

QRC

submission

Working together for a shared future

A large, stylized graphic of a leaf or branch, composed of several overlapping, curved lines. The lines are in shades of grey and green, creating a sense of movement and growth. The graphic is positioned on the left side of the page, partially overlapping the text.

Submission in response to QCA's Draft Decision on
QR Network's 2009 Draft Access Undertaking

To the Queensland Competition Authority

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Introduction

QRC provides this submission in response to the QCA's Draft Decision regarding QR Network's voluntary 2009 Draft Access Undertaking (UT3.1).

Industry notes that QR Network has recently provided a *Statement of Regulatory Intent*, which amongst other things, foreshadows QR Network's intention to withdraw UT3.1 and to submit another draft access undertaking (UT3.2) during early March 2010. Given this process, the QRC's focus is now to engage directly with QR Network, taking account of the information provided in the QCA's Draft Decision, in order to ensure that QR Network has the maximum opportunity available to consider the views of QRC members prior to finalising its next draft undertaking to be submitted to the QCA.

QRC considers that the Draft Decision provides a useful starting point for further discussions between QR Network and industry and we appreciate the work which the QCA and its consultants have undertaken in the development of the Draft Decision. However, due to the passage of time (some fifteen months have elapsed since the QRC provided its submission to the QCA on the initial UT3.1), the impending privatisation of an integrated above- and below-rail entity in central Queensland, and mounting concerns regarding the future expansion of the network, QRC's key issues cannot be limited to those raised in the November 2008 submission nor to the issues highlighted solely within the Draft Decision.

This submission therefore provides a brief overview of QRC's views regarding specific elements of the Draft Decision and highlights a number of overarching concerns. QRC has refrained from making detailed arguments in respect of each issue as we consider that direct engagement with QR Network is the most appropriate use of time at this stage. QR Network has indicated a willingness to engage in consultation with stakeholders and this is absolutely critical if QR Network is to achieve its stated objective of having an approved replacement undertaking in place before 30 June 2010. QRC looks forward to a constructive consultation process over the coming weeks. Naturally, to the extent that QRC's views are not reflected in the draft UT3.2 which is to be submitted by QR Network, QRC will make a detailed submission during the QCA's statutory consultation process addressing these matters.

Overarching concerns

Obligation to invest

QRC is concerned that the access undertaking framework provides QR Network with opportunities to withhold investment and to demand above-regulated returns and excessive risk transfer through more frequent resort to direct agreements with customers. These opportunities arise not only under the proposed 'major projects' provisions, but potentially in respect of any investment in the network. QRC members expect that QR Network will seek to further apply such arrangements to the investments planned for the Blackwater and Moura systems which support the Wiggins Island project, regardless of whether these projects satisfy the final definition of Major Projects.

Customers are also concerned about unexplained delays in undertaking routine enhancements of existing mainlines, including projects approved in past customer voting processes. The perception that such delays are a result of QR Network being reluctant to invest at the regulated WACC are reinforced by comments from QR Network management regarding the attractiveness (or otherwise) of investments earning the regulator's approved rate of return. Fundamental disregard for the role of



the regulator and the State Government's access regime heighten industry's concern about the future environment for competition without a direct ownership role by the Government in QR.

The ability of QR Network to demand above-regulated returns and excessive risk transfer arises from material weaknesses in the access undertaking's provisions surrounding QR Network's obligation to invest, in combination with unworkable mechanisms for the timely resolution of these situations. Customers are forced to choose between the cost of excessive project delays and the cost of accepting QR Network's excessive conditions.

QRC will be making representations to Government and to QR Network regarding the importance of addressing these issues in the proposed replacement draft access undertaking and in the regulatory framework more generally. Industry reserves further comments on the issue until the draft UT3.2 is available and QRC has the opportunity to consider the extent to which these critical issues have been addressed by QR Network.

