

**QR ACCESS UNDERTAKING
REFERENCE TARRIF
AMENDMENTS**



**PACIFIC NATIONAL
SUBMISSION TO QCA**

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1 EXECUTIVE SUMMARY

The proposed amendment to UT2.0 poses particular problems in that it requires the QCA to form a view about a number of matters that were subject to previous rigorous investigation, only a relatively short time ago. A problem that Pacific National recognised as working through the proposed amendment is the difficulty in comparing decisions taken in June 2006 that were intended to apply for 4 years (plus one year retrospectively) with the current situation where circumstances may have moved on (eg the adoption of a revenue cap). There are clearly significant lessons for the forthcoming UT3 and Pacific National again points to the problems that arise through the adoption of a long term approach to pricing where the intention is to adopt a revenue capping approach.

In summary:

- Pacific National's view is that some elements of QR's claim appear to be justified.
- It is suggested that the basis of the QCA's approach should remain founded in the efficient cost criterion.
- To the extent that the efficient costs to perform the task have moved beyond the range anticipated by the QCA in its decision on UT2.0, then QR ought to be compensated for these changes.
- In determining the scope of efficient costs, Pacific National supports a broad rather than narrow view that includes consideration of the circumstances in which the costs are expended. Thus where QR has incurred additional costs in order to meet genuine customer demand, it ought to be compensated for this. Similarly if the input components of efficient costs have moved out of step with previous estimates, QR has a legitimate claim.
- It would be appropriate for the QCA to consider any gains that QR has previously received beyond the intended rate of return for UT1 when assessing the variations prices in UT2. Similarly if returns were earned above the economically efficient level during the first part of UT2, these should be taken into account.
- It is understood why QR has adopted a particular methodology for its submission that is somewhat indirect. Care needs to be taken to avoid drawing incorrect conclusions from the application of generalised factors to aggregate figures. However, Pacific National accepts that it would be inappropriate to engage in a full re-evaluation of efficient costs at this stage in the life of UT2.
- Pacific National is particularly concerned that a major systematic accounting error appears to have gone unnoticed for a number of years. In particular this calls into question the utility of the Costing Manual. Pacific National has long considered this document to be of little value and it is suggested that it has out-lived any usefulness that it might initially have had.

2 INTRODUCTION

This submission responds to the proposed amendment to QR's Access Undertaking to increase the reference tariffs to apply to central Queensland coal haulage services.

2.1 TERMINOLOGY

This submission uses the following abbreviations:

ARTC	Australian Rail Track Corporation
CPI	Consumer price index
QCA	Queensland Competition Authority

UT1	The QR Access Undertaking, in its various versions, in force between 2002 and 2006 (retrospectively terminated 20 June 2005)
UT2	The QR Access Undertaking, in its various versions, in force between July 2005 and June 2009 (approved 30 June 2006)
UT2.-1	The version of UT2 disapproved by the QCA December 2005
UT2.0	The version of UT2 approved by the QCA 30 June 2006
UT2.1	UT2 as proposed for amendment to change to a revenue cap
UT2.2	UT2 as proposed for amendment to incorporate changes to relinquishment fees
UT2.3	UT2 as proposed for amendment to incorporate changes to the reference tariffs (ie the proposed amendment which is the subject of this submission)
UT3	The QR Access Undertaking to expected to apply from July 2009

3 CONTEXT FOR QR AMENDMENT

QR is seeking to modify a component of UT2.0 that was intended, but for two defined events, to be definitive during the term of UT2. UT2.0 was submitted to the QCA for approval less than 12 months ago on 9 June 2006.¹

The QCA Decision indicates that QR modified its maintenance costs to match an adjustment to the volume forecast at the time it submitted the final draft of UT2.0.² It would be expected that QR would also at that time have been aware of at least a substantial element of the problems besetting their estimate of maintenance costs (to the extent that this impacted on efficient costs). At the very least, QR would have had the benefit of at least 9 months of the 2005/06 financial year results to understand that they were incurring costs approximately 38% above budget and some indication that this was not a temporary anomaly. It is acknowledged that QR is not able to affect world fuel prices, and that management strategies such as hedging are only a temporary measure against a fundamental shift in prices. However, it was certainly in QR's control to put forward prices at the time of UT2.0 that reflected existing conditions at that time.

