

# QR ACCESS UNDERTAKING REVENUE CAP AMENDMENTS



# PACIFIC NATIONAL SUBMISSION TO QCA

March 2007



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## 1 SUMMARY OF PN'S COMMENTS

Pacific National (**PN**) welcomes the opportunity to provide this submission to the Queensland Competition Authority (**QCA**) regarding the QR Amended Access Undertaking (Undertaking).

It is noted that the change from a price cap to a revenue cap is a substantial amendment to the Undertaking and as such it is unusual (notwithstanding that this was flagged in the QCA's approval of the QR 2006 Undertaking) that such a change would apply "mid-stream" through a regulatory period. It is PN's view that this gives rise to complexity in the proposal that might be avoided if the revenue cap was adopted at the start of the regulatory period.

It is PN's view that the proposed amendments suffer from the following three general issues:

- A failure to accept that each of these coal chains are systems and the focus on precise origin-destination movements is inimical to the system approach.
- Attempting to cater for existing contracts.
- Persistence with the use of long-term forecasts.

These general concerns are reflected in a number of specific issues. PN supports the use of a revenue cap for coal rail infrastructure that is capable of supporting access prices at the maximum regulated revenue, however PN does not support the proposal by QR for the following specific reasons:

- The arrangements perpetuate the current approach that is directed at aligning costs with individual load-points rather than addressing the systems genuinely as systems. This leads to significant in-built inflexibility and complexity that discourages competitors to the incumbent.
- It is unclear that QR will impose the new arrangements on itself – indeed it appears that the proposal expressly seeks to avoid this through the take-or-pay mechanism.
- The proposal is unnecessarily complex, primarily due to retaining a multi-year approach to the cap and price setting whereas a far more robust and simple arrangement could apply if a process for setting these parameters was performed annually as demonstrated in the NSW Hunter Valley coal system;
- Any process that differentiates between access contracts within a particular coal system contravenes the neutrality that must underpin access arrangements – this is particularly so where QR is the only party under one arrangement and any new operator would be under a different arrangement;
- The proposal appears imbalanced eg the volume increment.

## 2 CONSEQUENCES OF SYSTEM VIEW

The Undertaking is built with an underlying premise that there is a body of cost that needs to be recovered from each of the coal systems – this can be seen from the nature of both the existing price cap and the proposed revenue cap, the volume forecasts and various adjustment mechanisms (eg the take-or-pay arrangements). However, the Undertaking attempts to achieve recovery of the cost of the system by reference back to individual hauls rather than seeking to generalise it. This shows up particularly in the complex take-or-pay arrangements.

QR<sup>1</sup> has, throughout the period of open access, adopted a very narrow view of the product it is providing, ie access to the network, with a focus on particular origin-destination movements in the definition of access rights rather than providing access to a particular coal system. While

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<sup>1</sup> This is not a trait restricted to QR – typically access providers are focussed on selling train paths that are very narrow and precise; this makes sense in some circumstances but is unhelpful in others, particularly where flexibility and a system view is required.

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some accommodation is made in the manner in which coal access rights are sold (eg QR offers coal train paths – in broad terms – as a number of paths of a defined cycle time within a specified period), this is still very much based on a particular mine-port operation in circumstances where the industry only approximates this behaviour at the macro level (eg on an annual basis), particularly where a “cargo-assembly” style operation prevails eg at Dalrymple Bay.

PN strongly supports a view that these coal chains are systems. A consequence of the system view is that it is difficult to frame rail access arrangements on a holistic basis while at the same time quarantining costs and capacity to each participant in the chain. This is further exacerbated by the fact that, despite provisions to the contrary, the end-users are not the parties purchasing access – ie to date, it has been train operators and not coal producers that are the access contract holders.

In securing revenues for a particular system it would appear that there are two types of approach available:

- a) Sell capacity to a particular mine (or its train operator) on a fixed cost basis, or
- b) Sell a less precise capacity that allows for some level of ‘socialisation’ of cost within the system.