Issues arising from privatisation of QR as an integrated above/below coal rail business

QRC's long-held concerns regarding the vertically-integrated nature of QR's coal rail business are heightened by the forthcoming privatisation process (which includes the monopoly coal network assets in central Queensland).

In light of the State Government's stated approach to the privatisation of QR's central Queensland coal operations, industry has commenced working through the range of regulatory and legislative measures which will be needed to ensure the future of the coal industry is protected from the perverse incentives of an ownership model that provides direct financial incentives to extract monopoly profit from the below-rail supply chain, rather than maximise the efficiency of Queensland's rail-to-port coal network.

It is important to note that genuine separation of QR's above- and below-rail central Queensland operations, combined with a government and/or industry based ownership model (aligned ownership) of the monopoly below-rail network, would directly address a number of industry concerns.

QRC considers that the regulatory environment must:

- Ensure coal infrastructure assets maximise the efficiency of Queensland's rail-to-port coal supply chain and recognise the importance of aligning ownership interests and incentives across the supply chain.
- Maintain the international cost competitiveness of the State's export coal industry to promote the timely development of the State's coal resource – which generates royalties, employment and economic activity to the benefit of all Queenslanders.
- Enhance competition in the above-rail sector.
- Appropriately promote operational (ideally structural) separation of QR's above-rail operations (which are essentially contestable), from influencing the monopoly below-rail business or related supply chain infrastructure.



Industry does not consider that these outcomes will be delivered under the proposed IPO of an integrated above- and below-rail coal business. In the absence of appropriate ownership and structure, industry is reliant on a 'second best' policy response to mitigate the *worst* aspects of the proposed model. Despite these concerns, QRC is committed to working with the QCA and Government to *minimise* the worst aspects of the non-aligned ownership model.

QRC's detailed views in relation to these matters will be provided following industry's assessment of the Government's approach to the overarching competition policy framework to apply to the privatised QR, including amongst other things, the extent to which the revised UT3.2 to be submitted by QR Network practically addresses industry's concerns. Fundamentally, an access regime approach provides a framework to obtain third-party access to the rail network; however the regulatory regime will now need to have a greater focus on credibly addressing the incentives for a non-aligned, vertically integrated monopoly to abuse its monopoly power at the expense of third-party operators and coal industry operations.

Perverse incentives that will need to be addressed include:

- Withholding investment while seeking unreasonable contractual terms and conditions;
- Failing to adequately maintain the network; and
- Hindering, stifling and manipulating the regulatory regime to effectively reduce competition and extract super-monopoly profits.

Industry has reviewed a draft of Asciano's submission regarding these matters and shares their overarching fear that a privatised vertically integrated QR will have strong commercial incentives to discriminate against third-party competitors. QRC believes that the Asciano paper provides an excellent discussion of these matters.

Balance of risk and rewards

QRC supports the Authority's intention to seek "*an appropriate balance between the risks and rewards proposed by QR Network and the rights of QR Network and the users of QR Network's below-rail infrastructure*". This is consistent with QRC's 14 November 2008 submission which noted: "*QRC does not have a particular view as to whether QR Network should be a very low risk business or should accept a higher level of risk: We do however, have a strong view that risks and rewards must be linked, and that if the systematic process of removing risks is allowed to continue, that this must be reflected in the assessment of QR Network's WACC*".

Industry notes that the Draft Decision proposes to accept a number of QR's proposals which would have the effect of reducing QR Network's risk, but that the Authority has "*not accepted QR's proposals to increase its rate of return at the same time as reducing its risk*". QRC supports this approach.

Furthermore, the absence of meaningful incentives to drive behaviour in the below-rail business is a matter which needs to be adequately addressed – in terms of promoting incentives to improve operational performance and promote a culture of transparency and efficiency within QR Network.



Response to specific elements of the Draft Decision

Feedback on specific elements of the Draft Decision is provided in the following sections of this submission. The absence of direct comments by QRC should not be taken to represent acceptance, as, in some cases, this will reflect the time available to assess the range of associated implications. Furthermore, due to the time provided to respond to the Draft Decision, QRC has not yet completed any legal due diligence on the range of proposals and reserves the right to provide further information, arguments and evidence to QR Network and the QCA in subsequent consultation processes.