Similarly, one would have expected QR to have substantially progressed its budget for the 2006/07 financial year by the time the final draft of UT2.0 was submitted to the QCA. It would be most unusual for an organisation of the size and competence of QR to have engaged in an annual budgetary process without having due regard to current levels of expenditure (at that time) for all substantial activities. Thus again it would seem curious that QR's infrastructure maintenance managers had been unaware at that time of the expected level of activities and associated costs planned for the 2006/07 financial year. QR's submission indicates that by that time the modified maintenance practices were in place and the unit costs were well above the consumer price index (CPI) allowance and therefore the increased costs ought to have been apparent.

It is difficult to conclude otherwise than that there has been a major failure of management process in submitting (or resubmitting) the reference tariffs in June 2006 to the QCA for approval when information must have been available that at least partly forms the basis for QR's proposed amendment. Under the current form of the undertaking that QR has chosen to adopt, June 2006 was the time at which such issues ought to have been considered.

Pacific National has made the point time and again that the form of access undertaking adopted by QR leads inevitably to excessive complexity and difficulty by attempting to forecast values for a number parameters over multiple years. This claim by QR is yet another example of the

¹ Queensland Competition Authority, Final Approval, QR's 2006 Draft Access Undertaking, June 2006, p ii

² *ibid* p 5

problems that this approach causes. While this is not the forum for fundamentally changing UT2, Pacific National suggests that this example be heeded when considering UT3 along with the benefits of adopting an annual appraisal of access charges under a revenue cap form of price regulation. Had that approach been adopted, any misalignment of prices to costs would have been adjusted after 12 months thereby quarantining the issue to a single year (unless an undetected systematic error was imported into the process).³

QR's presentation to stakeholders on UT2.3 suggested that QR might have to reconsider its maintenance program if it is substantially denied the increase in access charges that it is seeking. If this is intended to intimidate stakeholders, then this would reflect very poorly on QR, particularly as the causes of the problem were issues that were under the management of QR. However, it is clearly in the interests of service users, coal producers and the general public that QR provide sufficient rail infrastructure to meet demand for coal exports and it is not in anyone's interest to have supply needlessly constrained due to a negative reaction to a regulatory outcome whether to meet genuine budgetary constraints or otherwise.

Pacific National's understanding of UT2.0 (ie the version prior to any decision by the QCA to approve the recent proposed amendments for UT2.1 and UT2.2) is that the reference tariffs may be altered due to an "Endorsed Variation Event" or a "Review Event" occurring. PN is not aware of either of these circumstances coming to pass. QR's submission indicates that it is relying on the *Queensland Competition Authority Act 1997* s 142(1) as the basis for submitting a draft amending access undertaking. This is a general provision that allows for an amending undertaking to be submitted to the QCA for approval and is to be considered in accordance with the normal "interests" related criteria contained in s 138(2) of that Act. Pacific National suggests that it is appropriate for the QCA, in forming a view regarding the interests of the various parties to take into consideration the facts that:

- the current approved undertaking (whether that be UT2.0, UT2.1 or UT2.2 at the time of the decision for UT2.3) does not contemplate a change in reference tariffs on the basis for which QR is claiming,
- it was QR itself that submitted UT2.0 as a voluntary undertaking,
- regardless of the merits of QR's arguments for an increase, many of the issues were known, or should have been known, to QR at the time of submitting UT2.0,
- it is in the interests of service users and the general public that QR continues to provide sufficient rail infrastructure capacity to meet the demands of coal exporters, and
- while it is clearly in the interests of QR to secure higher prices, it is in the interests of service users and the public at large (including in relation to having competition) that the undertaking approved by the QCA remains stable over the period it is intended to operate.

4 SUMMARY OF QR CASE

While not wishing to over-simplify the complex issues that underlie QR's submission, it is useful to paraphrase the grounds on which QR has based its case:

- 1) QR has been subject to rising input costs, substantially greater than were allowed for in the UT2.0 approval, that were not readily predictable.
- 2) Although increased network activity of a similar magnitude was forecast, the impact on maintenance costs was not appreciated at the time leading to an under-estimate.
- 3) QR has changed its maintenance practices to provide additional train capacity on the network, leading to increased costs.

