Submission on Queensland Rail's 2015 Draft Access Undertaking

Submission on QCA's Draft Decision

Volume 2

West Moreton Coal Reference Tariff

December 2015

Introduction

This Volume 2 of the New Hope Corporation (**NHC**) submission comprises NHC's submissions on the West Moreton coal Reference Tariff and related pricing matters, which were covered in Part 8 of the QCA's Draft Decision.

It should be read in the context of being part of NHC's 4 volume submission (Volume 3 of which principally considers the body of the access undertaking, and Volume 4 of which principally considers the standard access agreement). This Volume does not generally seek to duplicate submissions made in each of those Volumes, each of which touch on some pricing matters relating to QR's 2015 DAU as well.

NHC agrees with the QCA's ultimate conclusion in the Draft Decision that it is not appropriate to approve QR's 2015 DAU (including QR's proposed West Moreton network tariffs), having had regard to each of the matters referred to in section 138(2) of the QCA Act.

This Volume sets out NHC's views on each of the decisions comprised in Part 8 of the Draft Decision, and provides submissions regarding the refinements that would be required to the approach to reference tariffs and other pricing matters in order for NHC to consider it appropriate for the QCA to approve the 2015 DAU.

Executive Summary

NHC supports the vast majority of the QCA's reasoning regarding the approach to pricing matters and the West Moreton coal reference tariffs.

In particular, NHC strongly supports the QCA's approach to valuing the regulatory asset base and determination to apply an Adjustment Amount, and considers that those decisions are the only appropriate decisions that could be made on those issues.

However, there are a number of areas which NHC considers should be approached differently, principally being:

(a) the weight given to affordability and competitiveness in assessing the appropriate tariff;

(b) the allocation of fixed costs to coal services;

(c) the need for a separate overall assessment of appropriateness after application of the pure building blocks methodology;

(d) the proportion of the tariff that should be subject to take or pay obligations; and

(e) the adjustment amount being calculated to include an amount in respect of services east of Rosewood.

NHC is reliant on the QCA to conduct a thorough consideration of the prudency of QR's costs and to update the weighted average cost of capital parameters (risk free rate and debt margin) as discussed in Section 3.8 of Volume 2 of NHC's submission.

Structure of this volume

Section numbering and content throughout the body of this Volume is aligned with that in Part 8 of the QCA's Draft Decision.

8.1 Summary of QCA decisions

Section 8.1 of the Draft Decision summarises the QCA's Draft Decisions in regard to various issues relating to West Moreton Reference Tariffs. This section provides an overview of NHC's response to each of these items.

In addition to comments on individual elements of the 'building blocks' within the proposed tariff, NHC considers that it would not be appropriate to approve a tariff which was uncompetitive and further reduced the demand for use of the West Moreton network infrastructure, having regard to:

(a) the object of the QCA Act, particularly in relation to efficient operation and use of QR's rail infrastructure (section 138(2)(a) QCA Act)

(b) the public interest, particularly as it relates to the economic benefits of the coal industry to the region and the return to the government from the use of QR's infrastructure (section 138(2)(d) Act)

(c) the interests of Access Seekers (section 138(2)(e))

(d) the interests of Access Holders (which NHC agrees is relevant to section 138(2)(h)); and

(e) the need for regulatory certainty (which NHC agrees is relevant to section 138(2)(h)).

That is, NHC considers that there is a level which tariffs cannot exceed and still be said to be appropriate having regard to the statutory criteria, even if a mechanical application of a pure building block methodology may suggest a higher tariff. The 'legitimate business interests' of QR (as relevant under section 138(2)(b)) do not justify charging a price which exceeds that level of appropriateness. In fact, NHC would suggest that such a tariff would not be consistent with QR's legitimate business interests.

NHC supports the QCA's conclusions in Part 10 of the Draft Decision that:

(a) 'legitimate business interests' connotes a reference to what is objectively regarded as allowable and appropriate in commercial or business terms in the context of providing access to the declared service, meaning that a concept of reasonableness and proportionality is implied by the use of the word 'legitimate' (page 251 Draft Decision), as opposed to Queensland Rail's subjective view as a monopolist about what its preferred position is; and

(b) the competitiveness of consumers of rail services who sell their products in international markets will be undermined if the cost of providing rail services are not efficient, and that is a matter relevant to the QCA's consideration of the public interest (page 254 Draft Decision).

Both on a pure building block methodology and an overall assessment of appropriateness, NHC considers the indicative reference tariffs in the Draft Decision are too high.

NHC's positions on each of the Draft Decisions in Part 8 are as set out in the table below:

QCA Draft Decision	Issue	QR position (NHC interpretation)	QCA Draft Decision	NHC response and reference to further explanation
8.1(a)/8.3	Regulatory context	Very restricted view of QCA powers; s. 138(2)(g)/s.168A(a) has priority over other criteria.	QCA powers are as per the QCA Act. All of the factors in s 138(2) need to be weighed up in determining appropriateness. The pricing principle in section 168A(a) is one of the factors to have regard to, but can be outweighed by other factors.	Section 8.3: Agree with Draft Decision
8.1(b)/8.4.1	Allocation of common costs	Costs allocated mainly based on forecast usage, therefore predominantly to coal	Allocation to coal capped at paths available to contract to coal	Section 8.4.1: NHC does not support either the QCA Draft Decision or the QR position. Allocation of common costs should be based on the higher of contract or forecast paths as a proportion of total available paths. The Draft Decision represents inappropriate risk transfer regarding QR's approach to pricing of both coal and non-coal services.
8.4.2	Volumes	Forecasts provided for coal and non-coal	Accept QR forecasts	Section 8.4.2: Forecasts for coal services are lower than a reasonable estimate.
8.1(c)/8.5	Maintenance costs	$143m	$114.6m	8.5: NHC suggests that the QCA's estimate is likely to exceed efficient costs
8.1(d)/8.6	Operating costs	$37.2m	$37.2m	8.6: NHC suggests that the QCA's estimate is likely to exceed efficient costs
8.1(e)/8.7	Regulatory asset base	Opening $471.6m Past capex $57.2m Future capex $141.9m	Opening $272.2m Past capex $37.7m Future capex $144.2m	8.7: NHC supports the QCA's approach to valuation of life expired assets.
8.1(f)/8.8	Capital charges	Various proposals for depreciation, WACC, tax.	Accept QR position	8.8: NHC supports the methodology applied by the QCA and is reliant on the QCA to update the time-variant WACC parameters.

8.1(g)/8.9	Form of regulation and tariff structure	Price cap, two part tariff	Accept, but with review provisions	8.9: Accept Draft Decision subject to QCA confirming that reference tariff won't breach pricing limits for New Acland
8.1(h)/8.10	Ceiling price	$34.92/'000gtk	$18.88/'000gtk (indicative)	8.10: Indicative tariff remains too high (both on a building blocks and overall appropriateness basis)
8.1(i)/8.11	Adjustment amount	Withdrew commitment to provide adjustment	Future tariffs take account of past recoveries by QR	8.11: Support Draft Decision subject to adjusted calculations (particularly in respect of revenue attributable to the use of the infrastructure from Rosewood to the Port)
8.1(j)/8.12	Reference Tariffs	$19.41/'000gtk	$15.88/'000gtk (indicative West Moreton, inclusive of Adjustment Amount).	8.10: The indicative tariff remains too high and should be lowered by a re-examination of the parameters noted in other decisions. In addition, the QCA should perform an overall assessment of appropriateness that may limit the appropriate tariff below that set by a strict application of the building blocks methodology.

8.2 QR's 2015 DAU proposal

This section of the Draft Decision summarises the QCA's understanding of QR's proposal, and of stakeholder comments.

As will be clearly outlined in this submission, NHC remains strongly opposed to QR's positions in respect of pricing.

NHC agrees with each of the stakeholder concerns listed in Section 8.2 of the QCA's Draft Decision, including those raised by other stakeholders (Aurizon, Yancoal, Sekitan and the Port of Brisbane), and considers each of those concerns is critical to an assessment of the appropriate tariff.

8.3 Regulatory context of the Draft Decision

We support the Draft Decision that QR's proposed reference tariff is inconsistent with the approval criteria in the QCA Act, and we generally support the QCA's application of the approval criteria.

However, we consider that two elements of this analysis require further consideration:

(a) **Relative prices of train services**: The QCA Draft Decision states that "our decision has not given material weight to the issue of relative prices of other train services" (page 138). The QCA goes on to note "*we do not consider that we must be precluded*

from taking relative prices into account in the future. Indeed, such comparisons are amongst a range of factors we could give greater weight to when assessing a reference tariff under the approval criteria in the QCA Act, especially in the face of material falling demand on the West Moreton Network" (page 138/9). Similarly the QCA notes that "*Where consumers of rail services sell their products in international markets or face intense competition in their domestic markets, the ability of such consumers to pass on the rail transport costs is likely to be constrained*." and recognises that is a matter relevant to the QCA's consideration of the public interest (page 254 Draft Decision).

