



Issues Paper

**Queensland Rail Draft Undertaking –
Treatment of Past Capital
Contributions**

July 1999

SUBMISSIONS

The Queensland Competition Authority (the Authority) considers public involvement to be an important element of its decision making processes. It therefore invites submissions from interested parties concerning the appropriate treatment of capital contributions to Queensland Rail in its consideration of QR's draft undertaking for third party access to its network.

To facilitate the publication of submissions on the QCA's website, it is preferred if submissions could be made electronically by disk or by e-mail. However, if this is not possible, submissions can be made in writing. Submissions, comments or inquiries regarding this paper should be directed to:

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The **closing date** for submissions is 27 August, 1999.

Confidentiality

In the interests of transparency and to promote informed discussion, the Authority would prefer submissions to be made publicly available wherever this is reasonable. However, if a person making a submission does not want that submission to be public, that person should claim confidentiality in respect of the document (or any part of the document). Claims for confidentiality should be clearly noted on the front page of the submission and the relevant sections of the submission should be marked as confidential, so that the remainder of the document can be made publicly available.

To facilitate disclosure of the non-confidential portion of submissions, it would be appreciated if a copy of the submission with the confidential information excised could be provided in addition to the full submission. Again, it is preferred if the relevant submissions could be made electronically by disk or by e-mail. However, if this is not possible, the submissions can be made in writing. Where it is unclear why a submission has been marked "confidential", the status of the submission will be discussed with the person making the submission.

While the Authority will endeavour to identify and protect material claimed as confidential as well as exempt documents (within the meaning of the *Freedom of Information (FOI) Act 1989*), it cannot guarantee that submissions will not ultimately be made publicly available. As stated in s187 of the *Queensland Competition Authority Act 1997*, the Authority must take all reasonable steps to ensure the information is not disclosed without the person's consent, provided the Authority is satisfied that the person's belief is justified and that the disclosure of the information would not be in the public interest.

Public access to submissions

Subject to the above, submissions will normally be made available for public inspection at the Brisbane office of the Authority (see below), or on its website at www.qca.org.au. Information about the role and current activities of the Authority, including copies of reports, papers and submissions can also be found on this website.

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ATTACHMENTS

1. Approach of Other Regulatory Bodies

1. INTRODUCTION

1.1 The Role of the Queensland Competition Authority

Queensland Rail (QR) has submitted a draft access undertaking to the QCA covering certain services relating to the use of rail transportation infrastructure owned by QR. Accompanying the draft access undertaking is an explanatory guide which QR has produced to clarify the intent of selected provisions of the undertaking. These documents are available from the QCA (phone Ms Natasha Bree on (07) 3222 0555) or can be downloaded from the QCA's website at www.qca.org.au.

The draft access undertaking sets out the basis under which QR proposes to provide third party access to certain declared services. Under Part 5 of the *Queensland Competition Authority Act 1997*, the QCA is required to assess the undertaking and decide whether or not to approve it. In determining whether to approve QR's draft undertaking, the Authority is mindful of the role of an undertaking under the QCA Act, which is principally to provide certainty to stakeholders in future arbitrations. If approved, the undertaking will effectively bind the Authority in any future disputes between QR and those seeking to use its network.

The Authority has adopted a consultative approach to its assessment of the undertaking. The Authority has already produced the following papers intended to facilitate stakeholder feedback on a range of issues that are relevant to the Authority's assessment of the draft undertaking:

- a Request for Comments Paper in relation to QR's Draft Undertaking; and
- a paper dealing with asset valuation methods, depreciation approaches and the quantification of an allowed rate of return for QR for the purpose of developing reference tariffs.

Copies of these papers are available from the QCA and may be downloaded from the Authority's website.

As part of this process, the QCA considers that user funded capital contributions need to be considered in the development of appropriate access prices. The QCA is therefore seeking the views of interested parties as to the most appropriate method of dealing with past capital contributions.

