



**Submission To Queensland Competition
Authority**

**QR Draft Amending Undertaking
– October 2007
(Escalation)**

October 2007



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1 Executive Summary

Asciano welcomes the opportunity to provide this submission to the Queensland Competition Authority (QCA) regarding the approval of the QR Limited amending access undertaking (AAU) submitted to the QCA in October 2007.

Our key comments are as follows:

- The AAU is a result of an error of methodology in a previous amendment to the QR 2005 Rail Access Undertaking (UT2) earlier this year. This is the second amendment relating to errors in UT2 and the fourth amendment to UT2 since its approval in June 2006.
- Asciano has significant concerns regarding QR's approach to the regulatory process. The almost continual amendment of UT2 and the admitted errors undermine confidence in UT2 and the regulatory process. It is critical for the QCA to adopt measures to avoid further errors by QR and re-establish the integrity of the regulatory process.
- QR has identified certain modelling errors and sought to correct them to its own benefit. Stakeholders have no mechanism to determine whether there are any other errors that ought to be corrected, either that QR has not publicly recognised or of which QR itself is unaware.
- Asciano suggests that an appropriate way for the QCA to avoid such errors and to restore stakeholder confidence in the process is to require QR to provide a full independent audit of the methodology for determining the revenue cap, reference tariffs, the calculation of those values for which approval is being sought in the AAU and their incorporation into UT2.
- The QCA should require QR to conduct such an audit whenever it seeks approval of an undertaking or amendment in the future to avoid the reoccurrence of unnecessary remedial amendments.
- In the specific circumstances which surround the AAU, Asciano supports QR's proposal that the System Allowable Revenue (SAR) be adjusted to reflect the actual consumer price index (CPI) of the period, provided that the calculation correctly applies the quarterly escalator adjustment to the relevant revenues and that the model used to perform the calculation is independently audited.

2 Background

The AAU is the fourth amendment being sought to UT2 since it was approved by the QCA in June 2006.

Asciano's understanding is that the issue that has led to QR submitting the AAU for approval is a result of the change from a price cap to a revenue cap earlier this year. The effect of that change was to bring a previously benign artefact of the methodology used in the calculation of reference tariffs into conflict with the calculation of the SAR that forms the new revenue cap. Specifically, the escalation of reference tariffs is achieved through the application of the actual CPI for the previous quarter while the calculation of the revenue limit is based on a forecast escalator at the commencement of the regulatory period. This leads to an unintended mismatch between the actual revenue and the SAR unless actual CPI is exactly the same as forecast CPI throughout the regulatory period – an unlikely occurrence.



QR is seeking to remedy the error through an ex post adjustment of the forecast CPI to match actual CPI for the relevant period.

3 Undertaking Approval Process

The QR submission raises several issues regarding the process for approval of UT2 itself and the subsequent amendments to UT2. These are:

- Responsibility for the conduct of the regulatory process.
- Transparency in calculation of reference tariffs.
- Reference tariff calculation errors.
- Reliance of stakeholders on the QCA.
- Burden on stakeholders in regulatory process.

Each of these is discussed below.

3.1 Responsibility for the conduct of the regulatory process

The AAU represents the fourth amendment to UT2 being considered this year. Two of these amendments were as a direct result of QR's errors in previous regulatory processes. Considerable time and resources are expended by the QCA and stakeholders in responding to each undertaking and amendment, and presumably QR also invests considerable resources in addressing these issues.

The QCA Act which governs much of the regulatory process associated with undertakings places the owner of a facility in a position to take a significant level of control in the initiation of the regulatory process. For example, a facility owner may submit a voluntary undertaking or amending undertaking at any time.¹

The QCA Act does not expressly place any obligation on a facility owner to act responsibly with regard to initiating the approval of an undertaking. However, given the time and resources all stakeholders are required to invest in the process, and the proponent's access to key information and its control over initiation of the process, there is clearly a moral obligation that the party seeking regulatory approval will:

- not engage in the process recklessly;
- avoid knowingly making material misrepresentation; and
- take reasonable care to ensure that its submissions to the QCA are correct and free of error.