(b) **Affordability:** The QCA Draft Decision states in footnote 367 that "*we did not take 'affordability' into account*" when reaching the Draft Decision. The QCA Draft Decision goes on to note (page 140) that "*there is a prima facie case that the QCA should consider the 2015 DAU provisions for reducing the value of assets contained in the regulatory asset base where demand for access has deteriorated to such an extent that regulated prices based on an unoptimised asset value would result in a further decline in demand for access*".

Despite these comments, the Draft Decision appears to lack any explanation as to why the QCA has:

(a) failed to give material weight to relative prices and affordability in the face of actual (rather than hypothetical) material falling demand on the West Moreton Network; and

(b) not acted on the '*prima facie case*' that consideration should be given to reducing the value of assets to prevent a further decline in demand for access.

We also note that, in the QCA's December 2015 Draft Decision regarding Aurizon Network's 2015 DAU (Page 134 of Vol 3), the QCA identifies the following matter as a relevant consideration under section 138(2)(h) of the Act: *"Market conditions – as the CQCR continues to face globally competitive conditions, a balance has to be struck between preserving individual stakeholders' business interests and promoting the public interest (i.e. ensuring the CQCN's medium- to long-term competitive position in the global coal markets)".* If such a consideration is a relevant matter in the CQCR, then we suggest that this is clearly a relevant matter for the West Moreton network, given that the proposed ceiling tariff for New Acland is more than double the average CQCR tariff (and Cameby Downs nearly triple) and given that West Moreton above-rail costs are significantly higher due to the technical obsolescence of the below rail infrastructure. NHC seeks a tariff which is competitive in the long term. However, shorter term considerations such as current market conditions remain relevant as these conditions increase the risks involved in over-estimating tariffs. Current market conditions are also relevant to issues involving the timing of cashflows (such as depreciation profiling, discussed in Section 8.9, or the treatment of capital charges on surplus capacity, discussed in Section 8.4.1).

NHC considers that adjustments are required to a number of elements of the Draft Decision which feed into the calculation of reference tariffs. If appropriate adjustments are made to these elements, then NHC acknowledges that the revised tariff *may* not be at such a level that consideration needs to be given to alternatives such as reducing the value of assets to prevent a further decline in demand for access. However, if the QCA's analysis of the building block elements as set out in this Draft Decision is confirmed (or if adjustments are made which increase the tariff), then NHC considers that section 138(2)(a), (d), (e) and (h) require that the QCA fully considers the matters discussed above. The QCA must then weigh the requirements of those matters against any elements of section 138(2) which appear in conflict with these requirements. In this context, we note that a tariff which induces further deterioration in demand is not in QR's legitimate business interests (section 138(2)(b)) and will not assist in achieving the revenue adequacy objective (sections 138(2)(g) and 168A(a)).

NHC has previously provided information to the QCA regarding the relative prices of train services and affordability (see Annexure A to Volume 2 of NHC's initial submissions on the 2015 DAU), and

continues to consider those comparisons present a clear and stark picture of the inappropriateness of the current and proposed future West Moreton network pricing regime.

Should the QCA require any additional information which is relevant to these considerations, then, subject to addressing confidentiality requirements, NHC would be pleased to provide it.

8.4 Volumes and allocation of common network costs

Draft Decision numbers	Item	QCA Draft Decision	NHC response
8.1-8.3	Allocation of common costs	Fixed costs allocated based on portion coal is able to contract, variable costs based on volumes	Support elements of Draft Decision, but significant remaining concerns regarding allocation methodology (Section 8.4.1)
8.4-8.5	Volume forecasts-non-coal	Accept QR proposal	Accept Draft Decision due to 77 path cap on coal share of all fixed costs (Section 8.4.2)
8.6-8.7	Volume forecasts-coal	Approve QR volumes, subject to new Endorsed Variation Event	Forecasts remain too low, Endorsed Variation Event requires revision (Section 8.4.2)

8.4.1 Allocation of common network costs

Supported elements of Draft Decision:

NHC strongly supports the Draft Decision to reject QR's proposal for the allocation of fixed costs. QR's proposal included allocating fixed maintenance costs and fixed operating costs based on forecast volumes. This had the effect of transferring the risk of declining demand for non-coal services from QR to coal producers. NHC agrees with the QCA's assessment that any anticipated shortfall in non-coal revenue is a commercial matter for QR.

This is not a risk which coal producers are able to manage or to which coal producers should reasonably have expected to be exposed. The recent reduction in non-coal traffic has been substantial. QR attributes much of the reduction to competition from road transport, yet there is no indication that QR has a strategy to address this situation, whether through price competition or otherwise. Instead, QR seeks to address the impacts on its business by passing the fixed costs associated with the relevant capacity to coal producers. This is clearly inappropriate.

The QCA's approach in the Draft Decision to fixed cost allocation (which deals with fixed maintenance, fixed operating costs and capital charges) will result in QR recovering from coal producers the full amount of (and in NHC's view, more than) the fixed costs that are reasonably attributable to coal producers. Whether QR is able to recover the fixed costs which are attributable to other services from its other customers is not a matter which the West Moreton reference tariff need address. To do so would involve the West Moreton coal producers underwriting this element of QR's non-coal costs and revenues. This:

(a) would not be consistent with sections 138(2)(a), (d) and (e) QCA Act;

(b) would not be consistent with section 138(2)(h) QCA Act, as we would suggest that the inequity of requiring coal producers to pay fixed costs relating to train paths which they are not permitted to contract for should be an "*other issue*" which the QCA considers relevant;

(c) is not consistent with QR's legitimate business interests (s 138(2)(b) QCA Act), as we do not agree that it is legitimate or reasonable to seek to recover the costs of these services from customers who are not allowed to contract for this capacity; and

(d) does not involve any tension with section 138(2)(g) or the pricing principle in s 168A(a), as the QCA's alternative proposal will provide QR with revenue from access to the relevant service (coal trains) which is adequate to meet the efficient costs of providing access to *that* service. QR's recovery of the costs of providing other services is not relevant, as is reflected in the QCA's recognition that "*whether Queensland Rail recovers the non-coal share of maintenance costs from non-coal services is not relevant for setting reference tariffs for coal-carrying train services on the West Moreton network*" (page 156 Draft Decision).

Significant remaining concerns:

While the QCA's approach to the fixed costs of capacity which is unable to be contracted by coal services is welcomed, NHC has serious concerns regarding the proposal to recover from the remaining coal producers the fixed costs of capacity formerly contracted for the Wilkie Creek mine.

The basis of the QCA's proposal appears to be a view that either:

(a) coal producers as a group should collectively underwrite this spare capacity, because this capacity was once used by another coal producer; or

(b) coal producers should pay the costs of this capacity, because it is available to them for contracting.

NHC strongly rejects the appropriateness of both of those views, and considers that in the commercial context of the West Moreton system those principles do not stand up to scrutiny.

In regard to the first point, coal producers did not collectively request investment in, nor promise to underwrite, this capacity, in the same way as could be said to have occurred in Central Queensland or the Hunter Valley (where the relevant assets were largely put in place for a larger group of coal producers and where the producers as a collective have had a role in contributing to and/or approving investments). Many of the assets on the West Moreton network to which the relevant fixed costs relate were not developed for coal and would pre-date the use of this capacity by any coal producer. The fact that this capacity was used by a coal producer for a certain period of time should not artificially dictate a requirement that forever more the remaining coal users (currently, NHC and Yancoal) must assume this exposure, merely on the basis that they produce the same commodity as the former customer.

In regard to the second point, it is important to note that *the capacity is not reserved for coal*. To NHC's knowledge, there is no capacity reservation or guaranteed number of minimum train paths available for contracting by coal services – rather there is an effective government policy cap on the maximum number of coal services. To NHC's understanding, there is nothing preventing non-coal services from contracting available paths from the 77 paths the QCA appears to have concluded are solely available for coal.

While that maximum of 77 paths is theoretically available for coal services, any surplus capacity above the current contract volume is equally available for contracting by general freight or other commodities. If 'availability for contracting' is the basis on which the fixed costs of this capacity are allocated to coal,

then an equally strong basis exists for allocating the costs to non-coal services, and some proportion of the costs of the unutilised train paths in that 77 should be allocated to non-coal services. NHC considers that allocating all of the costs of this spare capacity to one group of customers, in a mixed-use system, is inequitable, will distort competition in markets, and is not appropriate having regard to section 138(2)(a), (d), (e) of the QCA Act.