The use of a combinatorial ceiling is an example of cost socialisation through the allocation of common costs between parties on some basis. This is usually not seen as undesirable by end-customers because it reduces the prices that individuals would otherwise have to pay if they were charged on a stand-alone basis, although at times the way in which common costs are distributed is a cause for debate.

For the purpose of this point, the socialised cost at issue is the risk portion of that cost, ie the amount that system users will need to contribute if one or more of them fails to perform (or conversely the discount each party receives if some parties outperform their commitments). Under a fixed allocation, the cost is fixed *ex ante* and it is necessary to have individual ‘take-or-pay’ arrangements, but these must then necessarily be referenced back to the system revenues as a whole to avoid breaching the revenue cap. Under the socialisation model, prices are adjusted *ex post* and it is still necessary to have some form of ‘take-or-pay’ but this is determined globally and distributed between the parties on some basis. Because of the averaging that takes place across the performance of the system as a whole, one would expect that the outcome will be more muted from an individual participant’s perspective (ie each individual has diversified its risk to that of the system), though necessarily it means that the ability of the individual to affect the result is also dampened – one is captive to the performance of the system, but if it is accepted that, for better or worse, the individual is participating in a system, then that is both the price and benefit of participation.

Access charging in the Hunter Valley coal system in NSW has been operated on a revenue cap basis for a number of years. While not perfect, that system has operated very well and is, compared to the QR proposal relatively simple and uncontroversial. The PN experience from the Hunter Valley, is that, while the socialisation of costs is often thought of as undesirable, it has not resulted in any genuinely unfair outcomes. Accepting that, in some instances, the movement of the cost (or benefit) burden onto other end-users will occur, allows the adoption of a charging approach that is simpler and more flexible, to the benefit of all parties.<sup>2</sup>

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<sup>2</sup> The chief objections to this view must stem from a belief that the individual can successfully compete against others for, in this case, rail access outcomes, or that one is able to better manage rail access performance such that one is able to better access any overall reduction in access cost eg by quarantining take or pay obligations. However, such a view sees the rail system, not as a of the coal chain, but as an independent and separable component of activity which can be manipulated to advantage without impacting on system efficiency – PN believes that such a view is likely to lead to inefficient outcomes compared to a true systems view.

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### 3 CATERING FOR EXISTING CONTRACTS

If one accepts that access charging for each coal system is to cater for the system as a whole, then it is almost inevitable that uniform rules need to apply to all participants. If this is not so, then one of the key pillars of the rail access arrangements in Queensland will be undermined. That pillar is that access arrangements will not, of themselves, be a point of competition between service providers, or, put another way, that all access seekers can gain access to the track on the same basis.

If different access contracts made under different regulatory arrangements are allowed to co-exist, except by chance, different outcomes will result. It is clear from the QR proposal and also the comments on the Queensland Resources Council (**QRC**) position that both parties are, either by default or through specific choice, wedded to the proposition that existing access arrangements should be retained, at least in part. It appears to PN that it is inevitable that this will place a new access seeker in a position of disadvantage if it negotiates to take on existing volumes that are currently assigned to an operator that negotiated its position under the previous arrangements.

As the only party hauling coal on rail in Queensland at the moment is QR, it is worth noting that QR has an internal<sup>3</sup> access contract extending to 2020.<sup>4</sup> If access arrangements for the incumbent are “frozen” for that period it begs the question as to how the current and future access undertakings are supposed to operate effectively when a substantial part of the traffic is effectively locked in under different arrangements. PN is not aware where this has ever been discussed by the QCA and believes that it represents a significant obstacle to competition if it leads to a divergence of treatment between traffic under one operator compared to another.

