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Mr John Hall
Chief Executive
Queensland Competition Authority
Level 19, 12 Creek St
Brisbane QLD 4001

Dear Mr Hall,

Response to QR Network Access Undertaking (2008) Proposed Reference Tariff Variation (2008/09 Revenue Cap)

QR's above rail coal interests are managed by the QRNational Coal business which offers rail-based transport and logistics solutions to customers moving coal within Queensland and New South Wales.

The regulatory framework for rail operations in Queensland has a significant impact on QRNational Coal. The attached submission responds to the QCA's invitation for interested parties to respond to QR Network's Proposed Reference Tariff Variation (2008/09 Revenue Cap). This submission specifically highlights the implications of the treatment of UT1 Take or Pay under System Allowable Revenue and the inequity it creates.

Treatment of UT1 Take or Pay under System Allowable Revenue

QRNational Coal has undertaken a comprehensive validation process around FY08/09 Take or Pay for Access. As part of this process we did an in-depth analysis of how QR Network treated Take or Pay signed up under the 2001 Access Undertaking (UT1) vis-à-vis the System Allowable Revenue (SAR), which is essentially a 'revenue cap'.

Based on a review of the QR Network Take or Pay model, it is apparent that QR Network has interpreted the Undertaking, under a 'revenue cap' model, as having no cap on the amount of Take or Pay for paths contracted under the 2001 Access Undertaking (UT1). This means that in some coal systems in 2008/09, the SAR is being exceeded purely as a result of the UT1 Take or Pay amount.

We believe that QR Network should not be entitled to earn Take or Pay on UT1 paths that means it exceeds the SAR for that system for the following reasons:

- Intent of the revenue cap model

- Lack of clarity in the 2008 Access Undertaking regarding the calculation of and Networks' entitlement to charge take or pay on "UT1" paths
- Inequity between UT1 and UT2 access holders

Intent of System Allowable Revenue

Our interpretation of the intent of the revenue cap model under which the 2008 Access Undertakings (2008 AU) is based, is that the revenue from reference tariffs AT2-4 is capped by system to the SAR. We understand that this was endorsed by the QCA in 2006/7 and applied from the 2006/7 year.

The 2008 Access Undertaking states that where the Take or Pay amounts for 2008AU paths would exceed the SAR, when added to the actual revenue received from the AT2-4 tariffs, the Take or Pay is proportionally reduced to the point that QR Network receives no more than the SAR. Given the intent of a revenue cap model, this should clearly apply to all Take or Pay entitlements. We also contend that both UT1 and 2008AU Take or Pay entitlements should be reduced in the same proportion.

Lack of clarity in the 2008 Access Undertaking and the Access Agreements

The detail on how to treat UT2 Take or Pay and the SAR is very specific in the 2008AU (refer clause 2.2.6) of Schedule F. In contrast, the entitlement to UT1 Take or Pay under the revenue cap model is ambiguous.

The only reference to the treatment of UT1 Take or Pay in Clause 2.2.5 which refers back to Clause 3 of the 2001AU and an amendment to Schedule F, which raises the following questions:

- Clause 3 of 2001AU only refers to how Take or Pay is calculated for UT1 paths. There is no discussion of how Take or Pay should be treated with respect to QR Network's total allowable revenue.
- There appears to be no amended Schedule F, although QR Network have advised us that Clause 3B of the 2008AU is in fact the amendment to Schedule F. Clause 3B discusses the Revenue Adjustment concept that applies when QR Network earns more than the SAR. This clause makes no reference to the contribution or otherwise of UT1 Take or Pay.

In addition, Schedule 3 of the current Access Agreements executed between QRNational Coal and QR Network for both UT1 and UT2 paths only include methodologies for how Take or Pay is calculated, not how they are treated in terms of SAR and/or Revenue Adjustments. On this basis, QRNational concludes that the 2008 Access Undertaking provides the overall direction to QR Network in treating UT2, and by extension, UT1 in terms of the System Allowable Revenue.

