Queensland Competition Authority

Decision

Aurizon Network 2014 extension DAAU

May 2014

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THE ROLE OF THE QCA

The Queensland Competition Authority (QCA) is an independent statutory authority to promote competition as the basis for enhancing efficiency and growth in the Queensland economy.

The QCA's primary role is to ensure that monopoly businesses operating in Queensland, particularly in the provision of key infrastructure, do not abuse their market power through unfair pricing or restrictive access arrangements.

In 2012, that role was expanded to allow the QCA to be directed to investigate, and report on, any matter relating to competition, industry, productivity or best practice regulation; and review and report on existing legislation.

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INTRODUCTION

On 7 April 2014, Aurizon Network submitted to us for approval, in accordance with section 142(1) of the *Queensland Competition Authority Act 1997* (the QCA Act), a draft amending access undertaking (the 2014 Extension DAAU) proposing to, among other things, further extend the term of its 2010 access undertaking (UT3).

For the reasons outlined in this decision document, we have decided not to approve the 2014 Extension DAAU.

We consider it is appropriate to amend the DAAU to remove $21.3 million, related to the 2013 flood review event claim in the Blackwater and Moura systems, from the maximum allowable revenue (MAR) proposed to be used to determine transitional reference tariffs for 2014-15.

We are separately considering the flood review event claim in accordance with the provisions of UT3.

PROPOSAL

UT3 is due to expire on 30 June 2014. The 2014 Extension DAAU sought to:

- extend the term of UT3 to the earlier of the date the proposed 2013 access undertaking (UT4) is approved or 30 June 2015
- confirm 'final' reference tariffs for the central Queensland coal region (CQCR) for 2013-14
- confirm the basis on which variations between actual and allowable revenues for 2013-14 will be returned to, or collected from, access holders
- establish transitional reference tariffs for 2014-15, to apply until such time as UT4 is approved.

2013-14 reference tariffs

The Explanatory Memorandum to the 2014 Extension DAAU indicates volumes for 2013-14 are expected to be significantly higher than forecast in the Goonyella and Blackwater systems, resulting in an over-recovery of revenues compared to the transitional system allowable revenues (that were included in the approved May 2013 Extension DAAU). For other systems:

- Moura - volumes are expected to be lower than forecast. If take-or-pay is not triggered, an under-recovery is expected, if take-or-pay is triggered, under-recovery will be limited to the AT1 shortfall
- Newlands - volumes are expected to be lower than forecast. Take-or-pay is expected to cover the AT2-4 shortfall, with under-recovery limited to the AT1 shortfall
- GAP - volumes will be lower than forecast. Take-or-pay will be payable, but those amounts will be insufficient to reach the system cap, meaning under-recovery is expected.

Overall, the significantly higher than expected forecast tonnages in the Goonyella and Blackwater systems will mean a significant net over-recovery of MAR is expected for the CQCR for 2013-14.

Returns to (collection from) access holders

Aurizon Network's covering letter to its May 2013 Extension DAAU proposed that differences between 2013-14 actual and transitional allowable revenues be returned to, or collected from, access holders via an Adjustment Charge. This proposed arrangement is generally reflected in the 2014 Extension DAAU.

The exceptions to this arrangement are:

- AT1 under-recoveries will be incorporated into the final approved UT4 revenues
- variations between actual and forecast payments attributable to rebateable assets, variations between electric charge (EC) revenues and electric energy costs, and settlement of an outstanding dispute in the Goonyella system will be addressed via the revenue cap submission (which is due to be submitted to us by 30 September 2014).

The 2014 Extension DAAU provides that the Adjustment Charge application must be submitted to us by the end of August 2014. The proposal would, in effect, confirm the 2013-14 transitional tariffs as final tariffs.

2014-15 transitional reference tariffs

Aurizon Network's covering letter to its May 2013 Extension DAAU said, if it was likely UT4 would not be approved by 30 June 2014, a further set of transitional tariffs for 2014-15 would be proposed (though a methodology for determining these tariffs was not discussed).

