

11 June 2013

Mr Paul Bilyk
Director
Queensland Competition Authority
Level 19, 12 Creek Street
GPO Box 2257
Brisbane QLD 4001

Dear Mr Bilyk

Aurizon Network's 2013 Blackwater AT5 Draft Amending Access Undertaking

On 24 April 2013, Aurizon Network (AN) submitted a draft amending access undertaking (2013 AT₅ DAAU) to the Authority. BHP Billiton Mitsubishi Alliance (BMA) and BHP Mitsui Coal Pty Ltd (BMC) welcome the renewed opportunity to provide a submission under this process. We refer to our April 2012 submission to the Authority on AN's 2011 Electric Traction DAAU (2011 DAAU) and request that the issues raised in that submission be considered by the Authority in the context of this 2013 AT₅ DAAU.

We recommend the Authority reject the 2013 AT₅ DAAU for the reasons set out in this submission. Specifically, AN has not addressed the issues raised by stakeholders or the Authority through the 2011 DAAU and relies heavily on the Authority's Working Paper (issued in January 2013). This Working Paper has no regulatory standing and stakeholders were not afforded any opportunity to respond to the Authority on the issues contained within it. It is our position that the 2013 AT₅ DAAU

- does not represent a compromise position by AN
- does not respond to any of the concerns raised by the Authority in its Draft Decision
- does not reflect any recognition of the genuine concerns held by users of the Queensland Coal Network (QCCN); and
- appears focused only on ensuring AN is guaranteed its full regulatory return on the capital invested by AN as part of the Blackwater Electric Upgrade Program.

1. The 2013 AT₅ DAAU does not respond to the Authority's Draft Decision on the 2011 DAAU

Importantly, the Authority noted in its Draft Decision on the 2011 DAAU, that it had a number of concerns with the 2011 DAAU. Specifically that:

- AN had not made a convincing case that electric traction is more efficient than diesel;
- it would effectively compel all train operators to use electric traction when the choice of traction type should be left to the competitive market;
- it would adversely affect competition in several above rail markets and would have an adverse impact on the interests of current and future access seekers/holders;
- it was not consistent with the objects clause of Part 5 of the *Queensland Competition Authority Act 1997* (the QCA Act) or with the pricing principles in section 168A of the QCA Act;
- it is not in the public interest; and

- it would be best left as an issue to be dealt with as part of the 2013 Draft Access Undertaking (UT4).

Despite the Authority's reasoning in the Draft Decision, AN submitted the 2013 AT₅ DAAU as part of a separate process to the recently submitted 2013 Draft Access Undertaking.

2. The 2010 Access Undertaking (UT3) provides flexible pricing arrangements to manage short term asset pricing risks from new investments

The application of a fixed electrification charge plus revenue deferral could potentially be implemented by AN without the need to submit the 2013 AT₅ DAAU. Under Clause 3.3.2 of Schedule A, the 2010 Access Undertaking contemplates that if an investment has not gone through a valid pre-approval of scope process, and the resultant demand for the project is not forthcoming on completion, then AN can defer full asset inclusion in the asset base until the demand for the service occurs. Under these circumstances, AN can capitalise the losses at the regulatory rate of return and recover that revenue in future revenue streams.

We support this flexible pricing approach as the means through which AN can apply a fixed electric charge over the two undertaking periods (UT4 and UT5) and deliver itself an NPV neutral outcome. We argue that the pre-approval process underpinning the Blackwater electric upgrade program did not constitute a valid pre-approval of scope (see note 6 below) and so it is reasonable for AN to rely on Clause 3.3.2(d) in order to address the current Blackwater electric pricing issue without the need for a DAAU.

If AN has confidence in all the parameters it has applied to its Total Cost of Ownership (TCO) model and the pricing based on an 85% utilisation rate, then we believe AN is in the best position to stand behind that analysis. It is therefore within AN's existing regulatory scope to apply a fixed electrification charge and defer any revenue forgone to a future date when the demand for electric paths increases.

However, should the Authority be of the opinion that the 2010 Access Undertaking provisions in Clauses 3.3.2 of Schedule A are not broad enough to allow AN to utilise this loss capitalisation option for the Blackwater electric upgrade, then we would be supportive of AN submitting a new AT₅ DAAU to achieve this outcome, in advance of the 2013 Draft Access Undertaking process.

3. The 2013 AT₅ DAAU is inconsistent with the QCA Act

The 2013 AT₅ DAAU proposes the introduction of an Under-Utilisation Payment (UUP) in the event the revenue from the new fixed electrification charge falls short of the total approved costs at the end of UT4 and UT5. We do not support the application of a UUP as it is inconsistent with the QCA Act.

