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# Reference Tariff for the West Moreton Network

*Queensland Rail*

*Supporting analysis for submission to the QCA*

*4 May 2015*

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# *Executive summary*

Queensland Rail intends to submit to the Queensland Competition Authority (QCA) a draft access undertaking (the 2015 DAU) relating to third party access to Queensland Rail's rail network including the West Moreton Network, the Mt Isa Network, the North Coast Network and the Metropolitan Network.

Regulatory approval of a draft access undertaking provides a level of certainty to both access seekers and providers, reduces transaction costs and facilitates commercial decision making. But an access undertaking need not resolve every financial and non-financial aspect of a future access agreement. The premise of a negotiate/arbitrate model is that flexibility ought to be preserved for the parties to negotiate appropriate access terms, with recourse to the regulator only where required.

Queensland Rail intends to submit to the QCA a reference tariff for the West Moreton Network which is below the "ceiling" tariff which Queensland Rail considers a regulator would determine, using generally-accepted regulatory methods (including a DORC network valuation).

PwC has been engaged by Queensland Rail to provide advice on factors that are relevant to Queensland Rail determining a reference tariff below the ceiling price. Queensland Rail proposes to:

- set a ceiling price based on a generally-accepted regulatory building block approach, which reflecting the current utilisation of the network suggests a ceiling access charge of $34.92/'000 gtk.
- within a negotiate/arbitrate model, determine a reference tariff at a lower rate of $19.41/'000 gtk.

In our view, there is no single, formulaic way to express how a reference tariff may appropriately vary from a conventionally-calculated ceiling. Rather, the difference reflects a range of commercial, economic, user and system-specific factors, which may vary over time.

Particularly relevant is the impact of the sharp decline in market conditions facing thermal coal exporters on the users of Queensland Rail's West Moreton Network.

Queensland Rail is responding to these market conditions by proposing a new arrangement whereby the reference tariff is set below the price ceiling, but at a level which is similar to the currently applied access charge. Queensland Rail believes that flexibility is necessary in order to preserve its customer base. Without this flexibility, network assets could become stranded which would not be in the interests of Queensland Rail, current access holders and future access seekers. Following this regulatory period, consistent with the negotiate/arbitrate model, Queensland Rail and access seekers will be able to negotiate different terms as market conditions improve.

The following points summarise our key findings:

1. The ceiling price should be set on sound economic principles and follow generally-accepted regulatory principles. A ceiling tariff ought to be determined using a building block approach, using appropriate parameters, including a current-cost valuation of network assets.
2. The reference tariff for the West Moreton Network could reasonably be determined within a negotiate/arbitrate framework, where the agreed tariff is below the ceiling price.
3. In determining the reference tariff to apply, Queensland Rail might consider the current market conditions facing the coal industry and acknowledge also the advantage of providing access seekers with a degree of price stability. Relevant in this regard is the relativity with a long term benchmark for West Moreton Network below-rail access charges.
4. Under the proposed reference tariff, volume risk on the West Moreton Network would be borne by Queensland Rail with customers benefiting from a reference tariff lower than any ceiling charge. Following this regulatory period, consistent with the negotiate/arbitrate model, Queensland Rail and access seekers will be able to negotiate different terms as market conditions improve.

# 1 Introduction

## 1.1 Background

Queensland Rail's primary business is the delivery of public transport through the provision of passenger rail services and supporting private freight services through the provision of rail infrastructure. Queensland Rail's intra-state rail network is declared for access under Part 5 of the *Queensland Competition Authority Act 1997* (the QCA Act). It also is subject to the terms of the access undertaking approved by the Queensland Competition Authority (QCA) in 2008 (as revised in 2010).

Queensland Rail owns and operates the West Moreton Network which extends from Macalister to the Port of Brisbane. While the entirety of Queensland Rail's intra-state rail network is subject to declaration and coverage under the 2008 undertaking, a reference tariff only exists for coal train services on the West Moreton Network. The West Moreton Network tariff is paid by users to Queensland Rail for trains carrying thermal coal from mines on the Darling Downs to the Fisherman Islands export terminal at the Port of Brisbane.

