

April 2011

Mr John Hall
Chief Executive
Queensland Competition Authority

QR Network's Review Event Application – Central Queensland Flooding

Dear John,

Thank you for the opportunity to provide comments on QR Network's Review Event application to directly pass-through \$5.9 million of costs associated with various flood incidents that occurred on the central Queensland coal network between December 2010 and January 2011.

Industry recognises QR National's engineering and operational recovery efforts to restore the network for coal carrying train services following the various flood incidents. This submission is provided by industry to assist the Authority's consideration of QR Network's application to pass-through flood recovery costs.

The Council has a number of specific concerns with QR Network's proposal to increase the Reference Tariffs of the Blackwater and Moura Systems to recover \$5.9 million over the current 2011-12 financial year which are outlined in this submission.

→ Review Event process must only pass-through additional incremental costs

The Council recognises that the 2010 Access Undertaking provides a Review Event process to assess specific cost-pass applications. In terms of QR Network's flood recovery application, the Council notes that the Review Event process was specifically developed to ensure that only claims for *additional incremental* costs associated with *catastrophic* damage, or for those events which had not assumed within QR Network's self-insurance arrangements, could be formally assessed by the Authority.

QR Network said that, while some weather-related events were covered by its self-insurance risk premium, and other catastrophe-related costs could be claimed through On Track Insurance, this coverage did not include a range of potential costs arising from a force majeure event such as an earthquake or tropical cyclone ... The Authority therefore approves the creation of a review event for costs greater than \$1 million arising from catastrophes, as the review event provisions give the Authority sufficient discretion in assessing such a claim. (p51)

QR Network has advised the Authority that it omitted to provide any mechanism for applying for a pass-through of uninsured costs relating to a catastrophic event such as an earthquake or major storm... it has now proposed to add a review event to allow it to apply for such a pass-through. (p189)

QCA Draft Decision December 2009

It is important that the Authority's assessment process ensures that there is no double-recovery / windfall gain to QR Network. In particular, the Authority must take into account QR Network's risk and insurance arrangements that have been approved by the Authority, to ensure that any increase to Reference Tariffs only reflects those costs which are *additional incremental* costs. That is, after taking into account approved insurance coverage for assumed risks.

→ **Application of existing self-insurance arrangements for flood events**

Industry took considerable comfort that the Authority, in approving QR Network's 2010 Access Undertaking insurance and risk arrangements, had thoroughly:

- Identified the specific risks and events that QR Network would undertake to self-insure, including the consideration of self-insurance claim thresholds;
- Quantified the expected incidence and costs of risk with a method consistent with an actuarial assessment including, a report from a qualified insurance consultant confirming risk estimates and proposed self-insurance premiums; and
- Developed a clear process by which the QR Network Board would implement a transparent self-insurance function, which amongst other things, required the following to be completed by 31 December 2010:
 - A resolution by the QR Network Board resolving which events were being self-insured and acknowledging that QR Network would have sufficient financial capacity to assume such self-insured risks; and
 - Either QR Network demonstrating to the Authority that self-insured losses would not be otherwise recovered through revenue recovery provided for by the 2010 Access Undertaking, or submitting a draft amending access undertaking to remove the potential for any such recovery.

QR Network's application has not given adequate consideration to the current self-insurance arrangements endorsed as part of the 2010 Access Undertaking approval process.

The Reference Tariffs and System Allowable Revenues approved by the Authority within QR Network's 2010 Access Undertaking were developed with the inclusion of self-insurance premiums to provide cover for specific events – including for flood. QR Network's August 2008 submission included self-insurance premiums for *extreme weather events* (which included amongst other things, coverage for flood events). On 18 December 2009, the Authority published a Draft Decision which assessed QR Network's sought self-insurance premium and coverage, and released an independent report undertaken by PriceWaterhouseCoopers (PwC) to assess whether QR Network's claims for risk and insurance were cost-effective and reasonable.

The PwC report noted that in assessing QR Network's proposed self-insurance premiums for assuming these risks (including those for weather related events such as flood), QR Network's actuarial assessment was based on QR Network self-insuring for specific claims up to \$8 million:

Any self-insured claim in excess of \$8m (1% of revenue) will be subject to "pass-through" in that such unanticipated losses can be passed through to customers separately...

QCA Draft Decision December 2009 Page 51

The Council notes the Authority's December 2009 Draft Decision, which found that QR Network had addressed concerns about previous self-insurance claims by providing an actuarial assessment of its proposed self-insurance costs and by identifying the specific risks to be insured (including flood events). Moreover, QR Network's sought self-insurance allowance was independently reviewed by PwC which found that notwithstanding issues with data, the actuarial assessment provided by QR Network to estimate the risk premium to provide insurance coverage for derailments, weather-related (including flood) events and other proposed self-insured events were reasonable. On this basis the Authority's December 2009 Draft Decision approved a self-insurance premium to be recovered within QR Network Reference Tariffs. Subsequent access undertakings submitted by QR Network, including those ultimately approved by the Authority, included the same risk and insurance allowance the Authority proposed in the December 2009 Draft Decision.

