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19 November 2012

Mr John Hall
Queensland Competition Authority
GPO Box 2257
Brisbane, QLD 4001

By email: rail@qca.org.au

Dear Mr Hall,

RTCA response to QR Network's proposed GAPE reference tariff DAAU

Rio Tinto Coal Australia (**RTCA**) welcomes this opportunity to respond to the Authority's request for comments in relation to QR Network's (**QRNN's**) Draft Amending Access Undertaking (**DAAU**) to implement its proposed approach to a reference tariff for the Goonyella Abbot Point Expansion (**GAPE**) project.

While RTCA accepts the principle of incremental pricing for major expansions, it does not support the DAAU including because:

- The degree of engagement and transparency provided by QRNN in relation to this process – which has substantial cost implications for the industry – has once again been entirely inadequate. The DAAU submission does not permit stakeholders (or the Authority) to properly assess QRNN's reference tariff model, including its consistency and interaction with the commercial GAPE funding arrangements.

- It is not clear that the way that incremental pricing has been implemented protects foundation GAPE and NAPE customers from future access seekers 'free riding' on their investment – in that there does not appear to be any explicit recognition that savings associated with future expansions will be 'socialised' with the costs incurred by foundation customers under the GAPE and NAPE Deeds.

- Several elements of the reference tariff appear inflated or are otherwise not properly justified, including incremental maintenance and insurance costs.

- Some amendments (such as an allowance for retrospective recovery of equity raising costs) are not required as part of this process and are inconsistent with regulatory precedent.

More detail on each of these issues is set out in the attached submission. RTCA understands that this submission may be made publicly available.

For the various reasons set out in the submission, RTCA considers that the GAPE DAAU is not currently capable of acceptance by the Authority under s.142 of the Queensland Competition Authority Act (the **Act**).

RTCA would welcome the opportunity for the Authority to lead a proper, inclusive process around the development of the GAPE reference tariffs, based on principles of transparency and efficiency.

Please refer any questions in relation to this submission to Xiao Fan Zhuang on 3625 5197 or myself on 3625 5533.

Yours sincerely,

[redacted]

Timothy Renwick
General Manager - Infrastructure

Rio Tinto Coal Australia

Submission in response to QR Network's proposed DAAU in relation to a GAPE reference tariff

19 November 2012

Executive summary

GAPE pricing will constitute a significant cost for industry and therefore needs to be fully and transparently tested

- The GAPE project involves capital investment underpinned by coal producers of over $1.2 billion in the Queensland rail network. As QRNN acknowledges, this constitutes one of the largest and most significant investments in infrastructure in Australia.
- Given the very significant capital cost which this imposes on existing and future customers, reference pricing for GAPE should not be established without the Authority and coal producers being provided with an opportunity to analyse and test all of QRNN's pricing and capacity assumptions, principles and the modelling and methodology underlying the proposed prices.
- The proposal submitted by QRNN is manifestly inadequate and does not provide the Authority or industry with sufficient information to enable them to assess the proposed reference tariffs and how they interact with the commercial pricing under the GAPE and NAPE Deeds.
- In response to repeated customer requests, after the Authority's process had commenced, QRNN provided some additional information, including limited versions of models. However, these remain inadequate. RTCA considers that a proper industry process, led by the Authority, should now be used to ensure stakeholders have sufficient information to comment on the tariffs.

Both the reference tariff and GAPE pricing models need to be made available to the Authority and users

- The reference tariff interacts in important ways with the GAPE pricing agreed with customers under the earlier UT2 framework, as reflected in the GAPE and NAPE Deeds. A separate GAPE pricing model has been used by QRNN for this purpose, with a separate set of inputs (and assumptions).
- While RTCA accepts that the reference tariff process should not 'reopen' the commercial deal, the Authority cannot reasonably form a view about QRNN's proposed reference tariff without understanding the commercial GAPE pricing structure, inputs and assumptions.
- Amongst other things, access to both models is needed because:
  - QRNN itself acknowledges that the commercial GAPE Fee and the reference tariff are 'integrated' (see section 1 of the supporting submission).
  - QRNN receives a higher rate of return under the commercial GAPE pricing than the regulated rate reflected in the reference tariff, which therefore directly impacts on its incentives to allocate costs across and within the GAPE, Newlands and Goonyella systems.
  - QRNN proposes that future users of the GAPE system would be treated equitably with foundation customers – with the effect that GAPE commercial pricing should have an effect on future access seekers.