In the relatively recent past, the export market for thermal coal has deteriorated such that, combined with reductions in other traffics, Queensland Rail's West Moreton Network has significant spare capacity - an estimated 46 paths, or 41 per cent of paths, are currently unused. These factors conspire to create a situation where a "ceiling" tariff, calculated using generally-accepted regulatory methods, is above the level which could reasonably be expected to be commercially-feasible to Queensland Rail's West Moreton Network access holders and seekers.

## 1.2 2013 Draft Access Undertaking (2013 DAU)

The current access undertaking that applies to Queensland Rail is based on QR Network's 2008 Access Undertaking. The 2008 access undertaking was revised in 2010, and is due to expire on 30 June 2015, unless extended.

Queensland Rail submitted a new draft access undertaking to the QCA in June 2013 (the 2013 DAU) that included a proposed tariff for the West Moreton Network of $22.22/'000 gtk.

In response to the 2013 DAU, the QCA released a Consultation Paper in June 2014 which provided two different approaches for calculating the access tariff:

- historical cost option resulting in a price of $13.59/'000 gtk, including placing a zero value of pre-1995 assets
- revised DORC option, resulting in a price of $17.21/'000 gtk, including adjusting the 2009 valuation to reflect an updated assessment of the network's condition.[1]

Following stakeholder feedback and further consideration, the QCA released a Draft Decision for the 2013 DAU in October 2014, suggesting that a tariff of $14.29/'000 gtk was appropriate, based on a revised asset valuation.[2]

In a separate report, we comment on the QCA's approach to asset valuation in this Draft Decision. Although not stated as such, it would seem that the QCA has sought to "moderate" the valuation as proposed by Queensland Rail, in the view that to apply this valuation unadjusted would derive a tariff which was commercially unfeasible to users on the West Moreton Network. This approach is inconsistent with regulatory precedent.

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1 Queensland Competition Authority (2014), *Consultation Paper on Queensland Rail's 2013 Draft Access Undertaking*.

2 Queensland Competition Authority (2014), D*raft Decision on Queensland Rail's 2013 Draft Access Undertaking*, page 139.

## 1.3 2015 Draft Access Undertaking (2015 DAU)

Due to significant changes in the business environment and changes to the QCA's regulatory approach, Queensland Rail withdrew 2013 DAU in December 2014.[3] In order to take into account these changes, and ensure that Queensland Rail's access undertaking is fit for purpose, Queensland Rail is proposing amendments to 2013 DAU. A revised draft access undertaking (2015 DAU) is to be submitted by Queensland Rail to the QCA by 5 May 2015 in accordance with the QCA's initial undertaking notice.

The 2015 DAU will apply to all third party access to Queensland Rail's network including the West Moreton Network, the Mt Isa Network, the North Coast Network and the Metropolitan Network. Queensland Rail currently has 45 access agreements with access holders including:

- 7 access agreements for the West Moreton Network
- 8 access agreements for the Mt Isa Network
- 12 access agreements for the Metropolitan Network
- 11 access agreements for the North Coast Network
- 7 access agreements for the other Networks (West, South Western, Maryborough and Tablelands).

Queensland Rail's 2015 DAU proposes to "decouple" the ceiling tariff the regulator would determine, using conventional building block methods, from the reference tariff that would apply to current and future users on the West Moreton Network. This allows the network valuation to be reconsidered, knowing that it does not impact directly the reference tariff that would apply.

Queensland Rail proposes in the 2015 DAU to set a Reference Tariff for the West Moreton Network which is below the "ceiling" tariff that otherwise would apply due to the following principles:

- the ceiling price for the West Moreton Network coal services should be assessed using generally-accepted regulatory principles based on a building block approach
- if this ceiling price is in excess of what reasonably could be recovered from West Moreton Network users then the reference tariff should be set below the ceiling price.

Indeed, Queensland Rail's proposed approach for the West Moreton Network is broadly consistent with that adopted for Queensland Rail's other systems, including the Mt Isa and North Coast Networks. For these networks access charges are set between the floor and the ceiling prices, based on the specific circumstances of each user, the terms of their access agreement and market conditions.

