

QRC

submission

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A large, stylized graphic of a leaf or petal, composed of several overlapping, curved lines. The lines are in shades of grey and green, creating a sense of movement and growth. The graphic is positioned on the left side of the page, partially overlapping the text.

Submission in response to:
QR Network's 2010 Draft Access Undertaking
– *Reference Tariffs*

To the Queensland Competition Authority
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INTRODUCTION	3
→ QRC's Position on QR Network's proposed UT3.2 reference tariffs:	3
QR NETWORK'S PROPOSED REFERENCE TARIFFS	4
1. Weighted average cost of capital	4
→ Overview	4
→ QR Network's proposed equity beta is excessive	5
→ Further evidence in support of a lower beta estimate.....	6
→ Risk Free Rate	7
→ Gamma	7
2. Opening asset value and proposed maintenance costs	8
3. Removal of endorsed projects from the Capital Indicator	8
4. Overarching concern with excessive internal margins.	9
5. Appropriateness of QR Network's revised electric transmission and connection charges	10
6. Accelerated depreciation	10
7. Western System Reference Tariffs and Revenues.....	10
8. Maintenance Issues – scope, costs and obligation to maintain the network.....	11
→ Maintenance incentives and obligations.....	11
→ QRC's proposed approach to ensuring the network is maintained	12
(i) <i>Obligation to maintain the network.....</i>	12
(ii) <i>Annual Network Maintenance Master Planning process.....</i>	13
(iii) <i>An allowance built into reference tariffs which reflects the reasonable cost of expected maintenance</i>	13
(iv) <i>Write down of assets to reflect current condition.....</i>	14
(v) <i>A maintenance scope 'unders/overs' mechanism</i>	14
(vi) <i>Establishment of incentives under the proposed incentive framework w</i>	15
(vii) <i>A defined process to independently assess the condition of the network at the end of the regulatory period</i>	15
(viii) <i>A requirement that Access Agreements should not excuse QR Network from meeting its obligations</i>	15



INTRODUCTION

QRC provides this submission to the Queensland Competition Authority (QCA) in order to assist in the assessment of the proposed reference tariffs and system allowable revenues contained in QR Network's 2010 voluntary draft access undertaking (UT3.2).

QRC has been informed that the QCA will undertake a 'parallel' consultation process for the remainder of UT3.2 – thereby providing additional time for submissions and consultation on 'non-price' matters. QRC welcomes the additional time allowed for the consideration of non-price matters, given that the initial deadline for submissions provided by the Authority effectively afforded QRC and its member companies 14 business days to review QR Network's UT3.2 related documentation (comprising in excess of some 1,700 pages of material).

However, as was noted by the QCA in the December 2009 Draft Decision, "*any assessment of the WACC should be in the context of the risks faced by QR Network*". These risks are yet to be determined, and most likely will be resolved in a process which will be concluded after the assessment of QR Network's reference tariffs. QRC considers that the parallel process could readily address this issue by:

- approving reference tariffs for the 2009/10 year only, or
- releasing a draft decision on non-price matters prior to the approval of reference tariffs, and ensuring that the final decision on non-price matters is based on a similar risk profile.

QRC requests that the QCA clarifies its approach in this regard.

In order to assist the QCA's assessment of QR Network proposed reference tariffs, QRC has sought to keep this submission focused on the cost and tariff elements of reference tariffs and system allowable revenues. QRC intends to make timely submissions to the QCA as industry develops formal responses on the remaining items, which includes the remainder of Schedule F. We note that Schedule F amendments can potentially alter reference tariffs, but consider that these issues must be addressed in conjunction with the remainder of the undertaking, given the strong links between elements of the undertaking and the fact that alternations to the remainder of Schedule F would not result in changes to 2009/10 reference tariffs.

→ QRC's Position on QR Network's proposed UT3.2 reference tariffs:

QRC Position

QRC strongly supports that the QCA develops a process which ensures that approved reference tariffs are appropriate in the context of the risk profile faced by QR Network under the ultimately approved undertaking. For reasons set out in the remainder of this submission, QRC considers that the QCA should **not approve** QR Network's proposed UT3.2 reference tariffs.



