman by its consultants; and
 - (b) the report by GHD assumes that culvert materials are transported to the site by rail. However, Portman is informed by its consultants that rail transport would be unusual in the circumstances and would be more costly than road transport. The cheaper road transport costs should be substituted.
12. It is not indicated at what rates previous quotes for timber sleepers have been escalated.
13. The surcharge of "between 5% and 10%" for track laying in remote sites needs to be substantiated by Westnet. Further, WestNet should be required explain its criteria for identifying particular sites as "remote". In this regard, Portman submits that no part of the WestNet system is "remote".
14. The basis for calculating unit price is not always clear. For example, the signalling unit price estimates provided by GHD does not define units.
15. The basis of turnout pricing is unclear. For example, it is assumed that a 60kg turnout between Avon Yard and West Kalgoorlie has the same price as a 50kg turnout on the Esperance and Leonora branches.

MAINTENANCE AND OPERATING COSTS

16. Operating Costs is defined under section 1 of Schedule 4 to the Code to mean, in relation to the railway infrastructure:
 - (a) train control costs, signalling and communications costs, train scheduling costs, emergency management costs and the cost of information reporting; and
 - (b) the costs of maintenance of railway infrastructure calculated on the basis of cyclical maintenance costs being evenly spread over the maintenance cycle,

being costs that would be incurred if that infrastructure was replaced using MEA.
17. WestNet has based the calculation of "operating costs" on its *actual* costs, or the costs of its contractors, in operating and maintaining the *existing* railway infrastructure. However, WestNet's actual operating costs are irrelevant for the purposes of calculating "operating cost" under the Code. This is because the Code requires "operating costs" to be based upon costs that would be incurred were the railway infrastructure replaced using MEA, not on actual costs of operating and maintaining existing railway infrastructure.
18. Further, it is clear, by virtue of the fact that section 29(2) incorporates the matters set out in the Competition Principles Agreement, that the Code allows the railway owner to recover only the "efficient costs" of operating and maintaining the railway infrastructure on the basis that the railway infrastructure requires only the operation and maintenance levels of MEA. In this regard, WestNet fails to demonstrate that the costs are based on efficient practices.



19. WestNet has also included overheads for services provided by Australia Railroad Group Pty Ltd ("ARG"), WestNet's parent company. Given the relationship between WestNet and ARG, these costs and any other costs provided by ARG or any other affiliated companies, such as, for example, the costs of transporting bulk track materials, should be confirmed independently as "efficient costs".
20. Generally, Operating Costs have been calculated in the WNR Determination using a "track maintenance model" (which is part of the WestNet Costing Model) which has not been available to Portman or other third parties. Accordingly, it is not possible for Portman to test the estimates provided in the WNR Determination without knowledge of the techniques and work volumes adopted by the model for various track maintenance activities. Portman considers that WestNet must make available details of its track maintenance model.
21. We note that the maintenance costs include WestNet's maintenance management costs. This is inappropriate as such costs are neither actual operating and maintenance costs nor overheads. For example WestNet's costs of managing its access contracts is a business cost and not a cost of operating and maintaining the rail network.
22. As stated in paragraph 19 above WestNet has included overheads for services provided by ARG, which should be confirmed independently as "efficient costs". For example, the group overhead of 31% seems to reflect an actual cost and not a cost based on MEA.
23. As mentioned in paragraph 8, the engineering overhead also appears excessive.
24. The costs of complying with regulatory regimes relating to the use of the infrastructure corridor for public and private utilities (eg. telecommunication carriers) and to the grant of public access to that corridor are not costs which are in the nature of the overheads attributable to the performance of the rail owner's access-related functions. These costs would be recoverable from those utilities and should be excluded from the WNR Determination.
25. Generally, we are unable to verify WestNet's overheads because the WestNet Costing Model has not been made available for review by Portman and other third parties. This model must be made available for review by third parties.

OTHER COMMENTS

26. As noted in paragraphs 10, 20 and 25, it is not possible to assess the WNR Determination because the WestNet Costing Model has not been made available for review by third parties. However, it is useful to compare the Ceiling Price calculation in the WNR Determination with other publicly quoted prices for access to railway infrastructure access. In this context, it is noted that:
 - (a) the proposed Ceiling prices for Forrestfield - Kalgoorlie is \$K36 per kilometre of track, while the average revenue for all ARTC track is \$K24 per kilometre (as contained in ARTC's 2002 Annual Report);
 - (b) the maintenance cost per kilometre of track for Forrestfield - Kalgoorlie is \$K 24 and for Kalgoorlie - Esperance is \$K 12 while the average maintenance cost per



kilometre for all ARTC track is \$K 10 (as contained in ARTC's 2002 Annual Report); and

- (c) the Gross Replacement Value for the railway infrastructure for Koolyanobbing - Kalgoorlie is estimated at \$K 1119 per kilometre while the total cost of constructing the Alice Springs -Darwin railway project (which involved the construction of 50 kilogram rail, concrete sleepers, formation, buildings, construction interest, working capital and contingency costs) is, in accordance with the advice received from Portman's consultants, estimated at \$K 915 per kilometre. We understand that, to date, the usual "rule of thumb" estimate of the cost of building new railway infrastructure in benign landscape is between \$K 600 and \$K 700 per kilometre of track.
27. It is submitted that generally WestNet's proposed capital costs and operating costs are significantly too high and must be reduced to levels that are comparable to similar costs in the industry.