It is unclear that the proposed changes from a price cap to a revenue cap would be applied to QR's existing internal access contract. If QR is volunteering to adopt the necessary changes, this would be laudable, but PN was not able from QR's submission to clearly identify such a commitment. It is almost as though all parties have assumed that all will naturally flow once the new arrangement is approved however, it would be useful for the QCA to confirm in its final decision that this assumption is correct. Obviously if QR was not intending to adopt the revenue cap arrangements in their entirety, this should call into question the whole point of the exercise given that it is the only party operating coal trains at the moment.

It is noted that some members of the QRC are concerned that their contracts with QR were crafted under circumstances where QR took volume risk and that QR should not be reward with a reduction in risk without a reopening of the relevant commercial arrangements. If QR is willing to adopt the proposed changes, one would question why it would not be willing to renegotiate its customer contracts to the extent that a material change in access regulation imposed different costs or benefits on the various parties.

Notwithstanding the foregoing, it is noted that much of the discussion regarding the QR proposal has focussed on how to deal with the take-or-pay arrangements that result from very sort of divergence of access contracts noted above. Ultimately PN believes that, to be successful (let alone understandable) access contracts for traffics at the ceiling in such a situation need to have one of two characteristics;

- access contracts should not extend beyond the regulatory period, or
- access contracts should be crafted to automatically adjust to any changes in the regulations.

Of the two, PN would prefer the latter. Going forward, if parties understand that this is the position, commercial arrangements between train operators and coal producers can be negotiated accordingly – this would only cause hardship if imposed on existing contracts where

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<sup>3</sup> As it is an agreement within a single entity, this is not a legally enforceable contract.

<sup>4</sup> QR Coal & Freight Access Agreement [www.qca.org.au/rail/2006auammend/coalaa.php](http://www.qca.org.au/rail/2006auammend/coalaa.php).

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a party was not able to negotiate appropriate changes. While such problems should not be ignored, PN's preference would be that specific transitional arrangements were provided rather than effectively dismantling the regulatory arrangements due to divergence over time.

#### **4 USE OF LONG-TERM FORECASTS**

Many of the concerns raised, and much of the complexity of the proposal, stem from QR's persistence with using long term forecasts for the determination of volumes, prices and the revenue cap.

As PN has noted a number of times in various submissions to the QCA the problems that arise through the use of long term forecasts as a basis for price determination and under a revenue cap this approach has even less merit. The living example of the Hunter Valley coal system demonstrates that an annual calculation of prices to deliver a revenue cap is not only perfectly workable, it can be achieved with substantially less debate and complexity than has already arisen under the QR proposal.

The adoption of an annual review of volumes, prices and revenue cap simplifies both the scope of the task and reduces uncertainty. All participants in a coal chain will have a substantially higher level of confidence in their forecasts over a period of one year compared to the 5 years required for the Undertaking. The potential for gaming is reduced due to a wider range of measures being available over the shorter time-span eg mine capacity, production plans, port forecasts and other industry knowledge all serve to place boundaries around volume forecasts and the more immediate and shorter time-scale reduces the need to safe-guard future options (eg will Mine X start production in 2 years or 2½ years?).

It is recognised that the QCA is not in a position to dictate to QR how it chooses to frame a voluntary undertaking, but PN believes the continued multi-year approach introduces substantial unnecessary complexity in an environment that is already replete with difficulty and thus serious consideration should be given to adopting an annual pricing and revenue cap process.

In passing it is noted that this does not mean that other parameters eg asset values and the rate of return need to be recalculated annually. It is quite appropriate to retain longer term processes for these values (eg the current annual CPI based adjustment to asset base values with revaluation at the start of the regulatory period).

#### **5 SUPPORT FOR REVENUE CAP**

PN supports the use of a revenue cap in place of a pricing cap provided that it is appropriately implemented. A price cap, coupled with the multi-year period over which it was determined is inevitably contentious as has been demonstrated with the first two groups of QR Undertakings<sup>5</sup> and a revenue cap appears better suited to the circumstances of a rail infrastructure provider where revenues are likely to achieve the ceiling.