## 1.4 Disclaimer

This Report has been prepared for Queensland Rail under the terms of our Engagement Contract with Queensland Rail. As an independent report, it has been prepared for Queensland Rail but does not necessarily reflect the views of Queensland Rail.

In preparing this Report we have only considered the circumstances of Queensland Rail. Our Report is not appropriate for use by persons other than Queensland Rail, and we do not accept or assume responsibility to anyone other than Queensland Rail in respect of our Report.

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3 Queensland Rail: 2013 DAU withdrawal letter addressed to Mr Hindmarsh, Chief Executive Officer of QCA, dated 12 December 2014. [http://www.qca.org.au/Rail/Queensland-Rail/More-on-QLD-Rail/Draft-Access-Undertaking/Archive/2013-Draft-Access-Undertaking].

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# 2 Setting the price ceiling

## 2.1 Applying sound regulatory principles

Queensland Rail has proposed the use of a building block methodology to set the ceiling tariff for the West Moreton Network. The use of the transparent and repeatable building block approach will provide a degree of revenue/cost certainty going forward, for Queensland Rail and access seekers. It is also a fairly conventional and uncontroversial approach.

Section 138(2) of the QCA Act requires the QCA to take into account the following matters (*assessment criteria*) when approving an access undertaking:

> *(a) the object of Part 5 of the QCA Act which is, to promote the economically efficient operation of, use of and investment in, significant infrastructure by which services are provided, with the effect of promoting effective competition in upstream and downstream markets*
>
> *(b) the legitimate business interests of the owner or operator of the service*
>
> *(c) if the owner and operator of the service are different entities, the legitimate business interests of the operator of the service*
>
> *(d) the public interest*
>
> *(e) the interests of persons who may seek access to the service*
>
> *(f) the effect of excluding existing assets for pricing purposes*
>
> *(g) the pricing principles, which in relation to the price of access to a service should,*
>
> *i. generate expected revenue for the service that is at least enough to meet the efficient costs of providing access to the service and include a return on investment commensurate with the regulatory and commercial risks involved*
>
> *ii. allow for multi-part pricing and price discrimination when it aids efficiency*
>
> *iii. not allow a related access provider to set terms and conditions that discriminate in favour of the downstream operations of the access provider or a related body corporate of the access provider, except to the extent the cost of providing access to other operators is higher*
>
> iv. *provide incentives to reduce costs or otherwise improve productivity*
>
> *(h) any other issues the authority considers relevant.*

The QCA Act does not provide any specific guidance on asset valuation or methodology, beyond stating that the expected revenue for the access provider should '*include a return on investment commensurate with the regulatory and commercial risks involved*'.[4] The QCA is required to have regard to wider considerations such as the legitimate business interests of the provider of the services and interests of the users.

The building block approach assesses the revenue requirement for regulated businesses to ensure the business has adequate revenue to meet the efficient costs of providing access to regulated services. This should include a return on investment commensurate with the regulatory and commercial risks involved, consistent with sections 138(2)(g) and 168(A)(a) of the QCA Act. Indeed, in its Draft Decision on Aurizon's network in 2014, the QCA considered the application of the building block model to be consistent with the requirements of the QCA Act.[5] The QCA's approach in relation to the building block methodology is summarised in Figure 1.

