

16 November 2012

John Hall
Chief Executive Officer
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Dear John

Draft Amending Access Agreement – GAPE Reference Tariffs

Thank you for the opportunity to respond to QR Network's (QRNN) Draft Amending Access Agreement (DAAU) on the Goonyella Abbot Point Expansion (GAPE) Reference Tariffs.

BHP Billiton Mitsubishi Alliance (BMA) and BHP Billiton Mitsui (BMC) have reviewed the GAPE DAAU. We do not believe the GAPE DAAU delivers a low cost, efficient rail infrastructure service for GAPE customers. QRNN has simply sought to maximise its revenue base by:

1. using the 2010 Access Undertaking (UT3) cost parameters as the accepted benchmarked costs and then applying those costs to the newly constructed GAPE rail infrastructure (on a '000 gtk or ntk basis);
2. using the contracted GAPE Deed tonnage numbers as the forecast estimate tonnage which overestimates the actual tonnes expected to traverse the GAPE infrastructure in FY13; and
3. not recognising the existing maintenance synergies in the current Goonyella and Newlands infrastructure operations which minimises any potential cost impact from the addition of the GAPE infrastructure. For example:
 - a. QRNN's maintenance and operating costs were significantly increased in UT3 when compared to the cost profile in the previous UT2; and
 - b. current FY13 tonnage forecasts in Goonyella and Newlands are currently significantly below the 2010 UT3 FY13 tonnage forecasts on which QRNN's maintenance and operational expenditure approved limits were based.

QRNN's theoretical methodology does not accurately reflect the incremental costs incurred by QRNN when adding additional infrastructure (including 69km of new track) to its existing CQCR operations. QRNN's success ultimately relies on the commercial success of the coal producers who utilise the CQCR service. Failure to understand this symbiotic relationship means QRNN risks its own business outcomes by pushing a theoretically higher GAPE cost base and ultimately undermining the viability of the customers who underwrote the GAPE capital investment.

Accordingly, we do not support the QR Network DAAU and recommend the QCA give further consideration to QRNN's underlying cost parameters contained within the GAPE DAAU and the key economic principles contained in UT3 and Queensland *Competition Authority Act 1997*. Attached is a detailed paper which sets out our specific issues with the GAPE DAAU. We also support the submission made by the Queensland Resources Council. We would appreciate if you could consider all these issues in your review of QRNN's DAAU.

If you have any queries or require more information, please feel free to contact Ms Tanya Boyle on mobile 0459 812257.

Yours sincerely

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DAAU – GAPE Reference Tariffs

BMA and BMC do not support QRNN's DAAU and proposed GAPE reference tariffs. We request the QCA consider the following issues in its deliberations on the DAAU.

1. Cost Competitiveness of the Coal Rail Infrastructure Market in Queensland

BMA and BMC are GAPE foundation customers and executed commercial agreements with QRNN in 2010. The GAPE commercial agreements were based on a commercially agreed risk allocation and guarantee QRNN an above regulatory return for its investment in, and construction of, the GAPE infrastructure.

The GAPE negotiation occurred in 2009 and 2010 when the Queensland coal industry was enjoying the benefits of a global resources boom. There was significant producer demand for the construction of new logistics pathways to address the logistic bottlenecks in the Queensland coal rail and port networks. QRNN, as the monopoly provider of coal rail infrastructure in Queensland, was well placed to identify, construct and commission new rail infrastructure to connect the Goonyella and Newlands Systems to increase coal railings through to the Abbot Point Coal Terminal. However, rather than expand the Central Queensland Coal Rail (CQCR) via the traditional regulatory expansion process, QRNN indicated it would only expand the CQCR if it was guaranteed an above regulatory rate of return. The absence of any defined regulatory protections for new CQCR expansions in the 2008 Access Undertaking meant producers had no option but to accept QRNN's terms if they wanted to grow their coal business in Queensland.

Regulatory protections now exist in UT3 which prevent QRNN from requiring customers to sign confidentiality agreements which removes the customers right to seek QCA review of the non-standard commercial price and risk allocation underpinning any QRNN proposed CQCR expansion. Given UT3 and the QCA's consideration of the Wiggins Island Coal Export Terminal UT3 Access Conditions, we support the QCA having access to the confidential GAPE Deed documents. In this way, the QCA can better understand the GAPE DAAU within the context of the commercial principles underpinning the GAPE infrastructure and the self styled "access conditions" which preceded UT3.