Current and future impacts of 77 path basis for coal share

NHC is also concerned about the implications of continuing this approach into the future. In the event that Yancoal was to close its Cameby Downs mine and the QCA maintained this approach, NHC's tariffs would increase by more than 50% (NHC estimate based on information in the Draft Decision). In the alternative case (such as if the extension of the New Acland mining lease is not approved), NHC estimates that the Cameby Downs tariff would increase by more than 200%. It goes without saying that such increases would be highly damaging to the viability of either of those operations. We assume that in these cases the need to alter the approach to setting reference tariffs would be clear and undisputed. NHC suggests that the closure of Wilkie Creek, which appears to have impacted tariffs by more than 20%, also requires consideration of such issues. Alternatives which are open to the QCA include:

(a) reducing the value of assets to reflect the assets required for the current volumes and to exclude the cost of spare capacity;

(b) capping tariffs while maintaining the value of assets, so that the asset value is preserved for future recovery, should demand increase; and/or

(c) deferring (or capitalising) the returns on, and depreciation of, the assets which are not currently required. We note that the QCA's Draft Decision on the Wiggins Island Rail Project supports such an approach. That Draft Decision seeks to ensure that the cost of capacity which was contracted by parties who are now not expected to use that capacity (at least for the period under consideration) is not borne by remaining customers.

NHC requests that the QCA reconsider the appropriateness of each of those approaches.

Common cost allocation: conclusion:

NHC supports the QCA's Draft Decision, to the extent that it prevents QR from recovering through the West Moreton reference tariff the revenue lost due to the decline in non-coal services. We consider that the recovery from remaining coal producers of revenue lost due to the closure of Wilkie Creek is similarly inappropriate and unsustainable.

8.4.2 Volumes for coal pricing purposes

Non-coal services

NHC considers that setting the forecast for non-coal services at this time is likely to underestimate the volumes over the longer term, given that QR has attributed some of the recent reduction to drought. However, under the QCA's proposal in which the share of all fixed costs allocated to coal is capped to reflect the portion of paths which are able to be contracted to coal, coal producers are not exposed to variations in non-coal volumes (which is appropriate). We therefore accept the Draft Decision.

Coal services

NHC considers that QR's forecast for coal services underestimates the likely volumes. This was explained in detail in NHC's submission of August 2015 (parts of which were confidential), and our forecasts have not changed since that time. We note that the QCA has proposed a new Endorsed Variation Event relating to contracted Reference Train Services in the West Moreton Network and

Metropolitan Network. This mechanism mitigates the risk of the volume forecast being too low only if access seekers have a genuine ability to enter into new access agreements within reasonable timeframes, which requires an effective access undertaking, and in particular an effective negotiation and dispute process. Currently, no access undertaking applies to the West Moreton Network, and NHC's own experience is that the difficulty of access negotiations with QR has contributed to the current use of substantial ad-hoc paths. In this context, we consider that the QCA will need to re-examine QR's volume forecasts, NHC's submission and any other available data, and ensure that the volume forecasts are reasonable.

In regard to the proposed Endorsed Variation Event, we note that the Draft Decision states that this will operate on an "*origin-destination basis*" (page 198). NHC considers that is appropriate, but it appears not to be reflected in the drafting of the Endorsed Variation Event within the QCA's mark-up of the 2015 DAU in the Draft Decision. A drafting amendment which NHC considers would reflect the QCA's intended outcome is included in Appendix A of Volume 3 of NHC's submission.

8.5 Forecast maintenance costs

8.5.1 Forecast total maintenance costs

NHC considers that QR's forecasts of maintenance costs are excessive, and generally supports the Draft Decision to reduce these costs towards efficient levels. We remain concerned that QR appears to lack a coherent capital investment, maintenance and asset replacement strategy and we agree with B&H Strategic Services' view, which was expressed as follows:

We find that Queensland Rail's plans are not reasonable on a number of levels……..there is no coordination of plans and it is evidenced by all maintenance activities continuing at the levels ….when capital activities reduce….it appears that individual maintenance plans have been created independently and those have been created independently from the capital plans (page i)

In situations such as this, with poor planning and poor planning coordination, it is inevitable that QR will neither have developed a prudent scope of works, nor undertaken efficient maintenance and construction activities. NHC acknowledges that some of the maintenance costs relate to the old and not designed for coal nature of the infrastructure (which goes to the asset valuation issues). However, that should not become an excuse for inefficient maintenance costs. The net result is that customers will be asked to pay the higher cost of these inefficiencies (in addition to the already high costs driven by the nature of the infrastructure).

NHC had hoped that the significant loss of demand for contracted paths would have resulted in QR seriously questioning what work needed to be done and how the work would be undertaken. Unfortunately, this does not appear to have been the case.

NHC notes the Recast Maintenance and Capital Asset Management Plan (B&H Figures 1 and 2 respectively) and appreciates B&H's assessment of the two programs. However, NHC considers B&H has been far too conservative in its assessment and provides more specific comments below (using B&H headings):

(a) Background to 2015 DAU: NHC agrees with B&H that there will be more track time available to perform maintenance "*since 26 contracted return services of non-coal traffic and 14 services for coal traffic will now not be on the network*" (p2).

(b) Review of Maintenance Cost Elements: The Balance Advisory report which was attached to NHC's June 2015 submission supports B&H's view that "*in fact a deep review of this network at the forecast traffic levels could conclude that it contained many redundant assets and that an entirely different RAB is constructed and a new maintenance plan conceived" (p4).* The annual maintenance cost of $59,376 per track kilometre (p 5) excluding mechanised re-sleepering has increased even above the very

high level of the 2013 DAU. This is counter-intuitive given the materially lower demand for paths and reduced gross tonne kilometres. NHC also supports the B&H view that the "*maintenance program for structures appears, like the capital program for structures to be not well structured in expenditure timing with large lumps of expenditure and a 'loss of continuity' in the elements" (p8)*.

(c) Benchmark Maintenance on the Western System: The Benchmarking undertaken by Balance Advisory (attachment to Volume 2 of the NHC June 2015 submission) is reasonably consistent with the B&H position that a reasonable benchmark cost is closer to $30,000 per kilometre.

(d) Fixed and Variable Maintenance Costs: NHC generally agrees with the B&H estimates of the proportions of fixed and variable costs. We would however argue that rail joint management and turnout maintenance have a more significant variable component.

Based on the above analysis, NHC has very serious doubts about the prudency and efficiency of the levels of maintenance costs being proposed by QR. NHC supports the QCA's Draft Decision to reduce the forecast maintenance costs towards efficient levels. We remain concerned that QR appears to lack a coherent asset strategy. Such a strategy is critical as a means of ensuring that the network is maintained to a prudent standard and at an efficient cost. Users of the network are necessarily reliant on the QCA for the assessment of efficient costs, but the evidence currently available to NHC indicates that prudent maintenance costs are lower than those accepted in the Draft Decision.

8.5.2 Coal services share of forecast maintenance costs

In section 8.4.1 and 8.4.2, NHC discussed the QCA's proposed approach to allocating fixed costs (including fixed maintenance costs) between coal and non-coal services. NHC:

(a) supported the Draft Decision that coal services should not pay the fixed costs of capacity which coal services are not able to contract; but

(b) raised concerns with the Draft Decision which requires the remaining coal producers to underwrite fixed costs relating to all capacity which is available to be contracted by coal services, but which is not reserved for coal services and is equally available to be contracted by non-coal services.

Subject to the concerns with overhead and administration costs noted below, NHC accepts the proposed allocation of variable costs based on the coal and non-coal share of forecast volumes (with the view that if the costs are truly variable that will be an appropriate allocation to the services that are directly causing those costs to be incurred).

8.6 Operating costs

NHC considers that the operating costs which the QCA proposes to approve are excessive and highly unlikely to be efficient.

Table 2 on page 32 of the B&H report shows that corporate overheads ($1,568,000), Business Management ($446,000) and Group Management ($505,000) together make up 46% of all operating costs or, put another way, add 85% above the total of direct and other allocated costs.

For comparison, it is noted that:

(a) general and administration expenses of BNSF Railroad for the year ending 31 December 2013 as a percentage of operating costs are 7.5% (Surface Transportation Board (USA) website); and

(b) a report prepared by Ernst & Young for Aurizon Benchmarking of Corporate Overhead Costs for Aurizon Network Operations dated 22 January 2013 suggested norms for corporate overheads of 6.4% of revenue.

Both of these data points suggests that QR's overheads are either extremely inefficient or are allocated disproportionately to the Western System.

It appears to NHC that those high overhead and administration costs will principally relate to QR's passenger services. Allocating those cost categories based on the number of services operated, without considering the relative overheads required to support different traffic types, is likely to result in coal services cross-subsidising passenger services.

NHC suggests that the allocation of overhead and administration costs requires further consideration, particularly regarding the impacts of passenger services on these costs. Allocation of remaining variable costs between coal and non-coal services on the basis of the number of services appears reasonable. Our views on the allocation of fixed operating costs, as for all fixed costs, are:

(a) we support the Draft Decision that coal services should not pay the fixed costs of capacity which coal services are not able to contract; and

(b) we do not accept the proposal that the remaining coal producers underwrite fixed costs relating to spare capacity which is available to be contracted by coal services, but which is not reserved for coal services and is equally available to be contracted by non-coal services.