Inequity between UT1 and UT2 access holders

The current treatment of UT1 will result in an inequity between UT1 and UT2 access holders in that under QR Network's treatment of the UT1 Take or Pay, the amount of UT1 Take or Pay collected above the SAR will be adjusted from the SAR in a following financial year. This will result in reduced access charges across the corridor, which in effect means that UT1 access holders will subsidise UT2 (and later UT3) access holders.

The amount of 'over-recovery' by QR Network is a substantial amount and affects both QRNational Coal and Xstrata. The amount and proportion by affected party is detailed in the confidential attachment to this letter.

It is arguable that this treatment of UT1 Take or Pay is inappropriate both on the basis of the inequity it creates as well as the potential to impact on competition in above rail haulage services. Other producers may be less likely to transfer their UT1 paths to another operator if they perceive an increased likelihood that they will be subject to similar treatment as a result.

QRNational Coal's Position

As 2008AU is ambiguous on the entitlement to and how UT1 Take or Pay should be treated, as opposed to how it is calculated, we contend that there is a case to treat UT1 Take or Pay in accordance with the 'intent' of 2008AU, specifically that QR Network should not earn any Take or Pay to the extent that it exceeds the SAR. This would apply to Take or Pay under UT1 paths and 2008AU paths and paths sold under future Access Undertakings.

In addition, in accordance with the principles within the 2008AU, where Take or Pay exceeds the SAR, both UT1 and 2008AU Take or Pay (and the Take or Pay for future paths) should be proportionally reduced back so that it meets the SAR.

Independent Advice and Xstrata endorsement

In developing this submission, we have sought independent advice on this issue through Synergies Economic Consulting. A copy of their report is provided.

We have also consulted with Xstrata on our submission and have their endorsement to make this submission with specific reference to and on behalf of them.

Conclusion

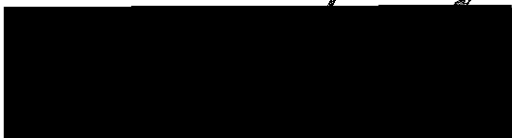
We believe the general principle that QR Network should not earn more than SAR, except where this results from an unintentional 'overs' through different raiiling profiles than contracted, is one that the broader industry and the QCA would support.

We therefore request the QCA review this submission and provide a determination on the treatment of UT1 Take or Pay for FY08/09 as well as for the 2009 and subsequent Access Undertakings.

For the purpose of clarification, QRNational Coal wishes to advise that the final take or pay figure for 2008/09 has yet to be formally agreed between the relevant parties.

If you have any further queries or require more information please feel free to contact Michelle Yeaman, National Access Manager on telephone 07 3235 7849.

Yours sincerely



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QRNational Coal



Revenue cap adjustments and take or pay

A report for QR National Coal

September 2009
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Disclaimer

Synergies Economic Consulting (Synergies) has prepared this advice exclusively for the use of the party or parties specified in the report (the client) and for the purposes specified in the report. The report is supplied in good faith and reflects the knowledge, expertise and experience of the consultants involved. Synergies accepts no responsibility whatsoever for any loss suffered by any person taking action or refraining from taking action as a result of reliance on the report, other than the client.

In conducting the analysis in the report Synergies has used information available at the date of publication, noting that the intention of this work is to provide material relevant to the development of policy rather than definitive guidance as to the appropriate level of pricing to be specified for particular circumstance.

Executive Summary

Synergies Economic Consulting has been engaged by QR National Coal to examine an issue that has arisen as a consequence of the differential treatment of UT1 and UT2 take or pay for the purpose of assessing the revenue cap, in accordance with Schedule F of QR Network's current (2008) Access Undertaking.

The problem that has emerged is that under the existing revenue cap mechanism, which caps UT2 take or pay but not UT1, UT1 take or pay amounts can result in Total Actual Revenue exceeding System Allowable Revenue, even if actual volumes are below system forecasts. This in turn results in UT1 Access Holders subsidising UT2 Access Holders, because the amount of that over-recovery will be returned to all Access Holders (UT1 and UT2) as part of the revenue cap adjustment.