³ It is also likely that even the effects of a single year's miscalculation would be recoverable through the unders/overs mechanism, provided the under recovery was within the efficient cost paradigm.

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- 4) The UT2 cost estimates were based on erroneous data from QR's accounting system that systematically under-reported infrastructure maintenance costs.
 - 5) The UT2 estimates were based on targeted efficiency gains that are no longer expected to be realised.

The following sections examine each of these grounds in turn.

5 INPUT UNIT COSTS

UT2.0 allows for escalation of reference tariffs by Consumer Price Index (CPI) on a quarterly basis. It is widely accepted that CPI is a broad descriptor of the movement of prices within the community and that it does not necessarily closely reflect the annual movements in prices for an individual sector such as rail infrastructure. Nevertheless, it is also generally accepted that the changes in costs to that sector, over the longer term, are sufficiently reflected by movements in the CPI such that the use of that index is still a reasonably valid proxy for the changes in input costs. The CPI has substantial advantages over purpose built indexes in that it is:

- a) Independently calculated by a body which enjoys a substantial reputation for such work;
- b) The measure is calculated on a known and consistent basis; and
- c) The measure is available publicly.

During the debate over UT2.-1, the point of contention was not whether the CPI should be used, but the level of efficiency discount that should be applied (the "x" in $CPI - x$).⁴ This is in contrast to the use of an escalator for the asset base where QR strongly argued for the use of Rawlinsons construction index in place of the CPI. From this, Pacific National concludes that QR has been comfortable to date with the CPI as an escalator for access prices.

Pacific National accepts at face value the conclusion from the Booz Allen Hamilton input cost report that the resources boom over the last several years, coupled with substantial increases in diesel fuel prices has led to a sustained increase in input prices to QR above the raw CPI allowance contained in UT2.0. What is less clear is the extent to which these input prices have impacted on QR's total costs. It would be most helpful to understand the "output cost" effect of the input price increases given that QR is seeking a rise in "output" prices. It should also be borne in mind that the escalation of the whole access price by CPI almost certainly overstates the impact of a rise in costs in that it is applied to fixed as well as variable costs and the profit component. Hence when there is an increasing traffic task, where at least some of QR's costs are not variable (ie on the basis of QR's argument, the 60% that are fixed plus the asset depreciation effect and profit components), even if the input costs to some of those fixed components do rise, they will be allocated over a broader base hence dampening the effective "output" unit rate increase. Pacific National was not able to detect from QR's submission how it has taken this effect into account when translating the raw Booz Allen Hamilton input cost comparison to the CPI into its claim for a price increase.

For comparison, the NSW Hunter Valley has similarly been through a period of expanding coal volumes at the same time as input costs have been rising, but ARTC to date has been able to hold overall access prices at a similar level to previous years.⁵ To some extent this may be due to the adoption of an annual price reset so that the effect of input costs is not as stark as that being claimed by QR where prices were discounted by an average of 30% and set for a 4 year period prior to the commencement of a sustained above average increase.

⁴ The QCA determined that QR's efficiency gains as evidenced by the 40% reduction in maintenance costs underpinning the reference tariffs were sufficient that no on-going efficiency improvement should be sought and set x at 0 (QCA Decision QR's 2005 Draft Access Undertaking December 2005 p 60).

⁵ Access prices have nominally been held constant between 05/06 and 06/07 but due to an adjustment to the setting of the volume threshold the result is an increase that is close to the CPI movement.

Notwithstanding that data should have been available to QR at the time it submitted its prices to the QCA for UT2.0, it is Pacific National's view that in a "normal" (ie unregulated) commercial arrangement, a supplier of the type of key input service provided by QR, with long term contracts, would be expected to have contracted with its customers to escalate prices annually having regard to changes in input costs as well as on-going efficiency improvements (ie the typical CPI – x approach). Had QR adopted an annual price review the initial prices set at the commencement of UT2.0 would not have resulted in such a deep discount, based as they were on a whole of UT2 volume and cost forecast.⁶ Consistent with the view that access pricing should be reviewed annually, Pacific National suggests that it is not unreasonable to allow QR to recoup a proportion of the effect of increased input costs, provided that:

- a) the increase allowed for this factor takes into account the genuine output cost effect on QR and is not simply based on a comparison of a raw input price index to CPI.
- b) appropriate account is taken of the on-going requirement for efficiency.