8.7 Regulatory asset base

Draft Decision numbers	Item	QCA Draft Decision	NHC response
8.8-8.10	Initial asset base	Reject QR claim, propose value of $272.2m	Support methodology subject to comments regarding need to revisit whether a further reduction is appropriate to ensure an appropriate final tariff (Section 8.7.1)
8.11-8.13	Schedule E (maintaining the RAB)	Require amendments	Support Draft Decision

8.7.1 Initial asset base

An initial asset base has never been settled

NHC agrees with the QCA that "*the initial asset base for the West Moreton network has never been settled*" (page 159 of Draft Decision). This section of our submission responds to QR's claims regarding the existence of an initial asset base, as set out in QR's July 2015 submission "*Further submissions – DORC valuation and roll forward of initial asset base for West Moreton Network*".

The fact that an initial asset value has never been approved for the West Moreton network has been understood by QR, other stakeholders, and the QCA throughout the history of regulatory processes relating to this system. The fact has been acknowledged by QR in a range of submissions, including recent submissions. PWC correctly stated, in a report submitted to the QCA by QR in May of this year, that "*While a tariff has been part of an approved undertaking since 2006, the tariffs have never been calculated from an agreed and settled asset value, nor an agreed underlying set of assumptions in relation to the initial asset value*". (QR's 2015 DAU submission, volume 2, Appendix 2, Section 1.1).

The QCA has also acknowledged the lack of an approved basis for deriving tariffs in this system, including within the June 2010 Draft Decision which was confirmed in the Final Decision of the same month, and which QR now claims constituted an approval of the asset valuation which appeared in the 2009 Draft Decision.

QR now seeks to re-write this history and claim the existence of an approved valuation of the initial asset base in order to limit the QCA's discretion in applying the statutory criteria to the assessment of the 2015 DAU. QR proposes that:

(a) the QCA must provide regulatory certainty by rolling forward the purported approved valuation from the 2009 Draft Decision; but

(b) despite the claimed existence of an approved asset valuation and need for regulatory certainty, the valuation and the methodology should be revised in regard to elements which are considered unfavourable to QR.

QR's key claim is that, by approving tariffs in the June 2010 decision which corresponded to tariffs which appeared within the 2009 Draft Decision, the QCA is deemed to have approved the asset values discussed in that Draft Decision. In reality, no stakeholders (including Aurizon Network) supported the asset values set out in the Draft Decision, and other factors led to acceptance of the tariffs (but not the asset values or the methodology). The QCA's June 2010 Draft Decision (section 2.13) puts this question beyond any doubt, stating that "*there remains outstanding the question of the most appropriate way of deriving these tariffs*" and "*It is also apparent that the Authority has not achieved its desired objective of finalising a repeatable and transparent methodology for deriving the western system tariff. However, in order for there to be greater certainty about future tariffs, the Authority is keen to work with QR Network to develop an agreed approach for future undertakings*."

The fact that an approved asset base was not established through the 2010 process has been understood and accepted by all stakeholders, including (until recently) by QR:

(a) Section 3.1 of QR's June 2013 submission to the QCA, states, in regard to previous undertakings, that *"While there was a common objective, i.e. the development of a transparent and repeatable approach that provides a robust methodology suitable for rolling forward into future regulatory periods, in past undertakings the QCA and QR Network were unable to reach agreement on exact building block parameters for the West Moreton System".*

(b) As was noted on the previous page, QR's 2015 DAU submission contained a PWC report which stated: "*While a tariff has been part of an approved undertaking since 2006, the tariffs have never been calculated from an agreed and settled asset value, nor an agreed underlying set of assumptions in relation to the initial asset value*". This was the opinion of PWC, as QR's consultant, as recently as May of this year.

We must therefore conclude that QR held the view that "*tariffs have never been calculated from an agreed and settled asset value*" as recently as the 7th of May 2015, and has only reneged on that view because it now considers doing so is in its commercial interest.

Clearly, a transparent methodology for developing tariffs, including the asset valuation, was not established in 2010, and it has not been established since that time. Contrary to QR's submissions, regulatory certainty requires that the QCA focus in this decision on achieving an appropriate valuation of the regulatory asset base through a thorough examination of the issues, rather than by adopting amounts for which there is no solid or settled foundation.

QCA is not bound to adopt a "conventional" DORC valuation

The second main theme of QR's July 2015 submission "*Further submissions – DORC valuation and roll forward of initial asset base for West Moreton Network*", presumably prepared as a back-up to the

flawed claim that an approved asset valuation already exists, is that the QCA should apply a 'conventional' DORC valuation to the relevant assets. This claim is not new, and NHC has responded in numerous past submissions. Our view remains as follows:

(a) the QCA's role is to approve or reject the DAU after considering the factors set out in Section 138(2) of the QCA Act;

(b) the QCA has wide discretion as to what is appropriate;

(c) the statutory criteria may be in conflict or have a clear tension between them. In such a case, a decision can only be reached by applying differing weightings to the factors;

(d) there is no one cornerstone, dominant or paramount factor which must be given the most weight;

(e) the QCA is not bound to follow any particular regulatory precedent, and must not follow a precedent if to do so would result in approval of an undertaking which is not appropriate having regard to the section 138(2) factors;

(f) the use of DORC-based approaches by other regulators, by the QCA in other decisions, and by the QCA in the Draft Decision of 2009, does not relieve the QCA of its obligation to consider the question of asset valuation on its merits, based on the statutory criteria, within the current process;

(g) no one valuation methodology is presumed by regulators to be appropriate for all circumstances. Regulators can and do adopt a range of alternative approaches to best meet the criteria under various circumstances. The West Moreton System has a range of unusual characteristics, such that, in NHC's view, it is unlikely that simply following the most commonly used asset valuation methodology will be appropriate;

(h) regulators who do choose to apply a DORC valuation often identify the need to make certain adjustments to the valuation taking into account the specific circumstances. This is common and should therefore be considered a "conventional" application of the DORC approach;

(i) even where DORC is used, assets commissioned after establishment of the RAB are generally valued at a Depreciated Actual Cost (**DAC**), such that the valuation methodology is actually a blend of DORC and DAC, with the portion of assets valued at DORC diminishing over time; and

(j) we refer to Section 3.2.1 of Volume 2 of NHC's submission of 5 June 2015, which discusses this issue further, and which details the supporting advice of Gilbert + Tobin lawyers and the views of Professor Flavio Menezes (advice to QCA of April 2015).

High maintenance and ongoing capital requirements must inform the valuation

NHC has made this point on numerous occasions. We consider that it is self-evident that the value of an asset is influenced by its condition, and that high ongoing maintenance and replacement expenditure is clearly indicative of the age and technical obsolescence of the relevant infrastructure and its unsuitability for its current use.

Various methods of deriving an asset value which reflect the condition of the asset have now been considered, including the exclusion of assets commissioned prior to 1995, the use of depreciated actual costs, and the "zero valuation" of assets that are likely to be fully depreciated based on their lives (in which the overall valuation of the network is taken to include the value of these assets, such that they are not given a specific value).

NHC is not wedded to a particular method being used to ensure that the asset value reflects its condition and value in use, however we note that the 'zero valuation' approach for assets which have

exceeded their expected useful lives (as now proposed by the QCA) has a number of advantages, including that this approach reflects:

(a) the reality that these assets are likely to remain in service only because of future (high) maintenance allowances;

(b) that these assets may have undergone replacement, partial replacement or renewal over time in order to remain in service, with the relevant costs being expensed as maintenance (but arguably being of a capital nature). Re-establishing an asset value in such cases would represent a double payment of the past maintenance costs and an inefficient windfall gain for QR;

(c) that QR has had an opportunity to recover the economic costs of these assets during their useful lives via depreciation, and that the Financial Capital Maintenance Principles (page 163 of Draft Decision) suggest that capital should not be over-recovered nor a fully depreciated asset be revalued; and

(d) the method is consistent with and aligned with that generally used to value assets once they are accepted within a RAB; that is, the value declines over time due to depreciation, and, at the end of the expected useful life, the value is zero, regardless of whether the asset remains in use.

The QCA notes (page 175) the potential advantages of using a DAC approach to asset valuation, but does not adopt this methodology, citing information constraints. In the case of assets which have exceeded their expected lives, we know that a DAC approach would give a zero valuation. While not the basis of the QCA's decision, we consider that it would be appropriate to apply a DAC valuation where information is available, while using DORC for other assets due to information constraints. QCA's approach provides a result which is consistent with this alternative.

Applying and balancing the s. 138(2) criteria in regard to asset valuation

NHC supports the QCA's view that the method of asset valuation should be selected to suit the particular circumstances of the West Moreton network, applying the s. 138(2) criteria. We support the QCA's treatment of life expired assets and do not consider this treatment to be inconsistent with QR's legitimate business interests (s. 138(2)(b)) or with the pricing principles (s. 138(2)(g)). To the extent that QR considers than there is any inconsistency, we agree with the view of Aurizon that:

"*the objective of promoting efficient investment and utilisation of rail infrastructure requires that increased weight should be given to improving the standard and capacity of the rail infrastructure relative to providing a return on tunnels, land and civils where the original costs were incurred over a century ago*" (Draft Decision, page 174). We support this sentiment as we consider that the QCA's approach to these assets:

(a) promotes the utilisation of the infrastructure (section 138(2)(a));

(b) is in the public interest (section 138(2)(d));

(c) is in the interests of persons who may seek access (section 138(2)(e));

(d) appropriately considers the effect of excluding assets for pricing purposes (section 138(2)(f)); and

(e) prevents inefficient windfall gains and monopoly rents (section 138(2)(h)).