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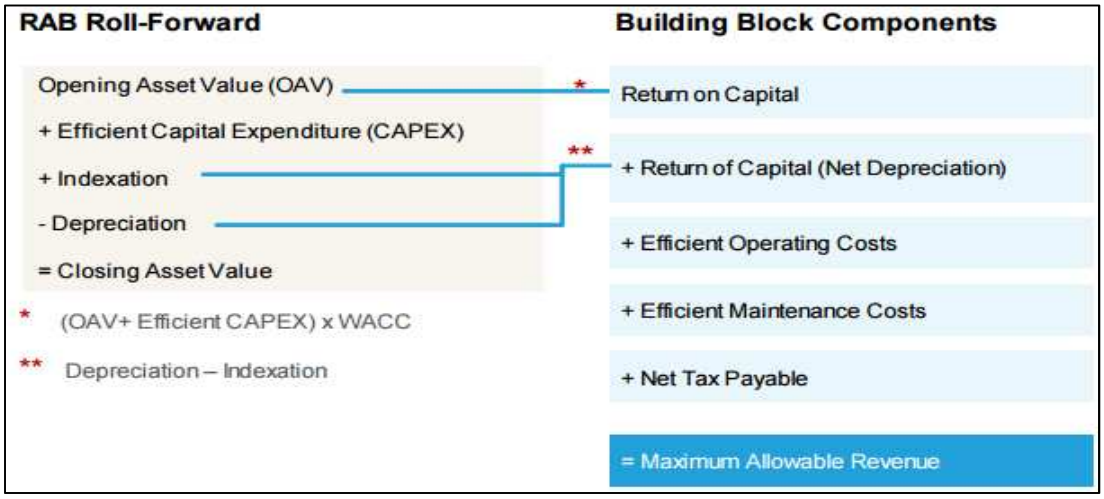
4 *Queensland Competition Authority Act 1997*, section 168A(a).

5 Queensland Competition Authority (2014), *Draft Decision Aurizon Network 2014 Draft Access Undertaking – Maximum Allowable Revenue*, page 28.

**Figure 1: Building Block Approach**




*Source: QCA, Draft Decision Aurizon Network 2014 Draft Access Undertaking – Maximum Allowable Revenue, September 2014.*

## 2.2 Decoupling the price ceiling from the reference tariff

Access undertakings can promote economic efficiency and align incentives for efficient operation and investment in the supply chain, benefiting both access providers and seekers.[6] A negotiate/arbitrate model, where tariffs are set between a floor and ceiling, by definition contemplates that an access tariff might be determined to be less than the regulator-determined ceiling. Examples of such an approach include:

- ***Intra-state rail regime in NSW*** – the NSW Rail Access Undertaking makes provision for third party access to the rail network in NSW for which Railcorp or the ARTC is the owner. The Independent Pricing and Regulatory Tribunal (IPART) sets a floor and ceiling price with access providers and seekers then negotiating within this range.
- ***Intra-state rail regime in South Australia*** – the Essential Services Commission of South Australia (ESCOSA) is responsible for conducting 5-yearly reviews into the Access Regime that applies to the major intrastate railways in South Australia. This review includes setting a floor and ceiling price during the access undertaking process. The Tarcoola-Darwin rail regime in particular uses a 'sustainable competitive price' taking into consideration competition from other transport modes with the rail line. The ceiling access price is based on the highest price the provider could charge having regard to the costs of other transport modes.[7]
- ***Water services provided by Essential Energy*** – as part of the price review process, IPART may determine the maximum price that Essential Energy can charge for monopoly services. The services which, if supplied by Essential Energy, are declared as monopoly services include: water supply services, sewerage services, trade waste service and ancillary customer services.[8] The water service provider can then charge a usage charge below the approved ceiling price.

The determination of the ceiling tariff should reflect established regulatory practice and focus on the reasonably efficient costs of a hypothetical new entrant. The applied reference tariff might take into account a range of other commercial, system-specific and temporal factors.

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6 Productivity Commission (2013), *National Access Regime, Inquiry Report no. 66*, Canberra, page 192.
7 *Ibid*, page 192.
8 IPART (2014), *Essential Energy's water and sewerage services in Broken Hill - Review of prices from 1 July 2014 to 30 June 2018*, Final Determination.

Reflecting these principles, Queensland Rail intends to propose for the West Moreton Network:

- A ceiling price based on a generally-accepted regulatory building block approach, which reflecting the current utilisation of the network (60 per cent) suggests a ceiling access charge of $34.92/'000gtk.
- A lower reference tariff for the West Moreton Network of $19.41/'000gtk applying from the commencement of 2015 DAU, and fixed (other than for indexation) over the term of the undertaking.

It is noted that the reference tariff for the Metropolitan Network is linked to the reference tariff for the West Moreton Network, adjusted for any incremental capital expenditure. The access charge that will be applied to the West Moreton Network is a combination of a per train path charge and per gtk component (50:50 share in each), with a separate train path component for the Metropolitan System which covers the incremental capital expenditure in that section.