6 INCREASED NETWORK ACTIVITY

In many respects, Pacific National would expect this issue to be closely interwoven with the changes in maintenance practices and it would seem difficult to separate cost variations that are specifically related to increases in volume from those related to adopting a different maintenance strategy. As QR has not provided the proportion of cost increases attributable to increased volumes it is difficult to place the issue of under-forecasting maintenance activity compared to volumes in context.

In its submission, QR suggests that it adopted "traffic friendly" maintenance practices through 2005/06 even though traffic volumes were down on expectations. While Pacific National accepts this at face value, it would be expected that this would lead to a greater productivity being achieved by maintenance crews as they would presumably have had greater access to the track than might have been anticipated. The overall effect, over time, is that the track is better suited to carrying larger volumes than might otherwise have been the case leading to lower overall unit costs. This should have yielded a benefit to QR in the longer term rather than additional expense, even if the level of maintenance activity was greater than planned at the time. QR's submission says as much.

The lower volumes than planned in the 2005/06 year would seem to be at odds with QR's discussion regarding the availability of fewer maintenance windows. However, it would be understandable if it was the case that the complexities of maintenance planning were such that it was not possible to take full advantage of increased "track time" at short notice.

It is accepted that the impact of increased volumes might not have been fully understood at the time of setting the maintenance plans on which UT2.0 was based. However, this begs two lines of inquiry:

- a) The effects of increased volumes will take some period of time to show up as a significantly increased maintenance task. It would seem that insufficient time has elapsed since the submission of prices based on known issues in June 2006 for a real understanding of the effects of the increased traffic task to be gained. If this is so, on what basis has QR determined the effects of increased volumes and what level of certainty does it have regarding these estimates?
- b) How has QR estimated its modified maintenance plan to be able to confidently predict the new maintenance cost forecasts?

⁶ Access prices, and therefore, the actual discount, are determined on the basis of the overall volumes occurring through the period of regulation compared to the costs incurred; but as the highest volumes, in this instance, occur at the end of the regulatory period, there is some "skewing" of the prices set at the beginning of the period, ie the prices are lower than would appear to be justified if considered over a shorter period. This is exacerbated by the deflation of prices for the start of the regulatory period and subsequent periodic escalation. While the overall revenue for the period will theoretically meet the amount intended, any intra-period examination of prices may well be affected by the apparent "distortion".

An issue that is somewhat puzzling is the relative usage of train paths. It is noted that QR claims usage of around 50% of available paths in its coal systems. If this is correct, it would be expected that maintenance windows would be relatively plentiful. The Hunter Valley currently runs on 73% path utilisation and yet sufficient maintenance windows are able to be obtained to maintain the track efficiently. Admittedly this requires a substantial level of coordination between all participants in the coal chain so that overall "down-time" is minimised, but it demonstrates the point that, with a reasonable level of coordination, QR should not have excessive difficulty in finding maintenance windows.

Without a substantially more detailed exposition of this issue, Pacific National does not see how this could give rise to the levels of increased costs claimed by QR. On this basis Pacific National is not in a position to support the component of QR's claim attributable to higher volumes to the extent that this is in excess of the allowances underpinning QR's June 2006 prices.

QR has also raised under this heading the issue that new technology electric locomotives have higher adhesion leading to greater track wear.⁷ With respect, Pacific National does not see this as an issue related to volumes, nor maintenance issues related to increased volumes, but rather one related to a choice of technology by the above rail operator. If there is a genuine incremental cost that arises from the adoption of this technology, then it would seem that the correct response is to levy a higher access charge that is reflective of the incremental cost imposed. Notwithstanding this theoretical position, experience in the Hunter Valley, where a train operator has chosen to use heavier, high adhesion locomotives compared to the existing coal fleet suggests that the impact on maintenance costs is not material. In this instance the track owner has not raised an issue regarding increased maintenance costs and one must assume that the incremental cost is either not measurable or not sufficiently significant as to warrant imposing a differential charge. Similarly, experience has shown that while, conceptually, the use of self-steering bogies on wagons should result in a reduction in track maintenance costs, the impact is not sufficiently measurable to result in a change in access prices.