2. Incentive to Invest in Queensland

The lack of a competitive alternative in the provision of coal rail infrastructure is a significant business risk identified on our Critical Business Risk Register. Uncertainty in the timing, risk and cost of any future investment in the CQCR directly impacts on the commerciality of our mining operations by creating additional hurdle costs and adversely affecting our appetite to invest in Queensland. Such rail investment risks have heightened the impact of the current market environment where we are being required to absorb higher rail infrastructure costs in a market characterised by falling global coal prices. Continued success in our existing operations will critically depend on our ability to remove non-productive costs from our business.

To remain competitive in the global coal market, we are committed to the development of an alternative funding model as a key component of Queensland's rail regulatory framework. It is important QCA recognise the investment threat posed by GAPE styled negotiations and assist industry in delivering a stable and predictable regulatory investment framework to facilitate third party efficient, low cost investment in the CQCR. We are satisfied the current risk return allocation (the regulatory rate of return with all the attendant regulatory protections) within the Queensland regulatory framework provides sufficient commercial incentive for us to invest in the CQCR to underpin our future mine expansions. However, we still require a viable and bankable investment vehicle which will enable us to deliver competitive, low cost rail infrastructure market outcomes.

Until there is a viable competitive investment alternative to QRNN in the Queensland coal rail market it is imperative the QCA stringently apply its regulatory powers to ensure QRNN delivers an efficient, low cost and competitive rail infrastructure service in Queensland.

3. Regulatory Pricing Principles

It is important the QCA keep the regulatory framework and associated regulatory reference tariffs transparent, accountable and separate to the results of any negotiations QRNN might have with any of its customers on terms and conditions outside of the regulatory framework.

As part of its review of the GAPE DAAU, we would like to see the QCA endorse the following key regulatory pricing principles:

- Implementation of a hybrid incremental pricing principle for all new expansions in the CQCR; and
- Non-expanding customers should not bear any additional costs or risks associated with any new expansions for which:
 - a. they receive no benefit by way of increased tonnage throughput;
 - b. they have no say in the commercial details underpinning the expansion;
 - c. they are not exposed to any operational/capacity risk (eg increased congestion) associated with the expansion; and
 - c. QRNN earns revenue over and above its regulatory return.

Adoption of these principles will facilitate greater industry certainty on how new investments will be managed and incorporated into future QCA approved reference tariffs. The proposed regulatory pricing position on new investments will deliver a more stable investment framework for industry, enabling customers to understand the cost base of their existing business operations and how new investments will impact on that cost base both as an expanding or non-expanding customer. This cost certainty is fundamental to the Queensland coal industry's competitiveness in the global market and will ensure new entrants to the Queensland coal industry cannot adversely impact on an existing customer's ability to deliver efficient, low cost coal to the global coal market.

4. GAPE Consultation Process

QRNN did not consult with either GAPE customers or the QRC prior to the submission of the GAPE reference tariff DAAU. QRNN's submission does not detail all the required information to enable industry to understand the reasoning behind the proposed reference tariff methodology. Moreover, QRNN has departed from regulatory precedent on a number of matters which require customer and QCA consideration at a principle level.

The following identifies how QRNN has adjusted the GAPE reference tariffs and departed from QCA precedents:

- The development of a separate GAPE Regulatory Asset Base (RAB) to reflect the GAPE negotiated contract outcome with its GAPE customers.
 - a. The GAPE infrastructure is not a separate physical rail network similar to the four other coal systems in the CQCR.
 - b. If the assets had been constructed in accordance with the expansion process under UT3, the GAPE infrastructure would have been included in either the Newlands or Goonyella RAB, with the application of a cross system tariff for those Goonyella customers electing to take their coal north to Abbot Point.
 - c. The GAPE RAB combines electric and diesel infrastructure assets in a manner which is not cost reflective of the diesel only train services which operate across the GAPE infrastructure.
 - d. A decision by the QCA to mix diesel and electric infrastructure and invoice it against a diesel only train service should be made based on exceptional circumstances and should not be held as a regulatory precedent in the QCA's consideration of QRNN's Blackwater AT5 Draft Amending Access Undertaking.

We do not have a specific position on the merits or otherwise of a separate GAPE RAB, however, we ask the QCA to consider whether QRNN's proposed approach is consistent with the UT3 provisions for rail infrastructure expansions in the existing CQCR.

- The application of contracted demand as the demand forecast, despite the fact minimal tonnes will be transported across the GAPE infrastructure in FY2013.
 - a. QRNN's DAUU identifies demand throughput in FY2013 to be 10.55Mt. However, expected throughput is expected to be significantly below this forecast.

We believe QRNN's use of contracted GAPE tonnage overstates the operation and maintenance costs expected to be incurred by QRNN in FY13.