QR NETWORK'S PROPOSED REFERENCE TARIFFS

QR Network has proposed reference tariffs for coal-carrying train services operating on the central Queensland and Western coal systems. QRC provides the following submission in support of the QCA not approving these proposed reference tariffs and system allowable revenues. QRC's rationale is outlined in further in detail within this submission.

1. Weighted average cost of capital

→ Overview

QRC considers that the appropriate WACC must be assessed in the context of QR Network's risk profile. QRC notes the very low risk nature of QR Network's business and the systematic process of risk reduction achieved by QR Network over recent years. This has included, under UT2:

- The introduction of the Revenue Cap to address volume risk.
- Significant strengthening of Take or Pay to address stranding risk.
- Significant strengthening of Relinquishment Fees to address stranding risk.
- The introduction of a regulatory pre-approval mechanism regarding the prudence of the scope of capital expenditure, addressing optimisation risk.
- Accelerated depreciation, imposing a maximum remaining life of 50 years to all assets in the regulatory asset base, reducing asset stranding risk.
- Asymmetric use of regulatory processes.

The 2009 QCA Draft Decision supported the following additional proposals to further reduce QR Network's risk profile:

- accelerated depreciation mechanism for new capital expenditure;
- annual updates of volume forecasts;
- indexation of maintenance costs annually to a special purpose index;
- indexation of system allowable revenues by actual CPI;
- pass-through for costs greater than \$1 million arising from catastrophes;
- widening of the circumstances in which QR Network may seek Access Conditions; and
- dramatically reducing the scope of QR Network's obligation to invest in the network.

Meanwhile, the market outlook for QR Network's below-rail coal carrying train services continues to be strong, even when tested under the conditions created by the global financial crisis.

QRC has difficulty commenting on the WACC at this stage, given that "any assessment of the WACC should be in the context of the risks faced by QR Network" (QCA 2009 Draft Decision). However, we can say that the proposed WACC is excessive for the minimal risk profile proposed by QR Network, which includes (among many other risk mitigation measures) an obligation to invest only in 'minor' projects, and a right to seek above-regulated (in fact, unlimited) returns on all other projects. Should QR's proposal succeed, the WACC now being determined by the QCA will apply only to past investments and minor future projects, while QR Network's average returns will be significantly higher. This highlights the difficulty of assessing a WACC independently of the remainder of the undertaking.

In regard to the key issue of the investment hold up problem, QRC does not support this aspect of the draft undertaking and will be proposing an alternative for the QCA's consideration. However, we do



not consider that anything in the alternative proposal will impose additional risks on QR Network sufficient to justify the proposed WACC.

→ **QR Network's proposed equity beta is excessive**

QRC considers that the equity beta should be set at a lower rate than is proposed by QR Network. Certainly the QR Network proposed equity beta of 1.00 is beyond the top end of a credible range. The QCA's 2009 Draft Decision clearly articulated that there is a strong case for an equity beta **lower** than 0.80.

In summary, the 2009 Draft Decision:

- noted the results of a recent study by Professor Olan Henry (2008) prepared for the AER for its final 2009 decision on WACC parameters for electricity transmission and distribution businesses, which recommended an equity beta range of 0.35 to 0.62;
- agreed with QCA's consultant ACG that the most relevant comparators are the Australian regulated energy businesses;
- considered that QR Network's riskiness would tend to sit below that of the Australian regulated energy businesses and noted that the various mitigation measures that the Authority proposed to accept would further reduce QR Network's exposure to covariance (non-diversifiable or systematic) risk;
- concluded that given the measures it was proposing to accept and the demand and cost conditions of Queensland coal producers, QR Network's asset stranding risk is minimal;
- concluded there was a strong case for an equity beta lower than 0.80
- despite presenting strong evidence that a beta of 0.80 was beyond the top end of a reasonable range, proposed 0.80 as a conservative estimate.