7 CHANGES IN MAINTENANCE PRACTICES

Pacific National recognises and accepts that QR has changed its maintenance practices to provide a greater level of track availability for the movement of coal (and other traffics on those sections where coal shares the line). This is an appropriate "medium term" response in a time of capacity constraint. The appropriate longer term response is, of course, to provide more capacity, usually (though not exclusively) through investment in new infrastructure. It is also noted that QR has taken significant steps towards agreeing future capacity requirements with industry through the Masterplan process.⁸

It is Pacific National's view that "efficient costs" need to be considered in context. The adoption of more expensive maintenance costs to provide a greater level of capacity, *ceteris paribus*, when such capacity is in high demand, is appropriate. It is therefore appropriate that efficient costs would incorporate such a practice where it is warranted.

As described in QR's submission, this involves the acquisition and deployment of considerably more resources per unit of production (ie either producing less output with the same resources, or using more resources to produce the same output). One would expect that this particular issue is one that would show up immediately as an increased cost or alternatively reduced productivity. These new practices would not have been adopted precipitously nor without senior QR management knowledge. It would have involved an immediate impact on maintenance managers' budgets – presumably to some significant level. Given that QR

⁷ QR Submission 2 May 2007 p 20

⁸ Pacific National supports the Masterplan process and looks forward to it providing appropriate levels of capacity.

implemented these changed practices in 2004/05, Pacific National is puzzled that the effect was not understood until well past the submission of reference prices in June 2006.

Notwithstanding the seeming lack of flow-through of information to the UT2 approval process, Pacific National acknowledges that QR has genuinely attempted to improve service, to its cost. Accordingly Pacific National supports QR's claim in so far as the increased prices are a reflection of the costs associated with the changed practices. Such support is qualified in that Pacific National expects a more efficient longer term solution will be available with suitable investment and, provided the additional investment plus more productive maintenance practices yield a lower overall cost, Pacific National would expect that QR would seek to adopt such a solution.

8 UNDER-ESTIMATE OF UT2 COSTS

In its consideration of QR maintenance costs in UT2.-1, the QCA noted that QR had underspent its capital expenditure costs by \$100m during the UT1 period and that its maintenance costs were also below the QCA approved costs.⁹ Given that QR was operating under a price cap, this underspend was not reflected in any downwards access price adjustment. The QCA also noted in its Final Decision for UT2.-1 that there was no mechanism in either UT1 or UT2 for carrying forward any over- or under-spend into future regulatory periods (ie that QR retained the benefit of the under-spend).

It is accepted that QR under reported its maintenance expenditure during UT1 and that its operating expenditure was in fact above efficient costs. From a regulatory pricing perspective the amount in excess of efficient costs is not relevant, QR was entitled to gain the efficient cost of providing the network, not its actual costs. Thus the main area of relevant under-spend relates to capital expenditure and its impact on the efficient cost calculation that was used to determine prices (ie depreciation and return on assets). It is assumed that the QCA took the under-spend into account in modifying QR's asset base for UT2 and therefore this issue should not have transferred across to impact UT2.

However, this may have resulted in an over-recovery under UT1. Pacific National suggests that it is appropriate for the QCA to consider to what extent, if any, QR's commercial interests in seeking additional recovery in UT2 have been adequately addressed through the over-recovery of the capital components from UT1.

The evidence provided by QR is that the under-reporting of maintenance expenditure was between 7% and 15% each year through UT1 compared to its actual expenditure. Unfortunately QR has not vouchsafed the level of disparity that the accounting system error has caused in the cost estimates for UT2 so it is again difficult to know the impact of this issue.

QR has not provided any detail as to what the nature of the error was. Unique in Australian rail regulation, QR has prepared, and the QCA has approved, a cost allocation manual. It therefore begs the question as to whether the error was one that was:

- a) generated through following the Costing Manual;
- b) generated through ignoring or sub-verting a process mandated by the Costing Manual that would otherwise have obviated the problem; or
- c) one to which the Costing Manual was irrelevant.

