



# Submission to the Queensland Competition Authority

## Queensland Rail's 2015 Draft Access Undertaking

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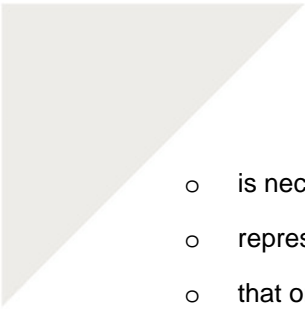
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# 1 Executive Summary

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- The rail infrastructure managed by Queensland Rail supports a large diversity of train services which operate across multiple markets and are subject to varying economic characteristics.
- Many of the markets in which rail services are provided are subject to constrained market pricing associated with substitute services such as road. Below rail pricing without reference to changes in the productivity and efficiency of competing services has direct impacts on the ability of rail operators to fund innovation to improve the efficiency and utilisation of rail infrastructure.
- While Queensland Rail, or a related party, does not compete directly in the downstream market the efficiency, reliability and availability of access to the declared service has a material impact on promoting demand for those services. Improvements in the scale of the market for transportation by rail associated with improvement in the efficiency and utilisation of rail infrastructure is a key driver of promoting competition.
- Aurizon's preferences for the Queensland Rail 2015 Draft Access Undertaking are to provide a framework which promotes and strengthens the effectiveness of the negotiate-arbitrate model as intended by the Competition Principles Agreement through:
  - Ensuring the undertaking adopts an appropriate allocation of risk and substantially reduces Queensland Rail's discretion to transfer risks which are best managed by the access provider through the standard access agreement;
  - addressing the substantial information asymmetry in the access negotiation through the disclosure of the relevant price and cost information to the access seeker;
  - ensuring the access provider has sufficient incentives to improve efficiency and support an effectively competitive above rail market by supporting an operators operational efficiency initiatives;
  - the increased accountability on the access provider through performance reporting and consultation requirements in relation to variations to the master train plan;
  - improving the predictability of the likely changes in the efficient costs of providing the access through sufficiently disaggregated financial information; and
  - incentivise the movement of freight from road transport to rail transport through efficient and effective pricing of access to the rail infrastructure.
- Aurizon considers it is a reasonable requirement for Queensland Rail to conduct a more conclusive capacity planning framework and to be subject to a greater obligation to assist access seeker's evaluation of options for improving utilisation of the declared services and improving the efficiency of the services that would be provided by that increased access. This should also extend to removing financial disincentives for capacity relinquishment associated with improving the payload of contracted services.
- Aurizon considers that the Queensland Rail 2015 Draft Access Undertaking principles to user funding are appropriate and appropriately rely on the access seekers to reach terms which are appropriate and relevant to the circumstances with appropriate recourse to dispute resolution. However, the predominant issues relevant to the Queensland Rail 2015 Draft Access Undertaking relate to whether the access provider's requirement for the access seeker to make a capital contribution:

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- is necessary in order to provide the access rights being sought;
  - represents the most efficient means of providing those access rights;
  - that only reflects prudently incurred costs;
  - is fair and reasonable and does not arise as a consequence of inefficiencies in the access provider's asset management practices; and
  - is appropriately reflected in the derivation of the access charge.
- On balance, Aurizon does not consider that Queensland Rail's proposed Western System reference tariff provides the economic framework to provide the necessary level of certainty and sustainability to promote access seekers to undertake the investments necessary to improve the productivity of the West Moreton coal chain.
  - Aurizon also considers that take or pay should only be relied upon for the purpose of Queensland Rail earning the same amount of revenue it expected to earn from the contracted volumes it executed and the price at which they were executed. Take or pay capping should also have retrospective effect given the timing of the approval of the 2015AU is attributable to actions directly taken by Queensland Rail.
  - Aurizon fundamentally supports the expectation that Queensland Rail should be entitled to earn an appropriate commercial return on its investments. However, Queensland Rail has not provided details of the value of investments to which the relevant statutory tests can be appropriately applied.
  - Given the potential for the recovery of sunk investments in the pricing of coal carrying train services for which there is no alternate use, no replacement requirement and no prospect of bypass then there is little economic utility in establishing ceiling prices based on the recovery of assets that will never be recovered.
  - Queensland Rail's proposal to value historic assets at replacement cost has the potential to increase disincentives for efficient forward looking investment by both Queensland Rail and in upstream and downstream markets.

