QUEENSLAND resources COUNCIL

Resourcing Queensland's future

21 July 2022

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Queensland Competition Authority
145 Ann Street
Brisbane QLD 4000
(Submitted via QCA Online Submission Form)

RE: Aurizon Network Draft Amending Access Undertaking – Electric Energy Charge FY23

The Queensland Resources Council (**QRC**), on behalf of the QRC's Rail Working Group, welcomes the opportunity to comment on Aurizon Network's Draft Amending Access Undertaking – Electric Energy Charge FY23 (the DAAU).

1. Introduction

Aurizon Network has submitted the DAAU so that it may "*recover the efficient costs of providing access to the service, as required under s168 of the Queensland Competition Authority Act, 1997(Qld)*"[1]. We accept that the Act allows Aurizon Network to recover efficient costs. This right does not extend to the recovery of costs incurred inefficiently, or as a result of imprudent management.

Aurizon Network's submission attempts to explain why a cost of $242/MWh is a reasonable forecast for an organisation which found itself in a position of having purchased or hedged none of its forecast FY23 demand until shortly before the commencement of the period. The submission does not explain how Aurizon Network has managed the procurement of electricity nor why the approach taken should be considered prudent.

[1] Aurizon Network supporting submission for DAAU, 8th June 2022, page 2.

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2. The impact of the additional cost

The Annual Review of Reference Tariffs for FY23 (ARRT) increased EC from $0.87 per eGTK'000 to $1.11 per eGTK'000. The DAAU proposes a further increase to $2.82 per eGTK'000. These tariffs are based on the following costs:

FY22 ARRT	$53.9m
FY23 per ARRT	$69.0m
FY23 per DAAU	$175.7m

The proposed cost increase is $106.7m compared to the forecast cost contained within the ARRT submitted by Aurizon Network in February, and $121.8m compared to current (FY22) tariffs. To put these increases into context:

- The total proposed increase between FY22 and FY23 of $121.8m is almost identical in value to the total FY22 forecast direct maintenance costs of the Blackwater and Goonyella systems combined ($121.7m)[2].

- Impacts on customers will vary with distance but are estimated at up to $1.40/t for the more distant mines.

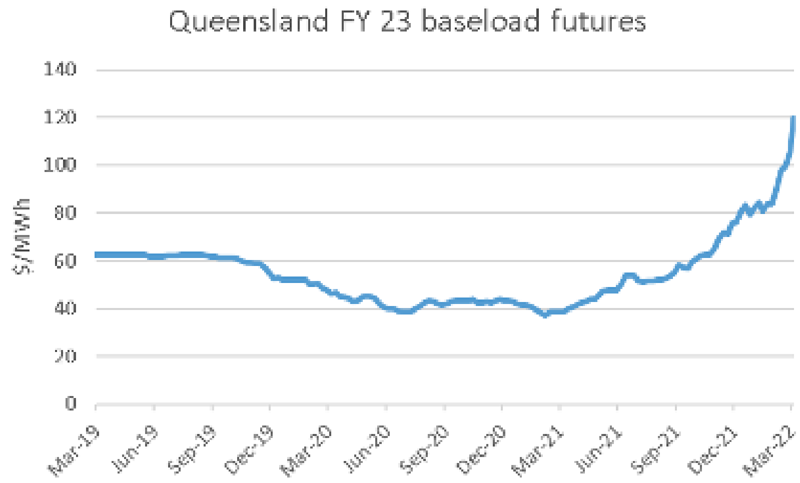
This is by far the largest cost increase ever proposed by Aurizon Network via a DAAU. It is critical that the QCA reviews this claim, not only to determine whether it represents a mathematically correct pass through of the likely cost (which we expect it does), but to determine the extent to which the increase is an efficient cost rather than a cost of imprudent management.

3. Electricity market conditions

We understand that electricity markets are volatile and that recent increases in market prices have been substantial. This is shown by the following graph[3]. The graph shows baseload futures prices for FY23 from March 2019 to March 2022.

[2] Aurizon Network FY23 Final Draft MRSB, 21 January 2022, table 2.

[3] https://reneweconomy.com.au/wounded-bulls-queensland-power-prices-soar-in-energy-policy-vacuum/



The graph indicates that:

- Prior to around October of 2021, prices below **$60/MWh** could have been locked in for FY23.
- By February of 2022 (the time of submission of the ARRT), FY23 contract prices had increased but could still be secured at around **$80/MWh**.
- As late as March 2022, contract prices of around **$120/MWh** remained available in the market.

