

07 April 2010

QCA
GPO Box 2257
BRISBANE QLD 4001

Our ref: 31/23314/180226
Your ref:

Dear Michael Blake

UT3 Maintenance and Operations Costs Response to Stakeholder Comments

This note provides GHD's response to comments recently made by stakeholders associated with the UT3 Maintenance and Operations costs and specifically relating to the draft GHD report "Assessment of Operating and Maintenance Costs for UT3".

We have received from your office submissions from ARTC, QR Network, QR Network written by Deloitte labelled App F, QRC, and QRNational Coal.

We will respond to each submission and summarise our findings.

ARTC

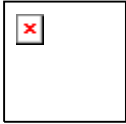
We note ARTC's emphasis on alignment between the parties in the coal chain and particularly the need to align the various elements in regard to reliability of the supply chain overall. While this specific aspect was not included in GHD's brief from QCA we have been conscious of the need to ensure that adequate maintenance is provided to meet the needs of the industry and that short term approaches may save expenditure initially but create large scale disruption. We have taken the view that prevention is better than cure and therefore our approach has been to encourage the use of preventative measures, proactive maintenance or operational measures.

ARTC noted GHD's reference to WestNet and ARTC benchmarks and suggested a "fairly heavy" reliance was taken. In fact GHD sought to assess QR's maintenance costs using both a top down (benchmark) as well as a bottom up approach. In short, GHD found that QR's maintenance costs were in the range expected from a benchmarking exercise but small adjustments were recommended when looking at the more detailed components.

ARTC's first dot point "*ARTC Operating Costs (06/07)*" indicates that the comparison made using an extrapolation of ARTC cost and tonnage data "would seem to be erroneous and likely to be misleading". In concluding that QR's costs were "*if not more efficient than ARTC's Hunter Valley operation*", the earlier comment from ARTC would suggest that this might not be the case. That is, QR's costs would not be more efficient than ARTC's Hunter Valley operation. Further, this may mean there was room for improvement in QR's costs.

In ARTC's second dot point "*ARTC Unit Maintenance Costs (\$07/08)*", indicates that "*the unit costs shown in Figure 22 are likely to have been substantially overstated when contemplated on a consistent basis*". This comment implies knowledge of the components of QR's costs but nevertheless suggest again that ARTC's view is that there is room for improvement in QR's costs.

In ARTC's third dot point "*ARTC Ballast Treatment Expenditure*" indicates that the "*5 year \$8.9m ballast cleaning program on the Hunter Valley coal network... is intended to establish a regular planned*



maintenance and ballast cleaning cycle...following a period of around 20 years where the network had not received any significant ballast maintenance or upgrade". In other words, ARTC regular ballast cleaning program would be lower than the snapshot used by GHD.

In concluding ARTC indicates that *"some conclusions drawn by GHD are questionable"* and from the evidence is suggesting that QR's costs are not comparable with ARTC's, that ARTC's costs are comparatively better than QR's and therefore there is room for improvement in QR's costs.

QR Network and (Deloitte's) App F

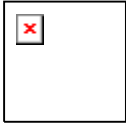
In regard to Operating costs, while GHD's interpretation of the cost components has been questioned by QR Network we re-emphasise the importance of reviewing the basis of cost allocation given the very high proportion of total costs emanating from allocated cost that still exists.

We note that QR Network has concern that GHD may have focussed on accommodation and other minor costs. These were only highlighted in the context of the way allocated costs can cloud the issue of efficiency and the need to be more transparent about reporting costs especially where allocation formulas have little bearing on actual costs being incurred. The allocation by GTK unfairly burdens the heavy haul coal systems with allocated shared costs. This allocation methodology is not a direct criticism of QR Network, rather a suggestion that the regime needs to change. We note that the proposed privatisation of QR may involve the full separation of the coal business from the remainder and therefore this issue may become resolved by other means, except that the principle of transparency will become very important in the proposed vertically integrated business.

In regard to Maintenance costs, a number of areas have been raised by QR Network and will be discussed separately.

With specific reference to the X-factor, GHD's recommendation was framed within the context of QR's overall approach to productivity. We note that QR has chosen to approach productivity by indicating *"a number of efficiency measures were also built into the cost forecasts"*. We were not convinced this was the best approach because it made too many presumptions and we would prefer that QR revealed base year costs and apply appropriate productivity improvements especially in the face of the their stated position in 3.1.2 of Appendix G of their Submission that the maintenance Alliance will amongst other things give "(b) an ongoing optimisation of maintenance effort, continuous productivity improvements and the achievement of efficient cost". Also QR have made it clear that they intend to raise productivity with new machinery which forms the basis of large cost increases and to which we have had no objection.

Therefore with the backdrop of this context GHD believes it is appropriate that an X-factor be applied. As to the size of the X-factor GHD could have made reference to a number of publications including the extensive discussion as part of the reviews made by the Australian Energy Market Commission in 2009, but concluded that the most appropriate was that made specifically for the industry, that carried out by the ERA of WA ("Rail Access Regulation Review CPI-X Implementation –Final Report, 2004"). Given that QR indicates that it has an Alliance arrangement with its maintenance provider that encourages improvements to productivity, that it intends to invest and has invested heavily into new highly productive equipment and that it proposes an MCI that properly reflects costs movements in the industry and to which we have no objection, we believe it is appropriate that QR be subject to an X-factor. The quantum of the X-factor proposed has been derived from analysis within the same industry and is modest in comparison to others proposed in other industries.