In light of the risk mitigation measures which QR Network has been able to extract over recent times and the evidence provided by the QCA in the 2009 Draft Decision, QRC considers that the cost of capital for QR Network should be significantly less than that provided by the QCA's Draft Decision. QRC concurs with the QCA's view that QR Network has a lower risk profile than the Australian regulated energy businesses.

*The Authority believes that **QR Network's risk profile should sit below these businesses** because QR Network is less exposed to the Australian economy and has in place, and has sought additional, risk mitigation measures that do not apply to the electricity networks. These businesses all face significant capital expenditure challenges. (QCA Draft Decision: 25)*

Indeed the QCA observed that:

*the AER determined an equity beta of 0.80 for the electricity networks **despite robust evidence that the high end of a reasonable range was 0.70**. (QCA Draft Decision: 25)*

The equity beta approved by the AER with respect to the Australian regulated energy businesses, of 0.80, was derived at 60% benchmark gearing levels and is equivalent to a beta of 0.71 at QR Network's benchmark gearing of 55%. As such, QRC considers that based on the evidence provided



by the QCA's 2009 Draft Decision (and its consultant ACG), there is sufficient justification that QR Network's equity beta is well below 0.71.

QRC considers QR Network's proposed equity beta is not within a credible range and would lead to a return materially in excess of the commercial and regulatory risk involved. Approving QR Network's proposed equity beta would not provide for the efficient use of and investment in rail infrastructure.

QRC considers that an equity beta of 0.71, at the proposed gearing of 55%, would:

- provide QR Network with a clear and identifiable uplift in the WACC – thereby providing QR Network with an unequivocal and explicit incentive to invest in the network into the future.
- be at the upper end of the reasonable range, provided that the final decision on non-price elements of the undertaking:
 - provides a strong and enforceable obligation to invest; and
 - is effective in preventing QR Network from using the investment hold up to extract unjustified additional returns.

QRC therefore considers that the QCA should determine a WACC based on an equity beta of up to 0.71 AND determine a strong and enforceable obligation to invest and effective mechanisms to prevent QR Network from using investment hold up to extract unjustified additional returns

→ **Further evidence in support of a lower beta estimate**

QCA has requested additional evidence on whether a lower equity beta estimate is justifiable for QR Network.

QRC considers that adequate evidence was presented by the QCA in the 2009 Draft Decision. However, an additional consideration for the QCA is the effect which non-standard agreements recently signed have will have on QR Network's risk profile and actual financial returns. Limited information regarding these agreements has previously been submitted to the QCA by a coal producer. Given that these agreements will remain in place regardless of the terms of UT3, they are a relevant consideration.

The ability of QR Network to receive above-regulated returns and excessive risk transfer arises from material weaknesses in the current access undertaking's provisions surrounding QR Network's obligation to invest and the scope of the declared service applying to infrastructure which is not yet operational, in combination with unworkable mechanisms for the timely resolution of these situations. Coal Producers are forced to choose between the cost of excessive project delays and the cost of accepting QR Network's conditions.

Irrespective of the merits, or otherwise, of the circumstances surrounding these agreements, QRC considers that the arrangements which have been entered into are relevant considerations in terms of QR Network's commercial and regulatory risk profile for the UT3 period.

QRC urges the QCA to use its section 185 powers in order to obtain relevant documents associated with the project deeds, and related documents, which are essential in understanding how these



'commercial' agreements impact on regulatory arrangements, and how these operate to lower QR Network's risk profile.

→ **Risk Free Rate**

QRC supports the QCA's approach of seeking to match the risk free rate and debt margin to the regulatory cycle (ie. in this case, five years) on the basis that the risk-free rate will be adjusted in any subsequent regulatory reset.

To the extent that any QCA approach seeks to incorporate hedging costs to address risks associated with borrowing strategies, QRC endorses the QCA's 2009 Draft Decision:

The Authority considers that the need to hedge the debt premium component stems from a strategy of using borrowings which have an average term in excess of the regulatory period and using the hedge market in an attempt to match the interest rate exposure with the regulatory period. Using borrowings which have a term that closely matches the regulatory term will avoid this mismatch, and potential risk, provided that the costs of refinancing debt are adequately met. The Authority considers that the uplift to the debt margin is reasonable in this regard. The actual debt financing and hedging strategy adopted is of course a matter for the individual regulated businesses.