Despite this worsening trend, it appears that Aurizon Network took no action to manage the risk of further cost increases, and by the date of submission of the DAAU (8th June 2022), Aurizon Network's estimated cost for FY23, based on advice from Edge2020, had increased to **$242/MWh**[4].

4. Expectations of customers

In 2016, Aurizon Network consulted with customers on electricity procurement, and customers supported an approach involving progressive procurement. This approach involves entering into a retail contract which allows the pricing for 'blocks' of demand to be locked in through a staged approach. The decision to lock in pricing for particular periods was to be made by Aurizon Network, informed by expert advice. During the UT5 approval process, the QCA reviewed the progressive procurement approach and noted that it appeared to be a sound procurement process[5].

Customers do not understand how, under a prudent implementation of the approved progressive procurement approach, Aurizon Network could have been in a position of being totally uncontracted and unhedged shortly before the commencement of FY23. We consider this outcome to be imprudent, having regard to the circumstances.

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[4] Aurizon Network supporting submission for DAAU, 8th June 2022, page 3.

[5] QCA Final Decision on the 2017 DAU, December 2018, page 185

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5. Expert advice

The electricity market is complex, as is the task of managing risk within the market. It is for this reason that customers encouraged Aurizon Network to engage Edge2020 (then "Edge Energy Services") in 2016. QRC considers that a key question to be considered, when assessing the prudency of the expected FY23 electricity cost, is the extent to which Aurizon Network sought and relied upon expert advice and, to the extent that it did, whether reasonable enquiries were made to test and challenge the approach being recommended by the advisor.

We have requested a copy of advice provided by Edge2020 and have offered to restrict distribution to a consultant who is subject to a confidentially agreement, but to date Aurizon Network has not provided this information. We encourage the QCA to obtain each of the reports provided by Edge2020 since the beginning of 2020 to establish whether Edge2020 advised Aurizon Network:

- Throughout 2020 and 2021, not to lock in pricing for any portion of the FY23 demand despite prices being below $60/MWh; and

- From late 2021 and for each month from January to May of 2022, not to lock in any portion of demand despite prices rising from $60/MWh (late 2021) to $80/MWh (February 2022) to $120/MWh (March 2022) to $242/MWh (DAAU forecast).

We do not seek to judge Aurizon Network's decisions with the benefit of hindsight. Rather, we request that the QCA reviews Aurizon Network's management of this critical procurement activity (including its management of any advisors) and considers the extent to which Aurizon Network's approach contributed to the current exposure.

6. How should Aurizon Network have mitigated the impact of the price increase?

Customers expected that Aurizon Network's progressive procurement approach should have resulted in some portion of FY23 demand being contracted during 2021, with further blocks contracted in early 2022. Our understanding is that Aurizon Network did not take this action because its existing retail contract was expiring on 30 June 2022 and Aurizon Network considered that it could not lock in pricing for any portion of demand until a retail contract was in place. We understand that the new contract was completed around May of 2022. Aurizon Network's management of the procurement process appears to have failed in the following areas:

- <u>Failure to enter into a new retail contract within a reasonable period ahead of FY23:</u> Unless Aurizon Network can demonstrate that unforeseeable circumstances beyond Aurizon Network's control caused this delay, we would conclude that Aurizon Network either commenced the process too late or failed to put adequate resources into concluding the negotiations. Aurizon Network states that "*the change in procurement approach to allow for the purchase of electricity from renewable sources required Aurizon Network to execute a new ESA*"[6]. Given that the ESA was expiring, the need for a new ESA was known and was not caused by any change in approach.

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[6] Aurizon Network supporting submission for DAAU, 8th June 2022, page 1.

- Failure to consider other risk mitigation options while negotiating the retail contract: Electricity price hedging can be achieved outside retail contracts. In discussions with Aurizon Network, QRC queried why, during the delayed finalisation of the retail contract, Aurizon Network did not consider hedging part of the electricity demand through a futures contract. We have not received an adequate response to this question. We understand that retail contracts sometimes provide that all of the demand must be locked in at some point under that contract, such that having a separate futures contract outside the retail agreement would become problematic (as Aurizon Network would then be 'long' on electricity rather than simply hedged). This concern could have been addressed by including the right to take a spot portion in the retail contract (matching the futures contract portion) or simply by selling the futures contract around the same time as the retailer locks in the relevant portion. Aurizon Network may have considered that purchasing a futures contract was not part of the procurement process which had been supported by customers. If this was a concern for Aurizon Network, then they ought to have consulted with customers on the situation. No such consultation or communication occurred. By not securing a retail contract within a reasonable timeframe, Aurizon Network put itself in an unusual and exposed position. Futures contracts are commonly used in the electricity market to manage such exposures, and yet Aurizon Network appears not to have considered this option.