- QRNN applies a hybrid incremental pricing approach which ensures the GAPE users pay all incremental costs associated with the GAPE investment.
 - a. This pricing approach ensures all non-expanding customers in the Goonyella and Newlands Systems do not bear any of the commercial risks and costs associated with the GAPE investment.

We support the hybrid incremental pricing approach and ask the QCA to confirm that the implementation of this pricing approach will be adopted as the regulatory pricing precedent to apply to all future rail infrastructure expansions which are associated with new port developments.

- QRNN applies the costs of the Goonyella enhancements (including electrification of additional passing loops) in the GAPE RAB on the basis that GAPE trains (bound for GAPE) triggered the need for the expansion of the Goonyella system and that electrification of this infrastructure was necessary to guarantee Goonyella remained an integrated fully electric system.
 - a. This approach ensures all non-expanding customers in the Goonyella System do not bear any of the commercial risks and costs associated with the GAPE investment.
 - b. This pricing approach could have been achieved through the allocation of all new electric assets to the Goonyella system and charging GAPE users a cross system premium to cover the costs triggered by the electrification of the two passing loops in the Goonyella System.

We support GAPE customers bearing the full cost of the impact their utilisation of the network but we ask the QCA to confirm the regulatory principle which might or might not apply to all future rail infrastructure expansions in the integrated rail systems (both electric and diesel infrastructure) which are associated with new port developments.

5. GAPE Capacity Robustness

GAPE customers were given the opportunity to review the project GAPE capital costs and to work with QRNN to reduce the cost of the GAPE rail infrastructure¹. Whilst the investment decision was supported by capacity modelling carried out by QRNN's capacity planning group, it has since been revealed by QRNN that it may not have fully appreciated the congestion interfaces which would occur between the Goonyella and Newlands Systems, with trains running both ways on the Goonyella System.

The GAPE Access Agreements are UT2 Access Agreements. They were executed before the endorsement of UT3 by the QCA and before the inclusion of the new Part 11 in UT3. This means that upon commissioning of the GAPE assets, QRNN is contracted to deliver its full contracted tonnage across the interlinked rail infrastructure through to DBCT, HPCT and APCT. In UT3, QRNN committed to a process whereby it would review all of its access contracts and undertake detailed capacity

¹ QRNN has advised the QCA that it adopted a Total Cost of Ownership (TCO) approach to its investment in the GAPE below rail infrastructure. We want to make it clear that at the time GAPE was negotiated there was no consideration of a TCO in the way defined by QRNN in its Blackwater System DAUU currently before the QCA.

modelling to verify that the rail infrastructure as constructed would deliver sufficient capacity to meet its contractual obligations. Where QRNN identified deficiencies in the robustness of its rail capacity to deliver to contract, QRNN undertook to immediately construct any additional 'robustness' infrastructure required to deliver QRNN's contracted capacity.

We would like the QCA to consider the GAPE "capacity robustness" as a QRNN GAPE contractual obligation. We ask the QCA to rule that should any additional rail infrastructure be required to deliver total contracted GAPE access rights then QRNN be required to construct so it can deliver on its contractual obligations.

6. Capital Costs for GAPE

QRNN has summarised its capital costs for the GAPE Infrastructure in the DAAU. We understand the construction cost of GAPE has not yet been finalised and that additional capital may be added in subsequent years once construction is complete. We request the QCA review QRNN's information on the basis of the efficiency of standard, scope and cost of the GAPE investment. We note QRNN's indication that any variance between the GAPE estimated cost and actual cost will be managed as part of the capital carryover account balance in the implementation of UT4.

7. Return on Capital

QRNN has identified it will accept the regulatory rate of return for the GAPE investment. We endorse the use of the regulated rate of return as the basis for pricing new infrastructure which is being included in QRNN's RAB. However, we do not support QRNN's proposal that it may seek future changes to the pricing methodology to address potential GAPE asset stranding risks over the longer term. Any additional regulatory protection from the longer term GAPE asset stranding risk (beyond the Schedule A protections) would alter the commercial risk allocation underpinning the original GAPE Deeds, for which GAPE customers are paying an above regulated rate of return.

8. Volumes across the GAPE Infrastructure

QRNN has identified that its forecast volume across the GAPE infrastructure is 10.55 Mtpa. This tonnage estimate is significantly higher than the expected actual railings for FY13. We request the QCA obtain more accurate tonnage forecasts (based on the railings pattern from July to December 2013) to better reflect the expected train movements in FY13. This information should then be used to determine the FY13 GAPE reference tariffs.

