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Via Electronic mail (rail.submissions@gca.org.au)

Dear Paul

QR Network 2009 Draft Access Undertaking: Queensland Competition Authority Draft Decision December 2009 – Rio Tinto Coal Australia's (RTCA) Submission.

Strategic context to RTCA's submission

This submission is RTCA's response to the Queensland Competition Authority's (QCA) *Draft Decision QR Network 2009 Draft Access Undertaking*.

RTCA endorses the Authority's decision to not approve the QR Network draft access undertaking (DAU). The DAU, in its current form, would deliver an access framework which in RTCA's view is inconsistent with the fundamental regulatory objectives set out in the *Queensland Competition Authority Act 1997* (QCA Act). RTCA believes that further substantive amendments are required to encourage the delivery of efficient below-rail services by QR Network and support the continued development of Queensland's export coal industry.

In not approving the DAU the Authority has determined a number of matters which are positive improvements from the current Access Undertaking (UT2) and the proposed draft replacement Access Undertaking (UT3). These include:

- a reduction in the Authority's assessment of QR Network's risk profile, translating into a reduced equity beta (though RTCA considers further reductions are warranted);
- provisions which clarify that mines can be Access Holders;
- a requirement for QR Network to reinstate certain ring-fencing obligations;
- an obligation on QR Network to develop a process for short-term transfers and to eliminate transfer fees on transfers of less than two years; and
- other amendments with the potential to strengthen the effectiveness of the access framework, such as a failure by QR Network to follow queuing rules confirmed as a breach of the undertaking.

RTCA submits that the Authority should retain these provisions in any final decision, notwithstanding QR Network's indication in its *Statement of Regulatory Intent – Position in response to QCA draft decision* (February 2010) that it

“rejects” a number of material elements of the QCA draft decision. RTCA draws the Authority’s attention to the submission provided by the Queensland Resources Council (QRC), which provides further commentary against these and other relevant matters, and which RTCA endorses.

Simply retaining these improvements on the UT2 framework, however, is not enough. RTCA maintains that the current access framework is deficient in a number of critical areas. The QCA must go further in enforcing changes to QR Network’s access undertaking, to ensure any future access framework is effective in protecting customers, encouraging efficient access, and restraining QR Network from exercising its market power. In the following sections of this submission we identify a number of areas where further change is necessary.

RTCA understands QR Network has indicated it intends to withdraw UT3 and submit a further undertaking – UT3.2 – in March this year. RTCA is concerned at this prospect of further delay in the resetting and realignment of rail access arrangements – the current process has already been in progress for some 18 months. We reserve our right to comment further on any future access proposal submitted by QR.

Finally, RTCA is concerned at Queensland Government’s announced intention to privatise QR as a vertically-integrated business. As highlighted in recent press coverage¹, RTCA believes the proposed business model presents now a substantially more challenging regulatory task. The Queensland Government has indicated that the sale/lease agreement is unlikely to include any specific competition protections as have been sought by coal producers, and therefore the industry is solely reliant on the effectiveness of the access framework for that protection.

One of industry’s key concerns is the extent to which a vertically-integrated QR can be constrained by effective ring-fencing obligations, to ensure non-discriminatory access terms and an even playing field for all market participants. Discriminatory conduct could occur in a range of ways, and in many cases would be very difficult for a regulator to identify and police. A vertically-integrated and privately-owned QR may favour investment in systems where it has a higher share of the above-rail market. It could prioritise network investments to favour its overall commercial performance, to the detriment of other above-rail providers and competitive outcomes more generally.

RTCA’s experience is that current ring-fencing arrangements are inadequate. These concerns will be amplified by simply recreating the same ineffectual obligations on a privatised QR. Regulating a privatised vertically-integrated entity, with an ineffectual ring-fencing framework, will inevitably make the regulatory process more intrusive, time- and cost-intensive, and ultimately will result in higher access charges for rail users.

RTCA will be pursuing these concerns with the Queensland Government but is foreshadowing to the QCA the level of concern we hold as to future regulatory arrangements.

¹ See, for instance, “QR sale will stifle competition”, *Australian Financial Review*, Tuesday 9 February 2010, page 63.

Integrity of the regulatory risk allocation framework

A fundamental regulatory objective is to determine an appropriate and efficient balance between the risks carried by each party, and the corresponding returns available to the regulated service provider.

In RTCA's view, over time there has been a systematic decrease in the QR Network's risk exposure, reflecting:

- the introduction of a revenue cap approach which has the effect of substantially insulating QR Network from volume risk;
- various changes to the Standard Access Agreement (SAA) to increase take-or-pay obligations on users;
- the absence of any meaningful KPI regime which would enforce a discipline on QR Network's operational and maintenance performance;
- the introduction of a capital expenditure carry-over mechanism;
- the capital investment project endorsement process for new investments, which provides *ex ante* certainty to QR Network as to the commercial viability of proposed network investment;
- the proposal contained in the Authority's draft decision to allow for accelerated depreciation for all new capital expenditure undertaken during the term of the undertaking; and
- additional access conditions allowed to be imposed on 'major projects', with the effect of allowing QR Network to contract for these outside of the 'package' terms of the undertaking – potentially extending to higher rates of return, accelerated capital recovery terms and longer contracting terms for customers.