QRC notes that the AER's review examined the debt profile of the Australian regulated energy businesses and found that the debt portfolios of these businesses were structured with the majority of debt having maturities less than five years (AER, December 2008).

→ **Gamma**

Gamma is the market value of each dollar of corporate tax paid by the company that could be distributed to the company's shareholders – a higher/lower gamma will result in a lower/higher tax allowance being included in QR Network's cashflows (and therefore have an impact on QR Network's proposed tariffs and system allowable revenues).

The QCA's 2009 Draft Decision notes that the Authority's proposed selection of gamma was based on QR Network's lower estimate of 0.50, which also reflected the QCA's practice of determining the gamma.

Given that the Authority rejects the estimate for gamma of zero, and the other estimate used by QR Network was 0.50, the Authority has chosen 0.50 as the value of gamma, which is consistent with its practice to date. (QCA Draft Decision 2009, p 24)

QRC has considered the contemporary regulatory evidence and suggests that the QCA should review QR Network's proposed gamma in light of recent Australian regulatory decisions (AER and ACCC) which have subsequently supported changing regulatory assumptions to adopt an estimate for gamma of 0.65. Indeed, QCA noted in its 2009 Draft Decision that:

as the utilisation rate for a domestic CAPM is likely to be closer to one than the current estimate of 0.625 adopted by the Authority, as any estimate should exclude the effect of foreign investors. In addition, it is noted that the AER recently increased its estimate of gamma from 0.50 to 0.65 (QCA Draft Decision 2009, p 24)



The AER's May 2009 Final Decision for Australian energy businesses reviewed the basis for estimating of gamma, with the AER considering the reasonable range for gamma and recommending a point estimate for gamma of 0.65. More recently, the ACCC recently endorsed the AER methodology within its March 2010 Draft Decision on ARTC's Hunter Valley Coal Undertaking and recommended a gamma of 0.65.

The arguments and evidence considered by the AER and the ACCC in support of a gamma of 0.65 are available in public documents. QRC looks forward to reviewing the QCA's consideration of these matters.

2. Opening asset value and proposed maintenance costs

QRC proposes that QR Network's opening asset value should be written down to the extent that the network's condition is found to be adversely impacted due to past maintenance or operational practices that have resulted in significant deterioration of the network assets. Further details are provided in *Section 9 – Maintenance Issues - Scope, Costs and Obligation to Maintain the Network*.

QRC remains concerned about the exclusion of certain system wide assets from the regulatory asset base, based on the sole consideration of ownership by the related parent company (QR Limited). Simply transferring assets out of QR Network could be used as a non-price means of restricting competition or earning above-regulated returns. It is not clear to QRC how these assets are being treated for pricing purposes – for example, are costs now:

- being based on allocations from QR Network's Costing Manual (which gives rise to a range of concerns about the efficiency of allocating inefficient costs using allocators),
- determined on a fee for service which includes 'special' margins; or
- provided on the same basis as when these assets were included within the regulatory asset base.

QRC is interested in understanding the methodology and proposed costs for these assets and how these have been developed for inclusion within tariffs.

3. Removal of endorsed projects from the Capital Indicator

QRC is concerned that QR Network has arbitrarily removed a number of Blackwater duplications which have already been approved by coal customers through the Master Plan endorsement process from the proposed UT3 capital indicator.