Existing access holders and users have made decisions and entered into haulage contracts on the basis of the current regulatory pricing arrangements. Accordingly, we do not support changing the UT3 pricing arrangements without a robust economic and regulatory justification and without AN bearing some of the risk associated with their short-comings with the Blackwater electric upgrade program. Moreover, we do not support AN applying electric infrastructure charges to users who do not use the electric infrastructure and who do not gain any benefit from the investment having been made.

In deciding whether or not to approve the 2013 AT₅ DAAU, the Authority must take into consideration the interests of users¹. Under all three UUP options put forward by AN, there will be some users who will potentially be charged for infrastructure from which they derive no benefit or utilisation of.

4. The DAAU does not demonstrate or provide sufficient evidence to support Aurizon Network's position that:

- a. electric traction is superior to diesel traction; and**
- b. that there is a situation of actual bypass in the Blackwater System.**

AN's rationale for its analysis is critically dependent on these two key assumptions. In the 2011 DAAU, AN provided some details of its TCO modelling it had undertaken to justify those assumptions. The TCO modelling approach was rejected by the QCA (and users). Despite this, AN continues to rely on the 2011 TCO model and assumptions to justify the application of a UUP. It is not clear why AN expects the

¹ Section 143(2) and 138(2)(e).

2011 TCO modelling to be acceptable to the Authority on this occasion, particularly given AN has not responded to the Authority's previous concerns with the modelling undertaken.

5. We have significant reservations around compensating AN for optimisation risk in the weighted average cost of capital (WACC) when this risk can be fully mitigated if the pre-approval process is appropriately managed.

The WACC provides compensation for systematic (and therefore non-diversifiable) risk. Optimisation risk is considered a non-systematic risk. Therefore, it would be inappropriate for the Authority to adjust the WACC for non-systematic risks as proposed in the January 2013 Discussion Paper².

Mechanisms other than the WACC are currently used to compensate AN for optimisation risk. UT3 minimises optimisation risk by providing clear guidance around the circumstances when assets will be optimised. Further, **Schedule A of UT3** includes detailed processes which allow for the pre-approval of the scope and standard of work which if managed properly would fully mitigate optimisation risk.

6. AN should not be 100% insulated from all rate of return risk when there was a failure in the Coal Rail Infrastructure Master Plan (CRIMP) process where AN did not disclose:

- a. **the full costs of the electric upgrade investment; and**
- b. **the pricing impact on the Blackwater AT5 in the absence of future approval of a socialisation of electric costs across Blackwater and Goonyella**

The QCA has recognised that it does not intend to strand assets supported by users in the CRIMP process unless it can be shown that AN provided information that was false or misleading. In the case of the Blackwater electric system upgrades the evidence shows that users were presented with information that was incomplete and misleading with respect to both the cost and pricing of the electric system upgrades.

The supporting documentation that AN prepared for the CRIMP process:

- 1) acknowledged that the decision to invest was dependent on the assumption that the total cost of ownership of the electric locomotives was less than that of diesel locomotives, but provided no detail on how AN was assessing this trade-off and, importantly, provided no indication that users would be collectively bearing the risk of AN's assessment of this trade-off³; and
- 2) did not detail the material increase in the cost of Powerlink's connection assets (which are recovered as part of Powerlink's operating charge) to users when it was presenting its analysis – or at least raise the possibility that such an increase could occur

As result, the cost of utilising electric infrastructure was significantly understated and users were required to make a decision based on an incomplete and incorrect assessment of the relative merits of diesel over electric traction.

At the same time, AN's proposal provided misleading signals with respect to the pricing of the Blackwater electric infrastructure. The CRIMP documents were based on an assumption that the below rail electric assets of Blackwater and Goonyella would be combined with the result that the Blackwater AT₅ would fall significantly despite the investment in the upgrades. This pricing approach was subsequently rejected by the Authority and the pricing of the Blackwater assets reverted to the previous standalone costing method. AN did not advise Blackwater Users of the pricing impact the Authority's Draft Decision had on the Blackwater electric upgrade. AN could have provided this information as the Draft Decision pre-dated the Powerlink connection contract.

7. AN has not fully revealed the decision making process related to Rolleston electrification investment proposition as required under the CRIMP process.

The 2008 – 2009 approval process for the Blackwater power system upgrades highlighted the complexity and risk associated with the approval process for electric infrastructure assets. Given this is

² QCA, Discussion Paper, Workshop on the Electric Infrastructure Tariff (AT₅), January 2013 (Page 3).

³ AN never disclosed that that the electric investments would only be viable on the condition that 85% of feasible electric paths were used, or that the approach to pricing would need to be dramatically altered such that diesel services would be required to contribute to the cost of electric infrastructure.

the case we are surprised AN has not ensured that the approval process for the Rolleston electric upgrades is open and transparent. We are again being asked to provide opinions on matters of large financial consequence without being provided with the information necessary to make an assessment.