- The consistency of inputs used across both models is likely to be a factor which the Authority considers is relevant in deciding whether such inputs are appropriate for the reference tariff.

- The Authority should take steps to ensure that it has copies of the relevant GAPE and NAPE Deeds, together with complete sets of both pricing models, including all assumptions and inputs.

- Subject to any confidentiality arrangements which the Authority considers are required, the Authority can then engage with all stakeholders, including QRNN and customers, about both models, and the reasonableness of the reference tariff, before seeking to reach a decision. This is consistent with regulatory practice in other sectors and reflects the importance for efficient investment of ensuring customers and access seekers have a reliable long term view of tariffs.

QRNN must provide certainty that the capacity on which the GAPE reference tariff is based will be delivered

- QRNN has repeatedly claimed that the GAPE project will deliver 50Mtpa to port and this must be the "Committed Capacity" for the purpose of clause 11.1.4 of UT3. As a result, the Authority must also ensure that QRNN:
  - delivers enhancements sufficient to ensure that GAPE system capacity meets this capacity – at the regulated rate of return; and
  - does not contract any additional capacity on the Goonyella or Newlands systems that would have an impact on the GAPE system capacity or proceed with any related Extensions or negotiations (including in relation to its own Galilee project), unless or until the additional work is undertaken to deliver the full GAPE tonnage.

It is not clear that the incremental pricing reflected in the tariff prevents future users from 'free riding' on the investment of GAPE and NAPE producers – undermining incentives to invest in future expansions

- RTCA accepts the "incremental up-socialised down" principle of pricing for Expansions. However, what is being implemented by QRNN does not appear consistent with this principle. While the DAAU provides for GAPE and NAPE customers to incur the incremental cost of the current Expansion, there is no clear right for them to benefit from lower-cost future Expansions (i.e. there is no 'socialising down' of capital savings).

- For the incremental up/socialise down principle to work as intended, it needs to be applied consistently through time to ensure that that later customers are not able to 'free ride' on the higher capital investment of foundation customers. Allowing free riding makes the 'first in' investors incur the cost risk of projects, which undermines incentives for efficient and timely investment in expansions.

- The DAAU **must** therefore include an acknowledgment of the 'socialise down' principle for any future expansion of the GAPE system, from the capital costs in the GAPE Deeds.

- RTCA is also concerned about the way in which QRNN proposes to implement incremental pricing. The creation of a new system ("Goonyella to Abbot Point" (**GAPE**) system) within the Central Queensland Coal Railway (**CQCR**) departs from the approach contemplated in UT3 for dealing with Expansions, which was based on cross-system tariffs (with System Premiums, if needed). It is not clear why QRNN formed the view that these tools, adopted in UT3 at the same time as the GAPE project was being undertaken, cannot be used.

- The creation of new ‘virtual’ systems to account for each Expansion will create substantial complexity and reduce transparency across systems. Full transparency is particularly important given that QRNN has announced plans to interconnect its own unregulated CQIRP railway to the Newlands system in the future and RTCA would vigorously object to a new or separate system being used to account for or deal with those Newlands-related costs.

- The tariff structure proposed by QRNN results in the tariff for diesel trains incorporating electrification costs of the Goonyella system associated with the GAPE expansion. RTCA objects to any mixing of traction types within the single tariff and invites QRNN and the Authority to explore other means of reflecting these costs. If the Authority ultimately accepts this approach for GAPE pricing, it should be on the basis that this would constitute an exceptional case and was not a precedent for any future charges.

The incremental maintenance costs claimed by QRNN are excessive and not justified for 69km of greenfield railway

- QRNN has not established that the maintenance costs claimed in respect of the GAPE infrastructure are prudent or reasonable. To the contrary, the ‘top down’ analysis used by QRNN is overly simplistic and unreliable. The alternative ‘bottom up’ analysis appears to significantly overstate the incremental maintenance costs which would be expected to be incurred in respect of a greenfield railway.

- The incremental insurance costs claimed also appear excessive and are not justified or supported by any evidence.

It is not clear why any amendment to the definition of ‘Review Event’ is needed

- QRNN has proposed an amendment to the definition of “Review Event” to permit System Allowable Revenue to be reopened in the event of a 10%+ increase in usage of the Newlands or GAPE Systems. QRNN’s submission is vague as to the reason for, and intention of, this amendment and despite RTCA approaching QRNN directly to clarify this change, no clarity has been provided.