The way forward – meeting QR’s timetable is secondary to a thorough consultation and assessment process

QRC maintains its support for the QCA’s past practice of providing a Draft Decision for consultation ahead of any Final Decision on a voluntary draft access undertaking – unless there is widespread acceptance from stakeholders to approve the draft UT3.2.

QRC notes that the timely approval of a replacement access undertaking will require a high level of commitment by all participants in this process to address the entire range of issues in a co-operative manner. The level of QR Network engagement with industry in the coming weeks will be critical to facilitate the timely approval of a replacement undertaking. QRC notes that relevant QR Network officers have clearly signalled that the development of UT3.2 will be informed by stakeholder views in the first instance. QRC strongly supports this approach.



QCA Draft Decisions – Supported by QRC

In principle, QRC supports a number of aspects of the QCA's Draft Decision including, but not limited to, the following.

Proposed rejection of reference tariffs for central Queensland and Western coal systems on the basis of the following Draft Decisions.

- Rejection of QR Network's proposed opening asset value of \$3.28 billion for the central Queensland coal network. In particular, QRC supports the QCA's proposed:
 - Inclusion of actual capital expenditure for the 2007-08 period (undertaken by means of a transparent assessment by the QCA) and the inclusion of the approved value for assets associated with the Minerva train service.
 - Inclusion of forecast capital expenditure for the 2008-09 which is subject to an appropriate variation mechanism (unless the QCA's assessment is able to be completed prior to the ultimate approval of the replacement undertaking).
 - Exclusion of capitalised costs associated with the GAPE project feasibility studies from reference tariffs calculations, as these should be included within the forthcoming assessment of the GAPE reference tariff.
- Rejection of QR Network's proposed WACC for the central Queensland coal network. In particular, QRC supports the QCA's Draft Decision:
 - That the rate of return proposed by QR Network was not commensurate with the risks faced by QR Network, therefore:
 - Rejection of QR Network's proposed asset/equity beta ranges.
 - Removal of the QCA's previous regulatory decision to *uplift* QR Network's equity beta from 0.80 to 0.90 (although industry is concerned that the proposed equity beta is too high: see "concerns" section of this paper).
 - To adopt a risk-free rate and debt margin with reference to a 5-year bond for the UT3 regulatory period.
 - Rejecting QR Network's proposed uplift of 0.45% to the cost of equity. QRC contends that the justification appears weak and represents an ambit claim.
 - Rejecting of QR Network's proposal for an effective point estimate of 6.75% for the market risk premium.
 - Rejection of QR Network's claim for a 15.5 basis point margin for higher debt refinancing costs.
 - Rejection of QR Network's claim for an effective gamma of 0.125.
- Rejection of QR Network's proposal to include \$171 million of capital expenditure within the Newlands reference tariff cost build-up which relates to the GAPE project.
- Rejection of QR Network's proposed maintenance and operating costs – on the basis that QR Network should receive efficient costs, developed on a stand-alone coal only basis.
 - QRC notes that the QCA has identified a range of double-counting of activities within multiple regulatory cost items (for example, operating costs and capitalised expenditures) and addressed industry concern surrounding the potential for the QR Group to earn returns beyond the WACC from its regulated QR Network business through application of margins on services.
 - QRC supports the proposed X-factor being applied to maintenance and operating costs.



QRC supports the QCA's proposed rejection of the following other aspects outlined in the Draft Decision.