8. We have concerns with the QCA approval process.

Section 142 of the QCA Act requires the Authority to approve or refuse to approve the DAAU. Rather than submitting a proposed amendment for approval, the 2013 AT₅ DAAU presents several options for implementation. We request the Authority clarify how the 2013 AT₅ DAAU fits within the legislative framework of the QCA Act and the process the Authority intends to take when a DAAU presents a number of regulatory pricing options for approval. In our view, the 2013 AT₅ DAAU holds no regulatory precedent.

For more detail on the above issues, please see the attached supporting document.

Given the failure of the CRIMP process, the questions around AN's TCO modelling and the lack of information presented to support the 2013 AT₅ DAAU's assumption around an 85% utilisation rate, AN should not be able to shift all of the risks associated with the electric traction investment to the users and leave itself whole from a capital and revenue perspective. To the extent AN considers that the outcome of the UT3 pricing arrangements to be sending the wrong price signals, AN must bear the consequences of its flawed management of the CRIMP approval process i.e. the risks associated with moving to a fixed AT₅ price path over the next two undertaking periods.

On this basis, we would be supportive of an AN approach where it introduces a fixed price path for AT₅ and defers some of its current revenue stream in the expectation that AN can recover the lost revenue in a future regulatory period. We are similarly supportive of allowing AN to escalate any revenue shortfall at the regulated rate of return. This outcome will ensure AN maintains the ability to recover the majority of its Blackwater electric investment over the UT4 regulatory period whilst it manages the electrification of the Rolleston branch line in accordance with the CRIMP process. Under AN's proposed position, a fixed price path plus Rolleston electrification will enable AN to maintain the AT₅ rate through UT5 and fully recover all of its revenue and be revenue neutral as to whether its AT₅ costs are correctly recovered in UT4 or collectively recovered over the UT4 and UT5 regulatory periods.

Our support for the above approach is contingent on the removal of the UUP pricing structure. We are of the view that a UUP is inconsistent with the QCA Act, particularly if it is to be applied to the access charges of diesel and non-Blackwater users.

We note there is precedent for our recommended approach in other regulatory regimes.

- The National Gas Rules allow for the use of a Speculative Capital Expenditure Account⁴. This means non-conforming capital expenditure can be added to a notional fund, the balance of which is increased annually at a rate determined by the regulator. When the capital expenditure complies with the new capital expenditure criteria the relevant portion is then rolled into the asset base.
- ARTC has capitalised a portion of its revenue in regard to Gunnedah region (Zone 3) in NSW, where ARTC formed a view that recovering its full allowable revenue from current coal traffic would result in an excessive access charge. ARTC expects that volumes in Zone 3 will grow over time and allow for the full recovery of the escalated deferred revenue. The ACCC has supported this approach. To the best of our knowledge, ARTC did not receive any guarantee of the recovery of the deferred revenue, nor approval to recover it from users in other Zones in the event that Zone 3 volumes do not grow as expected, nor any adjustment to the WACC for bearing this risk.

Whilst an outcome based on Aurizon Network deferring revenue and accepting the risk of later recovery is acceptable to BMA, we also believe this represents the best outcome for AN as it would demonstrate AN's efficient management of its regulated business and demonstrate a genuine belief on Aurizon's part that further investment in electric infrastructure, particularly the Rolleston electrification, is a robust business decision based on the relative efficiency of electric traction compared to diesel traction.

⁴ National Gas Rules, Version 17, Rule 84.

We request the QCA carefully consider the regulatory precedents that would be set across Australia, amongst all regulated businesses, if it accepts the 2013 AT₅ DAAU. At its simplest, the 2013 AT₅ DAAU proposes to allow AN to recover infrastructure costs from users that do not gain any benefit from that infrastructure and promotes inefficient and non-commercial management of the CQCN.

If you have any queries or require more information in relation to this submission, please contact Tanya Boyle on telephone [REDACTED] or mobile [REDACTED]

Yours sincerely

[REDACTED]

Neil Buckley ✓
Senior Manager
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ATTACHMENT

BMACC Submission on Aurizon Network's 2013 Blackwater Electric Traction Pricing Draft Amending Access Undertaking (2013 AT₅ DAAU)

BHP Billiton Mitsubishi Alliance (BMA) and BHP Mitsui Coal Pty Ltd (BMC) have a number of concerns with the 2013 AT₅ DAAU, specifically we:

- do not support the conclusion that electric traction is superior to diesel;
- consider Aurizon Network (AN) has failed to present sufficient evidence that there is actual bypass;
- have concerns with the rationale for compensating AN for optimisation risk;
- believe the DAAU with the application of an Under-Utilisation Payment (UUP) is inconsistent with the *Queensland Competition Authority Act 1997* (QCA Act);
- do not believe AN should be fully insulated from all risk due to its failure to provide adequate information to the 2010 Coal Rail Infrastructure Master Plan (CRIMP) process;
- have concerns with AN's decision making process related to Rolleston electrification;
- have concerns with the Queensland Competition Authority (QCA) process and the options based approach AN has taken in the 2013 AT₅ DAAU.