## 2 Regulatory Objectives and Process

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Queensland Rail's Draft Access Undertaking 1 ("2015DAU") has been submitted to the Queensland Competition Authority (QCA) in response to an initial undertaking notice issued to Queensland Rail following its withdrawal of the 2013 Draft Access Undertaking ("2013DAU") prior to stakeholders responding to the QCA's draft decision.

In part, the reasons provided by Queensland Rail for the withdrawal is the dissatisfaction with the regulatory process and a draft decision which was overly complex, prescriptive and misaligned to its incentives.

In its submission to the Harper Review, Aurizon noted the extent to which Australia's regulatory regimes have become disproportionately complex relative to the economic issues they are attempting to solve. Increasing complexity frequently appears to be chasing diminishing incremental benefits, at substantial private and public cost. The effect of this has been, in some cases to produce a one-size fits all outcome, limiting businesses' ability to be flexible and innovative in response to customer requirements, as well as creating a risk adverse culture that is not necessarily aligned to changing customer needs or market conditions.

In this regard the Harper Review noted<sup>1</sup>:

*The recent Productivity Commission (PC) inquiry concluded that the Regime is likely to generate net benefits to the community, but that its scope should be confined to ensure its use is limited to the exceptional cases where the benefits arising from increased competition in dependent markets are likely to outweigh the costs of regulated third-party access. The Panel agrees that, if the Regime is to be retained, the scope of the Regime should be confined because of the potential costs of regulation.*

In considering the 2015DAU the QCA has the opportunity to appropriately frame the regulatory objectives and the economic problems that the access undertaking should seek to address. The 2015DAU should also be cognisant of the incentives of the access provider in meeting the objectives of the QCA Act. For example, there would appear to be no prima facie case as to why Queensland Rail would not have incentives to provide access to promote competition in downstream markets.

However, Queensland Rail is also structurally separated from rail operations and decoupled from the markets in which the declared service is material input. As a consequence, it is not exposed to the direct implications in relation to its service quality, performance and efficiency which can materially and adversely affect the incentives to invest in downstream markets and the competitiveness of those services.

The markets likely to be serviced by rail operations utilising rail infrastructure for which Queensland Rail is the railway manager are diverse and each possesses its own economic characteristics which are relevant to the negotiated terms and conditions of access. Similarly, a large proportion of the rail infrastructure comprising the declared facility is of a standard substantially below that of a modern engineered railway. The demand for access to the declared service is also subject to a considerable degree of uncertainty and much of the costs associated with sustaining the rail infrastructure is met through direct government subsidies by way of Transport Services Contract payments.

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<sup>1</sup> The Australian Government Competition Policy Review (2014) Draft Report, September, p.54

Many of the rail services also operate in highly competitive markets where road provides a strong substitute and constrains the price of rail services. Therefore, rail operators have virtually no market power in many of the markets which they service and Aurizon has advocated through the Harper Review that there is no economic case for regulating these services when provided by a vertically integrated service provider in direct competition with credible and available substitutes<sup>2</sup>.

In circumstances where the access holder's, or its customers, barriers to exit are low, then Queensland Rail will also not possess market power in those markets. The notable exception is the provision of coal services in the Western System where Queensland Rail is theoretically capable of extracting economic rents either through consequential margin squeezing of rail operators or where there is capacity to pay by end users through the transfer of those rents.

In the remaining markets where there are barriers to exit across other elements of the supply chain the primary economic problem relevant to the access undertaking is the potential for economic hold-up where it is not possible to strike a long term access agreement which would prevent such conduct. In some circumstances, the access provider can also exercise market power to obtain an access charge substantially in excess of the costs of providing the service through withholding information and delaying negotiations. Accordingly, it is important that the access undertaking provides all the necessary information to support timely and effective negotiations.

Aurizon considers the dispute resolution and binding arbitration arrangements within the Queensland Rail Access Regime provides sufficient avenues to address any material risk of economic hold-up. In circumstances where an access seeker already possesses access rights to the network then it is Aurizon's expectation that the previous negotiated price represents the relevant price benchmark. In order to substantively uplift the offered access charge in real terms the access provider should need to demonstrate a material change in circumstances. The access provider would therefore need to identify either:

- A material change in market conditions which substantially altered the margins within the supply chain and that those conditions would be expected to prevail over the term of the renewed access agreement; or
- A material change in the cost of providing the service relevant to the access seeker (as opposed to a material change in Queensland Rail's overall business costs).

