

File Ref: 234729

20 February 2009

Mr John Prescott
Chairman
Queensland Rail Limited
GPO Box 1429
Brisbane QLD 4001

Dear Mr Prescott

Approval of QR Network's Revenue Cap Adjustment 2007-08

The Authority has approved QR Network's application to vary its coal network's revenue cap by \$43.6 million in 2009-10 to account for a revenue shortfall in 2007-08.

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

Details surrounding the Authority's assessment of that QR Network's application are summarised in **Attachment 1**.

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

Yours sincerely



Brian Parmenter
Chairperson

QR Network Revenue Cap Adjustment 2007-08
Summary of QR Network's Application and the Authority's Assessment

Background

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

On 3 November 2008, QR Network sought approval to increase its 2009-10 system allowable revenues, and associated reference tariffs, to recover the revenue shortfall it experienced in 2007-08. QR Network estimated the revenue cap adjustment on the basis of either:

- *scenario 1* – a \$43.2 million shortfall which assumes that QR Network's West Blackwater Reference tariff application currently before the Authority is approved; or
- *scenario 2* – a \$43.6 million shortfall assuming that it has not.

Given that QR Network's West Blackwater reference tariff application has not yet been approved by the Authority, the Authority has considered and assessed scenario 2.

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

The Authority received submissions from the Queensland Resources Council (QRC) and Asciano by the due date of 21 November 2008. QR Network's subsequent submission, received 12 December 2008, responded to stakeholders' comments.

QR Network's Proposal

QR Network estimated a revenue shortfall in 2007-08 of around \$37.1 million, comprising:

- a \$23.7 million shortfall in relation to non-electric assets – which is comprised of a \$49.4 million shortfall in AT_{2,4} access charge revenues, partially offset by around \$20 million in take-or-pay revenues; and
- a \$13.4 million in relation to electric assets (AT₅ reference tariff component).

QR Network calculated this shortfall by subtracting its actual revenues (\$361.1 million) from its approved 2007-08 revenues (\$398.2 million). QR Network's actual revenues are based on what QR Network was *entitled* to earn regardless of whether or not it collected this amount, including revenues associated with reference train services, non-reference train services, relinquishment and transfer fees, take-or-pay (ToP) obligations and other revenues which it was required to refund (but did not refund).

QR Network proposed to adjust its 2007-08 revenue shortfall based on its weighted average cost of capital (WACC) to account for the time lag in which the adjustment to reference tariffs occurs. QR Network's estimate of \$6.5 million was calculated by applying the WACC to the revenue shortfall over two years and allowing for quarterly compounding over this time.

On this basis, QR Network proposed a total revenue cap adjustment amount in 2009-10 of \$43.6 million for the Authority's approval. In addition, QR Network proposed to incorporate this into the reference tariffs ultimately approved by the Authority as part of the 2009 access undertaking.

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

Stakeholders' Comments

Stakeholders indicated that, in general, they had limited ability to comment on the specific details of QR Network's proposal given the lack of information and the level of disclosure by QR Network in its public submission.

Nevertheless, Asciano questioned the quantum of QR Network's revenue adjustment and more specifically, the size of the Blackwater and Goonyella AT₅ under-recovery. In its response, QR Network submitted that, in line with the standard access agreements, the take-or-pay charges in the Blackwater and Goonyella systems applies only to AT_{2,4} revenue. Accordingly, the AT₅ under-recovery for the relevant systems is relatively high.

While the QRC did not raise any specific concerns, it indicated it would rely on the Authority to undertake a complete and considered examination of QR Network's proposal and, to this end, listed matters for the Authority to consider including:

- reconciling the actual tonnages railed;
- reviewing QR Network's proposed take-or-pay revenues, for example QR Network's approach to calculating the deduction for 'QR cause' incidents;
- providing information from QR Network's financial model relating to each individual train service to the respective end-customer, in order for this information to be independently verified; and
- ensuring QR Network's proposal relates solely to the relevant revenue-cap provisions of QR Network's approved access undertaking.

Assessment Criteria

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

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

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

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

Assessment of QR Network's Proposal

Given that QR Network experienced an under-recovery of its 2007-08 revenue cap, it did not seek an increment to its revenues for a whole of coal supply chain productivity improvement.