The Council requests clarification from the Authority as to the approved regulatory insurance and risk arrangements relating to the self-insurance premium and flood events. Based on the Authority's published information it appears that QR Network has accepted to self-insure for certain weather events (including flood), based on a monetary threshold for individual claims (provided the specific event is less than \$8 million). Given that both of the proposed Review Events (for the Blackwater and Moura System Reference Tariffs) are within the monetary threshold apparently applicable for approved self-insurance events, the Authority must outline why such self-insurance arrangements should not be taken into consideration when assessing QR Network's flood cost recovery application.

The Council notes that QR Network's 2010 Access Undertaking provided obligations for QR Network to complete a variety of governance processes associated with self-insurance by 31 December 2010. Including:

a resolution by the QR Network Board resolving which events are being self-insured and acknowledging that it is considered that QR Network will have sufficient financial capacity to assume such self-insured risks

QR Network 2010 Access Undertaking, Definition of Review Event, (d)(i)

In considering QR Network's application, the Council requests the Authority outlines to stakeholders:

- How the current self-insurance allowances relating to flood events was developed, including the methodology used to determine the approved self-insurance allowance;
- What specific self-insured events, including applicable monetary thresholds for specific events, have assumed by QR Network by accepting the Authority's approved risk and insurance allowances; and
- The extent to which the current level of risk and insurance coverage for flood events, as approved by the Authority and accepted by QR Network, is not relevant to QR Network's flood cost recovery application when assessing if the proposed costs are actually of an additional incremental nature.

Industry needs to be certain that QR Network has not received insurance allowances within approved Reference Tariffs for assuming certain risks which are also within the scope of the proposed Review Event application. A key requirement for Review Event assessment process by the Authority is that the approved increase in Reference Tariffs are to recover only *additional incremental* costs, otherwise this would provide QR Network with a windfall revenue.

→ **Appropriateness of aggregating separate and identifiable flood events**

Generally, insurance for a flood-related event is based on the inundation of normally dry areas by the overflow of water from a single natural water course or river. QR Network's application is presented as the aggregation of a range of specific river systems flooding the Rail Infrastructure as a single event. That is, flood damage associated with the Comet, Dawson, Fitzroy, Mackenzie and Nogoia rivers have been treated as a single entire flood event across Blackwater and Moura Systems.

Given the limited public information available with respect to the development of QR Network's self-insurance arrangements, the Council is not in a position to offer a view as to the appropriateness of the proposed aggregation of separate flooding events as a single event. This again highlights the importance of greater transparency to coal producers of the relevant risk and insurance arrangements that were endorsed by the Authority during the 2010 Access Undertaking approval process.

The Council anticipates that this matter will be considered by the Authority following its consideration of the development of the approved self-insurance allowance arrangements – that is, to what extent were the self-insurance and risk arrangements developed with the aggregation of separate events.

→ **Review Event application must be assessed against impact on the relevant Reference Tariff**

The 2010 Access Undertaking definition of Review Event specifically refers to the assessment of additional incremental costs that QR Network has incurred or will incur to be assessed against the relevant Reference Tariff. However, QR Network's application has presented the assessment of additional incremental costs as an aggregation of both the Blackwater and Moura System Reference Tariff impacts.

The Council considers that the Authority, in considering QR Network's Review Event application, is required to ensure that the threshold for triggering the cost-pass through of any *additional incremental* costs is determined on the basis of the relevant Reference Tariff. That is, the Blackwater and Moura System Reference Tariffs should be considered as separate Review Events in terms of assessing the cost-pass through trigger for approved flood recovery costs.

→ **Efficiently of proposed costs, prudence of procurement and non-coal traffic contributions**

Given that QR Network has provided general information as to the proposed flood costs sought to be recovered, the Council assumes that the Authority will undertake an audit of the costs for each major site and review the procurement methodology to ensure that only efficient and prudent costs would be recovered. Moreover, this assessment would also ensure that costs that of a capital nature are not directly passed through as an expense item.

In terms of non-coal traffics contribution towards flood costs, the Council considers that the Authority should take into consideration an appropriate approach of allocating costs towards these traffics. In assessing additional incremental costs to be recovered the separate System Reference Tariffs, the Authority may need to determine an appropriate contribution from non-coal traffics in order to ensure that there are appropriate limitations on any inappropriate cross-subsidisation as between coal and non-coal traffics. The Council notes that this process may need to take into account previous regulatory processes used to allocate maintenance and/or capital costs when determining approved Reference Tariffs.

In conclusion, given that the 2010 Access Undertaking provides the Authority with a level of discretion when considering QR Network's Review Event application, the Council requests that the Authority's position on the matters raised in stakeholder's submissions are taken into consideration and addressed in any subsequent approval process. Transparency and accountability in the regulatory regime is of paramount importance and industry looks forward to reviewing the Authority's decision on QR Network's application.

Should you wish to discuss any of the issues raised in this submission, QRC would welcome the opportunity to assist with the Authority's timely consideration of this application.

Yours sincerely

Russell Silver-Thomas