To the best of Aurizon's knowledge, an access seeker has not directly sought to dispute the proposed term or condition of access in any rail access regime within Australia. It is preferable that where a regulator seeks to prescribe how a matter should be determined on an ex-ante basis, it has an identifiable economic problem that could not be resolvable via commercial negotiation in the first instance and cannot also be subject to an efficient and timely dispute resolution process.

## **2.1 Aurizon's Objectives for 2015DAU**

The role of the QCA in balancing the interests of stakeholders and understanding the trade-offs between facilitating effective negotiation and limiting the scope for dispute through the prescription of up-front terms is challenging in the absence of a regulatory directions statement in relation to Queensland Rail's long term commercial and broader transport policy objectives.

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<sup>2</sup> Aurizon (2013) Submission to the Competition Policy Review, p.54



These objectives are also relevant to determining to what extent technical and operational efficiency should be given greater weight relative to longer term productivity enhancing dynamic efficiency (a matter which has proven particularly relevant to whether rail infrastructure asset management strategies should be orientated towards improving productivity of existing assets and standards or migrating to higher standards to sustain higher productivity from higher levels of demand).

In considering the QCA's draft decision, Aurizon has focussed primarily on whether it supports the following objectives:

- Ensuring the access undertaking is simple, clear and reduces the regulatory costs associated with its ongoing administration and review;
- Provide a line in the sand approach to the Western System to support sustainable ongoing investment in asset productivity improvements and to provide an increased level of regulatory certainty to allow evaluation of economic trade-offs from alternate investment options across the supply chain;
- Provide appropriate and reasonable compensation for the provision of coal carrying train services within the Western System combined with effective financial incentives to increase throughput;
- Establish an increased level of performance accountability through effective and relevant reporting;
- Provides appropriate incentives to improve productivity and the sustainability and competitiveness of rail transportation services;
- Establish access agreement principles which represent an appropriate and reasonable balance of risk between the access seeker and the access provider; and
- Support commercial negotiation in the first instance but seeks to address the significant information asymmetry through increased cost transparency to provide more countervailing market power to the access seeker in an access negotiation.

## **2.2 Retrospective Application of the Western System Tariff**

In stakeholder information forums following the withdrawal of the 2013DAU, Queensland Rail advised that it was no longer its intention to retrospectively apply the approved tariff to the original commencement date of 1 July 2013.

Aurizon, among other stakeholders remain disappointed that Queensland Rail elected to not follow through on commitments to retrospectively apply the reference tariff given the good faith representations made by Queensland Rail when extending the 2008 Access Undertaking ("2008AU").

The QCA's request for comments on the 2015DAU seeks views on whether stakeholders had an expectation that the tariff outcome would apply retrospectively and what is the basis for that expectation.

The expectation regarding the retrospective application arose from written commitments given by Queensland Rail that due to the lodgement of the 2013DAU one month prior to the terminating date of the 2008AU that Queensland Rail would retrospectively apply the approved tariff.

This expectation is also consistent with the reliance on the previous retrospective application of the Western System reference tariff in the 2005AU and the 2008AU providing an appropriate and reliable regulatory precedent. The previous retrospective applications were also mutually supported, operated in both the favour of the users and the access provider and reflected the good faith intentions of the relevant stakeholders.

Aurizon is primarily affected by the retrospective application of take or pay capping. In response to the 2013DAU Aurizon submitted that Queensland Rail lacks appropriate incentives to negotiate take or pay capping as it would restrict its ability to earn revenue from coal carrying train services in excess of what it would expect to earn from the aggregate level of contracted services. The materiality of the take or pay also permitted Queensland Rail to earn revenue from the both the use and preservation of the same train path. The draft decision agreed that this created perverse incentives contrary to the objective of improving the utilisation of rail infrastructure.

Given the expectation that the reference tariff and take or pay capping would have retrospective effect and the preference to maintain regulatory certainty through the continuation of the 2008AU, Aurizon did not seek the QCA to make a determination on this matter in its submissions relating to the extension DAAUs for the 2008AU.

Aurizon maintains that Queensland Rail should not obtain a financial benefit arising from the reference tariff not commencing from 1 July 2013 given the approval date for the 2015DAU can be attributable to both:

- the lodgement of the Western System Reference tariff in May 2013; and
- the withdrawal of the 2013DAU.