- Given that the Newlands component of the GAPE Extension costs are being deferred until UT4 (and long term tonnage forecasts are readily available to QRNN), RTCA queries why any additional review mechanism is necessary or reasonable. To the extent that volume increases are relevant to increased maintenance costs or otherwise amount to a “material change in circumstances”, these are already addressed under the existing definition of Review Event.

Any retrospective allowance for equity raising costs is inappropriate

- QRNN have proposed a retrospective adjustment to allowable revenues to allow for recovery of equity raising costs in respect of the UT3 period. These amendments are not necessary for the GAPE DAAU and are inconsistent with regulatory precedent. They also raise complex questions about the appropriate level of dividend reinvestment, which are better left to UT4.

Transparency and access to QRNN's reference price and GAPE pricing models

Lack of prior consultation or detailed justification of the GAPE DAAU

RTCA remains concerned about the lack of transparency provided by QRNN around its modelling of GAPE reference tariffs and other matters relevant to the DAAU.

Despite the significant commercial impact of the tariff, during a period of extreme cost pressure for the Queensland coal industry, QRNN still did not engage in any consultation with industry before submitting the GAPE DAAU. While it has since provided some limited information over recent days – this occurred only *after* the Authority's process commenced.

Instead, QRNN lodged a short submission in support of the GAPE DAAU which included limited detail on the methodology, assumptions and inputs used to develop reference tariffs. QRNN has also refused access to a number of key inputs and assumptions and has yet to provide a full version of the reference tariff model to customers. As noted below (section 3), given the limited information provided to date, RTCA has been unable to verify or replicate key aspects of the QRNN tariff calculation.

This follows a similar experience in relation to QRNN's proposed 'electric traction' DAAU for the Blackwater tariff. There also, QRNN only engaged with industry after it became clear that its commercial objectives were unlikely to be accepted by industry and QRNN refused to provide genuine access to key modelling and inputs (in that case, QRNN's proposed 'total cost of ownership' modelling).

It is concerning to RTCA that QRNN have repeatedly failed to engage with industry or negotiate reasonable outcomes on a commercial basis, and within reasonable timeframes. None of the various elements of the UT3 framework which had been left for QRNN to develop, in consultation with industry, are completed or in place and this experience should provide a cautionary warning in relation to the process for development of UT4.

Access to GAPE and NAPE Deeds and associated pricing models

As a point of principle, RTCA accepts that the reference tariff process should not 're-open' the underlying commercial deal reached between foundation GAPE customers and QRNN, as documented in the GAPE and NAPE deeds.

However, the terms of the commercial transaction – and the price model used to determine the GAPE Fee – will nonetheless be of direct relevance to the Authority's assessment of the reasonableness of QRNN's proposed reference tariff. The Authority cannot reasonably form a view about the proposed tariff without understanding the structure, inputs and assumptions that underlie the GAPE Fee.

Amongst other things, this is because:

- QRNN itself recognises the degree of interaction between the commercial and regulatory pricing structures (describing them as 'integrated' in the supporting submission). It is doubtful that the Authority can properly assess such integrated pricing without reviewing and receiving input from stakeholders across both price models.

- QRNN receives a higher rate of return under the commercial GAPE pricing than the regulated rate reflected in the reference tariff, and this therefore directly impacts on its incentives to allocate costs across and within the GAPE, Newlands and Goonyella systems.

- QRNN proposes that future users of the NML would be required to pay an equal share of project costs with foundation customers (section 10.4 of the submission), so that the GAPE commercial pricing will have an effect on future access seekers.

- The consistency of inputs used across both models is likely to be a factor which the QCA takes into account in deciding whether such inputs are appropriate for the reference tariff. For example, the Authority may well wish to understand whether assumptions about total capacity, tonnage rates, asset lives, and other inputs are consistent across both regimes and, if not, why.

For these reasons, RTCA submits that the Authority should require QRNN to produce copies of the GAPE and NAPE Deeds and all supporting price modelling and assumptions. Subject to appropriate confidentiality arrangements, it is appropriate for these to also be made available, together with the full reference tariff model, to industry to review, test and reconcile.

As well as being necessary to ensure that the reference tariff is reasonable and efficient, this approach gives users and access seekers a greater ability to understand the likely development of below-rail pricing for GAPE moving forward. This facilitates efficient investment decisions, consistent with the objective in section 69E of the QCA Act.

Ensuring transparency around key cost and price models is also consistent with regulatory best practice in similar processes overseen by the Australian Energy Regulator (**AER**) and Australian Competition and Consumer Commission (**ACCC**).