In substance, this approach takes into account the interests of access seekers when setting the reference tariff, in accordance with section 138(2)(e) of the QCA Act, rather than seeking to address these factors in determining a ceiling tariff (through the asset value, or other building block parameter).

This approach also provides transparency to other access seekers and a level of certainty regarding how the ceiling price is determined for all users. These factors sometimes are identified as criticisms of a negotiate/arbitrate model, insofar as each access seeker may otherwise have to "re-litigate" each matter with the regulator.

# 3 Setting a reference tariff

There is no single, formulaic way to express how a reference tariff may appropriately vary from a conventionally-calculated price ceiling. Rather, the difference reflects a range of commercial, economic, user and system-specific factors, which may vary over time.

For the West Moreton Network, key factors include:

- Setting a reference tariff that seeks to maximise the traffic on the West Moreton Network without compromising the pricing principles of the QCA Act
- long term price stability including the relativity with long term benchmarks for the West Moreton Network below-rail access charges.

## 3.1 Maximising traffic on the Network

Ultimately, ensuring the commercial viability of the West Moreton Network is in the interests of Queensland Rail. Establishing access charges which are affordable to end users is a key consideration for Queensland Rail.

The volume of coal hauled on the West Moreton Network impacts the ceiling price in two offsetting ways:

- higher export volumes of coal lead to the greater utilisation of coal train paths, resulting in a higher allocation of shared network costs to coal services, but
- costs are then converted to unit rates (gtk) based on the volumes hauled, generally leading to a net reduction in access charges.

The decline in volumes of thermal coal hauled on the West Moreton Network has impacted Queensland Rail's revenue by approximately $16 million, or more than 25 per cent of the revenue linked to the West Moreton Network reference tariff regime.

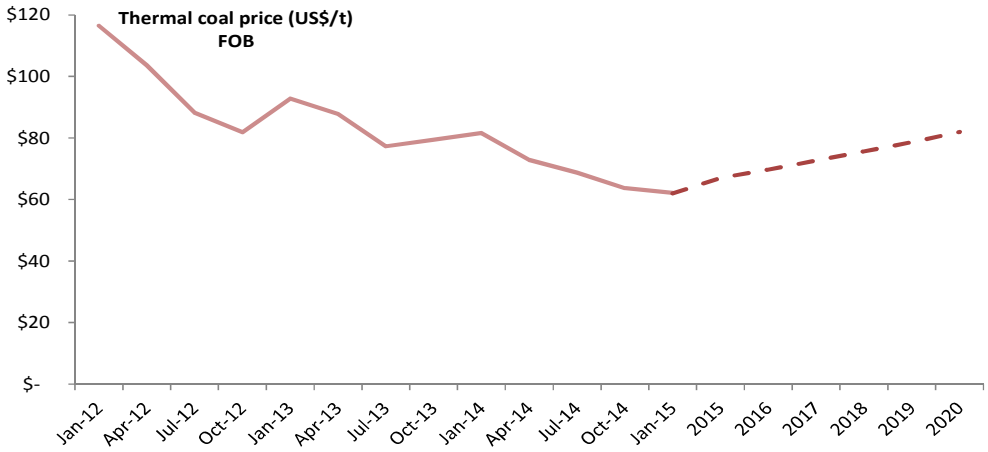
Looking forward, Queensland Rail's forecast coal volumes/network utilisation suggests a relatively high ceiling price of $34.92/'000gtk.

### Market conditions for thermal coal are set to improve

The thermal coal export industry has experienced a sharp decline in prices over the last three years, with the FOB price for thermal coal halving between 2012 and 2014 (see Figure 2). Weaker than forecast demand, a lack of supply discipline at producer-level and greater than expected cost cutting were the main drivers of this underperformance in the coal sector.[9] This commodity price decline, however, is expected to be temporary with prices expected to settle at $75 per tonne (US$) by late 2016, and trend positively thereafter.[10]