These concerns are outlined below.

Efficiency of electric traction compared to diesel

One of the key rationale's for AN's proposed DAAU is that electric trains are significantly more efficient than diesel locomotives. This analysis appears to rely on the same total cost of ownership (TCO) model that was detailed in the original DAAU that was rejected by the QCA in its draft decision¹ in July 2012. Key issues with this analysis include:

- 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, these would be expected to have changed significantly over the past twelve months;
- 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 the stranding of diesel assets;
- the assumption that Aurizon's operating costs could be assumed for PN (and other rail operators);
- basing the transit time analysis between electric and diesel electric locomotives on proposed green light running times rather than the normal operating conditions that take into account the impact of delays for train crossing and congestion in the network;
- potential new diesel developments which will enable a three diesel locomotive train consist to perform to the same operational performance standards as a three electric locomotive train consist (compared to the current four diesel locomotive consists which are operating in the Blackwater System); and

¹ QCA, Draft Decision, *QR Network Electric Traction Services Draft Amending Access Undertaking*, July 2012.

- evidence from other heavy haul railways in Australia.

It is noted that AN states that “AN’s TCO model has been independently reviewed”² by the Sapere Research Group. This report is presented as an appendix to the DAAU and it clear that this is not the case. The majority of the report is a discussion of the relative economic merits of alternative pricing approaches for AT₅ rather than a review of the TCO model and statements such as the one quoted below, clearly indicate that that Sapere did not do any independent modelling of the TCO but relied on AN’s own modelling and assumptions:

“Aurizon advises me that electric traction is substantially less expensive per gtk than diesel traction, assuming moderately high utilisation of electric infrastructure. This conclusion is based on total cost of ownership modelling. I have examined this modelling and, on the assumption that the input data is accurate, I find it convincing.”³

It is also noted that while AN is correct in stating that:

“The key TCO assumptions have been previously distributed to the QCA and stakeholders”⁴

However, distribution cannot be considered as acceptance. It is unclear why AN has not addressed specific criticisms of its modelling and assumptions contained in the QCA’s Draft Decision on AN’s 2011 Electric Traction Services DAAU (2011 AT₅ DAAU).

Given the TCO modelling issues identified by the QCA and users, have not been explicitly addressed in this DAAU, these issues remain outstanding and unresolved. We do not believe the modelling results can be relied on by the QCA in making a decision on the current DAAU. It is surprising to us that AN has not presented any updated information or assumptions around the model, particularly given that this modelling will be integral to any decision by customers to electrify the Rolleston spur in accordance with the CRIMP process.

Failure to present evidence of actual bypass

AN has not presented supporting evidence of actual bypass of the electrification infrastructure. The hypothesis that an increase in the AT₅ will make long term investment in electric locomotives uneconomic and result in a cycle where less the electric infrastructure becomes redundant ignores the long term asset life of the electric locomotive fleet.

Above rail operators buy locomotives to operate for up to 30 years and would be looking to achieve a benchmark return on capital over the life of the asset. Once purchased the locomotives would be expected to be utilised as long as the revenue that they generated was greater than the marginal cost of operation. As a result, it would be expected that an above rail operator would utilise its existing fleet of electric locomotives as long as the marginal cost of operation (including the AT₅ charges) was below the marginal revenue generated from its operation. The floor to the marginal revenue would be set by the price of running a diesel locomotive on the same route. It may be that this would result in a lower than expected return on the asset during this period, but the asset would continue to be utilised. This point is not acknowledged by AN.

To show that the electric infrastructure is likely to be bypassed under the current pricing methodology AN needs first to show:

1. an estimate of the likely AT₅ given the current fleet of electric locomotives (including any new locomotives that are expected to come on line given each operator’s committed purchasing plan); and
2. that at the level of the likely AT₅, the tariff would lead to the above rail operators choosing to not operate their electric locomotives during the current regulatory period.

² Draft Amending Access Undertaking for electric traction pricing in Blackwater (AT₅), AN, submission to the QCA, April 2013 (page 11).

³ Economic analysis of revised Aurizon DAAU for electric infrastructure, Independent report for AN prepared by Sapere Research Group, April 2013 (page 4).

⁴ Draft Amending Access Undertaking for electric traction pricing in Blackwater (AT₅), AN submission to the Queensland Competition Authority, April 2013 (page 11).

Compensating Aurizon Network for optimisation risk

The AN approach reflects comments made by the QCA in its Discussion Paper on the electric infrastructure tariff⁵. It is noted that this paper was issued by the QCA Secretariat and does not represent the fully considered views of the QCA Board. BMA concurs with the QCA Board's Draft Decision on the 2011 AT₅ DAAU. BMA queries the QCA's Discussion Paper and whether it can be relied on by AN to support the 2013 AT₅ DAAU without addressing the full range of concerns raised by the QCA in its Draft Decision on 2011 AT₅ DAAU.