Even more concerning to industry is that QR Network now proposes that these duplication projects will be subject to a range of 'commercial principles' as proposed within the *Rail Infrastructure for Wiggins Island Terminal Project - Request for Proposals* document which has been provided to companies participating in the Wiggins Island Coal Terminal (WICT) project. QR Network now claims that:

- these Blackwater System duplication projects involve QR Network accepting '*higher risks than regulation*' such that a '*project fee*' is required which will deliver '*QR Network a 15% pre-tax nominal rate of return on its total investment*'; and, mysteriously
- The original Master Plan reasoning for these projects being required by Blackwater System coal producers is no longer valid – even though this has not been justified by QR Network to the Blackwater System coal producers. The original scope justification submitted by QR Network, and subsequently endorsed by industry, was clearly outlined in *Working Paper 4.4 - Rationale for Projects - SBB76 (UT3)* for the remaining duplication between Rocklands and Blackwater:



Summary and Conclusion

Initial modelling using the static (CPUM) model indicated that a number of track sections would either significantly exceed or approach the 75% utilisation threshold which is a trigger point for consideration of infrastructure expansion action. In priority order the track sections to be reviewed were: Walton-Bluff, Kabra-Stanwell, Dingo-Umolo, Rocklands-Gracemere, Umolo-Parnabal, Parnabal-Walton and Gracemere-Kabra.

Dynamic modelling revealed that the single line section of Walton-Bluff would meet the scenario criteria with an above rail infrastructure increase to 31 Blackwater trains and 6 Moura trains. Because of the impact of the new proposed track possession regime under Access Undertaking UT3, it is proposed to add another duplication to provide a buffer. With Walton-Bluff, the Rocklands-Gracemere duplication will add 1.6mtpa after they have been constructed.

The benefits of duplicating all of the remaining single track sections were mentioned. This included the additional robustness to handle unforeseen variability and reduction of the impact of maintenance and construction.

The experience raises serious concerns about the independence and efficacy of master planning processes. In regard to the specific Blackwater duplications, QRC considers that the process undertaken during 2008, involving:

- QR Network proposing and justifying the projects
- Customers endorsing the projects based on this analysis
- QCA confirming that these projects were endorsed

confirms that the projects are required and are “commercially justified” based on the tests under Section 7.4.1(n) of the current Access Undertaking.

In light of the above circumstances, QRC urges the QCA to:

- Include these duplication projects within the capital indicator which is used to determine reference tariffs for the Blackwater System; and
- ensure that the non-price provisions of the undertaking include obligations to invest in the network which ensure that QR Network completes projects such as these without seeking above-regulated returns.

4. Overarching concern with excessive internal margins.

QRC remains concerned about the potential for the QR Group to earn returns beyond the WACC from its regulated QR Network business through application of margins on services (such as maintenance, insurance and capital expenditure) provided to QR Network by related parties. QRC considers that the efficient cost of providing these services should be assessed as the lesser of:

- The market rate for outsourced provision of the relevant services; or
- The cost at which QR Network (or a related QR party) performs the services (as it would be inefficient to outsource at a higher cost than the cost of self-performing the services).



QRC suggests that matters associated with excessive margins and QR internal-sourcing should be addressed within the QCA's proposed review of the Costing Manual. QRC will be making further submissions in relation to improving the transparency and consultation for the QCA's review of the Costing Manual in subsequent submissions to the QCA.

5. Appropriateness of QR Network's revised electric transmission and connection charges

In light of QR Network's new approach to forecasting transmission and connection charges, QRC considers that the QCA will need to review the proposed methodology and test the reasonableness of the proposed costs associated with these services. In particular, QRC would expect the QCA to commission an independent review to assess the relationship between the revised costs proposed, including the Powerlink 2009-10 charges and the scoping paper provided regarding the four new substations in the Blackwater System.

In the time available, QRC was unable to engage any formal review of QR Network's proposal.

6. Accelerated depreciation

The proposed rolling cap of 20 years for depreciation to apply to all new capital expenditure provides QR Network with a materially lower risk profile as it does not necessarily correlate with the asset lives of the projects to which these arrangements will apply, nor to the risks associated with these projects. QRC considers that the proposed rolling cap should not necessarily apply to all capital expenditure, nor necessarily be restricted to 20 years. The capping is proposed to occur notwithstanding that there may be no evidence of a material asset stranding risk.