9 World Bank, *Commodity Markets Outlook,* January 2015.
10 CLSA, *Sector Outlook – Global Coal*, November 2014.

## Figure 2: Actual and forecast thermal coal prices (US$/t)



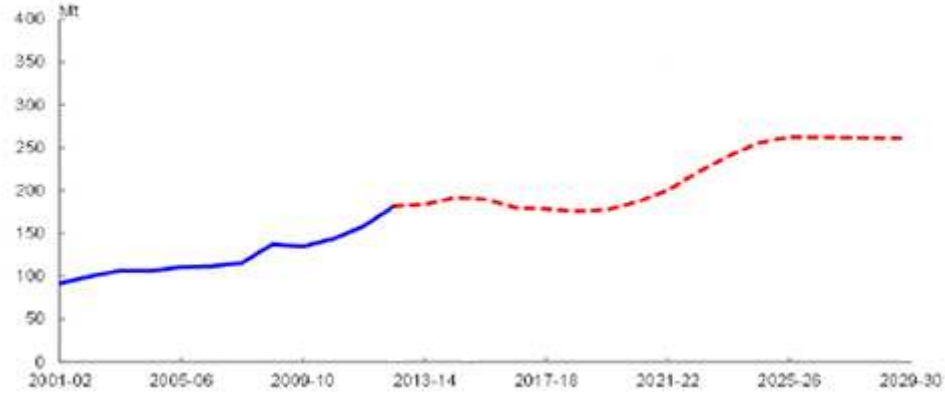

*Source: World Bank Commodity Price Data, March 2015 (actual)*
*World Bank Commodity Markets Outlook, January 2015 (forecast)*

Demand for thermal coal is set to increase with the two largest global importers of thermal coal, China and India, implementing policies to improve their coal allocation domestically (see Figure 3). This policy shift will drive demand in Australia with an expectation that Australia's coal export volumes will increase by over 25 per cent in the next decade (see Figure 4).

## Figure 3: Thermal coal imports by region (Mt)


*Source: Morgan Stanley, Global Metals Playbook – 2015 Outlook, December 2014.*

## Figure 4: Australian thermal coal export volume forecast (Mt)




*Source: Australian Government, Treasury Working Paper – Long-Run Forecast of Australia's Terms of Trade, May 2014.*

Market conditions facing thermal coal exports have deteriorated over the past 12-18 months. However, various forecasts suggest that market conditions will improve over the medium term, both in export price and anticipated volumes. Further depreciation in the exchange rate also could contribute to a material uplift in the $AUD value of thermal coal exports.

This supports an approach whereby the reference tariff applied could, in the future, adjust should more favourable market conditions allow, but still within the confines of a regulator-determined ceiling rate.

## The interests of both access provider and seekers are considered within a negotiate /arbitrate framework

Access regulation aims to prevent wasteful duplication of investment in infrastructure with natural monopoly and bottleneck characteristics and to provide incentives for efficient investment.[11] An access undertaking has three objectives:

- to provide certainty for access seekers and providers
- to reduce transaction costs
- to facilitate commercial decision making.[12]

An access undertaking need not resolve every financial and non-financial aspect of a future access agreement. The premise of a negotiate/arbitrate model is that flexibility ought to be preserved for the parties to negotiate appropriate access terms, with recourse to the regulator only where required.

The role of the regulator, expressed generally, ought to be balancing the infrastructure operator's interests in recovering its efficient costs and the access seekers' interest in obtaining sufficient certainty about access terms and conditions, to reduce the risks associated with complementary investments.[13] The underlying objective of an access undertaking is to streamline the process for negotiating the terms and conditions of access, particularly where there are multiple access seekers.[14] The QCA Act contemplates this balanced position, by requiring the QCA to consider both the interests of the operator of the service (section 138(2)(b) and 138(2)(c)) and the interests of access seekers (section 138(2)(e)).

An access undertaking, while providing a level of certainty, should allow access seekers to Queensland Rail's West Moreton Network to negotiate at arm's length with the appropriate checks and balances in place within the negotiate/arbitrate framework. To this end, not all matters need to be determined during the access undertaking process. The draft access undertaking should facilitate commercial decision making through the negotiate/arbitrate framework.

In the negotiate/arbitrate framework the interests of the access provider and seekers are both relevant to commercial negotiations. Ensuring the commercial viability of its Network is in Queensland Rail's interests. In this instance, a reference tariff less than the price ceiling during a time of declining volumes is an appropriate commercial strategy.