1.2 Past Capital Contributions

End Users have made substantial capital contributions towards the augmentation and upgrading of the rail network by QR, particularly in the coal and minerals corridors.

Therefore, an important consideration in the determination of access arrangements for rail infrastructure is the extent (if at all) past capital contributions made by users should be recognised in the determination of revenue limits and Reference Tariffs.

QR's Draft Undertaking does not make reference to the possible recognition of past capital contributions.

1.3 Purpose of the Paper

The purpose of this paper is two fold:

- to raise issues associated with the recognition and quantification of past capital contributions for the purposes of developing Reference Tariffs for QR's below rail services; and
- to seek feedback from interested parties which may assist in the development of a policy framework in this area.

At the outset, it should be noted that the practical and theoretical issues surrounding the treatment of contributed assets are extremely complex. A consensus is yet to emerge on the issue amongst regulatory bodies in Australia. This complexity and lack of consensus means that judgement will form a necessary and inevitable part of the process.

2. BACKGROUND

End users have made substantial capital contributions towards the augmentation and upgrading of the rail network by QR, particularly in the coal and minerals corridors.

The approach adopted by the Queensland Government and QR to user funded capital contributions has involved a mix of arrangements which have evolved over time in response to changes in the legal, financial and taxation environment. An examination of the implications of past user funded capital contributions for asset pricing could therefore be considered in light of the historical background in which the contributions were made.

There is an argument that users, having funded the initial capital for infrastructure to service a mine, should not be required to pay for those assets again by having to pay rail freight charges that include a commercial return on assets they have directly provided.

Alternatively, it may be argued that capital contributions represent past and irreversible cash flows, and as such “bygones should be bygones”. The possible recognition of past capital contributions, perhaps after many years, could potentially result in the rewriting of contracts that have already expired.

The purpose of this paper therefore is to raise issues that are relevant to the possible recognition of past capital contributions, and having done so, put forward a framework within which the issue may be as rigorously assessed as circumstances allow. There are three key sets of issues to be addressed in the context of the possible recognition of past capital contributions:

- whether recognition is justified, which is likely to be based primarily on equity considerations;
- in cases where recognition is deemed appropriate, how the extent of the recognition should be quantified; and
- transitional issues which might need to be addressed if past contributions are to be recognised.

These issues will be considered in turn.

3. RECOGNITION OF PAST CAPITAL CONTRIBUTIONS

Relevant considerations to the recognition decision include:

- the original contractual arrangements;
- equity considerations;
- the materiality of the contribution;
- the purpose of the contribution;
- the nature of the asset which was contributed;
- the identity of the contributor; and
- the length of time that has transpired since the contribution was made and whether the original contractual arrangements have been superseded.

In terms of assessing whether recognition is appropriate, it is important to note that the following discussion raises a number of issues of potential relevance. There is a great deal of overlap and some potential trade-offs between these considerations.

3.1 The relevance of the original contractual relationship

It is appropriate to consider the issue of contributed assets in the context of the original contractual relationship between the parties.

The intentions of the parties at the time in relation to the contribution will be relevant. In this context, an issue relates to the nature of any price/contribution trade-off negotiated between the parties (i.e. was a discount agreed to on account of the capital contribution at the time the contribution was made). In some instances recognition of past capital contributions may be reflected in current pricing structures and continuing contractual obligations.

It may be relevant to consider whether there is evidence of excessive profits being earned by QR in connection with the contracts pursuant to which the contributions were made

If, after taking into account the initial up front payment and the ongoing rail freights, there is no evidence of QR earning excessive returns, then it may be more accurate to characterise the contractual arrangement as one that involved a large initial or up front payment for the service they purchased (perhaps over many years). However, where QR was clearly making monopoly profits on this basis at the time of the contribution, and the capital contribution was a significant component of those monopoly profits, it may be appropriate to consider whether there should be some recognition for those past contributions.

3.2 Equity considerations

Generally speaking, the equity concerns in the possible recognition of past capital contributions relate to:

- equity between contributors and non-contributors; and
- equity between contributors and QR.