Revenue Cap Adjustment

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

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

- *reference tariff revenues* – were accurately estimated based on:
 - the approved reference tariffs;
 - actual railings (i.e. tonnages and origin/destination) independently confirmed by a significant sample of the customers (mining companies);
- *take-or-pay revenues* – were accurately estimated based on:
 - actual railings and contractual commitments in internal access agreements; and
 - the formulae in the 2001 and 2006 access undertaking standard access agreements – noting that, consistent with the earlier agreements, QR Network made no claims for take-or-pay revenue from pre-2001 agreements; and
- *relinquishment and transfer fees* – were confirmed based on:
 - consistency with the modelled train paths and the contracted train paths in QR Networks' internal access agreements with QR National; and
 - QR National's separate advice confirming the information provided by QR Network.

In addition to the concerns raised about the lack of information published, stakeholders were also concerned about the size of the revenue cap shortfall and, in particular, understanding the drivers of this, especially in relation to the shortfall in electric revenues.

On this basis, both the QRC and Asciano requested the Authority to provide contextual operational data to assist in explaining the shortfall. For example, Asciano suggested that a comparison of actual traffic compared to the forecast on which the system allowable revenue was calculated would help to show the linkage between the physical activity and the revenues collected.

In response to these comments, QR Network stated that detailed supporting information is provided to the Authority on the various parameters that make up its below-rail revenue and that this information is commercial-in-confidence as it contains specific information on individual train services. However, QR Network also stated that it has proposed a number of initiatives to address the concerns raised, including proposing as part of its 2009 draft amending undertaking application to publish certain railing information.

In considering this matter, the Authority has sought to provide greater insights into the reasons for the shortfall without disclosing commercially sensitive individual train service data.

Quantum of Adjustment

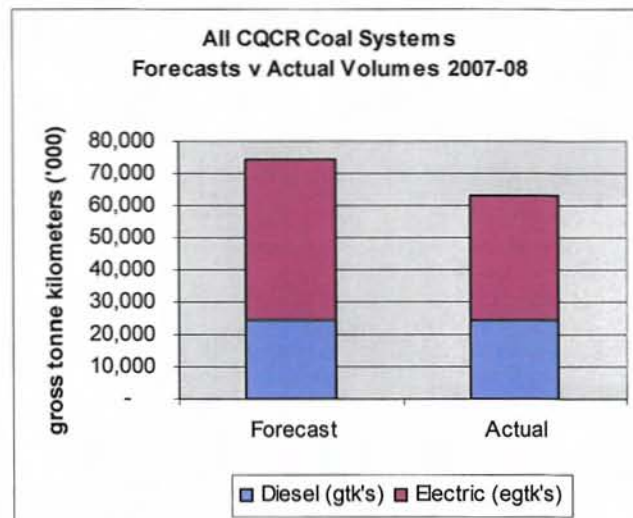
In its response to stakeholder comments, QR Network noted that the relatively high under-recovery of revenues:

- in Newlands relates to the high proportion of grandfathered services which have weak (or no) take-or-pay revenues; and
- for the Blackwater and Goonyella electric assets reflects the fact that take-or-pay only applies to non-electric revenue (AT₂₋₄) – i.e. take-or-pay revenues mitigate the impact of low volumes for the non-electric assets but not the electric assets.

However, the Authority’s analysis of the available material indicates that the non-electric take-or-pay revenue does not fully explain the difference in the shortfall in electric versus non-electric revenues. In this regard, the shortfall in electric revenues is also due to the disproportionately greater decline in the freight task undertaken by electric locomotives relative to diesel (see **Figure 1**). In particular:

- electric gross tonne kilometres were around 23% below forecast; yet
- gross tonne kilometres for diesel trains were on a par with forecasts.

Figure 1



As such, the relatively high under-recovery of electric revenues is almost equally attributable to the shortfall in the freight task undertaken by electric trains and the fact that this is not mitigated by take-or-pay arrangements.