The Explanatory Memorandum to the 2014 Extension DAAU indicates Aurizon Network has developed its proposed transitional tariffs for 2014-15 on the basis of the following principles:

- 2014-15 MAR should reflect, where reasonable, a roll-forward of the 2013-14 transitional MAR
- where a roll-forward is not reasonable (e.g. the expected UT4 outcome is for a lower amount), a lower MAR is proposed
- the roll-forward is restricted to CPI and revenue cap
- AT2-4 system allowable revenues for the Blackwater and Moura systems include an estimate of the amount expected to be approved as part of the 2013 flood review event claim
- AT5 for the Blackwater system reflects withdrawal of the 2013 AT5 DAAU (noting Aurizon Network expects other factors impacting on the UT4 building blocks to largely offset this adjustment).

The build-up of the proposed MAR for determining the 2014-15 transitional tariffs is shown in Table 1.

Table 1 Proposed Maximum Allowable Revenue - 2014-15 Transitional Tariffs

	Excluding GAP ($m)	*Including GAP ($m)*
2013-14 transitional MAR (excluding 2011-12 revenue cap)	722.5	861.7
Adjustments: Blackwater electric (net) GAPE	 2.6 -	 2.6 (19.4)
Sub-Total	725.1	844.9
CPI	16.2	16.2
2013 flood review event	21.3	21.3
2012-13 revenue cap	35.7	48.0
2014-15 transitional MAR	798.3	930.3

The break-down of the proposed MAR by CQCR system is shown in Table 2.

Table 2 Proposed Maximum Allowable Revenue - CQCR Systems

System	*AT1-4 ($m)*	*AT5 ($m)*	*Total ($m)*
Blackwater	220.4	94.2	314.6
Goonyella	255.8	75.0	330.8
Moura	52.7	-	52.7
Newlands	40.8	-	40.8
Sub-Total	629.1	169.1	798.3
GAP	132.0	-	132.0
Total	761.2	169.1	930.3

Aurizon Network proposed the MAR be recovered by developing transitional tariffs on the basis of revised system forecasts. Specifically, it used the tonnage forecasts for 2014-15 contained in its UT4 submission (total of 222.2 million tonnes) adjusted to exclude hauls it now expects will not operate in 2014-15, including railings from:

- proposed mines for which connection of spurs are now not expected to occur before the end of 2014-15
- existing and new mines in the Blackwater and Moura systems associated with the Wiggins Island Rail Project (WIRP), which is now not expected to be completed before the end of 2014-15.

Adjustments have also been made with respect to allocation between customers, to reflect transfers that have occurred between lodgement of UT4 and lodgement of the 2014 Extension DAAU.

The total tonnage proposed by Aurizon Network for the CQCR for 2014-15 is then 214.6 million tonnes, broken down in Table 3.

Table 3 Aurizon Network's System Forecasts

	2013-14 Transitional (million tonnes)	***2014-15 UT4 Submission (million tonnes)***	***2014-15 Proposed (million tonnes)***
Blackwater / WIRP	57.7	60.6	60.2
Goonyella	99.0	109.4	106.4
Moura	13.5	11.0	13.1
Newlands	15.8	15.8	14.0
Sub-Total	186.0	196.8	193.7
GAP	20.6	25.4	20.9
Total	206.6	222.2	214.6

Aurizon Network said these proposed volumes should be considered transitional rather than final - i.e. they are for the purposes of establishing the transitional reference tariffs for 2014-15 rather than also confirming the basis on which take-or-pay amounts are triggered (and calculated). This means the liabilities for UT1 take-or-pay, which includes a monthly element, cannot be confirmed on an ex-post basis until UT4 is approved.

STAKEHOLDER CONSULTATION

We published Aurizon Network's 2014 Extension DAAU, and supporting material, on our website and sought submissions from stakeholders by 2 May 2014. Seven submissions were received - from Anglo American, Aquila Resources, Asciano, Aurizon Operations, Bandanna Energy, Jellinbah Group and the Queensland Resources Council (QRC). Key issues raised regarding the Extension DAAU are outlined below.