Whilst the focus of users may be on achieving equity between themselves and QR, the relative equity between users is also important. Recognising a credit for past monopoly profits for one user who made a capital contribution but not another (who paid very high prices in lieu of a capital contribution) may be unfair for the latter. However, other aspects of the provision of up front capital may warrant recognition.

There is little difference between monopoly profits extracted by way of higher user charges and those extracted by way of capital contributions. Accordingly, if capital contributions are to be recognised, this issue needs to be carefully addressed. For example, all other things being equal, if the level of monopoly profit is the same in net present value terms between a contributor who paid up front and one who paid over time, via a monopoly profit component in freight charges, then on grounds of economic equity they should be treated equally. Hence, variations in the level of any monopoly profits contained in rail freights adds another level of complexity to the recognition of past capital contributions.

Equity between contributors is also relevant in situations where contributors had no say in what assets they funded. For example, the benefit accruing to a user whose contribution was used to purchase an asset with a long life could be greater than that accruing to a contributor whose contribution was used to purchase an asset with a shorter life.

3.3 The materiality of the contribution

It may be appropriate that a threshold value be established for the recognition of a user's capital contribution. A further consideration relates to the significance of a user's contribution relative to those made by others (in the context of their respective rail freights). Other things being the same, there may be a stronger case to recognise particularly significant past contributions, both in respect of timing and of amount.

3.4 Purpose of the contribution

The discussion of the nature of the original contractual relationship between the parties highlighted the importance of capital contributions being considered in the context of the entire relationship between the parties, and in particular whether the capital contribution gave rise to excessive (monopoly) profits being earned by the infrastructure provider.

However, there may be other considerations that are relevant to whether recognition is appropriate in the context of the profits earned as part of the arrangement. For example, where the implicit or explicit purpose of the contribution was to, say, extract a resource rent tax from users, it may be more difficult to support recognition, even where the amount of resource rents varies considerably across users. In this regard, the decision to move to commercial rail freights in 1993 might have some significance for the recognition decision.

Different considerations may arise where the contribution relates to an asset that was contributed in order for QR to manage asset stranding risk. By their very nature, stranded assets will tend to be mine specific. Common user assets, on the other hand are less likely to become stranded. All other things being equal, there may be a stronger case to recognise assets contributed to avoid asset stranding risk than assets used in the common user parts of the network.

3.5 The nature of the asset which was contributed

There may be a stronger case for the recognition of assets which were dedicated to a particular mine and remain in use. For example, where a user funded the construction of an asset to service its needs and no-one else's (eg a dedicated spur line), there may be a stronger case for recognition. This arises simply by virtue of the fact that the user may be in a position to point to the asset in question and the payments that were made to fund the initial construction.

3.6 The identity of the contributor

The issue here concerns whether the user is the original user or a successor in title. There may be an issue whether a claimant's case for recognition of a past contribution is as strong for a user who was not the original contributor but who bought the initial contributor's interests in the asset, say, a mine. In such a case, the legitimate expectations of the person buying the interest in the asset may become important.

If there was no reasonable expectation of user funded credits being recognised by the purchaser of a mine (e.g. because of a long term contract for rail services being assigned), then the case for the successor receiving a credit for the user funded assets may be weaker. This is because recognition for such a shipper may simply represent a windfall benefit for that user.

3.7 The time since the contribution and whether the contract has been superseded

The length of time since the contribution was made may be relevant, irrespective of the life of the contract, because of the existence of declining residual service potential of contributed assets over time. In addition, where QR has been responsible for the repair, maintenance and replacement of the infrastructure, it may be the case that little of the original service potential of the assets remains. In such cases, it might be appropriate that the contribution would only be recognised by the parties for a given period of time related to the useful life of the original assets.

The importance of the time since the contribution was made will depend to some extent on whether an asset or contract based approach, as discussed in the following section, is applied to the recognition of capital contributions.