In relation to adjustments made by GHD in its Table 9, we have reviewed those calculations and find that errors have occurred, appropriately identified by QR relating to track gang kilometre adjustment and margin. The adjustments to track gang and structures costs were made negatively so that it appeared QR were being penalised for increased track kilometres. The adjustment to margin was applied as a percentage of the remainder rather than to the whole and resulted in a greater amount being subtracted than was warranted. Consequently we provide an amended table as follows:

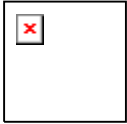
Adjusted Volume			(exclude GAPE)		Total Maintenance Costs (\$m nominal)		
System			2007/08	2008/09	2009/10	2010/11	Financial Year 2011/12 2012/13
[Redacted Content]							
13	QR	Total Proposed	111.5	123.15	152.80	166.07	174.79 172.34
		Direct Labour before any adjustment					
[Redacted Content]							
19	GHD Applied	Add items 13, 15, 16, 17, 18	111.5	123.15	139.05	149.74	156.97 155.82

The locations where the new adjustments have been applied are shaded green.

We have been unable to confirm or otherwise QR's assertion that a real cost increase of 4% has not occurred in their spreadsheet submissions but we are of the view that it is likely an increase has not occurred. The table shown above transparently shows that adjustment and on balance we suggest the QCA adjust costs to reflect the QR position despite the fact that the dialogue in their Submission indicates a real upward adjustment. QR has suggested it is a "misinterpretation" by GHD.

In relation to Margin generally, it has been a difficult analysis in the absence of the actual Alliance contract that is reported to exist between QR Network and QR Services. We have used our own experience in assessing what costs would normally have been included in an alliance arrangement, called direct costs, and what costs would have been omitted. Those costs omitted would be recovered through some sort of margin or overhead allowance.

In this regard we refer to the ARTC Stakeholder submission covered earlier in this note, second dot point "ARTC Maintenance Costs (\$07/08)" where ARTC advises that its maintenance cost reporting "includes all maintenance overheads and infrastructure management" and that "the unit cost figure used for the non-ARTC coal network also includes infrastructure overheads". These statements reinforce GHD's experience that in an alliance arrangement there is transparency of most if not all of the costs. Both parties will normally want to explicitly know where all of the costs are coming from in order to ensure that economies cannot be made by having the most appropriate party perform that portion of the work and



that duplication of effort is not occurring. In particular, where any risks may warrant extra attention, such as in the purchase of large items of materials or consumables and contractor services, these risks are mitigated by the employment of specific resources and which would be accounted for in direct costs.

Our suggestion that labour costs are a more appropriate area to which a margin applies reflects our experience that labour costs are more difficult to predict given training and other on-costs. Therefore we find it very strange that an alliance type contract would permit an all-in 15% factor to account for costs that reside in overheads, especially where it is applied to materials and consumables where manufacturer warranties, contractor warranties and other Quality Assurance measures are taken as a matter of course.

We note that the Deloitte report asserts that applying a margin to labour results in *“This would place a large proportion of maintenance costs at risk given the costs reimbursed to QR Services are not based on actuals, rather a budget which is prepared once every four years. QR Network have no opportunity to revisit the budget on the basis of fluctuations in the economic environment”* does not recognise the MCI mechanism proposed by QR and to which we have no objection. We have no objection to appropriate maintenance equipment capital cost recovery.

QRC

We agree with the QRC concerning the possibility of a maintenance deficit despite QR’s assertion that there is none. We do however note that considerable effort is being applied to modern maintenance practices with large increases in equipment capital expenditure and a pro-active approach to maintenance.

QRNational

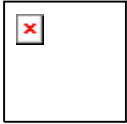
QRNational has described QCA’s decision as labelling QR Network’s costs as “inflated maintenance costs”. We reject any notion that any of our comments imply “inflated maintenance costs” as we have simply made recommendations where improvements could occur to the way in which costs are collected and allocated. We are concerned that longer term pro-active preventative maintenance practices occur and we have found no objection to the work program and the costs for MPM maintenance. We do however have difficulty understanding why in view of that pro-active program it is necessary to continue to provide high levels of reactive maintenance in the form of a Track and Structures workforce and to apply a margin to materials consumables and contractor services where those functions should be relatively easy to manage given appropriate direct costs functions.

The MCI arrangement proposed by QR will assist alleviate the movements in CPI amongst the various components of cost.

Summary

In reviewing the operations costs we remain of the view that the allocated component of those costs remains too high and that a review is required of the basis for any allocation. In view of QR’s privatisation proposal this review may take another path.

In relation to maintenance, we acknowledge that some adjustments need to be made to calculation errors when making adjustments in our Table 9 and these have been detailed in this note.



Overall we believe that we have represented a proper view of QR Network's Submission in relation to efficient and reasonable costs in compliance with your Brief. Our views have been reinforced or confirmed in many areas by way of these Stakeholder submissions and firmly believe that indeed there is room for improvement in QR's costs.

The main area of modification and controversy has been in relation to the proposed Margin. Without sighting the actual Alliance contract and its component unit rates and scoping we have had to rely on our own experience and other evidence to understand or reject the basis for a margin to be applied to any of the maintenance components. We have largely rejected the idea that a blanket Margin be applied.

If there are any further comments required please do not hesitate to contact us.

Yours faithfully
GHD Pty Ltd

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