We suggest that it is entirely appropriate to give these matters greater weight than any claimed legitimate business interest of QR in receiving a return on assets which have exceeded their expected useful lives. In any case it is difficult to see how it is truly legitimate for QR to seek to recover capital charges on investments which it ought to have already recovered in the past.

8.7.2 Past capital expenditure

NHC supports the Draft Decision regarding past capital expenditure, which seek to prevent inefficient windfall gains, and prevent the recovery of inefficient costs.

8.7.3 Forecast capital expenditure

NHC's comments regarding the allocation of forecast capital expenditure between coal and non-coal are provided in Section 8.4.1.

We rely on the QCA to assess the reasonableness of the Capital Indicator and the prudency of actual capital expenditure and rely on the Capital Expenditure Carry-Over mechanism to address variations between the Capital Indicator and actual prudent capital expenditure. The concerns expressed in the B&H report regarding planning also extend to capital investment, and NHC therefore requests that the prudency of future capital expenditure is carefully scrutinised.

We support the QCA's proposed amendments to Schedule E of the DAU.

8.7.4 Allocation of common network asset base

NHC's comments regarding the allocation of the asset base between coal and non-coal are provided in Section 8.4.1.

NHC generally supports the methodology used by B&H to estimate the coal services lost due to peak congestion and due to maintenance activities outside peak periods, although we maintain the view that B&H's estimate of 20.5% is likely to underestimate the impact. B&H has also noted that a higher adjustment may be warranted. However, we do not agree with the additional adjustment now proposed by B&H. B&H's explanation of the additional adjustment was as follows (page 64 of B&H report):

"A final factor to consider is one given in a verbal briefing on 19th June 2015 by Queensland Rail, that "freight paths are not always affected in a suburban shutdown" and which by implication means that in some circumstances the impact on suburban services is more severe than on freight services when suburban works occur. Quantification of this impact was not provided. Nevertheless, it is a significant factor and some amelioration is warranted".

In summary, someone at QR said that the impacts are sometimes less, QR did not apparently provide any evidence to support that view and B&H was not able to verify or quantify that, but nevertheless B&H made an adjustment. That is, at best, completely arbitrary. Given passenger priority, and the publicly sensitive nature of shutdowns/outages of passenger services, NHC highly doubts the assessment that freight services are less severely impacted. NHC can also point to adjustments which we suggest should be made, which we are unable to quantify. For example, we would suggest that the impact of the significant number of special events on weekends, which require additional passenger services, has not been taken into account, and that an arbitrary adjustment should be made to reflect this impact.

NHC continues to consider 22% as a reasonable estimate of the impact of the suburban system for the reasons explained in previous submissions.

We also note that B&H estimates West Moreton network capacity to be in the order of 135 paths rather than 112 paths, which would indicate that the portion attributable to coal services (which the QCA caps at the maximum 77 paths which are able to be contracted to coal) should be substantially lower. This difference does not appear to be assessed in the Draft Decision, and NHC requests that the QCA calculate the proportion based on the actual capacity B&H has estimated is available unless there is compelling evidence (of which NHC is not current aware) that B&H's higher estimate of available paths is flawed or incorrect.

8.7.5 Metropolitan capital expenditure

NHC's comments regarding the allocation of forecast capital expenditure between coal and non-coal are provided in Section 8.4.1. We rely on the QCA's assessment of the prudency and allocation of the capital expenditure within the Metropolitan network.

8.8 Capital charges for the coal RAB

NHC's comments on WACC are provided in Section 3.8 of Volume 3 of the NHC submissions.

We generally accept the QCA's Draft Decisions regarding depreciation. However, in the event that an overall assessment of the appropriateness of tariffs indicates that the tariff arising from a pure building blocks methodology is not appropriate, we suggest that an alternative depreciation profile could be considered.

8.9 Form of regulation, take or pay and tariff structure

Draft Decision numbers	Item	QCA Draft Decision	NHC response
8.15(a)	Form of regulation	Modified price cap, with ToP and Endorsed Variation Event triggered if contracted tonnes exceed forecast	Support subject to revision of Endorsed Variation Event to apply on an origin-destination basis (Section 8.9.1)
8.15(b)	Take or Pay cap	Collection capped to bring revenue to Approved Ceiling Revenue Limit	Support (Section 8.9.1)
8.15(c)	Take or pay basis	100%	Should not exceed the percentage aligned to QR's fixed costs (Section 8.9.1)

8.9.1 Form of regulation and take or pay

Form of regulation

NHC accepts the proposed hybrid price cap form of regulation. We consider that the QCA's proposed approach is reasonably balanced as:

(a) QR's exposure to volumes below forecasts is limited by take or pay;

(b) QR's upside if volumes exceed forecasts is subject to limits due to the proposed Endorsed Variation Event, applied if contracted tonnages exceed forecast; and

(c) QR retains volume upside to the extent that actual volumes exceed forecasts while contracted volumes remain lower than forecasts.

Modifying the operation of price caps to limit downside and upside for the regulated entity is not unusual. For example, the price cap under which QR National operated prior to the introduction of the revenue cap featured take or pay (although in a far more limited form than is proposed for QR) and triggers for price reviews. The QCA's proposed approach provides incentives for QR to achieve and exceed forecasts, while limiting QR's downside in the event that volumes fall short of expectations due to reduced demand from customers.

The QCA's proposed Endorsed Variation Event is absolutely critical under the QCA's proposed approach to the allocation of fixed costs, which involves coal producers paying the fixed costs of spare capacity which is available for contracting by coal and other customers. If that capacity was to be contracted by coal services during the term of the undertaking then, in the absence of the Endorsed Variation Event, coal producers as a group would be paying twice for the same capacity. NHC accepts that the Endorsed Variation Event will not be required if the QCA accepts NHC's position that the remaining coal producers in the West Moreton System should not be required to pay the fixed costs of spare capacity which is available for contracting by both coal and non-coal services.

We note that the QCA states, in regard to the Endorsed Variation Event (page 198) that "*this trigger would be applied on an origin-destination basis, so that the tariff would be reviewed if contracted volumes from any single loading point exceed the forecast used to assess the reference tariff. This approach has the additional benefit of resetting reference tariffs in the event that the Wilkie Creek mine resumes operations*". NHC supports this approach to the Endorsed Variation Event, however, we note that the drafting within the revised DAU does not reflect the origin-destination approach (and the drafting in Appendix A of Volume 3 of the NHC submissions includes an amendment to produce the QCA's intended result).

Take or pay

NHC accepts the need for take or pay under the modified price cap form of regulation in which there are reciprocal limits to QR's volume risk and upside. However, we consider that setting take or pay (**ToP**) at 100% of access charges for the shortfall against contract will over-compensate QR for its fixed costs. This will place QR in a position where it may be better off if volumes fall short of contract, as revenue is preserved, while variable costs such as maintenance which would be required with greater usage, are saved. NHC suggests that the maximum percentage of Access Charges to be paid under ToP for unused paths should be the percentage which reflects the proportion of QR's costs which are fixed.

NHC submits that it is far more appropriate to specify a take or pay proportion that is aligned to the proportion of QR's efficient costs that are truly fixed, rather than the 100% which is now proposed. For clarity, NHC accepts that take or pay will apply to 100% of the contracted train paths, such that any shortfall in usage (other than Force Majeure or QR Cause) will create a take or pay exposure, however, we consider that amount to be paid in regard to the shortfall should be less than 100% of the Access Charge. Similarly, take or pay in the Central Queensland coal region is based on 100% of the contracted paths, while the take or pay charge which is applied to the shortfall paths is substantially lower that the full Access Charge. For example, AT1, which is designed to reflect the variable component of maintenance, is not subject to take or pay. NHC considers that there is little basis for varying from the currently applied 80% charge, however, we acknowledge that the QCA is best placed to assess the correct proportion of truly fixed costs.

NHC also supports the capping of take or pay on a system basis, such that QR's revenue does not exceed the Approved Ceiling Revenue Limit. The primary purpose of take or pay is to mitigate QR's downside volume risk. This is an appropriate allocation of risk to the party best able to manage it. However it is not appropriate that take or pay be collected beyond the point at which QR has received its full revenue limit. Upside in the form of revenues which exceed the Approved Ceiling Revenue Limit is reasonable (to a point) when actual volumes exceed forecasts, as this result requires a contribution, in the form of system performance, from QR. Upside earned from the collection of take or pay, which requires no particular level of performance from QR, is not appropriate, and is likely to involve double payment for the same path, once through take or pay and again through another party using that path on an ad-hoc basis.