- Rejection of aspects relating to the scope and intent of the undertaking – in particular, the scope of assets to be covered by the undertaking and the proposed early termination triggers.
- Rejection of proposed ring-fencing provisions which limit transparency and processes to promote compliance. Other grounds for rejection include the QCA proposals to include requirements for joint review of yard control services and the requirement for general purpose financial statements – these are supported by QRC.
- Rejection due to QR Network not submitting standard access agreements for consideration and the requirement for a new form of contract to be developed.
- Rejection of the proposed pricing principles due to the removal of restrictions on establishing access charges for the purpose of hindering or preventing access by a related party of QR and proposals to ensure the rebate associated with access agreements reflect their purpose – that is, mitigate QR Network's exposure to asset stranding risks, given the approved rate of return and other measures that seek to reduce the risk profile of the business.
- QRC supports the proposal that any Access Seeker should have access to a dispute resolution process in regard to capacity allocation for major projects. This process must involve clear timelines so that major projects are not unnecessarily delayed by the resolution of such disputes.
- Rejection of the QR proposal that failure to comply with the queuing mechanism should not be a breach of the undertaking.
- QRC generally supports the QCA's Draft Decisions 4.5 to 4.10, subject to consideration of a number of drafting issues (which we expect will be undertaken in close consultation with industry).
- Rejection of the watering down of the criteria for pre-approving replacement capital expenditure to whether the amount of expenditure was consistent with the age composition of assets in the network.
- QRC supports the inclusion of asset replacement expenditure within the master plan as a means of providing at least some transparency of this aspect of QR Network's overall capital works program.
- QRC considers that there should be a clear obligation for QR Network to demonstrate that any proposed procurement strategy for an individual project will:
 - provide value for money;
 - ensure that all decisions associated with awarding and managing a contract are made with reference to pre-defined assessment criteria; and
 - decisions are recorded so compliance with the strategy can be audited.
- QRC supports the inclusion of provisions in the access undertaking that restrict QR Network establishing access charges for the purpose of preventing or hindering access by a non-QR Ltd party.
- QCA's proposals regarding the development of System Rules and dispute resolution.
- QRC supports QCA's proposals (outlined in Draft Decisions 7.6, 7.7 and 7.8) which seek to clarify that a mine can be an access holder, and clarify that certain rights extend to the mine as Access Holder (and are not limited to operators).
- Requirements that QR Network clearly specifies the proposed arrangements for short term and long term transfers of capacity.



- In principle, QRC supports the proposed amendments to rules for the renewal of expiring Access Rights (Draft Decisions 7.10 and 7.11) – subject to further detailed review of the proposed drafting.
- QRC supports QCA's proposals to clarify the application of relinquishment fees – although QRC will be engaging with QR Network further regarding the detail.
- QCA Draft Decision 7.16 is supported – this is a minor step forward to address industry's major concerns with the ability of QR Network to decline to invest, or to decline to invest on reasonable terms.
- QCA's rejection of reordering of the queue based on the term of access applications (with a term of ten or more years) is supported by QRC.
- QRC supports the QCA's proposed amendments to the definition of Available Capacity.

QCA Draft Decisions – Concerns of the QRC

QRC is concerned about the QCA's Draft Decision approach to the following matters:

- Exclusion of certain system wide assets from the regulatory asset base, based on the sole consideration of ownership by the related parent company (QR Limited).
 - It is not clear how these assets are being treated for pricing purposes. QRC is interested in understanding the methodology and proposed costs included in tariffs which relate to these assets.
 - Industry is concerned that transferring assets out of QR Network could be used as a non-price means of restricting competition or earning above-regulated returns.
- QCA's proposed asset beta of 0.8 is excessive and is not commensurate with QR Network's risk profile.
 - Measures proposed to be accepted by QCA, will further reduce QR's exposure to covariance risk – including the endorsed annual updates to volume forecasts and indexing maintenance costs annually with reference to a special purpose index of maintenance costs (rather than to CPI).
 - QRC agrees with the QCA that there is a strong case for an equity beta lower than 0.80 and the analysis indicating that equity beta of 0.70 would be a conservative estimate. QRC notes the following statement from the Draft Decision:

*“Indeed, the Authority believes that there is a strong argument that the equity beta for QR Network could be lower as it believes that QR Network's risk profile is lower than that of the regulated electricity networks, particularly as a result of the approved risk mitigation measures. In its May 2009 decision, the AER determined an equity beta of 0.80 for the electricity networks despite **robust evidence that the high end of a reasonable range was 0.70. The Authority believes that QR Network's risk profile should sit below these businesses**”.*

Given that these are the Authority's views, QRC will not make further arguments on this point at this time, other than to say that we trust that the Authority will make a final decision which is consistent with the stated views of the Authority.



