

16 April 2012

Mr John Hall
Chief Executive Officer
Queensland Competition Authority
Level 19, 12 Creek Street
GPO Box 2257
Brisbane QLD 4001

Dear Mr Hall

In December 2011, QR Network Pty Ltd (**QRN**) submitted a Draft Amending Access Undertaking (**DAAU**) to the Queensland Competition Authority (**QCA**) for its approval. The DAAU proposed three changes to the 2010 Access Undertaking (**AU**):

1. Pricing to reflect network benefits – Introduction of a single network AT5 charge, determined based on the total costs and total forecast utilisation of the electric network as a whole.
2. Electric utilisation rebate – Introduction of a requirement that operators pay AT5 for at least 90% of train services that can feasibly be operated with electric trains.
3. AT5 to provide long term price signal – Amendments to provide that, where revenue adjustments in a single year are substantial, QR Network may defer recovery of revenue cap amounts so that the total increase in AT5 is no greater than 5% per annum. Any unrecovered amount will be carried forward for recovery in a following year.

BHP Billiton Mitsubishi Alliance (**BMA**) and BHP Mitsui Coal Pty Ltd (**BMC**) do not support QRN's proposed DAAU nor any change to the current regulatory pricing arrangements. The proposed DAAU undermines the established regulatory principles underpinning the provision of diesel and electric rail infrastructure to underpin a competitive haulage market in both electric and diesel traction. The current regulatory framework has established access pricing principles which underpin the commercial decisions made by producers when negotiating long term haulage contracts (i.e. minimum 10 year contracts). Any departure from the existing regulatory pricing principles would create significant regulatory risk for industry and effectively allows for the re-opening of long-term contractual arrangements and jeopardises the commercial basis on which the original contract was executed.

Our main concerns with the DAAU broadly fall into the following three main categories:

- A. Competition Principles and whether the DAAU is consistent with the promotion of third party competition in the Queensland coal rail market;
- B. AU Framework Principles and whether the DAAU is consistent with the pricing principles and regulatory precedent contained in the AU; and
- C. Total Cost of Ownership Model and whether the DAAU is reflective of robust analysis on the real costs and benefits of diesel versus electric traction.

Competition Principles

- A fundamental tenet of National Competition Policy and the introduction of the Queensland Competition Authority Act in 1997 was the introduction of competition in the above rail market for rail services. In the last 5 years Queensland coal customers have had the competitive benefit of Pacific National entering the market as the second rail operator in Queensland. We are concerned the DAUU is seeking to use the regulatory process to discriminate against Pacific National in preference to QRN's related entity, QR National.
- A single AT5 charge effectively reduces competition between operators on the basis of cost efficiency, selection of preferred traction choice and innovation in the provision of rail services. The DAAU reduces customer market choice down to the lowest common denominator and penalises operators and producers who choose to utilise different and complementary rollingstock fleets in the interests of flexibility, innovation and security of service supply.
- There is limited to no competition in the provision of narrow gauge electric locomotives, with Siemens being the current sole supplier in the world. In contrast, there has been significant innovation and competition in the provision of diesel locomotive alternatives with current suppliers including UGL Rail and Downer EDI. The introduction of a single network AT5 will remove the competitive benefits obtained from diesel locomotive supplies and entrench Siemens monopoly pricing in the narrow gauge electric locomotive market.
- The DAAU locks electric traction in as the preferred option across the network, creates explicit cross subsidies as between electric and diesel customers and as between Goonyella and Blackwater customers whilst also imposing a diesel penalty over and above the socialisation of electric costs to further disadvantage customers and operators running diesel traction in the Blackwater System.
- The DAAU effectively ignores cost reflective pricing principles and is inconsistent with the key principles of National Competition Policy, namely:
 - Rail infrastructure services must be priced on a stand-alone basis, dependent on the traction choice of operators and customers;
 - Customers must only bear the infrastructure cost for the train services they utilise
 - Customers must have full flexibility to choose between diesel and electric above-rail technology;
 - There can be no cross subsidies between customers in the same market
 - Creation of cross subsidies within the same market creates winners and losers in the same market, encourages gaming between customers seeking to influence socialized pricing outcomes to their own gain and will result in distorted investment decisions which have no economic or commercial foundation.
- Rail operators currently operating on the central Queensland coal system have shown a willingness and ability to invest in electric locomotives in the last 5 years both in the Blackwater and Goonyella systems. This means that the commercial analysis undertaken by the rail operators would have supported the different traction investment decisions they have made over the last 5 years;
- There are currently significant numbers of electric locomotives available for use which could be utilised on both the Goonyella and Blackwater systems in the short to medium term ensuring that below rail electric assets remain fully funded.

- The current 100% market share of electric traction in the Goonyella system shows that electric traction can compete effectively with diesel traction given the appropriate pricing of above and below rail assets. Moreover, QRN has advised that by July 2012, it expects that it will be able to operate at least 90% of feasible electric services (over both Blackwater and Goonyella) with electric locomotives¹. If this is the case then it would be expected that the electric assets in both systems will remain fully funded without any change to the AU.
- QRN has explicitly stated that, assuming the cost of Blackwater is not socialised across Goonyella users, QRN would still support continued electrification of the Blackwater system on the basis of its TCO analysis. This suggests that the Blackwater electric option would remain competitive with diesel regardless of socialisation with Goonyella and diesel customers.