Regardless within which category the answer lies, it cannot be satisfactory. Looking at each category:

- a) If the manual caused (or failed to highlight) an error of significance, then the manual must be defective.

⁹ QCA, Draft Decision QR's 2005 Draft Access Undertaking, July 2005, p 10

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- b) If the process mandated by the manual has been corrupted, then this raises significant compliance issues.
 - c) If the matter is one with respect to which the manual is not relevant, what use is the manual serving?

Pacific National has long held the view that the Costing Manual provides no real information as to the nature and quantum of QR's costs. While it might provide some confidence that QR's cost allocations are appropriate, a costing manual is not required to achieve this – a simple statement by the QCA would provide the same confidence.¹⁰ As these costs are routinely required to be held in confidence by the QCA, the only use of the manual that Pacific National can see is perhaps by the QCA. However, if the manual has proved to be incapable of being relied upon to inform even the QCA then even this residual benefit is questionable. Pacific National suggests that manual should be decommissioned forthwith. The only sensible alternative would seem to be to require QR to remodel the document and for the QCA to conduct an exhaustive audit process to ensure that the manual actually reflects QR's process. Pacific National does not support the latter course on the grounds that the end product will still be of questionable value to stakeholders.

Pacific National would expect that QR runs a significant internal audit program. It would be expected that such a program would have identified significant under-reporting of expenditure (or a misallocation) far earlier (given that this problem had been in existence for a number of years) than the end of 2006. Without detail as to the nature of the problem, it is difficult to comment further than to say that the entire issue is thoroughly perplexing.

In the circumstances, Pacific National is not able to support QR's claim for a restatement of prices on the basis of the accounting error. Although addressed in the next section, it is also pertinent to point out that QR's actual costs are not the primary determinant of prices, unless those costs are deemed to be efficient or are an important step in determining efficient costs.

9 ACHIEVEMENT OF EFFICIENCY TARGETS

The basis of economic regulation adopted by the QCA has been that the costs which form an input into the pricing calculations should be the efficient cost of providing the relevant service.

In determining efficient costs, Pacific National argues that efficiency is a relative concept and must reference back to the scope and scale of the task rather than be based on a simplistic unit cost benchmark. There can be no question that it is cheaper per unit of input to work on an unrestricted basis than to have to work while otherwise providing an on-going service (eg making the track available for trains). As discussed above, Pacific National therefore would agree with QR that where it has adopted a more expensive method for maintaining the track in order to increase capacity that was in demand, the determination of efficient costs should take that into account. To the extent that this has been adopted after the determination of efficient costs on a different basis, Pacific National supports an adjustment to efficient costs to recognise the changed circumstances.

However, to the extent QR's claim is for an adjustment that does not reflect efficient costs in the circumstances, then Pacific National would not support such a change in prices. QR's proposition that it should be compensated for abandoning efficiencies that it had previously expected to achieve would not meet an efficient cost criterion, unless the abandonment was related to the move to different maintenance practices to provide additional capacity or,

¹⁰ It is recognised that the manual might have had greater value in the early stages of UT1 when it was important to demonstrate that QR had bone fide allocation mechanisms. But again, the lack of any ability to actually trace transactions through the process always made the manual a document of a "hearsay" nature that could never be objectively verified by an external party (except perhaps the QCA – though Pacific National is not aware that the QCA ever performed a thorough audit on such a basis to verify that the chain of transactions actually occurred in accordance with the manual).

alternatively, the previously planned efficiencies were in fact unrealistic and would not have formed the basis of a practice based on efficient cost.

Pacific National's view is that the criterion remains efficient cost, albeit considered in terms of the circumstances, and all of QR's claims for increased costs must be judged in that context.

10 QRNA METHODOLOGY

It is understood that QR has eschewed use of its UT2.0 cost estimates on the basis that they are contaminated with the systematic error of UT1. Pacific National has some sympathy for an argument that it is impractical at this point in the cycle of UT2 to undertake a complete bottom-up analysis of efficient costs. QR proposes the use of the 2004/05 unit costs which are then adjusted to account for various factors. This is unfortunate as it would have been conceptually better to have worked from the cost base that was actually considered by the QCA in some detail, explaining how the various factors have impacted on those costs leading to the proposed amendments.