System forecasts

The QRC indicated it is supportive of the system forecasts proposed by Aurizon Network being used to establish transitional tariffs for 2014-15, on the basis these forecasts are used solely for this purpose and final 2014-15 forecasts are determined through the UT4 approval process (including for determining take-or-pay triggers).

Asciano raised several concerns with Aurizon Network's proposed system forecasts:

- forecasts must be determined prior to the financial year for which they apply in order to avoid potential for 'gaming'
- forecasts used for determining reference tariffs and take-or-pay triggers must be identical
- Aurizon Network's proposal may favour UT1 access holders over UT2 and UT3 access holders
- Aurizon Network has adjusted its approach to forecasting between 2013-14 and 2014-15 - Asciano believes the approach should be consistent.

Flood review event

Anglo American and the QRC said the impact of the adjustment to tariffs due to the flood review event claim is very significant in the case of the Moura system - i.e. likely to lead to an increase in tariffs of around 25%. These stakeholders recommended this adjustment be excluded from the transitional tariffs for Moura, and resolved as part of UT4, as the:

- flood review event claim has not yet been approved
- question of whether any approved claim should be recovered within 2014-15, or smoothed over the remainder of the UT4 regulatory period, has not been settled.

Blackwater AT5

Aurizon Operations was concerned Aurizon Network's proposed treatment of the Blackwater AT5 tariff involves deferment of revenue to later years, which may increase bypass risk. Specifically, it requested we:

> *...scrutinize and assess the implications on the Blackwater AT5 rates for the FY15 to FY17 year associated with returning earned revenue to access holders via the adjustment charge relative to the alternative of contributing to a reduction between the transitional MAR and potential unsmoothed FY14 building block revenue inclusive of unrecovered UT3 revenue cap adjustment amounts.*

Asciano raised two concerns, namely the:

- basis on which over-recovery is predicted - i.e. whether higher expected Blackwater electric volumes are an extrapolation of year-to-date figures or an assumption of volumes growing strongly in the latter part of 2013-14
- in the context of the previous Blackwater AT5 DAAUs, whether proposals that involve diesel users potentially paying for electric infrastructure or 'smoothing of the regulatory asset base across time' are consistent with the pricing principles in the QCA Act, particularly in regard to the potential for price discrimination.

Other matters

Stakeholders also commented on a number of other matters concerning the 2014 Extension DAAU, including:

- exclusion of rebates from the revenue cap may reduce the transparency as to the rebates recovered or returned by Aurizon Network in the year in question (Asciano)
- the proposed approach to the Middlemount reference tariff (to be treated in accordance with Aurizon Network's separate application, if that is approved by 30 June 2014, or application of Goonyella tariffs if it is not approved by that date) is inappropriate (Asciano)
- the proposed approach to AT1 is acceptable, provided the final approach is determined in the UT4 approval process (the QRC)
- the proposed approach to escalation (using an interest rate rather than the UT4 WACC) is also acceptable, provided we are satisfied the final UT4 position will ensure revenue neutrality (the QRC)
- lack of clarity regarding the incorporation of Rolleston electrification works, expected to be completed by December 2014, into the build-up of reference tariffs (Asciano)
- any identifiable benefit that accrues to Aurizon Network due to the Extension DAAU be considered by us in making decisions on UT4 (Asciano).

QCA ANALYSIS AND POSITION

In considering the 2014 Extension DAAU, we have had regard to the assessment criteria in section 138(2) of the QCA Act, particularly the:

- object of Part 5 of the Act (to promote the economically efficient operation of, use of and investment in, significant infrastructure by which services are provided, with the effect of promoting effective competition in upstream and downstream markets) (section 138(2)(a))
- legitimate business interests of Aurizon Network (section 138(2)(b))
- public interest, including the public interest in having competition in markets (section 138(2)(d))
- interests of persons who may seek access to the service (section 138(2)(e))
- pricing principles mentioned in section 168A (section 138(2)(g)), including that the price of access should:
  - generate expected revenue for the service that is at least enough to meet the efficient costs of providing access to the service and include a return on investment commensurate with the regulatory and commercial risks involved (section 168A(a))
  - not allow a related access provider to set terms and conditions that discriminate in favour of the downstream operations of the access provider or a related body corporate of the access provider, except to the extent the cost of providing access to other operators is higher (section 168A(c)).