This is not to suggest that QR should be infallible, but repeated errors would indicate a lack of reasonable care in seeking regulatory approval.

Given that this is the second amendment required to remedy prior error in UT2, Asciano believes that it is necessary for the QCA to take positive action to avoid further occurrences.

¹ Queensland Competition Authority Act 1997 s 136



3.2 Transparency in calculation of reference tariffs

A major concern expressed by stakeholders during the UT2 approval process was that QR claimed confidentiality over the detailed methodology and data used to calculate the reference tariffs. This prevented the QCA from disclosing any detail to stakeholders regarding the calculation of reference tariffs. Without this detail, stakeholders were limited to commenting on concepts only. This lack of transparency can be contrasted with more open regulatory processes carried on in some other jurisdictions around Australia which provide significantly more detail about both the methodology and calculation of access charges, thereby allaying concerns and providing an opportunity for stakeholders to verify the integrity of the outcomes.

When considering issues associated with the introduction of the revenue cap earlier this year, stakeholders were again not privy to the methodology and it was not open to stakeholders other than QR and the QCA to comment on the mismatch of escalation processes as those were the only two parties who had access to the reference tariff calculation methodology and the calculation itself.

It is therefore very difficult for stakeholders to comment in any detail regarding QR's submission on the AAU. For example, QR's AAU submission (page 17) references a reference tariff model "check sheet". This is unhelpful to parties who have neither knowledge of, nor access to, the model. Another example is the reference also on page 17 to the escalation of the revenue cap from 2005/06 – this is particularly obscure given that the revenue cap approval by the QCA applies from 1 July 2006 and was indeed approved in May 2007, expressed in nominal dollar values (and therefore presumably calculated taking into account the actual CPI figures for the 05/06 year already). On this basis, one would assume that 2005/06 escalation values would be irrelevant. However, given that QR has made the point that these values need to be adjusted begs the question as to the basis on which the QCA approved values were determined.

3.3 Reference tariff calculation errors

The AAU and the previous application for amendment to reference tariffs by QR (the "Maintenance Costs Amendment" May 2007) are both, at least in part, the result of errors in methodology, data collection or calculation.² It is clear that the issue that the AAU is attempting to remedy was inherent in the process created by QR to calculate the reference tariffs. Had appropriate attention been paid to the calculation, the error ought to have been readily apparent. A simple test of simulating the revenues through the regulatory period (or even one year thereof) where actual CPI is different to the modelled assumption would have demonstrated the problem.

QR has brought these significant errors to light and sought to correct them to its own benefit. Stakeholders have no mechanism to determine whether there are any other errors that ought to be corrected, either that QR has not publicly recognised or of which QR itself is unaware.

Stakeholder confidence in QR's ability to accurately calculate and disclose reference tariffs and access revenues has been severely undermined. Asciano has, for some time, been concerned that the revenue calculation processes contained in UT2 and its various amendments are arcane and that the potential for error is high. QR has demonstrated that this concern is wholly justified.

² It is acknowledged that the need for the Maintenance Costs Amendment arose through several circumstances, of which error was one, but also included increased input costs and changes in practices.



Given the fundamental role that the undertaking has in providing access seekers with the confidence necessary to compete with QR to provide train services on the QR network, it is critical that the integrity of the undertaking and the approval process be restored.

3.4 Reliance of stakeholders on QCA

Given the opacity of the methodology for the calculation of reference tariffs, stakeholders are wholly reliant on the QCA to ensure that the methodology is appropriate, the correct data used and the calculation is accurate. To this end, it is recognised that the QCA is wholly reliant on the accuracy and appropriateness of the information disclosed by QR. For example, the QCA could not have reasonably been expected to anticipate the errors that were brought to light by QR in the Maintenance Costs Amendment earlier this year given the data that was provided to it during the UT2 approval process.

Stakeholders are entitled to assume that the reference tariff methodology and calculation were appropriately reviewed by the QCA when it approved the move from a price cap to the revenue cap. Asciano would have expected that the mismatch in escalation would have been identified during the approval process. If not, then the approval process itself would appear to require review.