BMA questions two propositions put by the QCA Secretariat in the Working Paper:

- that AN's weighted average cost of capital (WACC) is set on the assumption that the assets will only be optimised once when the assets enter the asset base and, if the current approach is changed to allow subsequent optimisation, the WACC will need to be increased; and
- that to the extent optimisation risk is not compensated for in an increase in the WACC (which would affect all users), it is reasonable for all users to pay for any action (regardless of AN's competence and efficiency in management of the investment) to avoid optimisation risk.

It is unclear how the QCA Secretariat reached the conclusion that the WACC has been set on the basis that the assets will only be optimised once, at the time the assets entered the asset base. The current WACC was set in the context of UT3 which included a number of circumstances in which AN's assets may be optimised. AN's 2010 Access Undertaking clause 1.4 of Schedule A lists a number of circumstances where assets can be optimised.

- a) The QCA has made its decision to accept the expenditure in the Regulatory Asset Base on the basis of information provided by AN that AN knew, or should have known, was false or misleading at the time it provided the information*
- b) Circumstances arise in the future where demand has deteriorated to such an extent that regulated prices on an unoptimised asset would result in a further decline in demand*
- c) It becomes clear there is the possibility of actual (not hypothetical) bypass*
- d) An End of Period Assessment conducted in accordance with clause 5 of this Schedule determines that the Rail Infrastructure has deteriorated by more than would have been the case had good operating practice and prudent effective maintenance and asset replacement policies and practices been pursued.*

Further, asset stranding risk, which encompasses optimisation risk, is considered a diversifiable risk. The WACC uses CAPM to determine the return on equity component. CAPM is based on portfolio theory which compensates an investor for risks that cannot be diversified by holding a balanced portfolio, that is, CAPM does not compensate investors for asymmetric risk. The Access Undertaking contains mechanisms to mitigate optimisation risk specifically

- limiting optimisation to four circumstances (listed above); and
- the ability of the AN to seek pre-approval to protect it from optimisation.

Consequently, it would be inappropriate for the QCA to adjust the WACC or allow further allowance for asset stranding/optimisation risk.

⁵ QCA, Discussion paper Workshop on the Electric Infrastructure Tariff (AT5), January 2003.

The 2013 AT₅ DAAU inconsistent with the *Queensland Competition Authority Act 1997*

We do not consider it reasonable for all users to pay for the risk of optimisation of a particular class of assets. Furthermore, the view put forward in the QCA Discussion Paper is inconsistent with the position previously taken by the QCA in its Draft Decision.

In AN's 2011 AT₅ DAAU, AN proposed to recover some of the Blackwater electric infrastructure costs from Goonyella electric trains and from Blackwater diesel trains. QCA rejected AN's proposal on two grounds:⁶

1. The socialisation of costs from one system to another would be a departure from the undertaking's reference tariff-setting rules, specifically, the pricing limits rules. The 2010 Undertaking specified that:⁷

"...price limits will apply in respect of Access Charges to be established for a Train Service such that, over the Evaluation Period, the expected Access revenue (determined in accordance with Clause 6.2.3(c)) for any combination of Train Services incorporating a Train Service:

- (i) Will not fall below the level that will recover the expected Incremental Cost of providing Access for that combination of Train Services; and*
- (ii) Subject to Clause 6.2.1(b), will not exceed the level that will recover the expected Stand Alone Cost of providing Access for that combination of Train Services."*

QCA considered that AN's proposal would involve Goonyella electric trains paying more than stand-alone costs of the Goonyella system, as they would be paying for assets in the Blackwater system that they do not use. Therefore this socialisation of costs from one system to another represents a departure from the pricing limits.⁸

2. Although QCA can approve a departure from these pricing rules for the primary purpose of promoting efficient investment by either AN or another person in the coal chain, the QCA was not satisfied, based on the information available then, that it was appropriate to approve such a departure as the QCA was not convinced that electric traction is superior to diesel traction. The QCA noted that:⁹

"it could be possible that the proposed DAAU would over-signal the benefits of investments in electric trains. The adverse economic impact of an over-investment in electric traction could be as significant as the currently claims adverse impact of an under-investment in electric traction".

QCA's previous position on the socialisation of costs from one system to another is that it would represent a departure from the pricing limits specified in the undertaking, and may be inconsistent with the object of Part 5 of the QCA Act to the extent that it is not promoting efficient use of the infrastructure. For AN to now suggest in the current DAAU that it would be appropriate to recover the costs of the electric traction from all users is inconsistent with previous views expressed by the QCA, and is inconsistent with the Part 5 of the QCA Act.