In this circumstance, where Queensland Rail is proposing a reference tariff below the ceiling price, Queensland Rail will bear the volume risk associated with coal services. If volumes fail to improve, the price access seekers are willing to pay will be a key consideration in future access negotiations. In effect, customers will benefit from a reduced tariff with Queensland Rail bearing the risk of uncertain volumes.

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11 ACCC (2013), *Submission to the Productivity Commission's Issues Paper on the Review of the National Access Regime*, page 45.
12 *Ibid*, page 24.
13 Productivity Commission (2013), *National Access Regime, Inquiry Report no. 66*, Canberra, page 203.
14 *Ibid*, page 203.

## 3.2 Tariff stability over the medium term

West Moreton Network access charges are currently $19.14/'000 gtk ($2014-15). The reference tariff proposed by Queensland Rail is, with indexation, not dissimilar to this existing tariff. Although this rate is significantly below what Queensland Rail considers a ceiling rate would be, there is merit in a tariff approach which provides a level of price stability over the medium term.[15]

This recognises that existing users on the West Moreton Network already are paying this access charge, and acknowledges also that Queensland Rail has before it a queue of access seekers whom, it could reasonably be argued, decided to submit for access knowing the current reference tariff.

Regulatory best practice acknowledges the promotion of price stability and predictability particularly between regulatory periods. The Australian Energy Market Commission, for instance, considers that good regulatory practice requires enhancing stability and predictability in prices and transparency of the process for setting prices in developing rules for electricity transmission pricing.[16] Similarly, the ACCC has recognised that the pricing mechanism chosen by the regulator must be transparent and promote price stability.[17]

The QCA has acknowledged that price stability is an important consideration for investors and customers alike. In its Statement of Regulatory Pricing Principles, the QCA has noted that, price stability leads to efficient outcomes,

> *Investors value stable returns in their own right and also because instability can create an uncertain political economy environment and cause investors to rethink, and possibly delay or even cancel previously planned projects. Moreover, producers and consumers may form expectations about the future course of prices (including expectations of price stability).*[18]

Over the long term, if coal volumes (and export prices) recover, then the gap between the ceiling price and the reference tariff may compress.

### Relativity to long term ceiling benchmarks

Historically the West Moreton Network has been a capacity constrained network with limited spare capacity. In 2013 the allocation for coal services was 77 paths. In 2015 the expected utilisation for coal services is anticipated to drop to 63 paths (with 46 paths unused) (see Table 1).

**Table 1: Utilisation of the West Moreton Network[19]**

| | **Coal** | Non-coal | Total used | **Unused** |
|---|---|---|---|---|
| 2013 utilisation | **77** | 29 | 106 | **6** |
| 2015 forecast (2015 DAU) | **63** | 3 | 66 | **46** |
| Optimum utilisation | **77** | 14 | 91 | **15** |

15 Setting the reference tariff at the current level is effectively 'pegging' the access charge to the optimum capacity utilisation price.
16 AEMC (2006), *National Electricity Amendment (Pricing of Prescribed Transmission Services) Rule 2006 No. 22,* Rule Determination, page 2.
17 ACCC (2011), *Pricing principles for price approvals and determinations under the Water Charge (Infrastructure) Rules 2010*, page 53.
18 QCA (2013), *Statement of Regulatory Pricing Principles*, page 12.
19 Due to a constraint from the Queensland government, only 87 out of the 112 paths can be allocated to coal services (77 per cent).

It is in the interests of Queensland Rail that the maximum amount of paths be allocated to coal services and that the commercial viability of its Network is ensured. The optimum utilisation of the West Moreton Network is also presented in Table 1. Without incurring any additional capital or maintenance expenditure, the Rosewood to Jondaryan (R2J) part of the network could cater for 15.7 gross million tonnes (GMT) (up from 11.5 GMT); while the Jondaryan to Columboola part of the network could cater for 3.6 GMT (up from 3 GMT).

Queensland Rail's analysis suggests that this additional volume and decline in coal path allocation (95 per cent to 84 per cent) would result in a ceiling price of $27.91/'000 gtk, or a 20 per cent decline. It is therefore conceivable that the gap between the ceiling price and reference tariff could reduce over time.