9. Total Maintenance of the GAPE Infrastructure

QRNN has employed a theoretical methodology to estimate GAPE maintenance costs for FY13. The incremental maintenance charge is based on the current AT1 reference tariff component in UT3 covering the CQCR and GAPE's contracted tonnage in FY13. The fixed maintenance charge is developed using the current UT3 approved maintenance allowance. Both benchmarks assume the GAPE infrastructure will have the same asset management and maintenance profile.

This approach is questionable given the proportion of new and upgraded rail infrastructure included in the GAPE RAB. In terms of some of the specific issues raised in QRNN's submission, we have a number of queries which we ask the QCA to consider:

- The GAPE infrastructure involves only 69km of new track and upgrades to existing infrastructure in the Newlands and Goonyella Systems. It is not the creation of a new physical rail system and so should not carry with it a theoretical stand-alone calculation of maintenance costs for a new rail system
- Fixed Railway Maintenance Costs– it appears questionable to use fixed maintenance costs for the existing Newlands rail system as an appropriate proxy for the new GAPE railway. There are

synergies with the fixed maintenance costs of the Goonyella and Newlands systems. This would reduce or remove the need for additional fixed costs for the GAPE infrastructure which will effectively lower the average cost across both the Goonyella and Newlands systems.

- For example, fixed costs including track machines, maintenance supervision, train control/management, etc will not be duplicated for GAPE but would be leveraged off existing resources in both the Goonyella and Newlands Systems.
- Network Strategic Asset Plan (NSAP) Assumptions –the NSAP model does not appear to correctly assess the early life cycle costs of the GAPE assets. Ballast cleaning and rail grinding are a large proportion of the incremental maintenance costs and these activities would not be expected for several years on new rail infrastructure. It is also not clear whether the NSAP model takes into account that the GAPE infrastructure does not have remote controlled signalling infrastructure.
- Total Maintenance Costs – total incremental plus fixed maintenance costs of \$14.94M in FY13 appears significantly high cost, particularly given the infrastructure is largely new and QRNN and assumes only 10.55 Mtpa operates across the infrastructure. In reality, tonnes significantly below 10.55 Mtpa will be crossing the GAPE infrastructure in FY13.

As the QCA is aware new rail infrastructure typically has a much lower maintenance requirement in the initial years of operation compared with the higher maintenance requirements of the older CQCR with old and sub-standard formation. QRNN should be required to maintain GAPE as an efficient and effective competitive rail infrastructure operation which recognises the full life cycle for the GAPE assets involved. It is expected that corrective maintenance requirements in the first five years will be minimal and the main focus will be on routine activities (e.g. inspections, track geometry assessments and manual maintenance of vegetation around easements). Given the GAPE infrastructure is an incremental expansion of QRNN's existing CQCR, QRNN's proposed GAPE cost base does not accurately reflect the incremental uplift in the routine maintenance workload which operates out of its existing business.

In our view, the incremental impact of the GAPE infrastructure on QRNN's existing maintenance expenditure is more than offset by the forecast reduction in FY13 volumes approved by the QCA earlier this year. In 2010, the QCA endorsed a significantly higher QRNN maintenance budget for the UT3 period when compared to the UT2 allocations. QRNN's justification for the increased cost base was based on the significantly higher volumes forecast over the regulatory period, the need to employ less cost maintenance practices to sustainably deliver coal throughput levels at the higher volumes and the need to remediate fouled ballast in the Blackwater and Goonyella Systems to improve reliability around operational performance. This position was not only accepted by the QCA, but it was also agreed that a Maintenance Cost Index (which is higher than CPI) would also be applied to the maintenance costs in recognition of the cost pressures being experienced in labour and materials in Central Queensland. This means that the following factors underpin QRNN's current maintenance budget allocation for FY13:

- The 2010 UT3 forecast tonnage for FY13 was 223.5 Mtpa, comprising 124.9 Mtpa for Goonyella and 17.5 Mtpa for Newlands (total of 142.40 Mtpa for the Northern Bowen Basin);
- QRNN's Annual Review of Reference Tariffs 2012-13 approved the lower FY13 tonnage forecast of 186 Mtpa, comprising 99 Mtpa for Goonyella and 15.8 Mtpa for Newlands (total of 114.8 Mtpa for the Northern Bowen Basin and represents a 19% reduction in tonnes compared to the 2010 estimate);
- The application of an annual adjustment of the maintenance budget with the QCA approved annual maintenance cost indices being applied means that by FY13, the original approval of the FY13 maintenance budget of \$159.9M (2007-08 dollars) has become an approved \$182.2M (effectively a 14% increase in QRNN's allowable maintenance revenue)