QRC considers that setting of the rolling cap (term and scope of application) should be applied within the overall policy investment framework surrounding Significant Investments and the appropriate commercial arrangements QRC would like to propose to apply to such investments. QRC will be providing more information around these proposals in the weeks ahead as part of the industry's consideration of approaches to risk mitigation and ensuring sufficient incentives for QR Network to invest.

7. Western System Reference Tariffs and Revenues

QRC does not consider that QR Network has demonstrated that its proposed Western System tariffs are derived based on a robust methodology, nor that the methodology is suitable for 'rolling forward' to the next undertaking in order to avoid subjective judgements in regard to UT4 tariffs. QR Network and the QCA failed to establish a robust approach to determining Western System tariffs for both UT1 and UT2. This matter has therefore been before the Authority since 1999. QRC is strongly opposed to a further decision which leaves this matter unresolved.

QRC considers that a reasonable process must be established for the assessment of Western System tariffs and that, in the absence of this process, no tariff increase should be approved. We note the apparent urgency to settle the tariffs for the Central Queensland region in the context of the privatisation of these assets and the natural focus of all parties on this part of the system. This focus appears set to prevent a proper assessment of tariffs and other issues for the Western System. We therefore suggest that existing tariffs be approved as the appropriate tariffs until a proper assessment of Western System issues and tariffs is completed at a later date.



Given that a new undertaking will be required upon the planned transfer of the Western System assets to a new Government Owned Corporation, and that this will raise a range of issues beyond tariffs, we suggest that the interim tariffs should remain in place until replaced by a properly assessed undertaking for the new GOC.

QRC considers that there should be no increase in Western System tariffs until the case for increases is demonstrated by a reasonable, repeatable and robust methodology.

8. Maintenance Issues – scope, costs and obligation to maintain the network

→ Maintenance incentives and obligations

QRC considers that the undertaking should be structured to provide appropriate incentives to ensure that adequate maintenance of the network is undertaken at an efficient cost.

The key concerns of industry with the approach taken to maintenance costs under the DAU are:

- QR's allowable revenues will include an allowance for maintenance costs, which QR Network will receive whether or not it does the work for which it is being paid. Therefore QR has a financial incentive to cut back on maintenance work.
- If QR fails to adequately maintain the network, the amount of maintenance activity required under UT4 will be increased, and there is a risk that industry will pay twice for the same work.
- To the extent that cutting back on maintenance impacts on the condition of assets and results in losses of system throughput, QR Network's revenues are protected under the revenue cap arrangements, and QR Network faces no meaningful financial incentives in regard to its performance either through KPI arrangements, the terms of Access Agreements or any other mechanism.

Currently, the only commercial incentives for QR Network to improve its maintenance performance are the risk that the QCA will identify an 'inefficiency gap' between QR Network's total actual costs and the QCA's determined level of total efficient costs for maintenance activities, or that the QCA will reduce asset values to reflect the condition of assets.

QRC considers that the current arrangements may result in QR Network seeking, to the extent possible, to constrain its maintenance spending to match the 'budget' approved by the QCA. As articulated by QR National Coal (submission to the QCA 2010):

*maintenance costs will determine the level of maintenance provided by QR Network ...
If the maintenance budget is insufficient, QRNational anticipates speed restrictions
will increase in response as maintenance levels fall behind demand on the network.
Speed restrictions decrease system capacity and QRNational's ability to deliver to
contracts. (QRNational Coal, 2010 p7)*

The risk of this is that, where the QCA reduces QR's claimed budget to reflect efficient costs, QR will respond by reducing the scope of work undertaken. For example, QR Network's submission (Volume 1) has sought to reduce its total maintenance by removing the costs of additional equipment which are required to complete ballast cleaning.



QRC considers that the undertaking must be structured to provide appropriate incentives to ensure that adequate maintenance of the network is undertaken at an efficient cost. QRC has prepared an approach designed to achieve this outcome.