Finally NHC supports the QCA's position that relinquishment fees should also be taken into account in the capping mechanism (page 199 Draft Decision), but could not see how this was reflected in the

drafting in the Access Agreement or Undertaking. Appendix A to Volume 3 of the NHC's submission contains some drafting which seeks to deal with this issue for the QCA's consideration.

8.9.2 West Moreton network tariff structure

QR proposed, and the QCA proposes to accept, continuation of the two part tariff structure in which half of QR's revenue is intended to be recovered through a 'per path' charge, with the remaining half to be recovered through a 'per gtk' charge.

We note that this provides a strong discount, in terms of cost per gtk, to the Cameby Downs mine. Based on the tariffs provided in the Draft Decision (exclusive of the adjustment charge), we estimate that, for the West of Rosewood section of the West Moreton network:

(a) the cost for New Acland is around $21.40/'000gtk.

(b) the cost for Cameby Downs is around $15.28/'000gtk.

(c) the average cost per gtk (taking into account the relative numbers of train paths and the higher gtks per path for Cameby) is $18.88/'000gtk (which is the basis of the decision).

We understand that the QCA has supported this type of distance taper in Central Queensland, and in past decisions regarding the West Moreton network, while in the Hunter Valley, all charges are levied on a basis which is fully variable with distance, such that no distance taper occurs.

NHC is not seeking to alter the tariff structure at this time. However, as this is the first access undertaking under which West Moreton reference tariffs are to be based on a clear building block methodology, we suggest that the QCA should review and confirm whether the Expected Access Revenue from services originating at New Acland will comply with the Ceiling Revenue Limit for those services, such that there is no cross subsidy (consistent with clause 3.2 of the DAU). For the purposes of this analysis, all capital charges relating to assets West of Jondaryan, and a reasonable allocation of operating, maintenance costs and overhead costs relating to those sections of track, should be excluded. It is important that the QCA confirm that the proposed Reference Tariffs would not breach the Pricing Limits prior to approving Reference Tariffs, as clause 3.5(e) of the DAU states that if QR formulates an Access Charge based on a Reference Tariff, then QR is taken to have complied with clause 3.1 and 3.2, such that this matter cannot be reassessed during the term of the approved access undertaking.

Clearly any tariff that would breach the pricing limits for New Acland services would not be appropriate to approve.

8.9.3 Metropolitan tariff

NHC supports the Draft Decision in respect of the methodology for deriving the Metropolitan tariff (subject to the further comments about the applicable Adjustment Amount set out in section 8.11 of this submission below). The proposed methodology for developing the Metropolitan tariff:

(a) is practical and transparent;

(b) provides QR with appropriate capital charges for past and future capital expenditure in the Metropolitan network by maintaining a separate asset base for investments made since 2002; and

(c) addresses the double-counting of capital expenditure West of Rosewood since 2002, which was a feature of QR's proposal.

However, NHC is unclear as to whether the QCA's intention, for future undertakings is to:

(d) continue to escalate the portion of the Metropolitan revenue requirement which was derived by reference to the West Moreton network at CPI; or

(e) to re-calculate this portion of the Metropolitan revenue requirement at each regulatory reset, so that this portion reflects the capital charges (excluding post 2002 assets), operating costs and maintenance of the West Moreton network, updated based on the assessment of costs for the next undertaking period.

NHC suggests that the second alternative is preferable as it will reflect changes in operating costs and maintenance over time, reducing the risk that QR will under-recover these costs (which may occur if the cost of materials used in maintenance escalates at a greater rate than CPI) or over-recovery (which may occur if QR's maintenance practices become more efficient).

Regardless of which alternative is preferred, we suggest that the final decision should be clear regarding the QCA's intentions, as this is likely to reduce debate during the development of the next undertaking. We understand that any indication given by the QCA will not bind that QCA to this approach, as the issue would need to be considered again during QCA's assessment of the replacement access undertaking.

8.10 QCA proposed ceiling price

NHC considers that the QCA's proposed ceiling price of $18.88/'000 gtk is excessive:

(a) based on a consideration of the 'building block' elements; and

(b) regardless of the consideration of the building block elements. That is, if the addition of the building blocks results in a tariff which is uncompetitive and risks inducing a further decline in demand, then approval of such a tariff would not be consistent with sections 138(2)(a), (d), (e) and (h) and may also not be consistent with section 138(2)(b). The ceiling price, and not the net tariff which includes the Adjustment Amount, is the tariff on which long term decisions such as the New Acland extension decision will be based.

We suggest that adjustments should be made to the building block elements as set out in this submission, and that the QCA should also give further consideration to:

(a) relative prices and affordability, particularly in the face of actual (rather than hypothetical) material falling demand on the West Moreton Network; and

(b) the '*prima facie case'* (page 140 of Draft Decision) that consideration should be given to reducing the value of assets to prevent a further decline in demand for access.

8.11 Adjustment Amount

Importance of the Adjustment Amount

The QCA has provided, in the Draft Decision, a comprehensive 14 page analysis of why an Adjustment Amount ought to be included in future tariffs, having regard to the approval criteria. NHC fully supports that well-reasoned analysis and agrees with every part of it. In particular NHC agrees with the QCA's conclusions that:

(a) the adjustment amount reflects regulatory expectations, thereby promoting regulatory certainty, which will encourage greater use of Queensland Rail's below rail infrastructure and mine investment (page 251 Draft Decision);

(b) the pricing principles are one of a number of factors to be weighed up under section 138(2) and although section 168A(a) of the QCA Act states that prices should generate revenue to at least meet the efficient costs of providing access, it is also true that prices above the efficient cost would not be in the interests of access seekers and holders, nor in the public interest (page 261 Draft Decision); and

(c) to the extent that the proposed West Moreton network does not generate expected revenue over the regulatory period that is at least enough to meet efficient costs and includes a return on investment commensurate with the regulatory and commercial risks of providing access because of the adjustment, that pricing principle is outweighed by other considerations under section 138(2) QCA Act including the object of Part 5 of the QCA Act, the public interest and the interests of access holders and access seekers (page 262 Draft Decision).

NHC has previously submitted advice from Allens lawyers that the QCA has the power to determine that the appropriate form of undertaking is one which backdates tariffs to 1 July 2013 (whether through applying the existing Adjustment Charges regime or an alternative form of financial adjustment). An updated version of the Allens advice which now also addresses legal advice annexed by QR to its submission, is enclosed in Annexure A to this Volume. The Draft Decision confirms that the QCA has the power to require an Adjustment Amount and explains why consideration of the section 138(2) criteria must lead to a decision to use that power. QCA has correctly identified a range of 'other issues' which are considered relevant (section 138(2)(h)). We suggest that, in addition to the list of 'other issues' identified by the QCA, the equity, fairness and reasonableness of the two alternatives is a relevant consideration. The alternatives as NHC view them are:

(a) windfall gains to a monopoly infrastructure provider that have effectively been exacerbated by its own conduct in relation to the regulatory process; or

(b) an adjustment which was anticipated by all stakeholders at the relevant times and which simply seeks to true-up the amounts charged to reflect appropriate pricing over the transitional period.

Before discussing NHC's concern regarding the calculation of the Adjustment Amount, we wish to comment on the importance of this decision. NHC considers that the approval of a DAU without appropriate Adjustment Amounts would demonstrate that QR is able to manipulate the regulatory regime to extract from its customers excessive charges to which QR has no rightful claim. In this case, the amount which QR seeks to capture through this gaming of the regime is in the tens of millions of dollars. The fact that QR has attempted to do this has increased NHC's assessment of the risks of investing in this region. A demonstration that the regulatory arrangements can be effective in preventing such a misuse of QR's position would go some way towards restoring confidence, while a failure of regulation in this case would further damage confidence in the regulatory regime and would extinguish regulatory certainty.

NHC's assessment of investment opportunities in this region, including the New Acland extension/expansion project (on which a decision must be made during the 2016 calendar year) would then be assessed on a basis akin to facing high sovereign risk. That is, NHC's risk assessments would need to reflect the fact that:

(a) a significant proportion of the offsite costs (and in fact total costs) for New Acland relate to rail transportation and the costs QR charges for rail access;

(b) QR has been willing to take this inappropriate action, and may therefore attempt similar actions in the future; and

(c) the regulatory regime has been ineffective in preventing QR from extracting these additional charges from customers.

To be clear, NHC's concerns would not be limited to the risk of QR again benefiting from transitional tariffs during a period in which properly assessed tariffs ought to be lower. Our concerns would go beyond this issue. A decision to invest large sums of capital (which become sunk costs) into mines which are entirely dependent on the use of QR's monopoly assets requires confidence that access to those assets will be available on reasonable terms through the life of the mine. This requires confidence in the broader integrity of the applicable regulatory framework. This confidence would be severely eroded by a failure to address the issue of Adjustment Amounts appropriately.

NHC has choices about where its money is invested, as was demonstrated by the recently agreed AUD 865m investment in a 40% share of the Bengalla mine in the Hunter Valley. Competitive access charges, and regulatory arrangements which provide confidence that this will continue, were important considerations in that investment decision.