For example:

- In 5-yearly reviews of revenue and price caps for electricity businesses, the AER typically requires a large amount of information to be provided in support of regulatory proposals. This information includes the service provider's revenue and pricing models, historic cost information and material supporting the development of expenditure forecasts. While some cost information is kept confidential, most of this information (including the revenue models) is published on the AER's website.

  A recent example showing the extent of information disclosure by electricity businesses is Powerlink's regulatory proposal for the 2012-2017 regulatory period, in respect of the Queensland electricity transmission network.[1] The information which was published with Powerlink's regulatory proposal included its post-tax revenue model and a range of supporting material for its proposed expenditure forecasts. The high degree of transparency provided by Powerlink allowed various stakeholders (including QR National) to make informed submissions to the AER.

- In its assessment of access undertakings in the telecommunications sector, the ACCC seeks a large amount of supporting information and makes most of this available to interested parties. Even where information is confidential to a proponent, the ACCC seeks to make this available to stakeholders subject to execution of confidentiality undertakings.

[1] Refer to: http://www.aer.gov.au/node/7945.

For example, during its assessment of Telstra's 2008 undertaking in respect of the unconditioned local loop service, the ACCC established a confidentiality regime whereby interested parties could gain access to Telstra's pricing model and other confidential material, subject to execution of undertakings.[2] A similar confidentiality regime was established in the context of the ACCC's more recent inquiry into making access determinations for fixed line services.[3]

There is no reason in principle why there should be less transparency in relation to the development of below-rail pricing than exists in these other regulated sectors. RTCA acknowledges that QRNN may hold some concerns around confidentiality, these can be addressed by establishing an appropriate confidentiality regime, as has been done under other regimes.

Establishment of the GAPE system and QRNN's proposed reference tariff structure

The pricing reflected in the tariff must ensure that future users are not able to 'free ride' on the investment of GAPE and NAPE producers – undermining incentives to invest in future expansions

RTCA supports the preferred industry approach to incremental pricing of major expansions set out in the QRC submission to the QCA in response to QRNN's proposed Investment Framework (18 March 2011). In short, this provides as follows:

- Where an expansion would result in an increase to existing reference tariffs for a system, a new tariff should apply to the expansion to ensure that existing users are not affected, but with no additional requirement for new users to contribute to common costs (incremental up).
- For expansions that are lower cost than an earlier stage, the capital cost should be averaged with the most expensive earlier stage (socialised down).

For incremental pricing to work as intended, it is vital that it applies consistently to future access seekers and that it ensures that they pay *at least* the existing costs incurred by foundation customers under the GAPE and NAPE Deeds (otherwise, any lower incremental cost should be socialised with those foundation customers).

QRNN's reference tariff structure is clearly intended to ensure that GAPE and NAPE customers pay the full incremental cost of the GAPE project. However, it is not entirely clear what QRNN is proposing in terms of future contribution by new customers to the project costs incurred by foundation customers.

The QRNN submission relevantly states (at page 32, with our emphasis added):

> "The commercial arrangements which underpin the development of the GAPE project are based on a uniform price of use by all users (i.e. an equal share of the project costs). As the project costs to be included in the GAPE Reference Tariff are also incremental to those users and not common costs with other users of the CQCR the requirement to recognise private infrastructure costs in the access charge has been removed. All new coal carrying train services will be required to pay the published reference tariff plus their specific incremental costs (private or QRNN).

[2] Refer to: http://www.accc.gov.au/content/index.phtml/itemId/806792.
[3] Refer to: http://www.accc.gov.au/content/index.phtml/itemId/990530.

> QRNN does not consider it reasonable that the published reference tariff should increase for one user due to the incremental costs specific to another user in this instance.
>
> This is not to say that the recognition could be made for a new service being required to an access charge lower than the approved GAPE Reference Tariff subject to the agreement of the QCA."

While RTCA agrees that foundation customers should not be required to pay additional tariffs to reflect any incremental costs associated with future users of the GAPE system, they must also benefit from socialised savings where future expansions can be delivered at a *lower* capital cost for capacity than the project costs incurred under the GAPE and NAPE Deeds.

This outcome is critically important to prevent 'free riding' by future access seekers, which would place the cost risk on foundation customers, fundamentally undermining incentives for efficient and timely investment in future expansions.

This issue is particularly relevant in relation to the GAPE infrastructure, as there is a likelihood that QRNN will itself (or through QR National) look to fund expansions in the future to support capacity to Abbot Point for its CQIRP project. If this additional capacity can be achieved at lower capital intensity then the original GAPE project, then those savings must be socialised with foundation customers.