→ **QRC's proposed approach to ensuring the network is maintained**

QRC suggests a framework to address concerns with the maintenance of the network which has the following elements:

- (i) An obligation to maintain the coal network
- (ii) An annual Network Maintenance Master Planning process to support this obligation.
- (iii) An allowance built into reference tariffs which reflects the reasonable cost (taking into account the current condition of the network) of undertaking the expected maintenance scope over the coming regulatory period.
- (iv) A write down of the existing RAB if necessary to reflect QCA's findings regarding the current condition of the assets in regard to ballast fouling.
- (v) A maintenance scope 'unders/overs' mechanism, which ensures that QR Network ultimately recovers, in respect of major maintenance items, the unit cost (based on an approved unit cost allowance) of the actual quantity of maintenance completed during the regulatory period.
- (vi) Establishment of incentives under the proposed incentive framework which reflect the impact on QR's performance in regard to maintenance.
- (vii) A defined process to independently assess the condition of the network at the end of the regulatory period, and to further adjust the asset base to the extent that QR Network has failed to maintain the network.
- (viii) A requirement that Access Agreements should not excuse QR Network from meeting its obligations to provide train paths on the basis of performing maintenance tasks.

QRC presents the following recommendations to the QCA to address each of these matters.

(i) Obligation to maintain the network

QRC considers that any lease agreement between the asset lessee (QR National) and asset owner (State Government) must include a meaningful obligation to maintain the network. However, as neither the QCA, Access Holders or Customers will be in a position to enforce these obligations, and the details of the obligations (if any) are not known, the undertaking needs to deal with maintenance issues without reliance on possible lease terms.

Fundamentally, QRC considers that control and accountability for infrastructure must reside with QR Network as the railway manager of the Queensland coal network, and this responsibility must be very clearly defined. As such, QRC considers that the Access Undertaking must explicitly provide for an obligation on QR Network to undertake maintenance of the rail network to a defined standard: at least to a 'fit for purpose' standard to meet contracted below-rail train paths.

QRC notes that other regulatory regimes include maintenance obligations on regulated railways. These include the proposed ARTC regime which contains an obligation on ARTC *"to maintain the Network in a condition which is fit for use by an Operator"*. Also, in regard to lease agreements, the Tarcoola to Darwin railway access regime has a similar obligation, and the Westnet lease agreement contains obligations for the network to be maintained to a standard that is "fit for purpose".



(ii) Annual Network Maintenance Master Planning process

QRC considers that the Access Undertaking should provide for QR Network to develop a transparent *Network Maintenance Master Plan* in order to:

- inform the CRIMP and any whole of coal chain system plan of future impacts on system performance of maintenance activities/operations.
- provide a sound basis for the assessment of efficient maintenance costs included within reference tariffs.
- provide participants in the coal supply chain with the opportunity to consider issues such as trade-offs between maintenance and capital expenditure, or options for minimising the impact of maintenance activities to create additional capacity.
- ensure QR is seeking to implement and achieve reasonable efficiencies within its maintenance operations.
- ensure there is sufficient data regarding the condition of network assets, such that the evaluation of investment in asset renewal or maintenance is being undertaken appropriately. QR Network's asset renewal program must be closely integrated with its network maintenance plans.

QRC notes that modifications to the proposed review of QR Network's asset management plan could reflect the intent of this proposal and recommends the above process to the QCA for its consideration. Moreover, it is important that this process promotes transparency, and as such, the Network Maintenance Planning Process should include obligations to consult with industry during its development.

(iii) An allowance built into reference tariffs which reflects the reasonable cost of undertaking the expected maintenance scope over the coming regulatory period.

QRC notes the QCA's draft findings regarding the current condition of assets in respect of ballast fouling. To the extent that maintenance costs during UT3 are expected to exceed 'efficient' levels due to the quantum of work required, QRC has strong concerns about an approach which provides QR Network with revenue based only on the efficient cost. As discussed above, the concern is that QR Network will reduce scope to match budget, leaving the existing issues unremedied.

QRC's preferred approach is to include in QR Network's allowable revenue the amount which QR Network will reasonably be expected to spend, based on efficiently performing the task which the network owner now confronts. To the extent that this cost exceeds an efficient cost due to past practices, this should be reflected in a write-down of assets (discussed below). This approach is necessary in order to ensure that QR Network faces no financial incentives to neglect to undertake the required work.