AU Framework Principles

- The below rail electric assets are currently recovering their maximum allowable revenue through the existing AT5 tariffs on both the Blackwater and Goonyella systems.
- The role of the QRNN is to respond to market signals with respect to the demand for rail infrastructure by preparing and costing expansions and replacements for both electric and non electric rail infrastructure in terms of the whole scope of infrastructure enhancements which could be implemented dependent on the needs of operator's and their customers.
- In submitting the previous Blackwater investment case to customers, QRN did not indicate to customers that support for the project was predicated on a fundamental change to the AU regarding the removal of traction choice for coal customers, nor did it indicate that without changes to the AU then the commercial integrity of the investment decision would be compromised.
- The operational benefit associated with the electrification of the Blackwater system is derived from the ability of rail operators to cascade their electric locomotives from the Goonyella to Blackwater systems if they lose a contract in the Goonyella system. This benefit will accrue as long as the electric system in Blackwater is operating and the AT5 plus EC charges are sufficient to provide a positive return on the otherwise sunk cost (at written down values) of the locomotive assets. QRN has not provided any evidence (i.e. a long term forecast of AT5 in the Blackwater system) to support a position that is inconsistent with this outcome occurring under the current AU.
- QRN identifies benefits from a 'buffer locomotive capacity' shifting between the Goonyella and Blackwater systems as demand requires throughout any given year. QRN has not provided sufficient detail of when this has actually occurred in recent years. Our understanding is that where an operator within a system has a relatively large fleet then the buffer capacity can be provided by shifting consists between customers rather than between systems.
- QRN's analysis is predicated on the network efficiencies that result from a 100% electric system. However, since Goonyella is already 100% electric, the marginal impact of proposed changes to the regulatory framework should be limited to perceived benefits on the Blackwater system.

¹ QR Network, Submission to QCA "Electric Draft Amending Access Undertaking, December 2011, pg 30.

- QRN has not given any consideration to the AT2 Slow Train Multiplier as a viable pricing mechanism to penalise train services if they cannot make sectional run times or operate within the reference train service parameters. If this multiplier needs to be adjusted upwards to further penalise slow train movements, then QRNN must present the required evidence to support higher penalties for inferior train performance.

Total Cost of Ownership Model

- The DAAU is predicated on the basis that an electrified rail system in the Blackwater and Goonyella systems has the lowest overall Total Cost of Ownership (TCO). We are not convinced that QRN's model is providing reliable or robust results with respect to the superiority of electric over diesel traction.
- We are concerned that QRN's model may have an inbuilt bias towards electric services and that the assumptions used in QRN's TCO model are not robust. For example significant uncertainty exists around the:
 - Future pricing forecasts for electricity and diesel fuel, with forecasts potentially being very divergent dependent on internal forecasting knowledge and capability;
 - Future forecast tonnage assumptions for the Blackwater and Goonyella systems, particularly where next stage of future demand is located in the Surat and Galilee Basins and are likely to be diesel operated;
 - Identified cycle time benefits of running only electric trains in the Blackwater system compared to the current reality where diesel trains are performing consistently at the same performance levels of the electric trains in the system;
 - Estimated costs associated with the existing investment in diesel locomotives, particularly the lack of transaction costs associated with moving from diesel to electric locomotives and effectively stranding the diesel assets;
 - QRN's advice that only preliminary modelling of the full electric and full diesel cases in the Goonyella system had been completed by QRN at the time of DAAU submission.
- We do not believe QRN has the capacity to effectively model the TCO without understanding the cost base and price signals of the second rail operator in the market. Merely assuming Pacific National has the same cost base, same rollingstock fleet efficiency, same labour market/industrial relations strategies and outcomes and same cycle time performance outcomes as QR National and its fleet of electric and diesel assets completely undermines the robustness of QRN's TCO modelled outcomes.
- QRN's transit time analysis between electric locomotives and diesel electric locomotives is based on "greenlight" running times and does not reflect operational reality within a congested rail network. Given normal operating conditions, including delays for train crossings and congestion, there is minimal difference in cycle times between electric locomotive and diesel locomotive hauled trains in the Blackwater System.
- To objectively consider the TCO model issue, we commissioned our own integrated rail economic model to replicate QRN's TCO model and embedded our own assumptions around system operating costs for diesel and electric traction choices and on future trade-off between diesel and electric pricing over time. Our model identified advantages in both diesel and electric traction but did not reveal any superiority in the selection of preferred traction choice. Rather, a customer or operator's selection of a preferred traction choice is heavily reliant on that customer or operator's future' view of the diesel electric pricing trade off. This means traction competition, flexibility in service choice and cost efficiency are key competitive

considerations for any customer seeking to negotiate a new rail haulage contract in Queensland.

Future Processes

We have participated in a cross-industry working group to consider the electric traction issues identified by QRN in its DAAU. We remain unconvinced on the rationale and merits of the DAAU and recommend the QCA reject the DAAU in its current form. We remain open to further discussions with QRN on the issues they have raised in the cross-industry working group, but we reserve our rights in respect to this process.

If you have any queries or require more information, please do not hesitate to contact Tanya Boyle on Telephone 0459 812 257.

Yours sincerely



Gordon Carlyle
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