Experience in the Hunter Valley and in Queensland suggests that factors other than direct profitability drive decisions regarding infrastructure performance. It is therefore PN's view that a lack of incentive does not detract from the adoption of a revenue cap in these circumstances.

As noted above, the adoption of a revenue cap based on an annual resetting of the parameters has real potential to remove much of the difficulty in price setting. This is not to say that there are no disagreements regarding the outcomes. However the scope of disagreement must be significantly lower due to the reduction in scale of the parameters (ie one year's worth of data)

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<sup>5</sup> Because of that very level of contention that such an approach raises, in both its first and second Undertakings, QR was required to submit more than one Undertaking in order to achieve approval, after extensive and extended processes.

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and the higher level of confidence that comes with it. There may still be argument about whether the costs for maintenance of a particular system are efficient etc. but the scale of such disagreement is likely to be commensurately less, and, if reasonable processes are put in place, even these problems can be much reduced.

## **6 BREADTH OF CAP**

PN agrees that the logical approach is that the revenue cap applies to the 'fixed' components of the access price ie  $AT_2 - AT_5$ . It would be inappropriate to set a revenue limit on the variable component.

For comparison, this is commensurate with the approach adopted in the Hunter Valley – although the mechanism is somewhat different, the concept is the same.

With regard to  $AT_5$ , the electricity infrastructure price component, PN supports the comments made by the QRC that there does not appear to be any compelling logic from a conceptual perspective that this should be managed jointly across the Blackwater and Goonyella systems, rather than on a separate system basis, as is contemplated for the other components. It is noted that QR has raised the issue that it wears a higher stranding risk on the Blackwater system because it is partly diesel and partly electric under current operations. However, this is potentially a self-fulfilling argument; QRNational makes its own decisions on how to deploy its electric and diesel locomotive fleets – there is nothing inherently special about the Goonyella system that makes it an "all electric" system, and so whether or not the assets are stranded is more to do with QR's internal deployment decisions rather than the impact of any external factors.

Reinforcing this point, for various reasons, it is unlikely that any new operator would be capable of fielding a substantial fleet of electric locomotives in Queensland,<sup>6</sup> not to mention the technical difficulties of actually purchasing electricity through the QR electric infrastructure,<sup>7</sup> so any new entrant will almost certainly be using diesel locomotives. Thus the issue of the electric infrastructure is very much one that is, and will remain, a matter for QR. Therefore for QR to suggest it faces stranding risk is surely a matter that it is well placed to resolve to its own satisfaction.

On a related matter, QR notes in its submission at page 8, that the variable component of revenue  $AT_1$  which is attributed on a gross tonne kilometre basis is not directly variable with usage. This is a curious comment given that the intent of the  $AT_1$  component was to reflect directly variable costs and bears further explanation. We look forward with interest to seeing QR's further thoughts on this matter when the next Undertaking is considered. However, it somewhat undermines QR's reasons for wholly excluding  $AT_1$  from the revenue cap if there is a fixed component of cost contained within it.

## **7 VOLUME FORECASTS**

PN's position with regard to the dysfunction occasioned by multi-year forecasts and the benefits of an annual volume forecast are discussed above.

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<sup>6</sup> There are very limited opportunities to acquire existing electric locomotives suitable for use on the QR narrow gauge track with its 25KVA power system. The existing designs for electric locomotives in operation on the QR network are owned by QR and not generally available to manufacturers to construct new locomotives for other parties. The cost of a new design would be prohibitive unless a large fleet was being purchased which is unlikely to be the case at least at start-up for a new operator. Thus PN's view is that electric traction is not a practical solution in the short to medium term.

<sup>7</sup> PN is of the view that there are intractable difficulties in sourcing power from an electricity supplier through the QR infrastructure, and QR has previously indicated it believes it is not legally able to on-sell electricity to a third party, thus it is far from clear that a third party operator would be able to actually use the electric infrastructure.

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Notwithstanding our view on multi-year forecasts, PN also supports the QRC's view that there is no obvious logic to QR's proposal to re-profile the volume forecasts for the remainder of the regulatory period.