- Failure to inform customers of the unhedged position: Aurizon Network's consultation with customers on electricity procurement was limited to a meeting held on 18th January 2022, during which Aurizon Network informed customers of its intention to procure a portion of electricity from renewable sources. Aurizon Network's procurement process was well advanced at this stage, with the retail contract expected to be executed in February. Given the advanced stage of Aurizon Network's process and limited information provided, customers found it difficult to provide any meaningful feedback. In mid-March, Aurizon Network indicated that negotiation of the retail contract was continuing and was expected to be completed within a month. The focus of the consultation was on the question of whether Aurizon Network should exceed its minimum obligations for the purchase of renewable energy. Aurizon Network did not inform customers of its unhedged position or discuss the risks which this posed in the context of a volatile electricity market. Had customers been alerted to the situation, individual customers would have had the opportunity to manage the risk through futures contracts or work with Aurizon on a hedging strategy at that stage.

7. Aurizon Network's resourcing of electricity procurement

Electricity is a major component of access charges. To put the proposed FY23 electricity costs into context, the costs, if approved, would significantly exceed direct maintenance costs. Through the Rail Industry Group, customers now have good visibility of the extensive resources which Aurizon Network devotes to developing its maintenance and renewals plans, and to engaging with customers on the strategy and budget. In contrast, management of electricity procurement appears poorly resourced, and consultation with customers is extremely limited. Aurizon Network appears to treat electricity as a cost pass-through.

We note that Aurizon Network proposed a number of 'step changes' in its UT5 operating expenditure allowance. One of these step changes, which was ultimately approved by the QCA[7] was the creation of an '*electrical specialist role'* within the Commercial Development and Governance group. This role was to "*engage in regulatory and policy processes regarding electricity wholesale and network issues*". Aurizon Network, in its response to the QCA's Draft Decision (which had proposed not to approve this allowance) said that one of the reasons for the creation of this specialist role was "*more efficiently managing energy procurement, through progressive purchasing and pricing*"[8]. Despite Aurizon Network being provided with this allowance, our understanding is that electricity procurement remains a small part of a much larger role. For example, during late 2021 and early 2022 (the period during which we consider that the retail contract ought to have been finalised and a portion of FY23 demand locked in), the relevant role included responsibility for managing Aurizon Network's response to the Initial Capacity Assessment Report, consulting on transitional arrangements, and developing the ICAR DAAU. Aurizon Network may be able to demonstrate that resources equal to a full-time equivalent (FTE) role are involved in matters relating to electricity across the business, however, the allowance in UT5 was for an additional FTE above the baseline (FY16) costs, and we see no evidence that this has occurred.

Based on the information available to customers, it appears that the failure to manage electricity price risks for FY23 is a consequence of Aurizon Network electing not to establish the specialist role despite Aurizon Network clearly being aware of the importance of such a role and being provided with funding to support it.

8. Conclusion

Based on the information available to QRC and Rail Working Group members, it appears that Aurizon Network failed:

- to fill the role of 'electrical specialist', despite Aurizon Network knowing, and demonstrating to the QCA's satisfaction, that prudent management of electricity procurement required such resources to be committed;

- to secure a retail contract within a reasonable period ahead of expiry of the existing agreement.

- to consider options for risk management while the retail contract was being negotiated, such as futures contracts.

- to inform customers of the exposure so that customers could have considered their own options for managing the risk.

In these circumstances, QRC considers that some portion of the proposed increase in electricity costs is not an efficient cost and therefore should not be reflected in the EC allowance nor be included in the 'unders and overs' adjustment in future periods. The value which would be considered imprudent is a matter for the QCA. This could be estimated in a variety of ways, including by considering what a prudent operator,

[7] QCA Final Decision on the 2017 DAU, December 2018, page 132
[8] Aurizon Network response to QCA Draft Decision, 12 March 2018, page 165

informed by the advice of Edge2020, would have done under a progressive procurement approach in 2020, 2021 and early 2022.

Thank you for the opportunity to provide this submission.

Yours sincerely

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