Where a capital contribution was made as part of a contract that has run its course and expired, and the contribution was made to lower the effective price under that initial agreement, then the contribution may be characterised as a past monopoly profit, indistinguishable from other past monopoly profits. Where a contractual approach is employed, it may be reasonable to restrict recognition to existing contracts.

There is also the issue of the life of the asset which the contribution funded. Where the capital contribution funded an asset with a useful life that exceeds the life of the contract under which it was funded, there is an issue as to whether further recognition should be considered. However, as time passes since a contribution was made, the greater the difficulties associated with asset valuation and depreciation. To avoid these problems it may be necessary to specify a time constraint in the recognition process.

4. QUANTIFYING THE EXTENT OF RECOGNITION

4.1 Components of a credit

If past contributions are to be recognised, the recognition will generally comprise two components:

- a return of capital (relating to the undepreciated value of the remaining service potential of the asset or the “principal” being the amount of the initial contribution); and
- a return on capital, being a weighted average cost of capital (WACC) related return on the amount of the principal that has not yet been returned to the contributor through the return of capital payments.

4.2 Approaches to the quantification of credits

There are two broad approaches that may be taken to the quantification of credits, namely:

- asset based recognition where the initial contribution is amortised over the life of the contributed asset¹; or
- contract based recognition where the initial contribution is amortised over the life of, and in the terms of, the contract under which it was made.

Ultimately, for new assets, the two approaches will yield identical outcomes in net present value terms (so long as the life of the mine is sufficiently long to utilise the full depreciation of the underlying asset). For existing assets, differences may arise on account of the asset valuation method that is adopted (the contract based approach would be consistent with a historical cost valuation approach) and the fact that the remaining life of the asset will rarely correspond to the life of the contract.

Accordingly, in practice, the choice of approach will have significant implications for quantifying the extent of recognition and the manner and time frame over which the credits are to be provided.

However, under either approach, there remains the issue of whether account should also be taken of the benefit the contributor derived from the contribution. For example, where the person who made a contribution derived a tax benefit from doing so, there is an issue as to whether, and if so how, account should be taken of such benefit in the quantification of any credits to arise.

¹ In cases where individual contributions can not be easily identified or where differences in contribution levels are not significant, it may be appropriate to apply the capital contribution across all users. However, since rail services for coal and mineral hauls are provided under individual contracts, it should generally be possible to identify the original contributor of an asset and the amount of the contribution and hence apply individual credits as appropriate.

Asset based recognition

An asset based approach to the assessment of contributed assets would produce credits much like the cash flow generated by that asset in a regulatory review. Accordingly, the asset based approach requires:

- a detailed specification of the assets involved;
- an assessment of their original and remaining service potential; and
- a valuation of the assets.

An asset-based approach will also require difficult judgements to be made about how much of the remaining service potential of the assets is due to the ongoing repairs and refurbishment undertaken by QR as the asset owner and manager (ie independently of the original contribution). In some cases, such as for general rail upgrades, this may be virtually impossible to determine with any precision.

Added to this complexity is that depreciation complications arise where contributed assets serve many users and where the assets remain productive after the mine which contributed them has ceased to operate. In such cases there is the additional complexity associated with the fact that “depreciation” of the principal of the contributed asset for the calculation of contributed asset credits is unlikely to mirror that actually applied by QR in its accounts.

If the asset based approach is to be adopted, it may be appropriate to value assets using the same asset valuation methodology used to value QR’s asset base.²

Contract based recognition

In broad terms, under contract based recognition, the amortisation of a contribution over the life of a contract simply requires that an allowance be recognised in tariff arrangements.³

If a contract based approach to the recognition of assets is adopted, then the asset valuation methodology has few implications for the extent of recognition of contributed assets, except in relation to transitional issues (if they are to be recognised at all).

Accordingly, a possible strength of the contract based approach is that it tends to avoid many of the problems associated with asset valuation and the calculation of depreciation that arise when applying an asset based approach.