RTCA submits that the Authority should therefore be satisfied that the reference tariff and GAPE commercial pricing operate to ensure that the DAAU includes an explicit acknowledgment of the 'socialise down' principle for any future expansion of the GAPE system, from the project costs in the GAPE and NAPE Deeds.

The importance of ensuring that future capital savings are 'socialised' is the single most important interaction between the GAPE/NAPE Deeds and the DAAU, and is also a reason why the Authority should require both models to be made available to all stakeholders. Foundation customers and others need to be comfortable that the way in which the incremental price structure has been implemented does not result in free riding.

The GAPE pricing also illustrates the extent to which pricing agreed commercially can (and should) influence, through reference tariffs, future users that benefit from those investments. This underscores why, for future projects, Access Conditions should be used for any Extensions that are not funded through user funding and all Access Condition Reports made available to stakeholders, not only the direct parties to those arrangements.

Creation of a separate GAPE system to implement incremental pricing

Under the GAPE DAAU, QRNN proposes establishing a separate coal system (Goonyella to Abbot Point) and a 'system premium' for the Newlands system to implement incremental pricing of the GAPE capital expenditure.

RTCA does not support the creation of a new coal system in the CQCR to implement incremental pricing, which it views as both unnecessary and a disruptive precedent for future development of the regime, for the following reasons:

- *New 'virtual' coal systems will create substantial complexity:* Creating new hypothetical systems for each Expansion will result in substantial additional complexity for processes such as the allocation of costs within and between systems, capacity planning and system operations.

- *A growing set of new systems runs the risk of lessening the degree of transparency that coal producers have over the systems they use:* RTCA is very concerned to ensure that coal producers are given greater transparency in relation to the planning and operation of the systems which they use. By allowing for the creation of new and overlapping virtual coal systems, there is a greater risk that QRNN will reduce the degree of transparency to coal producers in relation to decisions on other systems that impact their operations and capacity.

  For example, RTCA would be very concerned if QRNN in the future were to attempt to view its CQIRP project as a separate 'virtual' system from the Galilee to Abbot Point, notwithstanding that it required use of substantial and upgraded capacity on the Newlands system.

- *The approach is inconsistent with UT3.* The GAPE project was well advanced at the time of development of UT3 in 2010. UT3 introduced an approach to pricing for Expansions that anticipated the use of cross-system tariffs together with, if necessary, system premiums to provide flexibility for reference tariffs. QRNN has not sufficiently explained why these mechanisms could not be used to deliver the incremental pricing approach for GAPE, and why it has instead proposed a more disruptive model based around the creation of a new system.

An alternative and preferable approach to tariff structure is therefore to include the Northern Missing Link capital costs in the Newlands or Goonyella system tariffs, and then to apply cross-system tariffs or system premiums to ensure that the "incremental" outcome was achieved. This approach is consistent with UT3 and stakeholders should be informed why this was not adopted by QRNN in relation to the GAPE reference tariff.

Deferral of Newlands costs to UT4

RTCA supports the deferred introduction of the full Newlands tariff until UT4, given the low volumes and the disproportionate affect this would otherwise have on tariffs.

In the circumstances, it may also be appropriate to defer the Goonyella Extension capital expenditure for the same reason and RTCA encourages the Authority and QRNN to explore this with industry.

Treatment of electrification costs for Goonyella

As RTCA has made clear in its response to the 'electric traction' DAAU process that it opposes any mixing of traction charges in reference tariffs.

While acknowledging the electrification works associated with the Goonyella Enhancements, RTCA is keen to understand what alternative tariff options were considered by QRNN in relation to dealing with these costs and considers that an alternative approach would be preferable. If the Authority is minded to accept the inclusion of electric traction costs in the diesel tariff, this should be recognised as an exceptional case. It should not be allowed to be viewed or treated as any kind of precedent for the mixing of traction charges (as proposed currently by QRNN for Blackwater).

Capacity delivery, assumptions and cost allocation

Capacity delivery and assumptions

In its submission, QRNN acknowledges that the GAPE project was intended to deliver up to 50Mtpa to port. As noted in its supporting submission, this capacity (and the associated investment of over $1B) was based on modelling undertaken by QRNN's Capacity Planning group (see section 3).

While this modelling provided the basis for the scope of works under the GAPE Deed, RTCA remains concerned about the reliability and robustness of the cost and capacity modelling undertaken by QRNN and this is one of the reasons it has repeatedly sought greater transparency as part of UT3 regulatory processes.