QR Network would effectively be provided with a budget based on the efficient cost to maintain the asset starting from its current condition (which includes poor condition or more expensive activities associated with past inefficient practices or maintenance backlogs).



(iv) Write down of assets to reflect current condition

QRC considers that an asset write down is a preferred approach to addressing any deterioration of assets due to past maintenance failures. This write down should, at a minimum, reflect the extent to which future maintenance costs are expected to exceed efficient costs due to past practices.

QRC does not have adequate information as to the current condition of the network in order to comment on the extent of any adjustment. To the extent that this lack of information is also faced by the QCA, QRC would suggest that an immediate write down be required, based on the minimum adjustment which the QCA is currently able to determine, and that a review process be established within the undertaking to carry out further assessment. This would enable an independent assessment of the current condition of the network – including an assessment of how QR Network's operational, asset renewal and maintenance practices have impacted on the condition of the network. This task should be undertaken by the QCA to ensure that the assessment is genuinely independent of QR Network. This initial independent review should commence immediately, with the access undertaking containing an obligation on QR Network to provide the QCA with all information and assistance to complete this asset condition review process.

Following the completion of the QCA review of the condition of the network, the Authority will be in a position to understand if the network has deteriorated to the point of impairing the asset due to deficient practices – beyond the already identified ballast contamination issues. Triggers for an adjustment to asset values should include, but not be limited to, impacts on capacity (including foregone capacity), higher than otherwise required levels of temporary speed restrictions, and higher operational costs to address deficit maintenance practices (such as those which have been identified relating to ballast cleaning).

(v) A maintenance scope 'unders/overs' mechanism

QRC proposes this mechanism to ensure that QR Network ultimately recovers, in respect of major maintenance items, the cost (based on an approved unit cost allowance) of the actual quantity of maintenance completed during the regulatory period.

QRC considers that it is essential that a scope carryover mechanism be established for major maintenance tasks. This is a similar approach to that provided for capital expenditure variations and will remove contention surrounding changes to maintenance plans for major maintenance tasks.

QRC considers that there is merit in the development of mechanism that adjusts for scope variations in order to:

- Enable operational decisions which move maintenance resources within systems (for example, ballast cleaning activity from Goonyella to Blackwater due to timing associated with capital works projects) to be reflected within reference tariffs.
- Ensure that QR is not paid twice for maintenance which is deferred into a subsequent regulatory period.
- Ensure that QR Network does not face a financial disincentive to complete maintenance in excess of the quantities expected if this is found to be necessary.



(vi) Establishment of incentives under the proposed incentive framework which reflect the impact on QR Network's performance in regard to maintenance.

This is to be considered as part of the deferred process proposed by the QCA outlined in Part 2 of the proposed access undertaking – QRC will be making detailed submissions in response to this proposal.

(vii) A defined process to independently assess the condition of the network at the end of the regulatory period, and to further adjust the asset base to the extent that QR Network has failed to maintain the network.

As previously discussed, the QRC supports a defined process within the access undertaking for the independent assessment of the condition of the network by the QCA. QRC supports the QCA's review on the condition of the network to be finalised six months prior to the expiry date of the undertaking (that is, this process should be undertaken by the QCA prior to the commencement of future regulatory periods).

While the proposed unders/overs mechanism is an appropriate solution to address reasonable shifts in the timing of maintenance between regulatory periods, it will not address the issue of insufficient maintenance doing damage to the assets or increasing the unit cost of future maintenance.

(viii) A requirement that Access Agreements should not excuse QR Network from meeting its obligations to provide train paths on the basis of performing maintenance tasks

To the extent that QR Network has contracted train paths within Access Agreements, these would be expected to be developed on a basis which takes into account QR Network's maintenance practices. QRC understands that QR Network includes a range of modelling allowances to ensure that it is able to contract train paths based on a level of maintenance possessions such that it can meet contracted train paths. Therefore maintenance should not impact on the delivery of contracted paths.