While Aurizon considers that take or pay comprises a part of the reference tariff and therefore should have the same retrospective enforceability as the main reference tariff components there may be some doubt as to whether the necessary amendments to the SAA associated with the calculation and payment of rebates could be retrospectively applied. However, the regulatory and commercial certainty of retrospective application of take or pay capping could be substantially improved if the QCA required the final approved undertaking to include a requirement to refund to affected access holders the specified amount that aligns with the final approved Western System Reference Tariff. These would address any doubts as to the enforceability of retrospective variations to an executed access agreement, or where access rights are not renewed prior to the 2015DAU Approval Date.

In order to assess these amounts the QCA should establish the target revenue for the FY14 and FY15 years having regard to the roll-forward of the regulatory asset base relevant to this period (and as an input into the opening asset value for the period of the 2015DAU) and Queensland Rail's outturn operating and maintenance costs for this period. Where the revenue received (net of any consequential changes in a retrospective reference tariff) exceeds this amount that portion relating to take or pay should be required to be rebated to the affected access holder over a period commensurate with Queensland Rail's legitimate business interests.

#### **Recommendation**

The QCA should assess the reasonableness of Queensland Rail's revenues in FY14 against the approved reference tariff and to the extent necessary, and subject to Queensland Rail's legitimate business interests, require take or pay amounts in excess of the target revenue to be returned to the affected access holder over the term of the DAU.

## 3 Application and Scope

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Aurizon supports the proposed duration of five years for the term of the 2015DAU. However, amendments are necessary to Part 1 of the 2015DAU in order to satisfy the relevant statutory tests. Amendments are recommended for the following sections of the 2015DAU:

1. Specification of the scope of services;
2. Exclusion of third party facilities; and
3. Facilitation of network extensions and the development of principles around capital investment.

### 3.1 The scope of services to be provided is not sufficiently specified

Queensland Rail has adopted an excessively narrow definition of the scope of services able to be negotiated pursuant to the access undertaking due to the manner in which the section 1.2.1 has been constructed. In particular, clause 1.2.1(a) notes that the Undertaking:

*Applies to the negotiations between Queensland Rail and Access Seekers in relation to Access Rights.*

*Access Rights are defined only as an entitlement to Access [means the non-exclusive use of a part of the Network for the purpose of operating a Train between a specified origin to a specified destination] in accordance with a specified Train Service Entitlement.*

Clause 1.2.1(b) subsequently removes the right to negotiate services other than Access.

Aurizon considers that the definition of Access is not sufficiently specified to ensure that all services needed to provide the declared service will be subject to the access undertaking. The declaration in s.250(1)(b) of the QCA Act specifies the declared service as:

*The use of rail transport infrastructure for providing transportation by rail if the infrastructure is used for operating a railway for which Queensland Rail Limited or a successor, assign or subsidiary of Queensland Rail Limited, is the railway manager.*

The transportation by rail requires use of rail transport infrastructure for a broader range of activities than simply operating between a specified origin and a specified destination. Aurizon considers this issue was addressed extensively in the development of the original access undertaking in 2001 (the 2001AU)<sup>3</sup>. Aurizon also notes that Queensland Rail has adopted the definitions for Access and Train Service from the 2001AU but not also included the full scope of services associated with provision of the declared service. These provisions are consistent with those in clause 2.1(b) of the 2008AU.

#### **Recommendation**

The scope of services to be negotiated pursuant to the access undertaking is not consistent with the declared service and the undertaking should include clause 2.1(b) of the 2008AU.

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<sup>3</sup> Queensland Competition Authority (2000) Draft Decision on Queensland Rail's Draft Undertaking, Volume 2, December, pp. 145 – 153.

### 3.2 The exclusion of third party facilities is not appropriately constructed

The 2015DAU proposes to exclude rail infrastructure for which Queensland Rail is the railway manager but not the owner. Importantly, the exclusion applied only in circumstances 'where it is providing railway manager services to the owner of the infrastructure and the terms of its contract with the owner do not allow Queensland Rail to comply with aspects of the 2015DAU'<sup>4</sup>.