RTCA submits that the Authority must view any capacity claimed by QRNN in respect of GAPE as "Committed Capacity" for the purpose of clause 11.1.4 of UT3. As a result, QRNN must:

- deliver enhancements sufficient to ensure that system capacity meets the GAPE capacity – at the regulated rate of return; and
- not contract any additional capacity on the Goonyella or Newlands systems in a manner that may impact upon GAPE capacity, unless or until the additional work is undertaken to deliver the full GAPE tonnage.

Amongst other things, QRNN should not proceed with any Extensions or negotiations in relation to its CQIRP project until the Authority and other foundation customers are satisfied that the full committed GAPE capacity has been delivered.

QRNN should also undertake a Capacity Review of the GAPE system (under Part 11 of UT3) so that the impacts of GAPE capacity on the wider coal chain can be understood.

Capital cost allocation

The approach adopted to allocation of both capital and O&M costs across the GAPE system, Newlands and Goonyella, is a critically important element in the operation of the reference tariff.

Given the importance and complexity of cost allocation, QRNN must publish its allocation model including all assumptions and inputs. While some of the allocators have been identified in the submission, this is not true for all allocations. For example, QRNN has not made explicit its basis for allocating costs between the Goonyella Enhancements and the NML (although RTCA assumes this is on the basis of contracted tonnage).

The appropriateness of QRNN's allocation process (including all assumptions) must also be able to be assessed and verified by the Authority and those coal producers being required to pay the reference tariffs. For example, deferral of GAPE-related Newlands capex until UT4 (and capitalisation with WACC) may mean that opex and other costs are over-allocated to the GAPE system during this period.

Incremental operational and maintenance costs

QRNN's "top down" assessment of incremental maintenance costs

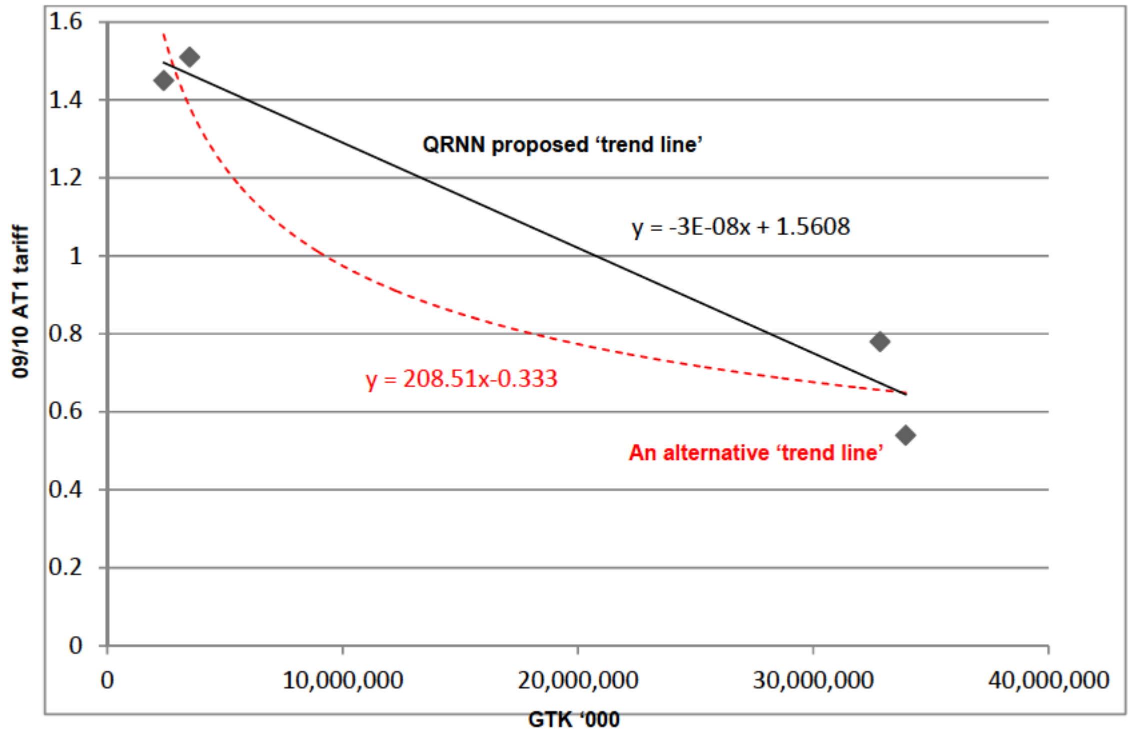
QRNN's estimate of incremental railway maintenance costs is based on the incremental costs for Newlands services, as reflected in the Newlands AT_1 tariff. QRNN asserts that the characteristics of coal carrying Train Services from GAPE customer mines are comparable to existing Newlands services, meaning that the AT_1 rate for the Newlands system need only be adjusted to reflect different volumes.