Our comments on the key issues raised by stakeholders regarding the 2014 Extension DAAU are outlined below.

System forecasts

We note the system forecasts proposed by Aurizon Network to determine the 2014-15 transitional tariffs are the forecasts it has proposed in UT4, subject to some adjustments for railings now not expected to occur, and to allocations between customers to take account of transfers that have occurred.

We share the QRC's view these system forecasts are appropriate to use for the purpose of establishing the transitional tariffs, but final forecasts should be determined through the UT4 approval process (including for the purposes of take-or-pay triggers). We will provide 2014-15 system forecasts as part of any approval of UT4.

With regard to Asciano's concerns, we make the following comments:

- we agree system forecasts should be determined prior to the financial year to which they apply. However, it is apparent UT4 will not be approved until some way into the regulatory period (most likely during 2014-15). Given this, it is not possible for final system forecasts for 2014-15 to be determined prior to the start of the financial year. We will ensure the final forecasts approved in UT4 are robust and not subject to 'gaming' by any parties
- we also agree forecasts used for determining reference tariffs and take-or-pay triggers should be the same. It is our intention to ensure the final reference tariffs that apply to 2014-15, as approved in UT4, are also appropriately used to determine take-or-pay triggers for that year
- we are not convinced Aurizon Network's 2014-15 transitional tariffs proposal will act to favour UT1 access holders to any greater degree than may be the case under the existing regulatory

arrangements. However, we will seek to ensure the final 2014-15 tariffs, as approved in UT4, do not act to unfairly benefit any access holder over any other access holder

- Asciano's comment regarding lack of consistency in the forecasting approach appears to relate to the adjustments made by Aurizon Network for railings it now expects not to occur, and transfers that have occurred. While we agree consistency of forecasting approach is important, we consider adjustments made on the basis of the best available information, which appears to be the case with Aurizon Network's forecasts, are justifiable.

Flood review event

We agree with Anglo American and the QRC that the impact of the adjustments to tariffs due to the 2013 flood review event claim is likely to be very significant in the case of the Moura system.

We are assessing the flood review event claim, and no decision on the claim has yet been made. As there is no decision on whether the full amount of the claim will be approved, we consider it is premature for the value of the claim to be included in the build-up of MAR for the purposes of determining transitional tariffs for 2014-15. We hold this view for both the Moura and Blackwater systems, as we consider they should be treated consistently, even if the impact on the Blackwater system tariffs is much less significant than for Moura.

We consider it is appropriate to amend the 2014 Extension DAAU to remove $21.3 million, related to the 2013 flood review event claim in the Blackwater and Moura systems, from the MAR proposed to be used to determine transitional reference tariffs for 2014-15. We will ensure the final value of any approved flood review event claim is appropriately incorporated in the approval of UT4.

With regard to the question of whether any approved flood review event claim should be recovered within 2014-15 or smoothed over the remainder of the UT4 regulatory period, our preliminary view is it should be recovered in 2014-15 (at least for the Blackwater system), noting the event itself occurred in early 2013. However, given the potentially significant proportional impact on Moura system reference tariffs, we will give further consideration to this matter in the UT4 approval process, in the context of the overall movements in the UT4 Moura tariffs.

Blackwater AT5

We note Aurizon Operations' view it may be appropriate for the expected over-recovery of the Blackwater AT5 tariff in 2013-14 to not be returned to access holders, but rather used to smooth revenue requirements for future years (when under-recoveries may be likely). We do not agree with this view, as we consider the over-recovery should be returned to access holders consistently with the other revenue over-recoveries in the Blackwater and Goonyella systems (and in-line with the general operation of the revenue cap framework). We also note, in this context, that the previous Blackwater AT5 DAAUs have been withdrawn by Aurizon Network.

We also note Asciano's concerns regarding the Blackwater AT5 tariff, but make the following comments:

- Aurizon Network has advised the predicted over-recovery is a conservative estimate based on nine months actual data and three months corporate plan forecast (it is not an extrapolation of year-to-date figures)
- the consistency of previous Blackwater AT5 proposals with the requirements of the QCA Act were considered in the draft decisions on the respective DAAUs. Any future proposals will be considered on their merits in accordance with the Act. We do not consider this is relevant for consideration of the 2014 Extension DAAU.