We believe this is an unintended consequence that was not anticipated when the revenue cap was originally designed. The focus at the time was on the relative strength of UT2 take or pay provisions, which we assume underpinned an (unstated) assumption that UT2 take or pay was much more likely to lead to an over-recovery of revenue.

In our view, the solution to this problem is a simple one – UT1 take or pay obligations should be capped on the same basis as UT2 take or pay. This will ensure that:

- take or pay amounts (UT1 or UT2) do not lead to an over-recovery of revenue, when actual volumes are at or below forecast; and
- all Access Holders are treated equitably in applying any proportionate reduction in their take or pay obligations. In this context, 'equitable' means:
 - all UT1 Access Holders are treated the same, and all UT2 Access Holders are treated the same (this is achieved by the way the cap is applied); and
 - the relative take or pay contribution of UT1 and UT2 Access Holders to any revenue shortfalls reflects their proportionate contribution to total take or pay revenue (that is, what would have applied if the cap did not need to be invoked).

It is understood that the UT1 take or pay impact for 2008-09 will be material; therefore we would recommend that consideration is given to implementing this change prior to finalising the 2008-09 revenue cap adjustment. This will avoid cross-subsidisation between UT1 and UT2 Access Holders in the last year of the current undertaking period. The necessary amendments would then be carried through to UT3.

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Introduction

Synergies Economic Consulting (Synergies) has been engaged by QR National Coal (QRNC) to examine an issue that has arisen as a consequence of the differential treatment of UT1 and UT2 take or pay for the purpose of assessing the revenue cap.

The differential treatment relates to the capping of UT2 take or pay revenue, but not UT1. The situation that has emerged following the recent downturn in volumes is that in at least one system in 2008-09, UT1 take or pay amounts will take Total Actual Revenue well above System Allowable Revenue, while actual volumes are below forecast. This situation cannot occur with UT2 take or pay because it is capped to the extent of any under-recovery of revenue. While the over-recovery (arising from UT1 take or pay revenue) will be returned to Access Holders, it will be returned to all Access Holders, not just UT1.

This report will examine this issue by:

- providing an overview of the problem;
- considering the relevant background to the development of the revenue cap mechanism (and the issue that has been identified);
- assessing the cause of the problem, and its consequences; and
- recommending a proposed solution.

Overview of the problem

In June 2007, the Queensland Competition Authority (the Authority) approved a change in QR Network's form of regulation from a price cap to a revenue cap. The primary reason for the change was to (largely) remove QR Network's exposure to volume risk. The revenue cap applies to the 'fixed' components of QR Network's multi-part tariff structure, being AT₂ to AT₄ and AT₅ (for electric traffics).

The revenue cap is designed to ensure that QR Network only recovers its System Allowable Revenue (SAR) in any one year – no more and no less.¹ In simple terms, this

¹ The exception to this is where an under-recovery of revenue occurs as a consequence of breach or negligence by QR Network. It is also entitled to submit a claim to retain a maximum of 2% of SAR in the event of an over-recovery of revenue, where it can be demonstrated that this occurred as a consequence (in whole or in part) of coal chain activities or initiatives undertaken by QR Network.

occurs by comparing the Total Actual Revenue (TAR) earned in the year with SAR. Where:

- TAR is greater than SAR, the additional revenue is returned to Access Holders;
- TAR is less than SAR, QR Network is entitled to recover the shortfall from Access Holders.

This occurs via adjustments to Reference Tariffs in the second year following the year in which the under- or over-recovery occurred.

TAR is defined to include all revenue earned under all Access Agreements in relation to the relevant coal system infrastructure, including any amounts that QR Network was entitled to earn (under the relevant Access Agreements) from take or pay, relinquishment fees and transfer fees. However, based on the current provisions set out in Schedule F of QR Network's 2008 Access Undertaking, there is a difference between the treatment of take or pay under those Access Agreements executed under the 2001 Access Undertaking (UT1), and those entered into on or after 2006 (UT2).