The first two years are revised downwards and the final year is increased. The QR proposal looks to be a manufactured result designed to achieve the same end result but through avoiding imposing a take-or-pay component early in the life of the revenue cap. PN is not privy to the forecast data on which these numbers are based and so is not in a position to comment on whether the bounteous final year is founded on sound predictions, but the impact of shifting the burden on to that final year will be to magnify any take-or-pay amounts that would arise if the forecast is in fact ill-founded. Therefore QR's suggestion that this mitigates the movement of volume risk from QR to coal producers does not appear to follow.

## **8 TAKE-OR-PAY**

It is noted that QR appears to be very concerned that there would be opportunities to "game the system" through various means eg by ambitious volume forecasts, and the take-or-pay arrangements are constructed to avoid the possibility of such games being played. Although this is mentioned at various places in the submission, QR doesn't provide any meaningful examples of how such gaming would occur, or if it occurs, how it would be effective. Without such examples, PN finds it difficult to understand the impact of the concern.

Much of the complexity arises due to the fact that the proposal is seeking to significantly change regulation "mid-stream" through the regulatory period leading to an attempt to protect existing contractual positions. This has been discussed above in more general terms, but it is unclear that the solution necessarily adds significant value under the circumstances and PN questions the wisdom of this course. In this regard, the attempt at re-profiling by QR appears to have the effect of neutralising the whole take-or-pay issue until the final year anyway so one must question why one would undergo the added difficulty rather than await the next regulatory period.

PN's concern about the effects of having different contracts arising under different regulatory periods has been noted above. The take-or-pay proposal shows the difficulty that arises from this issue. QR proposes that the take-or-pay provisions for each system will vary dependant on whether the contract was under the previous Undertaking (UT<sub>1</sub>) or the new Undertaking (UT<sub>2</sub>). This places a potential competitor in the position that it is necessarily subject to different access arrangements compared to the incumbent, and therefore is not something that PN could support. From PN's perspective this runs contrary to the fundamental precept that QR will not treat its internal train operators differently from external parties. To answer this proposition by saying that it is not QR that is treated differently but UT<sub>1</sub> access contract holders is not a valid answer as QR is the only relevant holder of a UT<sub>1</sub> contract.<sup>8</sup>

To some extent, the whole question as to the impact on existing access contract holders appears misconstrued. This proposal is about changes that would apply to access contracts. It does not necessarily reflect the arrangements between the access contract holder and the coal producer customer. It is the access contract holder that pays the access charge. The arrangements with end customers may, or may not pass through changes in access charges or the consequence of changes to the regulations.

If the arrangements between the access holder and its customers are materially affected then PN would recognise that party's concerns, but that is a matter between the access holder and the coal producer. Presumably when QR entered into its arrangements with the producer, the matter of access was taken into account and the risk of both access price and any change in regulation would have been assigned to one party or the other through their mutual consent. If the assumption of that risk results in an unexpected outcome, presumably that is a matter for

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<sup>8</sup> PN holds a UT<sub>1</sub> contract for non-coal services to which this issue does not apply.

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the parties to remedy. This does not give rise to the imposition of convoluted regulatory arrangements in the regulation of access that, as far as PN can discern, do not actually achieve the intended outcome. It would be particularly helpful for the QCA to explain its view as to how the interaction between the various parties is to be reflected through access regulation. This take-or-pay issue is a specific example of a wider concern of PN's that the Undertaking is more and more taking on the appearance of a "meta-contract" between QR and coal producers rather than being genuinely concerned with the provision of rail access to third parties. This serves to skew the whole basis of the regulatory instrument and detracts from facilitating competition in the process.

