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Mr Michael Carter
Executive General Manager
QR Network Pty Ltd
GPO Box 1429
Brisbane QLD 4001

Dear Mr Carter

Approval of QR Network's Revenue Cap Adjustment 2008-09

The Authority has approved QR Network's application to vary its coal network's revenue cap by \$32.9 million in 2010-11 to account for a revenue shortfall in 2008-09.

This decision is consistent with QR Network's revised application, dated 28 October 2009, in that it approves a revenue adjustment amount but not future reference tariffs as provided for in the 2008 undertaking. The Authority has accepted this approach on this occasion as the tariff adjustment will occur at a time beyond the term of the current undertaking and will be considered as part of the Authority's assessment of QR Network's 2009 draft access undertaking.

The Authority's assessment of QR Network's application is summarised in **Attachment 1**.

This letter constitutes a written notice for the purposes of cl. 3.3.8 of Part A of Schedule F of the access undertaking.

Yours sincerely



EJ Hall
Chief Executive

QR Network Revenue Cap Adjustment 2008-09
Summary of QR Network's Application and the Authority's Assessment

Background

QR Network's access undertaking provides for QR Network to seek the Authority's approval to adjust a subsequent year's revenue cap, and associated reference tariffs, to account for under- or over-recovery of approved system allowable revenue.

On 31 August 2009, QR Network sought approval to increase its 2010-11 system allowable revenues, and associated reference tariffs, to recover the revenue shortfall it experienced in 2008-09. At that time, QR Network estimated the revenue cap adjustment on the basis of a \$27.7 million shortfall which assumed that QR Network's proposed Lake Vermont reference tariff (July 2009) was approved.

In accordance with QR Network's access undertaking, the Authority published QR Network's proposal, invited stakeholders to comment and provided QR Network with an opportunity to respond to those comments.

During that time, QR Network amended its Lake Vermont reference tariff application (September 2009) to take account of the actual tonnages railed from the mine and the Authority approved a reference tariff based on those revised tonnages (22 October 2009).

In response to its request, the Authority received submissions from the Queensland Resources Council (QRC), QR National Coal and Xstrata on QR Network's revenue cap proposal by the due date of 2 October 2009.

QR Network's subsequent submission, received on 28 October 2009, responded to stakeholder comments and revised its revenue cap adjustment to take account of the approved Lake Vermont reference tariff, increasing the 2008-09 revenue shortfall to \$28.0 million.

QR Network's Proposal

QR Network's estimated revenue shortfall in 2008-09 of \$28.0 million comprises:

- (a) a \$3.9 million shortfall in relation to non-electric assets – which is comprised of a \$45.8 million shortfall in AT₂₋₄ access charge revenues, offset by \$41.9 million in take-or-pay revenues; and
- (b) a \$24.1 million shortfall in relation to electric assets (AT₅ reference tariff component).

QR Network calculated this shortfall by subtracting its 'actual' revenues (\$438.7 million) from its approved 2008-09 revenues (\$466.6 million). QR Network's 'actual' revenues are based on what QR Network was *entitled* to earn regardless of whether or not it collected this amount, including revenues associated with reference train services, non-reference train services, take-or-pay (ToP) obligations and other revenues which it was required to refund (but did not refund).

QR Network proposed to adjust its 2008-09 revenue shortfall based on its weighted average cost of capital (WACC) to account for the time lag in which the adjustment to reference tariffs occurs. QR Network's estimate of \$4.9 million for this was calculated by applying the WACC to the revenue shortfall over two years and allowing for quarterly compounding over this time.

On this basis, QR Network proposed a total revenue cap adjustment amount in 2010-11 of \$32.9 million for the Authority's approval.

QR Network advised it was not aware of any breaches of an access agreement or negligence by QR Network that would give rise to a deduction from the revenue cap adjustment sought.

Stakeholders' Comments

While the QRC did not raise any specific concerns, it indicated it would rely on the Authority to undertake a complete and considered examination of QR Network's proposal and, to this end, listed matters for the Authority to consider, including ensuring that the ultimate decision on the revenue cap adjustment included calculations based on the approved Lake Vermont reference tariff.

QR Network subsequently revised its revenue cap application to be consistent with the Authority's approval of the Lake Vermont DAAU. Accordingly, this matter is not considered further in this assessment.

QR National Coal and Xstrata raised concerns about QR Network's treatment of take-or-pay revenues and, in particular, the fact the take-or-pay revenues collected from UT1 and UT2 access agreements are treated differently:

the 2008 access undertaking states that where the take-or-pay amounts for 2008AU paths would exceed the system allowable revenue...the take-or-pay is proportionally reduced to the point that QR Network receives no more than the system allowable revenue. We also contend that both UT1 and 2008AU take-or-pay entitlements should be reduced in the same proportion. (QR National Coal sub 2).

As such, QR National Coal requested the Authority to review its submission (including the confidential information provided) and provide a determination on the treatment of UT1 take-or-pay revenues for 2008-09 as well as for the 2009 and subsequent access undertakings.

Assessment Criteria

QR Network's access undertaking states that the Authority *will approve* QR Network's proposed adjustment to its revenue cap and reference tariffs if it is satisfied that the proposal has been calculated in accordance with a three-step process, namely, that:

- (a) QR Network has identified the extent of any under- or over-recovery of its approved revenues;
- (b) if it over-recovers its approved revenues, QR Network can seek to retain some of this revenue, known as the increment, if it can demonstrate that it has achieved productivity improvements that have benefited the whole of the coal supply chain; and
- (c) QR Network has escalated its over- or under-recovery amount to account for the time lag in the adjustment to reference tariffs.