It cannot be overstressed that where stakeholders are wholly reliant on the QCA to safeguard their interests, such as in this instance, it is crucial that confidence can be placed in the QCA's evaluation processes to ensure that appropriate outcomes are achieved. In this context, it is noted that there is a general movement towards encouraging regulators to speed up their approval processes; for example the current QCA Act Amendment Bill proposes to require approval of undertakings within 6 months. However, Asciano is concerned that such pressure should not cause the QCA to reduce the diligence with which it reviews undertakings prior to approval. Asciano is of the view that delay in the approval of an undertaking in order to properly assess the issues is preferable to approval of a flawed document.

3.5 Burden on stakeholders in regulatory process

The purpose of an undertaking by QR is to facilitate third party access to the QR rail network in order to allow for competition between train operators. As such, public participation in the regulatory approval process is important in balancing the interests of all parties and ensuring stakeholder confidence. However, the imposition of four amendments, all of them non-trivial and for matters not related to extensions to the network, in less than 12 months places stakeholders in a most difficult position. Key stakeholders are keen to participate and are prepared to devote resources to the approval of rail access undertakings. However, such processes must be kept within reasonable boundaries and four amendments, two of which resulted purely from errors made by the regulated entity, surely is excessive by any measure.

The level of regulatory activity in the form of submissions and stakeholder interaction with both QR and the QCA is disproportionately high in Queensland in proportion to the amount of competition actually achieved, compared to that which occurs in other rail jurisdictions. This ought to be of concern to the QCA.

Asciano suggests that it is important for the QCA to review the avenues open to it to avoid the seemingly excessive recourse by QR to formal regulatory processes, giving rise to an almost continual stream of complex regulatory arrangements that appear to deliver little benefit towards achieving competition between train operators. Asciano is only too well



aware that the next undertaking (UT3) will shortly be due for consideration and it is a daunting prospect that issues might still arise regarding UT2 even while UT3 is under review.

3.6 Solution

The foregoing concerns suggest that there is a need for a change in the process for the approval of an undertaking submitted by QR. One approach that might be open to the QCA would be to impose a requirement that any application for approval of an undertaking or amendment should demonstrate an appropriate level of rigour.

Asciano suggests that it would be appropriate for the QCA to require QR to have any future undertaking or amendment audited for both methodology and accuracy by a competent independent auditor at its own cost prior to submission to the QCA. By requiring such a process to be carried out, the QCA and other stakeholders would gain confidence that any proposal will be;

- based on a methodology that is at least internally consistent,
- supported by appropriate data,
- calculated correctly,
- correctly translated into the regulatory document, and
- less likely to be subject to future amendments to correct matters that ought to have been dealt with in the initial proposal.

While this might deal with future undertakings, it does not address the concern that the AAU discloses all problems that may exist with the current UT2 methodology, nor that the proposed solution to the escalation problem will . To address this, Asciano suggests that the QCA require QR to conduct an independent audit of the proposed methodology and calculation arising from the AAU prior to the QCA approving the AAU. (See also discussion in section 4.4).

Asciano suggests that the QCA require QR to provide a full independent audit of:

- the methodology for determining the revenue cap and reference tariffs for which approval is being sought;
- the calculation of the key values; and
- translation of these into the undertaking document.

It is further suggested that the QCA should require these of QR whenever it seeks approval of an undertaking or amendment in the future.

4 Specific Issues Regarding QR Submission

4.1 Inflation risk

Asciano agrees with QR that it was not the intention of the QCA that QR bear the risk of inflation. It is clear from the formulation of the escalation provisions approved by the QCA in UT2 (under the price cap regime) that QR was to be allowed to be fully compensated for rises in general costs. This is reinforced by the recent Maintenance Costs Amendment draft



decision (September 2007) wherein the QCA has allowed a claim by QR for input cost increases above full CPI on the assumption that this was reflective of efficient costs.

Asciano (under the name of Pacific National) has pointed out in numerous previous submissions the difficulties that arise from price setting over multiple years given the circumstances under which this is required to occur. Much of the complexity contained in the UT2 arrangements arises from this insistence on retaining a multi-year approach. The AAU is yet another example of the problem. It is Asciano's strong view that far less regulatory activity would be involved, and the undertaking could be significantly less complex if an annual price setting mechanism is put in place.