A further concern is the way in which the proposal has been put forward. It is recognised that the QRC and QR have been in discussion over some period regarding this matter and that those parties are clear in their minds as to the meaning of the proposal. For PN, who has not been directly involved in those discussions, the precise meaning and intended operation is far from clear from the drafting. PN would have taken a great deal more comfort had an indicative example been provided to show the effect of the proposal compared to the existing take-or-pay provisions. As it stands, the effects appear obscure and are highly dependent on the effect of existing (UT<sub>1</sub>) contracts. It is assumed that the QCA has in fact satisfied itself as to the true meaning of the proposal and its effects and it would be of significant assistance to PN to see worked examples of the operation of the take-or-pay mechanism in the QCA's decision. Not only would that provide clarity to stakeholders but would also assist in any future interpretation required under resolution of a dispute.

On a closely related matter, PN has often raised its concerns with the obscurity of the invoicing arrangements contained in the Undertaking Standard Access Agreement (see SAA Schedule 3 Part 5). It would be highly instructive for the QCA to demonstrate the operation of the suite of formulae contained in that document, bearing in mind that this is supposed to determine how the contract holder's access invoice is to be calculated. The addition of a number of new terms to accommodate the new arrangements makes this process even more inscrutable.

## **9 RELINQUISHMENT FEES**

The question of relinquishment fees is closely related to the issues raised earlier regarding the trade-off between flexibility and "sheeting home" risk regarding capacity. Relinquishment fees are an appropriate response to a regime based on individual responsibility for system costs. Naturally this comes at a cost of inflexibility and the various arrangements that the Undertaking provides to mitigate the fees where capacity is on-sold.

PN's view is that, if these coal systems really are systems, then it is highly desirable that they be treated as such, and this includes socialising the costs between system users. The Hunter Valley access arrangements do precisely this. The Hunter Valley access arrangements:

- Have no individual take-or-pay requirements – but there are "system-wide" arrangements that adjust all prices based on the ceiling.
- Have no relinquishment fees or long term access charge obligations.
- Have no differential pricing based on variation from a reference train that happens to inherently advantage the incumbent.
- Provide substantial flexibility – an operator, once it has an access agreement, can go to any load or discharge point in the system without seeking further "access rights".
- Has no "path trading" – this is not necessary given the flexibility in pathing.

This demonstrates that a substantial amount of what applies in the Queensland coal fields is the result of a particular view about the commercial aspects of access rather than being driven by any compelling underlying reasons. Both PN's experience and its understanding of the operation of systems lead to the view that simplicity in access arrangements enhance the potential for actual competition and that inflexibility and complexity discourage it. The Hunter

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Valley demonstrates this – in the Hunter Valley there is competition for coal hauls, in the Queensland coal systems there is not.

It is noted that the QRC appears to favour the retention of relinquishment fees. PN believes that this is likely to impact on the ability of operators to enter and thrive in the market in the face of a substantial incumbent competitor and producers would need to underwrite those inflexibilities in order to encourage competition.

## **10 REVIEW EVENT**

The concept of a review event to reopen the revenue cap is intriguing given QR's insistence on using multi-year periods to determine prices. It has the element of "having it both ways". It also begs the question – why not strip away all of the dysfunction of multi-year forecasts and move directly to an annual price and revenue cap determination?

## **11 VOLUME INCREMENT**

PN's understanding is that QR is seeking the QCA to approve for QR to retain effectively up to 2% of revenue above the cap as an incentive to maximise railings.

Notwithstanding the eloquence of QR's submission it would appear that the intention is that the "revenue cap" is in fact a "revenue cap + up to 2%" and not a true revenue cap at all. This seems to be a hybrid of price and revenue cap with the down-side fully under-written through the take-or-pay provisions. It would be appropriate for QR, which admits it is attempting to move risk onto access contract holders, to provide a more robust argument as to why it should be granted what is in effect a substantial increase in the rate of return than QR would otherwise be permitted to earn.

QR's argument that this will provide incentive to perform is not compelling. We have noted earlier the view that a price cap is not particularly suitable to drive the behaviour of a publicly owned rail infrastructure owner towards maximising revenue and PN would regard the volume increment in the same light.