Similarly, NHC notes that the other coal user in the West Moreton system (Yancoal) has mines in both the Bowen Basin and the Hunter Valley, and will therefore also have alternatives to further expansion of and investment in Cameby Downs.

It is critical that a properly calculated adjustment charge be applied in order to avoid creating a strong disincentive to further investment in the West Moreton system. Evidence that this disincentive can have real, rather than theoretic impacts on investment will exist only after investment decisions have been taken and investment has been lost. However, we submit that the disincentive effect is self-evident, while the counterfactual (that NHC will be no less willing to invest in a mine which depends on a monopoly service provider which has misused the regulatory regime to extract material excess charges and proven the regime to be ineffective) is clearly implausible.

Calculation of Adjustment Amount

Regarding the calculation of the adjustment amount, we note that nothing in the QCA's 14 pages of analysis indicates that the application of the approval criteria could lead to a different conclusion in regard to over-recoveries arising on particular segments of the West Moreton network. However, the QCA states (footnote 630) that the over-recoveries have been calculated based on "*revenue and billing parameters provided by Queensland Rail for the Rosewood to Miles section of the West Moreton network*". It is also clear from Appendix A of the Draft Decision that no Adjustment Amount has been reflected in the proposed Reference Tariffs for the section between Rosewood and the Port (**East of Rosewood**).

The Draft Decision contains no indication that the question of an adjustment charge East of Rosewood was considered by the Authority, and we consider that the QCA's analysis of the issue of adjustment amounts must lead to the conclusion that the amount should be calculated across the full distance.

The over-recovery East of Rosewood is able to be calculated using the same methodology as was applied West of Rosewood, as:

(a) the revenue earned is readily available and presumably has already been notionally allocated to the East and West sections in the QCA's existing calculation; and

(b) the annual revenue requirement can be calculated for the relevant years using the same methodology as is reflected in Appendix A of the Draft Decision.

We therefore support the requirement for future tariffs to include an Adjustment Amount reflecting the full difference between:

(a) access charges paid from 1 July 2013 until the date on which new approved reference tariffs are applied; and

(b) the access charges which would have been payable over this period based on the revenue requirements which would have applied if calculated on a basis consistent with the Draft Decision.

Approving an Access Undertaking without an Adjustment Amount to reflect QR's full over-recovery during this period is not appropriate having regard to the statutory criteria, for the reasons which are well documented in Section 8.11 of the Draft Decision.

"True up" of the Adjustment Amount

We suggest that some form of true-up should apply in regard to the Adjustment Amount, such that if actual volumes during the term of the undertaking (in total for the term) vary from forecasts, an adjustment is carried forward into the next undertaking period as a reduction or increase to the revenue requirement. This is a balanced mechanism intended to ensure that customers obtain the full Adjustment Amount over time, and protects QR in the event that actual volumes exceed forecasts, so that the Adjustment Amount can achieve exactly what it was intended to – namely to correct the past over-recovery.

8.12 Conclusion

For the reasons outlined above, while NHC is generally supportive of much of the Draft Decision as it relates to West Moreton network reference tariffs, NHC continues to consider the indicative tariffs provided in the Draft Decision are inappropriately high.

In determining the appropriate tariff, NHC submits that the QCA should:

(a) critically re-examine each of the parameters used in the build-up of those tariffs through the usual building blocks methodology; and

(b) assess whether the tariffs produced by that critical re-examination need to be further reduced on the basis of overall appropriateness taking into account the factors in section 138(2) of the QCA Act; and

(c) calculate an Adjustment Amount for the East of Rosewood section and apply that Adjustment Amount to the East of Rosewood tariff.

Annexure A – Allens advice regarding Adjustment Amount and QCA Powers

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Dear Sam

Role and powers of the QCA in considering the 2015 DAU

1 Background

In May 2015 Queensland Rail Limited (***QR***) submitted to the Queensland Competition Authority (***QCA***) a draft access undertaking in relation to QR's rail network (the ***2015 DAU***).

In QR's supporting submissions to the 2015 DAU, QR made a number of assertions regarding the QCA's role and powers in considering the 2015 DAU, including the following:

(a) 'In considering what is "appropriate" the QCA cannot reject a draft access undertaking because the QCA or stakeholders would prefer to address the factors in section 138(2) of the *Queensland Competition Authority Act 1997* (Qld) (***QCA Act***) by different means. The QCA must turn its mind to each of the factors in that section to see whether the draft undertaking deals with them adequately and consistently with the object of Part 5 of the QCA Act. If it does, the QCA must approve the draft access undertaking – the QCA cannot impose a different access undertaking to achieve the same objectives.'

(b) 'The requirement in section 168A(a) is a cornerstone requirement in support of the object of Part 5 of the QCA Act .... Any decision by the QCA on reference tariffs and other pricing aspects of an undertaking that fails to meet the requirement in section 168A(a) would run contrary to the object of the QCA Act.'

(c) 'The QCA must assess the reference tariff proposed by an access provider and the inputs used to arrive at it against commonly accepted standards that are consistent with regulatory precedent. That reference tariff must deliver to the access provider at least the efficient costs and a return as required by section 168A(a). Anything less should not be approved and cannot be imposed.'

QR has also subsequently provided supplementary submissions which enclose legal advice from Corrs Chambers Wesgarth of 29 May 2015 asserting that the QCA cannot compel QR to provide a 'retrospective' Reference Tariff.

You have asked us to advise on the QCA's role and power in determining whether to approve or refuse to approve an access undertaking, with particular reference to the assertions made by QR.

2 Determining the 'appropriate' undertaking

The QCA may approve a draft access undertaking only if it considers it appropriate to do so having regard to each of the factors specified in section 138(2) of the QCA Act.

In determining whether a draft access undertaking is appropriate, the QCA must:

(a) have regard to each of the matters specified in section 138(2) QCA Act (s 138(2) QCA Act), which includes a specified list of factors and 'any other issues the authority considers relevant' (section 138(2)(h) QCA Act);

(b) have published the draft access undertaking, invited submissions on it and considered submissions received within the permitted time (s 138(3) QCA Act);

(c) otherwise provide natural justice to all stakeholders; and

(d) not refuse to approve a draft access undertaking only because the authority considers a minor and inconsequential amendment should be made to a particular part of the undertaking (s 138(5) QCA Act), with minor and inconsequential amendment, in relation to part of a draft access undertaking, meaning an amendment that, if made, would have no real effect or consequence in relation to that part of the undertaking and the undertaking as a whole (s 138(6) QCA Act).

Outside of those requirements, the QCA has a very wide discretion as to how it determines what is an appropriate form of access undertaking.

There is nothing in the QCA Act which supports QR's assertion that QR's draft access undertaking has some sort of default or de-facto standing such that the QCA's views as to the more appropriate position are not relevant once some degree of appropriateness is passed. In fact, section 138(5) QCA Act clearly suggests the opposite, that that is only the case where the only issues separating the QR draft access undertaking and the QCA's determination of the appropriate position are 'minor and inconsequential amendments'.

In all other cases the QCA is entitled to determine what it considers the appropriate position and make a decision to refuse to approve QR's draft access undertaking if it does not align with that position.

If any stakeholder (including QR) disagrees with the QCA's assessment of appropriateness, that is an issue that goes to the merits of the QCA's decision. The QCA's decision cannot be challenged under the *Judicial Review Act 1991* (Qld) on that basis unless the decision is so unreasonable no reasonable decision maker could have made that decision, which is an extremely high threshold.

3 'Failure' to meet the pricing principle in s 168A(a)

In relation to QR's assertions regarding section 168A(a), the first key point is that section 138(2) QCA Act does not impose a list of mandatory conditions that must be satisfied before an undertaking can be approved.

Rather, it specifies a number of matters which the QCA must 'have regard to'.

This is important in understanding the relevance of the section 168A pricing principles, because (as one of the factors the QCA must 'have regard to' under section 138(2)(g)) the only requirement of the QCA Act is that they be taken into account and considered in making the appropriate decision about whether to approve or refuse to approve an undertaking.

There is no requirement in the QCA Act that the appropriate decision is consistent with or gives priority to any particular one or more of the factors to which regard is to be had. The Authority's role is clearly specified in the QCA Act as one involving balancing of a number of factors to reach an appropriate decision on a draft access undertaking. Consequently, a particular factor may be given

less weight, or departed from, or not followed, in what the QCA ultimately determines is the appropriate decision on the relevant draft access undertaking.

In fact, it is clearly evident on a review of the factors to be taken into account (as set out in section 138(2)) that the QCA Act is not intended to provide for the QCA to follow or ensure its decision is absolutely consistent with all of the factors to be had regard to – as there is often a clear tension between some of the factors. To mention the obvious examples:

(a) there is a clear tension between the 'legitimate business interests of the owner or operator of the service' (s 138(2)(b) QCA Act) and 'the interests of persons who may seek access to the service' (s 138(2)(e) QCA Act); and

(b) section 138(2)(f) QCA Act refers to 'the effect of excluding existing assets for pricing purposes' when any such exclusion is likely to have some tension with providing 'a return on investment commensurate with the regulatory and commercial risks involved' (pricing principle in s 168A(a), to be had regard to under section 138(2)(g) QCA Act).