The difference is that under clause 2.2.6 of Part B of Schedule F, UT2 take or pay is capped to the amount of any under-recovery of revenue (refer below). While the treatment of UT1 take or pay is not clear, based on our review of Schedule F it is not apparent that this cap is applied to UT1 take or pay.

Given the unexpected downturn in the coal market following the global financial crisis, volumes have been significantly below forecast. This would be expected to trigger a revenue cap adjustment (from Access Holders to QR Network) to enable QR Network to recover its SAR. However, this is not necessarily the case in all systems.

For example, in the Blackwater system in 2008/09, indications are that notwithstanding actual volumes being below system forecasts (to the extent that UT1 take-or-pay amounts are not capped for the purpose of determining TAR), TAR will exceed SAR because of the UT1 take-or-pay amounts that QR Network is entitled to receive under the relevant Access Agreements. In other words, TAR is above SAR, not because volumes have exceeded forecasts, but because of UT1 take or pay. This cannot occur as a result of UT2 take or pay because it is capped for the purpose of determining TAR.

The practical consequence of this is that in this case, QR Network will need to return revenue to (all) Access Holders, where that revenue over-recovery has solely arisen as a consequence of UT1 take or pay entitlements, not increased throughput.

In our view, this was not a situation that was contemplated, or intended, when the revenue cap mechanism was designed. In particular, there are two key anomalies here. The first is that take-or-pay amounts – not increased volumes – has resulted in TAR

exceeding SAR (and triggering a revenue cap adjustment). The second is that it results in potential inequities between UT1 and UT2 Access Holders, which is inconsistent with the underlying contractual effect that is known and accepted by industry participants. Our reasons for this are set out in more detail below.

Take or pay and the revenue cap

Take or pay and the revenue cap are two separate and distinct mechanisms. Take or pay is a contractual mechanism, which transfers volume risk from the infrastructure owner to the Access Holder. This is independent of the form of regulation that governs the infrastructure owner.

The revenue cap is a regulatory mechanism, that 'balances' QR Network's annual revenue (based on SAR). The obligations under the contractual framework are not altered by the revenue cap - indeed, the integrity of that contractual framework is paramount in governing dealings between participants on the network (noting that the provisions in the contracts are based on the regulator-approved Standard Access Agreement). However, what the revenue cap is designed to do is to ensure that after taking into account the revenue that QR Network is entitled to earn under those contracts, it does not earn more (or less) than the SAR. This is explored further below.

Take or pay

For existing Access Holders on the Central Queensland Coal Network (CQCN), their take or pay obligations under their contract will be different depending on whether that Access Agreement was entered into during UT1 or UT2. This is because QR Network strengthened its take or pay provisions following the expiration of its first Access Undertaking period, with a view to reducing (but not eliminating) its exposure to volume risk.

This difference will gradually disappear over time as UT1 Access Agreements expire and are renewed based on the stronger take or pay provisions. In the meantime, the difference between UT1 and UT2 take or pay is recognised and understood by all supply chain participants. Indeed, we note that during the development of the revenue cap mechanism, industry was very clear to ensure that this existing calculation was maintained:

The QRC considers that the parties to existing Access Agreements and haulage agreements entered into contractual relations based on an understanding of the risks as reflected in the terms of these contracts, and should not subsequently be exposed to a substantial increase in their risk profiles as a result of changes flowing

from UT2. The QRC accepts that, as this generation of Access Agreements expires, replacement agreements for similar services will be entered into based on terms of the standard access agreement prevailing at the time. Therefore, if strong take or pay remains a feature of the standard access agreement in the future, all Access Agreements will ultimately reflect these terms.²

This position was acknowledged by the Authority in its Draft Decision, in response to concerns expressed by Pacific National (PN):

In relation to the PN's position on having different contracts arising under different regulatory periods, the Authority notes that it was never the Authority's intention to reopen existing contractual arrangements as a result of amendments to the access undertaking, or indeed as a consequence of accepting new or replacement access undertakings. The Authority accepts that this may lead to contracts signed at different times reflecting different regulatory arrangements.³

The position taken by all participants was to therefore preserve the contractual take-or-pay obligations based on the calculations as set out in the relevant access agreements.