The fundamental proposition in AN's 2013 AT₅ DAAU is that if there is any revenue shortfall from its Blackwater electric infrastructure, then users will have to pay for it via a UUP. AN is not particular about which users pay the UUP as long as AN remains whole from a capital and revenue perspective. We believe the application of a UUP must not be endorsed by the QCA because:

- it is inappropriate to attribute the shortfall in revenue from Blackwater electric asset to users that do not use the Blackwater electric infrastructure; and
- there are circumstances where it is not appropriate to attribute the revenue shortfall to Blackwater electric users.

⁶ QCA Draft Decision, *QR Network Electric Traction Services Draft Amending Access Undertaking*, July 2012 (Page 60).

⁷ Clause 6.2.3, *QR Network's 2010 Access Undertaking*, as approved 1 October 2010.

⁸ QCA Draft Decision, *QR Network Electric Traction Services Draft Amending Access Undertaking*, July 2012 (Page 60).

⁹ QCA Draft Decision, *QR Network Electric Traction Services Draft Amending Access Undertaking*, July 2012 (Page 60).

The three options for the UUP in the DAAU include:

1. users of the Blackwater system at the end of UT4 and UT5 if required;
2. users of the CQCN at the end of UT4 and UT5 if required; and
3. users of the Blackwater system at the end of UT4 and allocating the UUP charge across all users of the CQCN at the end of UT5.

BMA does not consider any of the three options satisfy the requirements of the QCA Act. In deciding the terms and conditions for access the QCA needs to take into consideration the interest of persons holding contracts for use of the infrastructure¹⁰. With all three proposals, to the extent there is a revenue shortfall, users will be charged for infrastructure from which they derive no benefit or utilisation of.

AN has argued for the inclusion of a UUP to protect it from the volume risk of electric haulage. It has identified two causes of the volume risk:¹¹

- the risk that electric haulage will not reach Aurizon's target 85% of feasible electric volumes because above-rail operators opt for diesel despite the reduction in AT5 ('electric utilisation risk'); and
- the risk that electric haulage volumes are lower than forecast because system volumes do not reach forecast levels ('system tonnage risk').

Whilst BMA accepts that users should bear the 'system-tonnage risk', BMA strongly objects that 'electric-utilisation risk' be borne by users for the following reasons:

- the target electric utilisation rate of 85% may well not be an appropriate target level. AN has provided no evidence that justifies 85% as an appropriate electric utilisation rate¹² Therefore users should not be penalised for the consequences of that target not being achieved; and
- users should not be penalised for making rational business decisions that maximise their business interests. To the extent that diesel is a more efficient option, diesel users should not be penalised through a UUP for using this option.

It is recommended the QCA reject the inclusion of a UUP. If AN is confident in its analysis that shows that electric haulage is more cost effective than diesel, and that 85% electric traction utilisation is efficient, AN should be confident that they can achieve revenue recovery under the current regulatory pricing without the need for a UUP.

However, to the extent the QCA Board is minded to accept elements of the DAAU and apply a UUP, we recommend the UUP should only apply to the users of the electric assets on the Blackwater system. However it would still not be appropriate for those electric users to bear all of the volume risk for this investment. Notably, there are other potential causes for revenue shortfalls which might occur independent of the volume risks raised by AN. Other reasons for non-achievement of revenue could be asset deterioration as a result of poor maintenance, or delays in the construction of electric assets which restrict utilisation of the electric assets. Blackwater electric users should not be responsible for the revenue shortfalls attributable to these causes.

Is it worth noting that the issue which Aurizon originally sought to address was the risk of bypass (the electric share of tonnes being low because of traction choices) yet the UUP would impose on all users (including diesel users) a charge resulting not only from an insufficient electric share of volumes, but also resulting from overall volumes being below the forecasts used by Aurizon. The need to do this appears to arise from an inherent disadvantage of electric traction, being that it involves a relatively high portion of fixed costs, which, when combined with Aurizon's decision over successive undertakings to not apply take or pay to AT5, can cause large revenue shortfalls. We do not consider that Aurizon has explained the proposal to socialise volume risk (as opposed to traction mix risk) and the revenue risk arising from a zero take or pay position, with users of diesel trains.

¹⁰ Section 143(2) and 138(2)(e) of the QCA Act.

¹¹ *Draft Amending Access Undertaking for electric traction pricing in Blackwater (AT5)*, April 2013 (Page 7).

¹² *Draft Amending Access Undertaking for electric traction pricing in Blackwater (AT5)*, April 2013 (page 11).

Failure of the CRIMP Process

The 2010 Access Undertaking contains a regulatory pre-approval process, this process is outlined in Clause 2 of Schedule A which states that the QCA will accept all prudent capital expenditure into the Regulatory Asset Base. Prudency is defined as having three aspects

- a) prudency in scope;
- b) prudency in standard of works; and
- c) prudency in cost.