In addition, the Authority can adjust the variation, but only to the extent that it makes a determination to do so, in relation to:

- (a) an increment – for the portion of over-recovery that QR is reasonably entitled to retain for productivity improvements (not exceeding 2% of the approved revenues for that system); and
- (b) 'QR cause' – for revenues which QR Network earned, but which the Authority reasonably determines it was not entitled to due to its own breach of an access agreement or negligence, provided that the breach or negligence resulted in the non-provision of at least 10% of total train services in an access agreement in any given month.

Treatment of UT1 take-or-pay revenues

The Authority has considered the comments from QR National Coal and Xstrata on the treatment of take-or-pay revenues and notes that QR National Coal has requested the Authority to make a determination in relation to the treatment of take-or-pay revenues for calculating the revenue cap adjustment.

QR National Coal's interpretation of the take-or-pay provisions is correct in that the arrangements in the 2001 and 2006 undertakings differ, namely the:

- (a) the 2001 undertaking requires that all take-or-pay revenues be recouped even if there is an over recovery of a system's revenue cap; whereas
- (b) the 2006 and 2008 undertakings provide for take-or-pay revenues to be reduced in the event of an over recovery of a system's revenue cap.

As a result, while there was an overall under-recovery of revenue across the four systems in central Queensland, QR Network over-recovered its revenue on the Blackwater system by around \$6 million because QR Network has sought to recoup all of its take-or-pay obligations from contracts signed with QR National during the term of the 2001 undertaking.

Notwithstanding, the Authority cannot accede to QR National Coal's and Xstrata's request. The provisions of the 2008 undertaking relating to the Authority's assessment and approval of the revenue cap adjustment make it clear that, if QR Network's proposed adjustment has been calculated in accordance with the process set out in the undertaking, then it is mandatory for the Authority to approve it.

On this basis, given that QR Network has calculated its take-or-pay revenues in accordance with the 2001 undertaking's standard access agreements, QR National Coal and Xstrata's request must be rejected.

Accordingly, this matter is not considered further in this assessment.

Assessment of QR Network's Proposal

Given that QR Network experienced an under-recovery of its 2008-09 revenue cap, it did not seek an increment to its revenues for any whole of coal supply chain productivity improvements.

Revenue Cap Adjustment

In reviewing QR Network's proposed revenue cap adjustment, the Authority sought to ensure that QR Network has correctly calculated its revenue shortfall and escalated this appropriately. Also, and as provided for in the undertaking, this review focused on the revenues that QR Network was *entitled* to earn whether or not it actually collected this amount, less any required deductions.

In considering QR Network's application, the Authority independently verified information that QR Network sourced from QR National. The Authority also verified that QR Network had appropriately applied the methodologies in the access undertaking, the relevant standard access agreement or its internal access agreements with QR National. In this regard, the Authority notes that:

- (a) *reference tariff revenues* – were accurately estimated based on:
 - (i) the approved reference tariffs;
 - (ii) actual railings (i.e. tonnages and origin/destination) independently confirmed by a significant sample of the customers (mining companies);
- (b) *non-reference tariff revenues* – were accurately estimated based on:
 - (i) using appropriate reference tariffs of the closest existing relevant cluster;
 - (ii) the approach previously applied and approved by the Authority in terms of allocating revenue between CQCR and non-CQCR systems where necessary;
- (c) *take-or-pay revenues* – were accurately estimated on:

- (i) actual railings and contractual commitments in access agreements; and
 - (ii) the formulae in the 2001 and 2006 access undertaking standard access agreements – noting that, consistent with the earlier agreements, QR Network made no claims for take-or-pay revenue from pre-2001 agreements; and
- (d) *relinquishment and transfer fees* – were confirmed based on:
- (i) consistency with the modelled train paths and the contracted train paths in QR Networks' internal access agreements with QR National; and
 - (ii) QR National's separate advice confirming the information provided by QR Network.

QR cause

The take-or-pay arrangements provide for QR Network to recover revenue from access holders, in this case QR National, where contracted service levels are not met. This arrangement is limited to the extent that QR Network is unable to make rail infrastructure available for the operation of train services in accordance with an access holder's train service entitlement, i.e. QR cause.

The revenue cap mechanism allows QR Network to recover the shortfall in take-or-pay revenues due to QR cause except where the cancellations in train services due to QR cause are more than 10% in any one month and are the result of QR Network's breach of an access agreement or negligence.

A review of QR Network's financial model indicates that in no one month did the number of cancellations due to QR cause exceed the 10% threshold – the highest was 4% for March and June 2009. Moreover, there was no indication by either QR Network or stakeholders that these cancellations were due to breach or negligence on the part of QR Network.

Accordingly, the Authority accepts QR Network's proposal as reasonable and notes that, in line with the undertaking, QR Network will recover the shortfall in take-or-pay revenues through the revenue cap mechanism and no deduction is to be made for QR cause.

Escalation and Final Revenue Cap Adjustment Amount

The Authority reviewed QR Network's claim regarding the escalation component of the revenue shortfall. QR Network's calculations correctly allow for it to earn an annual return on its revenue shortfall over the two-year period of 8.43%, the cost of capital on which the 2008 access undertaking is based.

The Authority accepts QR Network's proposal in relation to this. The amount is included in QR Network's proposed adjustment amount, raising the approved revenue shortfall amount for 2010-11 from \$28.0 million to \$32.9 million.