- Volume forecasts used in the derivation of the proposed tariffs, in particular for the current 2009/10 period and 2010-11, understate expected demand. QRC notes that:
 - The QCA's consultant report on central Queensland volumes was undertaken in October 2008 – there are reasonable grounds for this analysis to be reconsidered.
 - There is already seven months railings data for the current year which, consistent with previous regulatory decisions, should be taken into account when setting tariffs prior to approval of the replacement undertaking. QRC intends to provide further information to the QCA following discussions with QR Network in relation to this matter.
- The proposed approach to accelerated depreciation for new capital expenditure. QRC is interested in discussing this matter in detail with the QCA and QR Network, as this proposal has a material impact on the asset stranding risk profile which should provide a material incentive for QR Network to invest in the future.
- Proposed adoption of QR Network's asset lives for capital expenditure incurred from the commencement of the 2009 regulatory period. Again, this will need to be considered in terms of the overall risk profile determined appropriate for QR Network's operations.
- The Draft Decision does not adequately address maintenance deficits. For example, it is not clear the extent to which maintenance costs relating to ballast clearing represents a maintenance deficit. Users should only pay once and we are concerned that there is scope for shifting cost claims between regulatory periods in order to effectively require users to pay for the same activity in two regulatory periods even though it will ultimately be undertaken only once.
 - QRC considers that there needs to be a clear process to address identified maintenance deficits. This approach would provide greater certainty to industry and QR Network in the event that such a situation arises.
 - In order to address scope variations of major maintenance items, QRC supports a system which formally recognises under/over expenditures (similar to that provided for capital expenditure variations or aspects to revenue-cap adjustments) in order to remove contention surrounding scope of maintenance plans. Reporting of variations in the absence of a mechanism to address inter-regulatory period cost shifting may increase transparency, but would not be efficient.
- Western System tariffs – Industry will be considering this matter in detail and providing views to QR Network and the QCA during subsequent consultation processes. Industry is concerned with:
 - The proposed tariff structure and volume setting approach.
 - Assumptions used in the development of the reference tariffs.
- Risk and Insurance premiums – industry is concerned with increasing allowances for self-insurance without the necessary frameworks being implemented by QR Network.
- In terms of the intent of the undertaking – QRC considers that there may be merit in specifically noting the role of the regulator and having QR acknowledge in the undertaking that the approved rate of return (the QCA approved WACC) is, in the absence of 'special' risks for a particular project, "sufficient to commercially justify QR Network undertaking the Infrastructure Enhancements" under Section 7.3.3 of the Undertaking.
- Standard access agreements reflecting the Draft Decision need to be provided to enable due consideration of how the undertaking is translated into these important agreements. QRC considers that standard access agreements need to be concurrently assessed with the access undertaking, rather than as an output of the consideration of the provisions of the undertaking.



→ Master Planning, coordination and alignment of coal chain capacity – QRC is currently reviewing the recently provided Part 11 *Exposure Draft Co-Ordination and Planning* drafting provided by QR Network. QRC will also be considering how this proposed drafting aligns with Part 10.

→ While the proposed revision to the definition of Major Projects is an improvement on QR Network's proposed definition, QRC still has a number of fundamental concerns with the proposed approach. The definition has two purposes, which are:

- To trigger an alternative capacity allocation process; and
- To trigger a right for QR Network to impose 'access conditions' – most likely to be used to seek monopoly rents (far in excess of regulated returns), combined with strong underwriting.