The actual tariff structure presented in 2015 DAU is based on a two-part tariff structure with a charge per path and a charge per '000 gtk. This is reflected in the terms of the 2015 DAU. The West Moreton Network tariff is effectively a proxy for the Metropolitan System tariff. The Metropolitan System tariff is set based on the West Moreton System tariff, adjusted to account for incremental capital expenditure for that part of the network.

There is evidence to suggest that the negotiate/arbitrate model is working effectively, with recent access negotiations on the West Moreton Network taking into account the circumstances of the access seeker and provider. In a recent access renewal, the access charge was set at the current rate of $19.14/'000 gtk ($2014-15), suggesting that price stability is commercially appropriate for both parties.

# 4 Accounting for a reference tariff lower than ceiling

## Queensland Rail will bear the risk of volume uncertainty in the short term

A typical characteristic of regulated firms is high fixed costs that are invariant to the level of output; this feature potentially exposes such firms to demand or volume risk.[20] Setting the reference tariff for the West Moreton Network below the ceiling price exposes Queensland Rail to volume risk. There are various examples where regulators, including the QCA, have considered that the risk of demand/volume uncertainty should be borne by the access provider:

- ***Postal services*** – The *Australian Postal Corporation Act 1989* (Cwlth) establishes specific access arrangements for Australia Post's bulk postal services. The ACCC has the power to inquire into disputes about the terms and conditions of access to Australia Post's bulk mail services, including price, and makes a recommendation to the Minister on appropriate terms and conditions. In a recent price notification review, the ACCC considered the uncertainty surrounding longer-term letter volume forecasts. Due to declining volume forecasts, Australia Post under-recovers by approximately 15 per cent each year.[21]
- ***Commercial bulk water services*** – In a recent investigation of prices, the QCA considered Gladstone Area Water Board's exposure to certain downside revenue risk for demand variation through various mechanisms including incorporating reservation volumes within the tariff structures and price differentiation for contract length (to encourage customers to contract).[22]
- ***Metropolitan Water Supply Services*** – In its price review for Metropolitan Melbourne Water, the Essential Services Commission (ESC) sought to achieve a 'reasonable sharing' of demand risks between Melbourne Water and its customers. To this end, ESC provided scope for each business to adjust its tariff strategies or prices to take account of events that do not fall within the business' control. This included significant differences between actual and forecast demand.[23]

The reference tariff should reflect the market conditions faced by end users and replicate what occurs in a competitive market. That is, the willingness and ability to pay of users is an important consideration at the time of recontracting with each access seeker. At the time of renewal of each access agreement, it is in Queensland Rail's best interests to negotiate in accordance with commercial position of each access seeker.

## A loss capitalisation policy is not appropriate

There are instances where regulators have determined regulated charges which do not fully recover costs, but where this cost shortfall is carried forward (ie, "capitalised") and recovered in future regulatory periods. A more limited form of loss capitalisation is where regulatory revenue allowances are "smoothed" over the regulatory period, meaning that tariffs may under- or over-recover allowable costs in any one year.

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20 Network (2014), *Publication of the ACCC for the Utility Regulators Forum*, Issue 44.
21 ACCC (2014), *Australia Post Price notification for its 'ordinary' letter service - Decision*, page 33.
22 QCA (2010), *Final Report Gladstone Area Water Board: Investigation of Pricing Practices*.
23 *Ibid*.

A loss capitalisation approach is appropriate where spare capacity exists or current costs have been incurred but which will benefit future users. In these instances, the regulator may appropriately allow the business to recover its costs over the full 'capacity lifecycle'. This allows charges for today's users to be set reflecting that certain costs may be not immediately recovered, but will be in future periods.

However, a loss capitalisation approach could only be utilised if there is a specific forecast of how volumes will recover over time, and where it can be demonstrated that costs have been efficiently incurred now, to benefit future users (whether through expansions or otherwise). We understand that capitalisation of any losses is not proposed by Queensland Rail at this time as a specific forecast of how (or when) volumes will recover on the West Moreton Network is unknown.

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