If in managing this approval process AN provides information to users and the QCA which is not consequently shown to be false or misleading, the QCA has no option but to accept the assets into the asset base.

AN has argued that users should bear all the consequences of the investment in the Blackwater electric traction assets because it was approved by users through the CRIMP process. We agree users did approve the scope of the electric assets for the Blackwater power system upgrade through the 2008 CRIMP process, however questions remain around the validity of that approval process due to the limited information provided by AN prior to and during the customer voting process.

Our main concern is that, users were only informed of, and subsequently approved, the \$120M capital expenditure proposed in the 2008 CRIMP, other significant costs, namely the Powerlink connection costs were not mentioned in the 2008 CRIMP. The Powerlink connection costs have subsequently been included in the UT4 AT₅ calculation, and represents a significant component of the AT₅ tariff.

Our concerns around the details of the CRIMP processes include the following:

1. 2008 CRIMP

In 2008, AN proposed to seek endorsement from industry on a number of rail infrastructure projects to facilitate growth in the coal supply chains. The Blackwater power system upgrade project associated with SBB76 was a component of this Master Plan, which sought funding as part of the 2008 Master Plan customer vote process. The proposed scope included:¹³

- power system upgrade including 4 Feeder Stations at Raglan, Bluff, Duinga, and Wycarbah;
- filters and compensators for AC traction locomotives; and
- replacement of pinpoint detectors for AC traction locomotives.

The project was estimated to be at a cost of \$120 million (in 2008 dollars), and was expected to be delivered within the period 2009-2011. At the same time, as a result of the O'Donnell Review of the Goonyella Coal Chain, Aurizon publicly committed to purchasing AC traction locomotives that could only be used in the Blackwater system if AN completed the electric upgrade program.

AN received industry endorsement to proceed with the project in the 2008 CRIMP.

2. 2009 QCA defer regulatory pre-approval

In February 2009, the QCA made a decision to defer regulatory pre-approval for this project on the basis that "it was not clear the project was General Expenditure Capital Expenditure"¹⁴.

3. 2009 March CRIMP Working Paper

AN has acknowledged that the 2008 Master Plan contained only high level information on this project and that a number of customers requested more explanation of the project prior to this commencement. Subsequent to the publication of the Master Plan, further detailed electrical capacity modelling and more explanations on the rationale for these projects were provided by AN in its March 2009 CRIMP Working Paper.¹⁵

¹³ *Coal Rail Infrastructure Master Plan*, 2nd Edition, Issue: October 2008 (page 14).

¹⁴ *Draft Amending Access Undertaking for electric traction pricing in Blackwater (AT₅)*, April 2013 (page 12).

¹⁵ QR Network, *Working Paper 4.5 Rationale for Power System Upgrade in the Blackwater System, A Coal Rail Infrastructure Master Plan Working Paper*, March 2009.

In the 2009 Working Paper, apart from the three categories of capital expenditure specified in 2008 CRIMP, two more cost components were provided:

- overhead wiring (OHW) to new main line track, which is estimated to cost \$40 million¹⁶; and
- transmission costs charged by Powerlink and the “connection fee” covering the Powerlink asset connection to the QR feeder station.

AN submitted that:¹⁷

“Power is purchased by QR Network from a non-regulated Electricity Retailer, and supplied to the QR Network feeder stations by a regulated transmission system (owned and maintained by Powerlink). For practical considerations, QR Network purchases the power and includes the cost in the regulated train service charge it applies to electric train operators. This also includes the transmission costs charged by Powerlink and the “connection fee” covering the Powerlink asset connection to the QR feeder station.

These costs are to be include in Tariff as an operational expense (cost is site location specific). Notional cost for 132kV feeder line is \$1m/km, with the Powerlink switchgear and other equipment for each site up to \$10m.”

While the QCA subsequently approved the \$120M Blackwater power system upgrade in April 2009¹⁸, it did not have to approve the Powerlink cost because it would be treated as an operational expenditure that feeds into the tariff over the regulatory period.

At no stage in this CRIMP approval process did AN provide a TCO model to users to underpin the investment in the electric infrastructure. The pricing included in the working papers was based on AN’s UT3 proposal to socialise AT₅ across Blackwater and Goonyella. This proposal was subsequently rejected by the QCA as part of its Draft Decision on UT3 but QR Network continued with the investment in the upgrades. At no point following the Draft Decision, did AN return to users to advise them of the stand-alone pricing implications of the Blackwater electric upgrade program on Blackwater users. Had this information been revealed at this point, Blackwater users may have queried the investment in more detail. It is noted that the timing of the Draft Decisions and the potential opportunity for AN to provide this information to Blackwater users actually pre-dates AN entering into the commercial contract with Powerlink on its Blackwater connection costs.