The issue here is not about strong versus weak take or pay arrangements. It is about how take or pay should be treated under the revenue cap mechanism. The treatment under the revenue cap should not materially alter the relative contractual effect of the existing take or pay arrangements as reflected in the existing calculations.

Revenue cap mechanism

The key issue under consideration here is therefore whether it is appropriate to cap UT2 take or pay provisions but not UT1. In order to examine this further, we will explore the rationale behind the capping of UT2 take or pay provisions in more detail.

Schedule F provisions

As outlined above, the cap that is applied to UT2 take or pay (for the purpose of assessing TAR) is set out in clause 2.2.6 of Part B, Schedule F. This provision is contained in the Box below.

² Queensland Resources Council (2007), QRC Submission to the Queensland Competition Authority, 23 March, p.9.

³ Queensland Competition Authority (2007), Draft Decision: QR's Proposed Schedule F Amendment, April, p.3.

Box 1 Clause 2.2.6 of Part B, Schedule F: capping of UT2 take or pay

Notwithstanding Subclause 2.2.3, where the Total Actual Revenue for AT2-4 for an Individual Coal System Infrastructure less the aggregate amount of Take or Pay that QR Network would be entitled to earn from all Access Agreements in relation to that Individual Coal System Infrastructure executed or renewed on or after 30 June 2006 (other than New Access Agreements entered as part of transferring Access Rights from Access Agreements in place on the day immediately prior to 30 June 2006 pursuant to Paragraph 7.4.4(f) of the Undertaking) ("Total Revenue") is:

- a) greater than or equal to the System Allowable Revenue for AT2-4 in relation to that Individual Coal System Infrastructure, Take or Pay shall not be payable for that Year under Access Agreements in relation to that Individual Coal System Infrastructure executed or renewed on or after 30 June 2006 (other than New Access Agreements entered as part of transferring Access Rights from Access Agreements in place on the day immediately prior to 30 June 2006 pursuant to Paragraph 7.4.4(f) of the Undertaking) ("UT2 Agreements");
- b) less than the System Allowable Revenue for AT2-4 in relation to that Individual Coal System Infrastructure:
 - i. QR Network will calculate the aggregate amount of Take or Pay that QR Network would be entitled to earn from all UT2 Agreements ("Total Actual Take or Pay"); and
 - ii. if the Total Actual Take or Pay exceeds the amount by which the System Allowable Revenue for AT2-4 exceeds the Total Revenue for that Individual Coal System Infrastructure ("Maximum Take or Pay Amount"), then:
 - (A) QR Network will calculate for each relevant Access Holder, the proportion that the Access Holder's Take or Pay amount bears to the Total Actual Take or Pay ("Proportion"); and
 - (B) each relevant Access Holder's Take or Pay amount will be reduced to equal that Access Holder's Proportion of the Maximum Take or Pay Amount.

In other words, where TAR minus the UT2 take or pay revenue that QR Network is entitled to earn is:

- greater than or equal to SAR, UT2 take or pay will not be payable in that year. In other words, if TAR is already above SAR (before take or pay is taken into account), UT2 take or pay will not be payable;
- less than SAR, the UT2 take or pay that QR Network is entitled to earn will be capped to the amount of the under-recovery. This cap will be proportionately applied across all UT2 Access Holders.

Clause 2.2.5 specifies that:

Take or Pay revenue from a particular Reference Train Service will be determined in accordance with Clause 3.2 of the 2001 Undertaking, until such time that the amendments to Schedule F developed in accordance with Clause 3 take effect in accordance with Clause 3.8.

Clause 3.2 in the 2001 Undertaking sets out how UT1 take or pay will be calculated. It makes no reference as to how UT1 take or pay will be treated for the purpose of determining TAR (which is to be expected given QR Network was not subject to a revenue cap at that time). There is currently no Clause 3.8 (as referred to in clause 2.2.5 above). There are no provisions in the 2008 Access Undertaking that explicitly reference a cap being applied to UT1 take or pay revenue.