Other matters

With regard to the other key matters raised by stakeholders in submissions, we make the following comments:

- we agree exclusion of rebates from the revenue cap may reduce transparency if they are not appropriately accounted for elsewhere. We will investigate this matter further prior to the approval of any final tariffs as part of the UT4 process
- we are assessing the Middlemount reference tariff application. We will endeavour to finalise this matter prior to 30 June 2014. However, if this does not occur and the application is withdrawn, we consider it is then appropriate the matter is dealt with in accordance with the UT3 provisions
- we agree with the QRC the proposed approach to AT1 is acceptable, but confirm the final approach will be determined in the UT4 approval process
- we also agree with the QRC the proposed approach to escalation is acceptable, but confirm we will ensure the final UT4 approach is revenue neutral
- we will further investigate the proposed incorporation of Rolleston electrification works into the build-up of reference tariffs, as part of the UT4 approval process
- we agree with Asciano's general point that it is important any identifiable benefit, that accrues to Aurizon Network due to the 2014 Extension DAAU, is considered by us in making decisions on UT4.

Additional matters (not commented on in detail by stakeholders)

In addition to the above matters, there are a number of other important proposals contained in Aurizon Network's 2014 Extension DAAU. For completeness, we confirm we consider the following elements of the DAAU to be appropriate and consistent with the criteria in section 138(2) of the QCA Act:

- extension of the terminating date of UT3 to the earlier of 30 June 2015 or the date on which UT3 is withdrawn in accordance with the QCA Act (which would be when UT4 is approved)
- removal of any retrospective liability caused to Aurizon Network by the extension of the terminating date (this is similar to a provision included in the approved May 2013 Extension DAAU)
- provisions relating to the proposed Adjustment Charge application, including to:
  - give effect to the return or recovery of the difference between actual revenues and system allowable revenues for the 2013-14 transitional tariffs, as an Adjustment Charge
  - confirm a due date for the Adjustment Charge application of 31 August 2014
  - confirm the treatment of the Adjustment Charge in the 2013-14 revenue cap adjustment process.

FINAL 2013-14 ADJUSTMENT

An additional issue raised by Aurizon Network, and commented on by stakeholders, is the mechanism for providing a final adjustment to 2013-14 revenues, once UT4 is approved. Two options have been suggested:

- a second Adjustment Charge (which Aurizon Network had indicated was its intended approach in the covering letter to its May 2013 Extension DAAU)
- smoothing the adjustment over the remainder of the UT4 regulatory period (which is now Aurizon Network's preferred position).

Stakeholders have acknowledged it is not necessary for us to make a decision on this matter now in order to make a decision on the 2014 Extension DAAU. However, stakeholders have suggested they have a strong preference for us to indicate which option we are likely to support in the UT4 approval process.

Stakeholder comments

The QRC noted the approach to the final 2013-14 adjustment now proposed by Aurizon Network is not consistent with its May 2013 proposal, but said it is based on feedback from a number of customers. It said the approach is supported by Anglo American, BMA, BMC, Ensham Resources, Glencore, Peabody Energy, Rio Tinto Coal Australia, Sojitz Coal Mining, Yancoal Australia and Wesfarmers Curragh. Subsequently, Jellinbah Group also supported this approach. However, the QRC also noted coal producers do not have a unanimous view in regard to this issue.

Both Aquila Resources and Bandanna Energy supported Aurizon Network's original (i.e. May 2013) position. These producers considered:

- it is likely the 2013-14 transitional tariffs, particularly for the Blackwater system, will be significantly lower than those approved in UT4. This means tariffs for the years 2014-15 to 2016-17 are likely to be disproportionately higher, to account for under-recovery in 2013-14
- Aurizon Network's revised proposal is likely to provide existing producers with an immediate cash-flow benefit to the detriment of future producers, thereby decreasing the latter's competitiveness
- the revised proposal would, in effect, result in emerging producers subsidising existing producers for 2013-14, due to the additional capacity created by WIRP.