4. Inclusion of Powerlink connection cost in UT4 AT₅

In AN’s 2013 DAAU, the costs associated with the provision of the Powerlink connections services represent a significant component of the AT₅ tariff. The connection costs are forecasted to be more than \$30 million per year throughout the UT4 period.¹⁹

Throughout all of the CRIMP processes, users were unaware of the size of the additional capital expenditure associated with the Powerlink connection costs. At no time during the approval process did AN return to users to advise them of the higher than expected Powerlink costs and the impact those costs would have on the Blackwater AT₅ reference tariff. Had AN made the Powerlink connection cost information available to users, then users would have had an opportunity to review the project or to agree to proceed regardless of the additional costs. Under these circumstances a customer vote outcome may have been different to what has eventuated.

The lack of quality information made available to users through the CRIMP processes meant that the customer voting outcome was based on flawed assumptions and flawed information. We believe AN must take some responsibility for the flaws in the management of the CRIMP process and the limited information that was presented to users on which to base their decision.

¹⁶ QR Network, *Working Paper 4.5 Rationale for Power System Upgrade in the Blackwater System, A Coal Rail Infrastructure Master Plan Working Paper*, March 2009 (page 25).

¹⁷ QR Network, *Working Paper 4.5 Rationale for Power System Upgrade in the Blackwater System, A Coal Rail Infrastructure Master Plan Working Paper*, March 2009 (page 12).

¹⁸ <http://www.qca.org.au/files/R-2008AUammend-QCA0FinalDec08CustVote-0409.pdf>

¹⁹ *Aurizon 2013 Draft Access Undertaking, Volume 3: Maximum Allowable Revenue and Reference Tariffs*, 30 April 2013 (page 247).

Rolleston Electrification

AN is currently assessing whether or not to electrify the Rolleston spur. This is a critical decision that requires detailed, open, transparent analysis by AN to allow it, and its customers, to make an informed decision on the merits of the investment. To date this has not been the case and it appears that similar mistakes, to those which were made during the 2008-09 Blackwater electric upgrade decision making process, are being made again:

- AN is beginning its analysis of the options with the assumption that an electrified network is the preferred option and as a result its analysis appears biased;
- AN has not presented a base case that clearly outlines the investments required and probable below rail tariffs that would result if no electrification was undertaken;
- the decision making process is being significantly complicated by being combined with a proposal which will significantly affect the pricing of the investment; and
- the decision making process is being extended by uncertainty over how the investments in the electric assets will be priced.

AN's approach to the assessment of whether or not to electrify the Rolleston branch line does not appear to be an improvement on the flawed process that was used to assess the Blackwater electric system upgrades in 2008-09. Again AN appears to be making decisions on the basis of information which either has not been collected or is not being provided to the users. Perhaps more importantly AN is leaving itself open to a perceived conflict of interest between its decisions to electrify Rolleston and the long term utilisation of Aurizon's above rail electric locomotive fleet. AN has had twelve months since its previous DAAU to address these issues and failed to do so in the information it has made available to users.

QCA Regulatory Process

The process with respect to the 2013 AT₅ DAAU is inconsistent with the preparation and approval of draft amending access undertakings²⁰:

- on 16 December 2011, AN submitted its first 2011 AT₅ DAAU and users had the opportunity to provide submissions;
- on 27 July 2012, the QCA released a Draft Decision. Consistent with regulatory practice, AN and users had a further opportunity to make comment on the QCA's Draft Decision;
- on 22 January 2013, the QCA held an industry workshop to discuss the issues raised in the 2011 AT₅ DAAU. The QCA Secretariat released a Discussion Paper to facilitate discussion at the workshop. Both AN and users had an opportunity to participate at the workshop, but users did not have an opportunity to make formal submissions to the proposals put forward in the Secretariat's Discussion Paper;
- on 21 January 2013, AN withdrew the 2011 AT₅ DAAU in anticipation of further discussion occurring in the Workshop; and
- the QCA released minutes of the Workshop which identified no agreement between AN and users was reached.

Despite the fact that the Workshop Discussion Paper is non-binding on the QCA and the Minutes of the QCA Workshop identified that no consensus was reached, AN has now submitted the 2013 AT₅ DAAU which relies on the proposals and propositions put forward in the Workshop Discussion Paper. AN's 2013 AT₅ DAAU does not refute or address the QCA's original reasoning for the rejection of its 2011 AT₅ DAAU. At the same time, the 2013 AT₅ DAAU puts forward three recommended options which are of equal merit to AN as opposed to submitting a proposed recommended UT3 amendment for QCA approval. Section 142 of the QCA Act requires the QCA to approve or refuse to approve the DAAU.

We request the QCA clarify the process it intends to take on this DAAU which appears to present options for approval with no preference on which option it supports.

²⁰ QCA Act, Part 5, Division 7, Subdivision 2.