The scope of the declared service is not ambiguous. It clearly states that where Queensland Rail is the railway manager then the facility is subject to the provision of the declared service. As a consequence the exclusion would not have the desired effect as a party could still seek access to the facility under Part 5 of the QCA Act. Under these circumstances any agreement between Queensland Rail and the owner precluding the ability to provide access would be inconsistent with the QCA Act (and the scope of the declaration at the time the parties entered the agreement).

Aurizon acknowledges that the construction of the declaration potentially places Queensland Rail at a disadvantage in the market for railway manager services for third party owned infrastructure. However, the exclusion does not necessarily address that disadvantage.

Section 119(1) requires that the QCA must not make an access determination that is inconsistent with an approved access undertaking. The 2015DAU exclusion seeks to have the same effect as a partial revocation which should be subject to the appropriate statutory process. Therefore the exclusion should not prevent enforcement of the declaration by precluding the QCA from making an access determination in relation to that service under Part 5 of the QCA Act. Alternatively, in the event of an inconsistency between the QCA Act and an access undertaking then the s.168 of the QCA Act requires that the Act prevails and the exclusion is void for inconsistency.

Aurizon considers that it is preferable that the exclusion be limited to contestable services. A contestable service is considered to be management of customer specific rail infrastructure constructed after the undertaking approval date for which the ownership and or operation of the facility was contestable.

This approach would also promote competition in the market for construction, ownership and management of railway infrastructure and ensure the exclusion is limited to the appropriate circumstances rather than create incentives for the access provider to transfer ownership and reduce competition for railway manager services.

Queensland Rail's participation in the market for railway manager services for privately owned spurs has implications for the need and application of ringfencing. In circumstances where the privately owned spur is connected to the Network owned and operated by Queensland Rail then the declared service is an input into the provision of those services due to the need to obtain access rights to the declared service for the movement of maintenance plant. Queensland Rail should clarify the market it would participate in, the services it expects to contest and why ringfencing obligations are not required due to that participation.

#### **Recommendation**

Queensland Rail is able to seek partial revocation under clause 88(2) and this is the appropriate mechanism for exclusion of services from coverage under the access undertaking. The request for revocation to the authority would also permit the matter of ringfencing to be considered concurrently.

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<sup>4</sup> 2015DAU, clause 1.2.1(b)(i)(C)

### 3.3 Network Expansions and Investment Principles

A fundamental premise of the Access Regime is that the access provider and the access seeker will negotiate in good faith and the access provider must make all reasonable efforts to try to satisfy the reasonable requirements of the access seeker.

The purpose of the negotiate-arbitrate model is for the access seeker and the access provider to reach a mutual agreement which reflects all relevant information and presumably leaves neither party financially or economically disadvantaged. This is particularly relevant where the access provider does not possess market power which would lead to any adverse impacts on a relevant upstream or downstream market.

Where an approved access undertaking is required to prescribe an investment framework it is essential that the framework is relevant to and workable for all feasible scenarios. In the context of the broad and diverse nature of the services and the facilities providing those services by Queensland Rail this becomes an unattainable and undesirable objective. The requirement that Queensland Rail must enter into a rebate agreement which requires undefinable rent calculation methodologies and objectives only serves to reduce Queensland Rail's willingness to extend the facility as it will never possess the necessary demand and revenue certainty to execute such an agreement without the real prospect of a financial loss where rebates are funded by access charges beyond those of the contributing party.

The investment framework proposed in the Aurizon Network 2014DAU is only applicable in the very narrow circumstance of a defined regulatory asset base, revenue cap form of regulation and reasonable certainty of ongoing utilisation of the service. Conceptually, in relation to Queensland Rail a rebate methodology would need to be bespoke for each contribution which takes into consideration the purpose of the contribution and the current and long term projected economics of the extended facility.

Aurizon considers that the principles based approach proposed in section 1.4 of the 2015DAU is most appropriate in addressing the predominant issues relevant to investment decisions on rail corridors which are effectively subsidised or where access revenues are below economic cost and may create disincentives for investment.

As most access negotiations will need to consider and address the unique circumstances which give rise to the need for a capital contribution it is highly desirable that the approved access undertaking, and regulatory frameworks more generally, address any information asymmetry and provide appropriate guidance to an access seeker to assist in assessing whether the proposed terms and conditions of access are consistent with:

- the value of the service to the access seeker<sup>5</sup>; and
- the economic value to the access provider of any extensions to, or other additional investment in, the facility that the access provider or access seeker has undertaken or agreed to undertake.<sup>6</sup>

The capacity investment framework must not be overly prescriptive and should accommodate the diversity of circumstances which might require the access provider to require a capital contribution as a condition of obtaining access to the service. However, Aurizon is also very supportive of

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<sup>5</sup> Queensland Competition Authority Act 1997 s.120(1)(e)(i)

<sup>6</sup> Ibid, s.120(g)

requiring that adequate record keeping of these contributions be maintained so that those contributions can be considered in future decisions or access determinations.