The additional increase in QRNN's allowable maintenance revenue combined with the reduction in actual coal volumes going across the track infrastructure means that QRNN has unintentionally benefited from the current market environment and has, in fact, over recovered revenue by using base cost estimates referenced to the 2010 maintenance budget and volume estimates. If these factors

were normalised to take account of current volumes, then we believe the incorporation of the GAPE infrastructure into QRNN's existing FY13 maintenance budgetary allocation would not have any appreciable cost impact as the additional costs could be absorbed within the existing budgetary allocations for Goonyella and Newlands systems, thereby effectively and efficiently utilising QRNN's existing resources (labour, car fleet and track machines) deployed to the maintenance task in the Northern Bowen Basin.

We recommend the QCA engage consultants to identify whether there is in fact any incremental additional variable and fixed maintenance costs associated with the GAPE infrastructure which is over and above QRNN's existing maintenance cost base in the Northern Bowen Basin. We ask the QCA to consider this request in light of the significant reduction in tonnes which has occurred since the original maintenance budget was approved in 2010.

10. Incremental Operating Railway Management Costs for the GAPE Infrastructure

QRNN has proposed an operating cost for the GAPE infrastructure, inclusive of an insurance risk premium, of \$6.57M (approximately \$0.66 per tonne) for FY13. Similar to our previous point, we do not accept the GAPE infrastructure necessitates the additional operating cost base (planning and incident response, contract management staff, additional train control and insurance costs) of the magnitude proposed by QRNN. Again, the following factors underpin QRNN's current FY13 operating budget:

- The reduced volumes identified above such that only 114.8 Mtpa are expected to traverse the Northern Bowen Basin in FY13;
- The 2010 annual allocation for operating costs (excluding insurance) was \$56.9M and became \$57.7M in QRNN's Annual Review of Reference Tariffs 2012-13;

The 2010 uplift in operational costs occurred as a result of the forecast growth in coal volumes and associated market pressures to sustain throughput at the higher volumes. Again, we note that in the subsequent annual reference tariff reviews since 2010, QRNN has consistently reduced forecast volumes due to seasonal and market movements in both the Queensland coal industry as well as the global coal market. Accordingly, we believe that QRNN is over-recovering operating expenditure due to the lower coal volumes and the additional GAPE tonnes do not impose any additional cost pressures. Rather, the GAPE infrastructure simply absorbs the operating cost latency by utilising existing operating resources more efficiently and effectively.

We recommend the QCA engage a consultant to identify the incremental additional variable and fixed operating costs associated with the GAPE infrastructure which is over and above QRNN's existing budget to operate the existing Goonyella and Newlands systems.

11. Risk and Insurance Costs for the GAPE Infrastructure

We request the QCA to review its UT3 endorsement of the CQCR risk and insurance costs and identify whether the incremental QRNN self insurance costs QRNN has added to compensate it for the addition of the GAPE infrastructure is an accurate estimate of the marginal cost QRNN would actually incur for insurance in FY13.

We also ask the QCA to identify the scope of the insurance cover for the GAPE infrastructure. Noting the recent QRNN review event application relating to a pass through of the costs associated with flooding in central Queensland in December 2010 and January 2011, we would like to understand whether the GAPE insurance cost of \$1.04M in FY13 is simply insuring GAPE customers against the risk that the GAPE infrastructure will be damaged up to the value of \$1M. Is it correct to interpret that any damage to GAPE over and above \$1M will not be covered by QRNN's risk premium and that QRNN will seek a review event application from GAPE customers to recover costs above \$1M?

12. Reference Tariffs

QRNN has identified a willingness to defer inclusion of GAPE related Newlands capital expenditure until UT4 on the basis that the NAPE tonnage profile is not expected to commence until UT4. We ask the QCA to consider whether this approach should similarly apply to the GAPE related Goonyella capital expenditure. Such a review would be better informed by QCA obtaining a real picture of the FY13 actual railings from the Goonyella System through to APCT.

The deferral of GAPE capital expenditure until UT4 would be beneficial to GAPE customers as it would reduce some of the significant costs being incurred by GAPE customers who are not yet using the infrastructure. If QRNN transferred some of the GAPE cost burden to UT4 where coal volumes operating across GAPE were sufficient to meet the costs incurred, QRNN would still be able to earn its maximum allowable regulated revenue over time in a NPV neutral manner. This approach is consistent with the pricing principles in UT3 and with QRNN's position taken with respect to GAPE related Newlands capital expenditure.