In summary, the shortfall is broadly made up of revenues that could not be recovered due to the lower than forecast volumes experienced during 2007-08, particularly in relation to electric train services. In addition, while some of the revenue loss associated with the under-railings was able to be recovered through take-or-pay arrangements, most contracts have weak (or no) take-or-pay arrangements in relation to the non-electric infrastructure charges and no take-or-pay arrangements for electric infrastructure charges.

Non-reference train revenues

QR Network advised that six non-reference train services used the network within and outside the central Queensland coal network, namely train services from:

- the Minerva mine to the port of Gladstone via the Blackwater system;
- the Goonyella system to Abbot Point in the Newlands system via the North Coast Line; and

- the Goonyella system to Gladstone via the Blackwater system.

The undertaking requires that revenues for such train services be calculated using the same components as Reference Train Services (AT₁, AT₂, AT₃, AT₄, the QCA levy and AT₅ and Electric Charge (EC) if appropriate) even if they do not constitute a reference train service.

QR Network's estimated \$2.2 million of revenues for the Minerva service, calculated on the basis of the common cost contribution matrix in the undertaking and not on the basis of the central Blackwater reference tariff as required by the undertaking.

As the Authority considers QR Network has not assessed the revenue it is entitled to earn from the Minerva train service strictly in accordance with the undertaking, the Authority has discretion in the way it considers this matter.

Accordingly, the Authority has exercised its discretion to accept QR Network's proposal, in the same manner as it did in respect of the 2006-07 revenue cap. The Authority considers this approach appropriate given that QR Network is currently seeking the Authority's approval of a reference tariff for the Minerva service which will then form the basis of calculations required for the revenue cap process.

In relation to the other non-specific train services, QR Network has applied slightly different approaches to determining the revenues. In this regard, for:

- (a) services to Abbot Point – allocating revenue first to the Goonyella system on the basis of the relevant Goonyella reference tariff components proportioned for the distance travelled on the Goonyella system. The unallocated revenue has then been allocated between the North Coast Line and Newlands in proportion to the train kilometres travelled in each; and
- (b) services to Gladstone – allocating revenues to both the Goonyella and Blackwater systems on the basis of the relevant reference tariff components proportioned for the distance travelled within each. The capacity charge (AT₂) has been charged more than once if the train service has utilised more than one capacity constrained line section and revenues associated with this are recorded.

The provisions in the undertaking surrounding the treatment of these non-specific services do not cater for all circumstances that have occurred. In particular, the undertaking requires the unregulated service to be treated as if it was a reference service for the duration of the trip on the central Queensland coal region (CQCR). However, this arrangement does not cater for the circumstances where a train travels on a number of systems – QR Network has sought to clarify this matter as part of its 2009 draft access undertaking.

In considering this matter, the Authority sought to ensure that revenues were appropriately matched against the infrastructure used and, in particular, that an appropriate contribution is made for the use of 'revenue capped' assets where both regulated and non-regulated infrastructure was utilised.

The Authority has reviewed QR Network's proposal on this basis and considers it appropriate. In this regard, the Authority notes that QR Network's approach does not provide it with a material benefit over other possible approaches, nor does it unfairly allocate the revenue shortfall disproportionately to a particular system.

Accordingly, the Authority considers that, on balance, QR Network's proposal is a reasonable interpretation of the undertaking's provisions.

QR cause

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

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

QR Network advised that around 3.8% of train paths in central Queensland were cancelled due to QR cause and that it was not aware of any event which would give rise to a deduction in the revenue cap adjustment due to a QR cause incident due to breach or negligence.

On reviewing QR Network's financial model, the Authority confirms that in no one month did the number of cancellations due to QR cause exceed the 10% threshold – the highest was 7% for February 2008. Moreover, there was no indication by either QR Network or stakeholders that these cancellations were due to breach or negligence on the part of QR Network.

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

Escalation and Final Revenue Cap Adjustment Amount

The Authority reviewed QR Network's claim regarding the escalation component of the revenue shortfall. QR Network's calculations correctly allow for it to earn an annual return on its revenue shortfall over the two-year period of 8.43%, the cost of capital on which the 2006 access undertaking was based. The Authority accepts QR Network's proposal in relation to this. The amount is included in QR Network's proposed adjustment amount, raising the approved revenue shortfall amount for 2009-10 from \$37.1 million to \$43.6 million.