² For example, if assets are to be valued according to the depreciated optimised replacement cost approach, any increase in the asset value (ie if the appreciation of the current replacement cost overwhelms the depreciation) is analogous to a further “investment” by the customer. In such a case, the appreciation would, in theory, represent a (non-cash) credit in itself so long as the asset appreciation is reflected in higher returns on and of capital components of credits included in future freight charges.

³ This allowance could be an annuity similar to a credit foncier loan arrangement.

Such an approach may also be consistent with the philosophy that shippers are unlikely to have:

- had a great deal of discretion over the assets they contributed to; and
- contributed assets with a view to entering into the rail industry themselves, but rather intended to buy a service from QR under an individually negotiated contract.

However, a difficulty with contractually based recognition is that it may produce inequities where the initial contracts involving very large contributions have expired yet the asset which the user contributed remains in use (whether with or without enhancements from QR).

Accordingly, if contributions are to be recognised and a contract based approach is adopted, it may be appropriate to consider transitional arrangements for very large capital contributions for still operational assets made under contracts that have expired and been renewed.

A possible approach could be to amortise the contribution over the life of the mine. Adjustments would need to be made for the portion of the original contribution that was consumed prior to the start of the existing contract or the current review and to take account of any enhancements undertaken by QR.

5. TRANSITIONAL ISSUES

There are perhaps two transitional issues if past contributions are to be recognised:

- what is the appropriate vehicle for that recognition – note that the QCA has no role in relation to existing contracts and the rail freights under those contracts; and
- what is the appropriate treatment of above rail contributions.

The appropriate vehicle for recognition

Most of QR's current rail contracts for the coal industry remain on foot until at least 2005. The QCA does not have a role to review or rewrite these contracts. Accordingly, where past contributions are not currently being recognised, the QCA has no capacity to adjust current rail freights to recognise those contributions. Decisions regarding rail freight relief for current contracts currently rest with the Queensland Government and QR.

This raises the important issue of the appropriate vehicle for recognition of those past contributions should such recognition be considered appropriate.⁴ The QCA's development of Reference Tariffs for below rail coal services could provide a vehicle for credits, although, by definition, these tariffs relate to new mines or new contracts. Nevertheless, the amount of any existing credits on account of past capital contributions could be assessed in the context of determining the revenue requirements for each corridor of the network for Reference Tariff purposes.

Accordingly, if past capital contributions are to be recognised, the issue arises as to the most appropriate vehicle for this recognition to occur.

Above rail contributions

A further issue to be considered is whether there are any significant anti-competitive implications of recognising contributions. For example, a significant barrier to entry for above rail competitors could be inadvertently created if contributions for rolling stock are recognised only if QR's rolling stock is used for haulage purposes.

Indeed, the whole notion of recognising credit for past contributions for rollingstock is incompatible with the creation of a competitive market for the services provided by these assets.

In such a case, if a contribution is to be recognised, it may be appropriate that the contribution be deemed to relate to below rail assets. Such an approach could assist to produce a more competitively neutral outcome. This is particularly the case where users had little or no discretion over which assets their contributions funded.

Again, however, this depends upon whether Reference Tariffs represent an appropriate vehicle for the recognition of past capital contributions.

⁴ By way of example, capital contributions were recognised as part of the reform of the Queensland electricity supply industry (QESI). Power supply contracts for major customers were unbundled by the Queensland Government as part of this reform process. The unbundling effectively separated the network access issues (which were addressed in connection agreements with electricity distributors) from the purchase of energy (which became a contestable activity). As part of this process, there was some limited recognition of past capital contributions in the new connection agreements.