These and other adjustments have significantly skewed the balance of risk away from QR Network. Yet despite this, the quantifiable benefit to customers, in the form of a compensatory adjustment to the risk parameters implicit in the QR Network WACC, is disproportionately low.

The Authority has indicated that its approach to the proposed risk mitigation measures and WACC outcome is a "package" and, further, that "elements are not able to be adjusted without potential impact on other elements."² RTCA maintains, however, that the balance in this package is still too much in QR Network's favour.

In light of RTCA's and other industry stakeholder's submissions the QCA needs to consider the need for further downwards adjustment to the QR Network equity beta, to better reflect the substantial 'de-risking' which has occurred.

² Draft Decision, page 24.

Whole of coal supply chain management

RTCA is a long-standing advocate for the development of management and operational strategies which encompass the entire coal chain. The inability to realise fully the potential of Queensland's export coal infrastructure is one of the State's greatest export tragedies.

RTCA therefore is disappointed at the limited steps taken by the QCA to properly enforce the participation and conduct of QR Network in whole of coal chain master planning and integrated operational planning and execution. These and other related initiatives are intended to increase the efficiency of the coal chain, and ultimately would benefit all stakeholders, including QR Network.

In the context of the forthcoming reset of access arrangements at the Dalrymple Bay Coal Terminal (DBCT), industry stakeholders are seeking to negotiate a series of amendments to the relevant terminal access undertaking which collectively:

- impose an obligation on the regulated business to participate in a whole of coal chain integrated planning and operational execution for the Goonyella system;
- require the regulated business to promptly bring forward a draft amending access undertaking, where the whole of coal chain process delivers agreed outcomes which require amendments to the undertaking to be effective; and
- oblige the regulated business to adopt and comply with a System Master Plan, which would guide the priority and timing of future investment across the port, below- and above-rail and mine participants.

RTCA urges the Authority to revisit its draft decisions on master planning and whole of supply chain initiatives. The Authority needs to strengthen the obligations on QR Network to participate in these initiatives, and enforce the implementation of changes to the undertaking as are necessary to facilitate improvements in supply chain efficiency.

The QCA's draft decision notes the ongoing development of the proposed Long Term Solution (LTS) for the Goonyella coal chain, though observed "details of the LTS are not yet finalised and therefore are unable to be incorporated in the 2009 DAU at this time."³

The LTS by its nature will be an evolving framework, with a number of critical improvement initiatives likely to take some time to investigate, develop and agree with stakeholders. This should not preclude, however, the inclusion of an obligation in the undertaking for QR Network to give effect to any necessary LTS-consistent amendments in the future, as and when these may be determined. As it stands, there is no clear obligation on QR Network for this to occur.

³ Draft decision, page 244.

Future network infrastructure investment

Regulation has failed to encourage timely investment in enhancements to network capacity. The inability of the current access framework to compel investment, where it is clearly economic and reasonable (for example access seekers have signed take or pay commitments at a port and are investing in mines), is of significant concern. RTCA's view is that QR Network has been able to withhold investment, not just in major projects, as a means of extracting from users other concessions or non-standard access terms, including rates of return that are higher than those determined by the regulator.

As a general principle, RTCA would consider that:

- an investment able to be capitalised in the regulatory asset base and earn a regulated rate of return; and
- an investment substantially underwritten by long-term take-or-pay revenues under SAA terms;

should be determined as commercially-prudent and QR Network compelled to invest at the regulated rate of return.

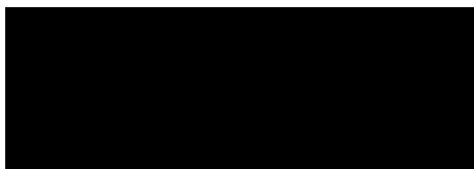
Without these provisions industry is subject continually to the threat of an investment 'hold up', and the effectiveness of the regulatory framework as a discipline against misuse of QR Network's market power is diminished. Additionally, a practical framework for user(s) to step in and self-fund capacity expansions or other works, where QR Network refuses to do so is considered necessary. Both of these mechanisms need further consideration in the context of the current draft access undertaking.

Regarding major projects, RTCA welcomes the changes proposed by the Authority to tighten the definition of a major project. However, in the context of the current investment environment and potential growth in the coal industry, a \$300m investment threshold may be too low.

Further amendments are necessary, however, to constrain the capacity of QR Network to demand access terms which are substantially different from those determined by the regulator and codified in the access undertaking and SAA.

In RTCA's view, there is a substantial difference between allowing, for instance, some form of additional capital underwriting in respect to a major project, where all other access terms remain as per the SAA, and a framework where for any major project QR Network can demand a higher rate of return, accelerated depreciation terms and longer user agreements, and hold-up investment until these are agreed to. [REDACTED]

In summary, this submission highlights a number of concerns RTCA has with the current and proposed regulatory framework and as a matter of urgency ask that the QCA make the necessary amendments to the framework to address these concerns. If you have any questions or require further clarification regarding this submission please do not hesitate to contact me on 3361 4209.



Graham Walker
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