The adoption of the proposed methodology raises questions as to whether there are any discontinuities in the underlying assumptions between the UT1 and UT2.0 estimates. Further, the methodology appears to rely wholly on a series of "macro" transformations (ie modifications to the cost base at an aggregate level) that have the potential to misstate the true position unless significant care is taken. Pacific National is in the position that it must accept QR's assertion that the alternative of disaggregating the UT2.0 costs and addressing the accounting error is too complex, though that seems an odd position for QR to be in. If QR is not in a position to identify its own costs, one must question how well QR understands the basis of its own claim. In turn this begs the question as to how QR has reliably formulated an alternative set of costs and hence prices? In proposing an alternative set of costs, Pacific National suggests that a reasonable level of detail is required to show how the various factors have impacted on the costs and how these relate to efficient costs.

Notwithstanding this, if one accepts that the use of the 2004/05 unit rates is an appropriate base, then care must be taken not to misapply generalisations in adjusting these rates. Pacific National finds itself at a disadvantage in that almost all details regarding the UT1 and UT2 unit rates have been kept confidential between QR and the QCA. It is therefore necessary to make comments at a conceptual level only and trust to the QCA to do the detailed investigation.

Issues that Pacific National suggests need close examination include:

- a) The increase of costs by 40% of the increase in volumes is probably a correct approach to account for changes in track maintenance. At the very least there is a substantial body of opinion, not the least the QCA's own experts, that the variability of track maintenance costs is of this magnitude.

However care should be taken not to apply this factor to all costs – for example it could hardly be argued that the various levels of overheads, telecommunications costs and other non-track related costs escalate with volumes. It is unclear from the QCA's working papers to UT1 precisely what components of costs would be considered subject to the increment, but it is clear it is not appropriate to escalate the entire operating cost base.¹¹

- b) It is unclear as to precisely how QR and the QCA approached the cyclic nature of rail infrastructure maintenance in determining the UT1 efficient costs, so it is not clear to Pacific National whether the costs have been normalised to provide an equivalent average annual cost or alternatively a specific scope of activity was planned and costed. If the latter, then care would need to be taken to ensure that the scope for 2004/05 is consistent with the scope for the remainder of UT2.

¹¹ See QCA Working Paper 2 Usage-related infrastructure maintenance costs in railways, December 2000

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- c) QR has provided a minimal breakdown of the 2004/05 costs it intends to use as a base. Pacific National is not aware of where any publication of the costs on which the QCA formed its decision for UT1 except at the highest level and therefore must accept any disaggregation and transformation of costs at face value.

It would assist stakeholder confidence for the QCA to clearly outline the steps it has taken to confirm the appropriateness of the cost base used.

- d) The simplistic escalation of maintenance costs (excluding ballast cleaning) by a further 10% above CPI in each of the first two years is an overstatement of the impact of increased unit input costs (as discussed above).

The cost of ballast cleaning is subject to a number of variables, for example the location of suitable ballast material compared to the work site. Pacific National accepts the unit rate nominated by QR as a reasonable generalised unit rate for this activity.

There appears to be at least potential for some double counting in the use of the Booz Allen Hamilton index – according to the QR submission the point of separating out the ballast cleaning activity is to avoid generalising the costs of a significant activity, yet the index appears to incorporate significant weightings for labour and materials, the very components that form a large part of the operating costs of a reballasting operation. Clearly labour and materials form a large part of most operations, but it would be helpful for the QCA to assure itself that the separate treatment of ballast cleaning does not result in a distortion of the index used for the other components of cost. If no such distortion occurs one might question the relevance of specifically separating out ballast cleaning.

- e) Pacific National supports the use of an averaging approach to cyclical maintenance for each system. So long as this is applied consistently over time, this should yield an appropriate result.

Erratum

Sections 3.3 and 3.4 of both versions of Schedule F accompanying the QR submission appear to have lost their numbering. This seems to have occurred less systematically in a number of other parts of the document eg parts of 4.1, 5.1, 5.2, 5.3 and a number of other locations.