6. ISSUES FOR COMMENT

The Authority seeks comments on the following:

- whether it is appropriate to recognise past contributions by rail users for pricing purposes
- what is the relevance of the initial contractual relationship to the recognition of past contributions
- how should equity between users be recognised
- is it appropriate that there be a minimum amount to qualify for individual recognition of a past contribution, and what value should be used to apply the threshold test eg original amount of the contribution, residual/depreciated value of the assets involved, etc.
- should asset contributions made since the phasing out of de facto royalties from coal freight rates in 1993 be treated differently from pre-1993 contributions
- is there any significance in the type of asset that was contributed as to whether it should be recognised or to the extent of recognition
- in relation to the possible recognition of past contributions, is there any significance in a claimant being a person other than the person who made the contribution (eg a new mine owner)
- are there any additional considerations which should be addressed in determining whether a past contribution should be recognised
- to the extent that past contributions are to be recognised, should an asset based or contract based approach be used in the quantification of credits
- what cost components (depreciation, cost of capital, or both) should be included in the calculation of any credit on account of past contributions
- should tax benefits received by a contributor be taken into account, and if so, how
- are there any additional considerations which should be addressed in quantifying the credit for past asset contributions
- if capital contributions are to be recognised, how should it be done given that QR's coal haulage contracts are set in place
- if capital contributions are to be recognised, how should above rail contributions be treated
- are there any other issues which should be considered

ATTACHMENT 1**APPROACH OF OTHER REGULATORY BODIES**

The treatment of contributed assets and developer charges has been considered by other regulatory agencies and commercial enterprises. Individual circumstances have been a significant factor behind the different approaches adopted by these organisations as reflected in the brief description below of the approaches taken by:

- the Independent Pricing and Regulatory Tribunal of New South Wales;
- Queensland Electricity Reform Unit; and
- Ports Corporation of Queensland

Independent Pricing and Regulatory Tribunal of New South Wales

Independent Pricing and Regulatory Tribunal (IPART) has not yet developed a formal policy with respect to the treatment of past capital contributions in the rail industry. To date, all significant contributions have been recognised in freight haulage contracts by way of reduced tariffs. The extent of these tariff reductions were the result of individual negotiations between rail operators and contributors. In the future, IPART intends to include the consideration of past capital contributions, along with a number of other factors, in adjusting the asset base for the purposes of tariff determination. In such cases, the amount of the contribution will be excluded from the asset base in the calculation of tariffs for the original contributor only, with other users of the contributed assets, if any, being required to pay the 'full' tariff.

Queensland Electricity Reform Unit

The Queensland Electricity Reform Unit framework for major customers, in general, allows for the recognition of past user funded assets where the contract for the supply of electricity under which the contribution was made has not expired or been terminated. Where a past contribution was associated with a clearly identifiable large customer or for dedicated assets, such as connection assets, then a specific recognition was made for that customer in the pricing framework via a rebate. The amount of this rebate was calculated on the basis of the return on assets multiplied by the original contribution. For existing contracts, the rebate is available for the remaining minimum term of the contract or 5 years, whichever is the greater. In cases where supply contracts have expired but where the remaining service potential of contributed assets is substantial, sufficient flexibility exists to enable some recognition to occur on a case by case basis.

Ports Corporation of Queensland

The Ports Corporation of Queensland (PCQ) has recently renegotiated port services contracts for the Dalrymple Bay Coal Terminal. Whilst the renegotiation of all existing contracts was not strictly necessary, PCQ was keen to put all users on an equal footing with respect to Special Harbour Dues and other contractual arrangements. As part of the renegotiation of contracts PCQ decided to recognise the past capital contributions of the four original users of the terminal. Those contributions relate to the development of the onshore facilities in the early 1980s worth nearly \$100m. The contributions were in proportion to the original capacity allocations for the original users that now total around 22mt. The contributions have not been explicitly recognised in the past even though new contracts were entered into in 1993.

The new arrangements involve PCQ paying a rebate of \$0.65/t on base contract volumes (i.e. 22.55mt) for the next 10 years, after which time no further recognition by PCQ will be required. This rebate will return a total of more than \$130m to the four original users of the facility. While the level of the rebate was the result of negotiations between users and the PCQ, in general terms it will constitute the amortisation of the original value of the contributions over the 10 years.