QRNN's approach ignores that the incremental costs reflected in the Newlands AT_1 tariff are costs associated with maintaining an *established* railway. QRNN does not recognise that the cost of maintaining a greenfield railway is likely to be substantially lower, and as a consequence QRNN does not make any adjustment for this.

The volume adjustment proposed by QRNN is also overly simplistic. QRN assumes a simple linear relationship between volumes and maintenance costs, without providing any justification for this assumption. This is illustrated in Figure 5 of the QRNN submission.

The assumption of a linear relationship between volume and costs has a very significant impact on the estimate of incremental maintenance costs. If a non-linear relationship is assumed (as in Figure 1 below), the estimate of maintenance costs per '000gtk falls from $1.22 (as estimated by QRNN) to well below $1.

Figure 1: An alternative relationship between GTK & AT1 rates approved for UT3



RTCA submits that maintenance costs to be included in GAPE reference tariffs cannot simply be inferred from costs associated with brownfield railways, assuming a simple linear relationship between costs and volume (particularly given the very limited number of data points from which to derive any such relationship).

QRNN also appears to have used the contracted GAPE volumes for the purpose of its calculation, when it concedes that actual railings have been well below the forecast levels.

For all of these reasons, the Authority should not accept QRNN's 'top down' assumption that maintenance costs for GAPE would reflect the costs incurred for the long-established Newlands system.

QRNN's "bottom up" assessment of incremental maintenance costs

QRNN has also provided an alternative measure of incremental maintenance costs, based on its 'Network Strategic Asset Planning' (**NSAP**) tool. However as noted above, it is not clear to RTCA how this alternative measure has been used in the estimation of Total Maintenance Costs and QRNN has not made the NSAP available to the Authority or other stakeholders to assess.

As RTCA does not have access to the inputs or modelling assumptions used in NSAP, it is unable to comment on the robustness of QRNN's 'bottom up assessment'. The NSAP should be made available to all stakeholders to enable all maintenance assumptions and to be tested.

Even without access to the NSAP modelling, however, RTCA notes that the values set out in Table 7 of QRNN's submission appear excessive for a greenfield railway. For example around two thirds of the incremental maintenance cost estimate (around $8.6 million) is attributable to mechanised maintenance activities such as ballast cleaning, rail grinding and track resurfacing. QRNN has not explained or justified why this high level of expenditure on such activities should be required during the early lifecycle of the NML and Newman and Goonyella extensions. This is also not consistent with the low volumes which QRNN has forecast for use of the infrastructure over the relevant period.

To the extent that estimates of maintenance costs based on NSAP are to be used in the determination of reference tariffs, it is imperative that this modelling be made transparent and tested by stakeholders (and, if necessary, third party technical experts). Reference tariffs should not be based on 'black box' estimates of maintenance costs.

RTCA considers that the Authority should commission an independent assessment of the likely incremental cost impact, if any, of the GAPE infrastructure – over and above QRNN's current operational and maintenance budget.

Total maintenance costs for the GAPE infrastructure

QRNN states that in calculating total maintenance costs for inclusion in reference tariffs it has combined the estimates of fixed and incremental maintenance costs. However QRNN does not specify which estimate of incremental maintenance costs it has used in this calculation and/or how it has combined the top-down and bottom-up estimates of incremental maintenance costs.

RTCA notes that for 2012/13, the Total Maintenance Costs set out in Table 9 of the QRNN submission ($14.94) significantly exceed the sum of Incremental Maintenance Costs (Table 3 of the QRNN submission) and Fixed Maintenance Costs (Table 6 of the QRNN submission) – together amount to $11.05.

It is unclear why this is the case. To the extent that the calculation of Total Maintenance Costs includes any additional adjustment, this needs to be explained.

Incremental railway management (operating) costs and treatment of the 'risk premium'

RTCA understands that by 'risk premium', QRNN means incremental insurance costs associated with the GAPE infrastructure.