The QRC also provided an attachment to its submission, which outlined the advantages (in the view of coal producers) of each option.

The QRC said the advantages of the second Adjustment Charge option are it:

- provides certainty due to consistency with Aurizon Network's May 2013 proposal - i.e.:

  > *Departing from the process which was indicated at that time creates uncertainty in regard to regulatory processes and in formulating responses to these processes*

- prevents inequities between producers - while deferring adjustments may be NPV neutral for Aurizon Network, this is not the case for individual producers
- prevents adverse impacts on industry competitiveness in later years - there is a substantial risk finalising 2013-14 tariffs at the interim levels will artificially inflate 2014-15 to 2016-17 tariffs, impacting on industry competitiveness over an extended period.

The QRC said the advantages of the smoothing option are it:

- provides certainty for 2013-14 - it noted:

> *The uncertainty regarding tariffs to date has been a significant burden for industry in setting budgets and reporting performance. It is not acceptable to create a situation in which the true cost of access for the FY2014 year is not known until many months after completion of that year*

- avoids complexities and further debate regarding take-or-pay calculations - two 2013-14 Adjustment Charge processes would create significant uncertainty regarding how take-or-pay would be applied
- provides immediate cash-flow relief - for a majority of producers, and on a net industry-wide basis.

QCA view

We have considered the arguments put forward by stakeholders in support of both options suggested for providing a final adjustment to 2013-14 revenues, once UT4 is approved.

We understand the concerns of Aquila Resources and Bandanna Energy (and, potentially, other emerging or new coal producers) that the smoothing option may result in these producers facing disproportionately higher reference tariffs for the 2014-15 to 2016-17 period, caused by under-recovery in 2013-14. We note the concerns this may have implications for competition in upstream markets and for the viability of new or emerging coal producers.

However, we also note the normal revenue cap arrangements that apply in UT3 provide for revenue under-recoveries (over-recoveries) to be recouped (returned) two years later. This means these arrangements, while maintaining revenue neutrality for Aurizon Network, are never likely to do so in practice for all individual coal producers. It is always likely that, in the two years between an under-recovery (over-recovery) and it being recouped (returned), some producers will exit the market and some new producers will enter. In addition, even among producers who stay in the market, there will inevitably be significant ramp-ups in production, and reductions in production for others, within the two-year period.

While we accept that (potentially) the under-recovery of revenues from 2013-14 that may need to be recouped via approved reference tariffs over the remainder of the UT4 regulatory period could be significant, we note revenue under-recoveries in past years that have been recouped two years later have also, on occasions, been significant. For example, in 2010-11 Aurizon Network had a net under-recovery in its MAR of $49.2 million, which was subsequently recouped from customers via 2012-13 reference tariffs.

Given the nature of the regulatory regime, and the operation of the revenue cap framework, our preliminary view is it is not unreasonable to accept the proposal to smooth any adjustment required over the remainder of the UT4 regulatory period. In that context, we note the advantages of the proposal identified by the QRC, particularly relating to budgeting for existing producers and avoidance of extra complexity in take-or-pay calculations.

That said, we also note we have not reached a finalised view on this matter - that will only occur in the context of the UT4 approval process.

CONCLUSION

For the reasons detailed in this decision document, we have decided not to approve Aurizon Network's 2014 Extension DAAU.

For the purposes of section 142(3)(b) of the QCA Act, we consider it is appropriate to amend the DAAU to remove $21.3 million, related to the 2013 flood review event claim in the Blackwater and Moura systems, from the MAR proposed to be used to determine transitional reference tariffs for 2014-15.

Decision

- **In accordance with section 142(2) of the QCA Act, we have decided not to approve Aurizon Network's 2014 Extension DAAU**
- **In accordance with section 142(3)(b) of the QCA Act, we consider it is appropriate to amend the DAAU to remove $21.3 million, related to the 2013 flood review event claim in the Blackwater and Moura systems, from the maximum allowable revenue proposed to be used to determine transitional reference tariffs for 2014-15.**