That, of itself, makes it clear that it is possible for the QCA to determine the appropriate position for the draft access undertaking as being one that is not consistent with (or to use QR's language, which 'offends') a particular section 138(2) factor, including the section 168A pricing principles.

If the QCA was to determine the appropriate position as one which is not consistent with or offends the pricing principle in section 168A(a), that does not invalidate the QCA's decision, provided it has considered the pricing principle and then has nevertheless determined that despite being inconsistent with that pricing principles it remains the appropriate position. To be invalid the QCA would have had to have failed to consider the pricing principle in reaching its decision on appropriateness, which would then open the QCA's decision to challenge under the *Judicial Review Act 1991* (Qld) on the basis of a failure to take account of a relevant consideration.

If any stakeholder (including QR) considers that the pricing principle in section 168A(a) should have been given more weight in determining the appropriate decision on the draft access undertaking that is an issue that goes to the merits of the QCA's decision. The QCA's decision cannot be challenged under the *Judicial Review Act 1991* (Qld) on that basis unless the decision is so unreasonable no reasonable decision maker could have made that decision, which is an extremely high threshold. In other words, the courts are loathe to, and don't have power to, second-guess the QCA's exercise of its wide discretion regarding determining the appropriate position.

4 Reference to commonly accepted standards consistent with regulatory precedent

There is nothing in the QCA Act which requires the QCA to accept or follow 'commonly accepted standards' or 'regulatory precedent' in its decision making.

Of course, the QCA is highly likely to have regard to those matters under section 138(2) QCA Act (and is clearly entitled to do so under section 138(2)(h) QCA Act), and typically therefore would follow regulatory precedent so as to provide regulatory certainty unless there were compelling reasons not to.

However, a slavish adherence to regulatory precedent (such that it was followed irrespective of the merits of the case) would potentially open the QCA's decision to risk of a successful judicial review challenge.

Consistent with that, it would clearly be open to the QCA to determine that, based on the merits of the draft access undertaking before it, that it was not appropriate for regulatory precedent to be followed in respect of a particular pricing matter. Where, for example, the QCA had considered regulatory precedent, but determined it was not appropriate to follow it in relation to the relevant part of the QR access undertaking on the basis that the circumstances or characteristics of QR or the

West Moreton system justified a different treatment, that would be a perfectly legitimate exercise of the QCA's discretion.

5 Retrospectivity and interaction of section 168A and adjustment amounts

The advice from Corrs Chambers Wesgarth of 29 May 2015, asserts that 'The QCA cannot, as a matter of law, compel Queensland to apply a retrospective Reference Tariff in its initial access undertaking (including by the QCA drafting its own access undertaking for application to Queensland Rail).'

5.1 QCA's Draft Decision does not seek a retrospective reference tariff

Critically, it needs to be recognised that, what is proposed in the QCA's Draft Decision on the 2015 DAU is in fact not retrospective at all, such that the conclusion reached in the advice (even if it is correct) is completely irrelevant to what is being proposed.

Retrospectivity, in a legal sense, involves the operation of a law or regulation prior to its enactment or approval. The QCA proposes something entirely different, being an adjustment to tariffs that will apply entirely during periods after approval of an access undertaking in respect of QR's network. The adjustment is entirely prospective or forward looking. The fact that it is calculated by reference to past circumstances does not make it retrospective.

The fact that it results in a tariff being applied that is lower than would have been applied if reference to past circumstances was not made, is similarly not a matter of retrospectivity, but whether that is an appropriate outcome having regarding to each of the matters in section 138(2) of the QCA Act. The Draft Decision correctly reflects the balancing analysis required to be undertaken, particularly as set out on page 260-261:

> The pricing principles state that regulated access prices should generate revenue for a regulated service that is at least enough to meet the efficient costs of providing access.
>
> ...
>
> It is open to the QCA to consider that a DAU which provides for a price that allows a service provider to recover at least the efficient costs of providing access to the service and a relevant return on investment is, including by reference to other factors such as the object of Part 5 of the QCA Act (section 138(2)(a)), the interests of access seekers and holders (section 138(2)(e) and (h) and the public interest (section 138(2)(d)), not one which is appropriate.

and it is clearly open to the QCA to reach the conclusion that it does regarding the appropriate balance (page 262):

> The West Moreton network tariff will not generate expected revenue for Queensland Rail over the regulatory period that is at least enough to meet efficient costs and includes a return on investment commensurate with the regulatory and commercial risks of providing access (section 168A(a)). This is because of the adjustment amount to account for the over-recovery of access charges by Queensland Rail.
>
> However, for the reasons set out in Chapter 8, the QCA considers that the pricing principles are outweighed by other considerations under section 138(2), including s. 138(2)(a) – the objects clause, s.138(2)(d) – the public interest, and s.138(2)(e) and (h) – the interests of access seekers/holders.

For the avoidance of any doubt, single adjustment payment occurring during a period after approval of a replacement undertaking would similarly not be retrospective in nature – and the same analysis above (that it was within the QCA's power subject to being satisfied it was appropriate) would apply.

5.2 Interpretation of section 168A(a)

In addition, we do not agree (as the Corrs Chambers Wesgarth advice appears to implicitly suggest) that section 168A(a) is solely confined to analysing whether sufficient revenue is earned across a single regulatory period.

Rather we consider it applies more broadly over the longer term economic life of the infrastructure, such that it can be taken into account in assessing the tariff (net of adjustment amounts) that over the economic life the adjustment is simply bringing QR back to a net result that reflects the revenue adequacy principle.

There is no evident basis in the QCA Act for taking the narrower view the advice to QR seeks to advance. It is a particularly strange view to take when assessing the methodology for providing a return to an infrastructure owner on a long life infrastructure asset where the term of the undertaking forms only a small part of that asset life and can be changed (as demonstrated aptly by the many recent extensions to the Queensland Rail access undertaking).

That view also ignores the common regulatory practice of applying many different types of 'carry-over' mechanisms from one regulatory period to another. For example in addition to the backdating of reference tariffs through adjustment charges, other provisions approved by Australian economic regulators have included capital carry-over accounts, efficiency/incentive arrangements, 'unders and overs' under a revenue cap and price paths. To the extent there is considered to be any ambiguity, a court would be anticipated to prefer a meaning which did not invalidate common regulatory practice at the time the pricing principles were introduced into the QCA Act.

In the current circumstances the narrow interpretation being considered would also have the absurd consequences of the principle in section 168A(a) being interpreted as:

(a) requiring that, where the QCA had the view that the reference tariff that should apply would be lower than that which has been transitionally applied (as suggested in the recent Draft Decision) the QCA should knowingly allow QR to retain a clear over-recovery during the period where transitional tariffs applied in excess of the 'return on investment commensurate with the regulatory and commercial risks involved' (in contravention of the other part of section 168A); and

(b) by allowing the retention of such an over recovery, rewarding an inefficient entity (which has charged a higher tariff than the QCA would recommend) for the delay in having a replacement access undertaking approved.

Again, when an alternative interpretation is open, a court will not adopt an interpretation which produces these sort of results.

When viewed properly, as simply guidance that regulated entities should generate expected revenue to cover at least the costs of providing access and receive a return on investment commensurate with the risks involved – it is clear that the pricing principle in section 168A(a) QCA Act is not prescriptive as to the period over which that should occur.

For the reasons noted above in the current circumstances it actually appears clear that the 'efficient cost' and 'commensurate return' principles will not be being followed where the QCA ignores the prior period in which transitional tariffs have been applied in assessing the appropriate tariff.

6 Conclusions

We disagree with each of the assertions made by QR that are referred to in section 1 of this advice.

A more accurate summary of the QCA's relevant role and powers in considering a draft access undertaking would be:

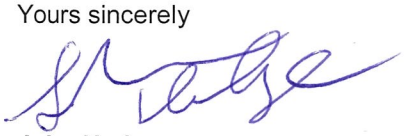
(a) The QCA is responsible for determining the appropriate position – and can only approve QR's draft access undertaking if it is either the same as the QCA's appropriate position or the only differences are 'minor and consequential amendments';

(b) In formulating its views on what the appropriate position is, the QCA must have regard to each of the factors specified in section 138(2) of the QCA Act (which includes the pricing principles in section 168A as well and any factors the QCA considers relevant); and

(c) Provided it has properly considered those factors, the QCA has a wide discretion as to how to balance the factors and come up with an appropriate position. There is no single factor which is to be given priority or which the appropriate position must be consistent with (or to put it another way, inconsistency with such a factor is not grounds for invalidity of the QCA's decision on appropriateness provided that factor has been considered).

In addition, a decision by the QCA to impose an adjustment amount (whether by adjustments across the term of the replacement undertaking or through a single payment) is not retrospective in nature, and is clearly within the QCA's power, subject to it determining that to be an appropriate result having had regard to the factors in section 138(2) QCA Act.

Yours sincerely



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