As part of providing the full reference tariff model, QRNN also needs to provide the 'tonnage ramp up profiles' (referred to in section 6.4.6 of the submission) used as the basis for allocation of this additional insurance cost as between GAPE, NAPE and the Goonyella Enhancements.

The Authority also needs to be satisfied that the increase in insurance costs claimed by QRNN reflects actual and prudent expenditure. RTCA assumes that evidence of increased premiums claimed from insurers have been submitted to justify these amounts. In the absence of any such evidence, QRNN must demonstrate why insurance costs should increase on a ntk basis by such a substantial amount, given that the insurance relates to 69km of infrastructure integrated within the existing (insured) network.

As a practical matter, QRNN should be required to explain to the Authority and customers what level and type of insurance cover is being acquired, including any material limitations or exceptions.

Consequential amendments to the 2010 QR Network Access Undertaking

Amendment of the definition of "Review event"

As noted above, QRNN accepts the deferral until UT4 of capital expenditure associated with the Newlands upgrades into the Newlands tariff – given low volumes.

However, given that this will then be dealt with as part of the UT4 process, it is not clear why any amendment is required to the definition of 'Review Event' to permit other changes to System Allowable Revenue (**SAR**) on the basis of a 10% increase in the number of contracted Train Services. Given that any increased volume of the GAPE project is contracted and forecast by QRNN, it is not clear why an increase in actual volumes should 'reopen' the SAR.

In addition, QRNN has not explained why the existing scope of "Review Event" does not provide sufficient flexibility to deal with volume related uncertainties. For example, to the extent that volume increases are relevant to increased maintenance costs or otherwise amount to a "material change in circumstances", these are already addressed under the existing definition of Review Event.

As noted above, as part of the full reference tariff model, QRNN must also produce the volume estimates referred to in section 10.2 of its submission.

Equity raising costs

QRNN proposes, as a "consequential amendment" to retrospectively adjust the amount of equity raising costs included in allowable revenues for the UT3 period. QRNN asserts that its approach to calculating equity raising costs is consistent with regulatory precedent. This raises two important issues:

1 Whether QRNN should be entitled to capitalise an amount for equity raising costs on an ex post basis; and

2 If so, then how should ex post allowance be calculated.

Ex post adjustment to equity raising costs

QRNN had previously assessed whether additional equity would need to be raised to fund forecast UT3 investments. QRNN found that it would be able to fund its forecast UT3 investments via retained earnings and borrowings and therefore did not include any allowance for equity raising costs in the calculation of tariffs for the UT3 period.

QRNN is now seeking to retrospectively adjust the allowance for equity raising costs for the UT3 period on the basis that its original assessment did not account for GAPE cash flows and project costs. RTCA does not agree that QRNN should be entitled to revisit its previous estimate of equity raising costs. There is no allowance for ex post adjustment of equity raising costs in other regulated sectors (e.g. electricity), even where out-turn capital expenditure is different to forecast.

Calculation of equity raising costs

Although QRNN claims to have adopted the AER's methodology for calculating equity raising costs, it is apparent that they have materially departed from this established methodology. QRNN states in its submission that:

> "The only point of difference is that QRNN does not propose to recognise a dividend reinvestment policy. The basis for the exclusion is to ensure consistency with the financial model used to determine reference tariffs in the CQCR."

The importance of this departure is that dividend reinvestment is typically assigned a lower cost, compared to "seasoned equity offerings" or SEO (1% for dividend reinvestment compared to 3% for SEO), and SEO are only deemed necessary where there is insufficient cashflow and dividend reinvestment (in that order). In other words, SEO are the last resort, because they are the most expensive option – for example in the Powerlink decision, there was actually no allowance for SEO because there was sufficient cashflow and dividend reinvestment to cover capital requirements. Here QRNN has decided that dividend reinvestment is out of the question and therefore they go straight to SEO where there is insufficient cashflow.

Even if an allowance for retrospective equity raising costs was permitted by the Authority, QRNN have failed to justify why the standard practice should not be followed in relation to assuming a dividend reinvestment.

Conclusion on equity raising costs

A retrospective adjustment to the allowance made in UT3 for QRNN's equity raising costs is unprecedented and unwarranted. If any adjustment were made, it is inappropriate to assume a dividend reinvestment of 0%, which is inconsistent with regulatory precedent (i.e. it is not consistent with the AER approach referred to by QRNN).

RTCA views the issue of equity raising costs as not one that needs to be dealt with in the GAPE DAAU process. It raises complex issues better suited to being addressed, together with other WACC variables, as part of the UT4 process.