However, notwithstanding that view, in the context that the AAU continues with the multi-year approach, Asciano agrees with the concept that, to the extent that the methodology for calculation of reference tariffs leads to a discrepancy between the tariffs and the revenue cap due to a difference between modelled and actual CPI, then the discrepancy should be removed when calculating the final allowable revenue to be used in determining the adjustment to future prices and take-or-pay amounts.

4.2 Maintenance of real prices

Asciano disagrees with QR's assertion that a regulated entity has a right to maintain real prices.³ It is suggested that the context of the quote included in QR's submission from the Institute for Research Into International Competitiveness was with regard to the need for the maintenance of prices relative to comparable unregulated goods and services, not an absolute endorsement of a regulated entity's right to real price maintenance. It is agreed that the intention of regulation is to replicate, as far as possible, a competitive market. However, there is nothing in economic theory to suggest that competitive markets necessarily generate the maintenance of real prices. To the contrary, many businesses experience real price decreases over time in competitive markets and are able to continue in business through productivity improvements. It is for this reason that regulators often apply a productivity discount to price escalators, as did the QCA for QR's first undertaking.

4.3 Escalation under UT3

It is noted that QR is seeking to move to a specially constructed index for escalation under UT3. While that is not strictly relevant to the decision of the QCA with respect to the AAU, Asciano believes it is appropriate to respond to the issue raised by QR, at least in passing, to avoid the implication that this matter is agreed.

The choice of an appropriate index for escalation inevitably raises difficulties. Asciano recognises that QR's cost base may not necessarily be reflective of the CPI at any particular time; however, the calculation of CPI does have many advantages that may not easily be replicated in a special purpose index. Therefore, in order for support to be given to the adoption of an alternative index, consideration would need to be given to a wide range of issues, for example:

- The disparity over time between CPI and the true cost base. Clearly this needs to be substantial and sustained to justify the adoption of a special index. A particular difficulty arises in measuring the efficient cost base rather than the actual cost base as this will inevitably involve additional judgement.

³ QR submission pp.6-7



- How is the index constituted – what basket of goods and services should be included, who chooses this, what process will be used to determine the inclusions/exclusions and the weightings given to each component? How relevant is the index to QR's efficient cost of operation? How variable is QR's cost of operation across different parts of the network, eg do the coal lines have a different mix of costs compared to general freight lines and how is this factored into the measure?
- How frequently and over what scope will the measurement take place – eg is the index simply a measure of QR's input prices on a particular day, an average over a period or an average of prices for several track owners across Australia? Do such measurement choices introduce any bias into the measure? Will the cost of collection be sustainable?
- Who is to perform the measurement – what degree of independence, skill and experience will be required? Is there any concern regarding conflict of interest in the management of the index?
- What impact do different commercial arrangements have? Will volume discounts apply or not? What is the impact of circumstance – eg the price of ballast might depend on the location for delivery compared to the source; the cost of concrete sleepers may well depend on whether they are part of a large order that has led to the setting up of a specific manufacturing plant in the region.
- Is the proposed measure stable or is there significant risk that the components will exhibit volatility both absolutely and with respect to other components (eg the order of a large volume of rail compared to normal due to network extensions)?

It is suggested that any proposal by QR for a move away from a CPI based measure would need to address these issues.

4.4 Remedy Proposed By QR

In the circumstances, Asciano supports QR's proposed remedy as an appropriate way to manage the issue, ie to adjust the escalation of the SAR on a quarterly basis to reflect actual CPI.

This support is given on the understanding that the escalation process is intended to be carried out on the relevant part of the SAR each quarter, not that the whole of the SAR is escalated by the compounded CPI annually or the whole regulatory period. This is specifically mentioned because it is not clear from the submission precisely what calculation QR is intending to perform.

The difference between the two methods is demonstrated in Table 1 and Table 2. Under the method in Table 2, the compounded escalator is applied to the whole of the revenue for the year whereas in Table 1 the compounded escalator is applied in each quarter to that quarter's revenue only. This results in a difference in both the overall quantum of the Forecast SAR and the adjustment to arrive at the Adjusted SAR. As the tables show, application of the fully compounded escalator nearly doubles the difference in this example over the period of one year from \$0.5 to \$0.9.