QRC suggests that the proposed definitions (of both QR Network and the QCA) contain a number of deficiencies and that consideration should be given to establishing separate triggers for each of these purposes. For example, the 'access conditions' trigger should include references to the project having a significantly different risk profile to QR Network's existing assets and should be restricted to new corridors (the latter of these conditions is intended, but not achieved, under the QCA's proposed definition). However, the alternative queuing/capacity allocation rules might reasonably be triggered in a broader range of circumstances, for example, where a number of mainline enhancements are committed as a package in response to a major port expansion. QRC considers that these issues require further consultation with industry.

→ The QCA's proposal to establish 'prescribed factors' for capacity allocation for major projects, with a mechanism for QR Network to seek approval to vary these factors, is supported, however, QRC has concerns regarding the proposed list of factors. For example:

- It is not clear whether the reference to 'the amount of capacity sought' is intended to favour smaller access applications (on the basis of diversifying risk) or larger applications (on the basis of some related efficiencies). QRC does not consider that either smaller or larger applications should be presumed to be preferable.
- Favouring longer term applications will create a competitive disadvantage for single mine coal producers. These producers will be limited to a term equal to their current mine life, while larger producers may offer longer term contract and transfer the access rights within their portfolio over time. QRC considers that it is reasonable for QR Network to specify a minimum term of a length sufficient to address asset stranding risk (and taking into account the full package of risk mitigation mechanisms being proposed for the particular project). A coal producer which offers this term should then not be disadvantaged in the allocation process relative to a producer offering a longer term.

→ The Draft Decision does not provide for meaningful improvements in the transparency of queuing arrangements. The QCA noted that "*if a customer wants this information then they should ensure that they are contracting with a train operator that is willing to pass the relevant information on to them*". This response is valid only if:

- The information which QR Network must provide to the Access Seeker in regard to the queue provides sufficient transparency to the Access Seeker. This is not the case.
- Customers are made aware of Access Applications relating to their mine/loading facility. No mechanism exists to ensure that this is the case. QRC proposed that a rule requiring QR Network to inform the owner of a loading facility of the existence of any Access Application relating to that loading facility would address this issue (as the owner of the loading facility could then lodge a 'Competing Application' and obtain information as an Access Seeker).

→ QRC raised a number of drafting issues in respect of Part 4 which do not appear to have addressed.



- In regard to capacity resumption, the clarification that the test is to apply to a 12 month period is supported, however, QRC considers that further consideration is required in regard to the trigger (particularly taking into account rules which has emerged at the ports over the past year). QRC had proposed an 85% trigger and maintains this view pending further consideration.
- QRC welcomes the proposed improvements regarding capacity transfers but maintains the view that further reform towards more efficient transfer mechanisms are required. We note that the removal of transfer fees in respect of transfers of less than two years duration is supported by all stakeholders, yet will apply only to new access agreements and will therefore have very limited application over the term of UT3. QRC considers that this issue can be addressed through UT3 (rather than through contract amendments) simply by QR undertaking not to collect transfer fees under its Access Agreements in these circumstances (and UT3 should then not deem QR to have collected this revenue).
- QRC is concerned that there are some transparency issues surrounding what happens after the QCA receives QR Network's strategic asset management plan. QRC are interested in how the QCA will be providing greater information surrounding this plan and what methods are available to promote greater transparency around QR Network's asset management plans.
- QRC is concerned that the proposal that costs associated with projects that have been formally discontinued will be considered by the QCA for inclusion within the regulatory asset base without any transparent consultation process or review mechanism. To the extent that certain projects do not proceed, there should be at least some industry consultation surrounding the reasons why projects have been discontinued. While there may be good reasons to include these costs, there may be a need for greater scrutiny of QR Network's claims.
- QRC is concerned that removing fundamental protections provided by the undertaking's pricing principles and providing a process rather than a strict set of guidelines exposes the QCA and industry to unnecessary regulatory risk (as this process could limit the ability of the regulator in making important pricing decisions).