Other documentation

From reviewing the documentation supporting the Authority's determination (including submissions made by stakeholders), the key focus at the time appeared to be on ensuring that UT2 Access Holders were not put at a relative disadvantage given their stronger take or pay calculation – this was also seen as a concern from the perspective of a new entrant who was more likely to be subject to a UT2 Access Agreement.

It is understood that QR Network's submissions on this matter were developed in consultation with the QRC. The original proposal put forward by the QRC was to structure take or pay into two tiers for revenue cap purposes. The first tier "broadly matched the commercial effect of Take or Pay for Access Agreements commenced during UT1".⁴ The second tier would 'top up' any remaining under-recovery to 100% of AT_{2.4}. QR Network's subsequent proposal slightly modified this position by capping the UT2 take or pay amount, rather than the 'tier two' amount.

The key rationale for the cap was to ensure that take or pay collections do not result in an over-recovery of system allowable revenues (which was also acknowledged by the Authority⁵). The proposals were generally supported by stakeholders, with the exception of:

- Pacific National's concerns regarding the underlying contractual differences between the calculation of UT1 and UT2 take or pay. As outlined above, the Authority did not accept that these differences should be altered (noting that the differences will be diminished through time), but sought to address these concerns by ensuring that the existing take or pay provisions flowed through to the new Access Agreement where access rights are transferred;
- concerns regarding what QR Network is entitled to collect and what it may actually collect. The Authority addressed this by ensuring that for the purpose of

⁴ QR Network (2007), QR Access Undertaking (2005), Submission to the Queensland Competition Authority – Proposed Schedule F Amendment, February, p.16.

⁵ Queensland Competition Authority (2007), op.cit., p.11.

calculating TAR, the take or pay amounts will be based on what QR Network was entitled to earn under the terms of the relevant Access Agreements.

On reviewing the background material underpinning the development of the revenue cap mechanism, there is a clear intention that take or pay revenue should not result in TAR exceeding SAR, hence the decision to apply a cap to UT2 take or pay. In relation to the cap itself, it is also apparent that the underlying premise of the decision to cap UT2 take or pay was an assumption (in all parties' minds) - whilst not explicitly stated - that the stronger UT2 take or pay obligations are most likely to take TAR above SAR. When commenting on its amendments to the QRC's original two-tier proposal, QR Network stated:

QR's amendment to the QRC's position is slightly more favourable to UT1 Access Arrangements than the Tier 1/Tier 2 arrangement proposed by the QRC. However, any advantage is expected to be negligible as the likelihood of any Tier 1 amounts needing to be capped is low whilst System Forecasts are broadly based upon contracted tonnages. QR's proposal also avoids the complexity arising from introducing 2 Take or Pay arrangements into UT2 Access Agreements.⁶

In our view, the effect that has emerged in the last two years of the regulatory period was therefore not anticipated by QR Network, the Authority or stakeholders.

Why the issue should be addressed

The issue that has emerged here is a reasonably straightforward one. From our review of the 2008 Undertaking and the relevant documentation supporting the development of the revenue cap, it is not clear that UT1 take or pay obligations are to be capped for the purpose of determining TAR.

The capping of UT2 take or pay as part of estimating TAR for the purposes of determining any revenue cap adjustments, but not UT1 take or pay, has the potential to give rise to an inconsistency that in our view, was not intended at the time the framework was developed. To the extent that any differences might be seen to arise, it was not expected to be material. With the reduction in volumes that has occurred following the global economic downturn (which was clearly not foreseen at the time the revenue cap was put in place), it is apparent that the impact is sufficiently material to enable UT1 take or pay amounts to change QR Network's position from an under-recovery of revenue, to an over-recovery. It is also understood that the amounts involved are material.

⁶ QR Network (2007), op.cit., p.18.

There are two main reasons why it should be addressed, being:

1. it is inconsistent with the philosophy underpinning the revenue cap; and
2. it results in inequities between UT1 and UT2 Access Holders that was not intended when the revenue cap was put in place.