This is a much simplified example, but shows that application of the accumulated escalator (and differences between the accumulated forecast and actual escalators) results in a significantly different outcome depending on the method used. The quantum of difference will depend on the CPI forecast and the difference between the forecast and actual CPI. However, the point is that the method adopted will significantly impact the outcome. While



this may appear obvious, it is important that the method is clearly identified and understood prior to being approved by the QCA, as it is not clear in the QR submission. Asciano believes that the appropriate method is the one demonstrated in Table 1 to achieve the intended alignment of the SAR with actual revenue.

Table 1: Escalation Adjusted On Quarterly Revenues

| Period | Forecast CPI | Forecast Escalator | Actual CPI | Actual Escalator | Real SAR \$ | Forecast SAR \$nom | Adjusted SAR \$nom | Diff. To F'cast \$ |
|--------|-----------------|-----------------------|---------------|---------------------|----------------|-----------------------|-----------------------|-----------------------|
| P1 | 1.0% | 1.0% | 1.2% | 1.2% | 25.0 | 25.3 | 25.3 | 0.0 |
| P2 | 1.0% | 2.0% | 1.0% | 2.2% | 25.0 | 25.5 | 25.6 | 0.1 |
| P3 | 1.0% | 3.0% | 1.5% | 3.7% | 25.0 | 25.8 | 25.9 | 0.1 |
| P4 | 1.0% | 4.1% | 1.2% | 5.0% | 25.0 | 26.0 | 26.2 | 0.2 |
| Totals | | | | | 100.0 | 102.5 | 103.0 | 0.5 |

Notes: Assumption is that real actual revenue matches real forecast revenue in each period.
Figures subject to rounding.

Table 2: Escalation Adjusted On End Period Revenues

| Period | Forecast CPI | Forecast Escalator | Actual CPI | Actual Escalator | Real SAR\$ | Forecast SAR \$nom | Adjusted SAR \$nom | Diff. To F'cast \$ |
|--------|-----------------|-----------------------|---------------|---------------------|---------------|-----------------------|-----------------------|-----------------------|
| P1 | 1.0% | 1.0% | 1.2% | 1.2% | | | | |
| P2 | 1.0% | 2.0% | 1.0% | 2.2% | | | | |
| P3 | 1.0% | 3.0% | 1.5% | 3.7% | | | | |
| P4 | 1.0% | 4.1% | 1.2% | 5.0% | 100.0 | 104.1 | 105.0 | 0.9 |
| Totals | | | | | 100.0 | 104.1 | 105.0 | 0.9 |

Note: Assumption is that real actual revenue matches real forecast revenue in each period.
Figures subject to rounding.

4.5 QR Submission Clarifications

The QR submission is unclear in several parts and it would be helpful for the QCA to demonstrate that the full ramifications of the proposal are understood by both the QCA and QR itself.

In particular the following two matters require clarification from the QR submission:

- Unnumbered table top of p.9 – the explanatory note regarding the synthesis of December 2007 escalation appears inconsistent with the numbers to which it refers. As this number has a significant bearing on the comparative outcome in the table (assuming the table has some significance) it is important that the derivation of the December 2007 estimate is clear. As it stands, the impression given by the table is that the value has been manufactured to ensure that a small negative difference arises. As a positive difference might be seen to weaken QR's assertion that a series of negative differences is likely to arise, without clarification, this has the appearance of being self-serving.
- It is unclear why QR has produced a table of results of the scenario analysis based on annual escalation when the subsequent commentary dismisses these results and



instead notes that quarterly escalation will be used and that this change has a substantial impact on the results. Why has QR not provided the quarterly results in the table, or if it is important to show the impact of quarterly in comparison to annual escalation, why not provide both in tabular form?

In the specific circumstances which surround the AAU, Asciano supports QR's proposal that the SAR be adjusted to reflect the actual CPI of the period, provided that the calculation correctly applies the quarterly escalator adjustment to the relevant revenues and that the model used to perform the calculation is independently audited.