Inconsistent with the philosophy of the revenue cap

First, this situation is not seen as consistent with the underlying philosophy of the revenue cap. The revenue cap relates to volume risk. In situations where actual volumes are greater than forecast, the revenue cap requires QR Network to return that additional revenue to access holders (subject to the 2% 'increment'). It does not contemplate SAR being exceeded when volumes are less than forecast due to take or pay.

Creates inequities between UT1 and UT2 Access Holders

It could be argued that it doesn't matter if take or pay revenue takes TAR above SAR (even if volumes are down) because QR Network will be required to return that additional revenue to Access Holders. If all Access Holders were subject to the same take or pay arrangements, this probably would be the case.

However, the inequity that is created here is that:

- UT2 take or pay obligations are capped to the extent of any under-recovery of revenue, which will reduce UT2 Access Holders' actual take or pay obligations relative to contract; while
- UT1 Access Holders must pay the full amount of their take or pay obligations regardless of whether there has been an under-recovery of revenue. Further, if this takes TAR above SAR, this difference will be returned to all Access Holders (that is, UT1 and UT2).

As a consequence, UT1 Access Holders are effectively subsidising UT2 Access Holders.

As outlined above, the different calculation of UT1 and UT2 take or pay was acknowledged and accepted at the time the revenue cap was put in place. The Authority determined that it was not appropriate to address differences in the relative strength of UT1 and UT2 obligations. We agree with this determination because this is the commercial intent of the contracts that were put in place at the time, noting that eventually, all Access Holders will be on the same arrangements. The capping of UT2

but not UT1 take or pay has inadvertently altered the *relative* take or pay exposure of UT1 and UT2 Access Holders.

What this issue is not about is whether or not take or pay obligations under an operator Access Agreement have been passed through to the underlying haulage agreements – this is dealt with by deeming TAR to be the revenue that QR Network was entitled to earn under the relevant Access Agreements. This is of no consequence when considering the issue that has emerged here, which is the difference between the treatment of UT1 and UT2 take or pay for the purpose of assessing any revenue cap adjustments. This anomaly will still arise irrespective of the identity of the Access Holder (that is, operator or end user), or whether these obligations have been passed through.

Recommended solution

For our review of the 2008 Access Undertaking and other documentation submitted as part of the development of the revenue cap, it is not clear that UT1 take or pay obligations are to be capped for the purpose of determining TAR.

There is nothing in the Authority's decisions, or the supporting submissions, to suggest that it was intended that UT1 take or pay could lead to an over-recovery of revenue. There is also nothing to suggest that the resulting implications for UT1 and UT2 Access Holders were recognised and accepted, nor is there any suggested rationale as to why this differential treatment might be seen as acceptable. In our view, one could reasonably interpret that there was an intention that take or pay revenue should not result in an over-recovery of revenue (which in turn necessitates a Revenue Cap Adjustment).

The solution to this problem is a simple one – UT1 take or pay obligations should be capped on the same basis as UT2 take or pay. This will ensure that:

- take or pay amounts (UT1 or UT2) do not lead to an over-recovery of revenue, when actual volumes are at or below forecast; and
- all Access Holders are treated equitably in applying any proportionate reduction in their take or pay obligations. In this context, 'equitable' means:
 - all UT1 Access Holders are treated the same, and all UT2 Access Holders are treated the same (this is achieved by the way the cap is applied); and
 - the relative take or pay contribution of UT1 and UT2 Access Holders to any revenue shortfalls reflects their proportionate contribution to total take or

pay revenue (that is, what would have applied if the cap did not need to be invoked).

As outlined previously, the UT1 take or pay impact for 2008-09 is considered material. Given this, and our view that the problem and solution are relatively straightforward, we would recommend that consideration is given to implementing this change prior to finalising the 2008-09 revenue cap adjustment. This will avoid cross-subsidisation between UT1 and UT2 Access Holders in the last year of the current undertaking period. The necessary amendments would then be carried through to UT3.