This section does not specifically address issues relevant to the Western System but considers the role and purpose of capital contributions where access revenue falls well below the economic ceiling in order to identify how the undertaking can address the legitimate interests of an access seeker.

### 3.3.1 The nature of the Queensland Rail Business

The rail infrastructure owned and managed by Queensland Rail can be broadly categorised as falling within one of the following classifications:

- Pricing at economic cost as occurs with Western System coal carrying trains services;
- Pricing at a level which allows sustaining capex and maintenance to be funded through access charges; or
- Pricing does not support sustained capex and maintenance without government contributions.

A key observation in all of these scenarios is that demand is subject to competition<sup>7</sup> and is therefore highly uncertain or access to bottleneck sections are subject to rail competition from alternate traffics<sup>8</sup>. In some circumstances the rail corridor or parts thereof may also be subject to bypass risk, stranding any investment in the existing facility.

Given these underlying factors it is reasonable to conclude that Queensland Rail's reluctance to extend its own facility is largely, and perhaps solely, attributable to the fundamentally uneconomic nature of those investments given the implicit risks to the access provider. The access provider's preferences are likely to lean towards allocating existing capacity to higher value services than to extend the facility to increase the total number of services with reduced profitability.

Capital contributions therefore play an important role in allowing economic projects to proceed where the extension is uneconomic to the access provider. That is, in the absence of economic rents within the access seeker's project to fund the capital contribution then it is unlikely the access could be granted without imposing uncompensated costs on the access provider.

Historically, the majority of the capital contributions which have been sought by Queensland Rail do not fit within either of these two descriptions and have been associated with increasing the reliability of the asset to accommodate the additional volumes. This occurs because capacity can be represented in two ways:

- the nominal capacity of the network as expressed in train paths; or
- the practical capacity of the network to accommodate gross tonnage within reasonably defined service quality parameters (that is the asset degradation and maintenance requirements of the additional tonnage should not impact on the ability to provide the current contracted service levels).

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<sup>7</sup> Competition occurs through competing modes or via highly competitive alternate supply chains both domestically such as the Central Queensland coal network and Hunter Valley coal networks or internationally.

<sup>8</sup> Western System coal carrying train services are subject to stranding risk through competition from passenger services in an increasingly utilised metropolitan system.

Examples of where this has occurred include replacement of timber/steel sleepers on both the Mt Isa Rail Corridor and the Western System. The investment is not renewal investment as it is simply replacing the existing assets to a higher standard. The assets also do not extend the facility as they do not provide for an increase in the number of services or an increase in train payloads (as the system already accommodates those dynamic loads).

The replacement of the existing assets with a higher standard or any relevant strengthening works is intended to maintain the service levels to existing access holders and to avoid more costly and disruptive maintenance expenditure from the increase in the number of train services. That is, these investments do not 'extend the facility'.

The principle issue arising for access seekers where a capital contribution is required for this type of investment is that the value of that contribution is fully and adequately reflected in the access charge. The prospect or likelihood for a capital contribution increases with the broader and necessary obligations on Queensland Rail to require the access provider to maintain the operational integrity of its network.

Aurizon also considers that transparency in relation to historical and projected cost and revenue information would strongly improve the ability of the access seeker to assess the reasonableness of the terms being proposed.

#### **Recommendations**

- For the avoidance of doubt the definition of extensions should exclude capital investment which does not support in increase in the productivity capacity of the railway;
- Queensland Rail should be required to maintain a register of capital contributions; and
- For the purpose of the determination of the maximum revenue limit in clause 3.2.3 of the 2015DAU, the asset value should exclude the value of any capital contributions and the revenue should be net of any payments associated with those contributions.

### **3.3.2 Facilitating extensions to the Network**

The structural separation of Queensland Rail requires an increased emphasis on investment coordination within supply chains to optimise costs and improve the overall efficiency of rail transportation services. Increased transparency and visibility in relation to the long term costs of providing the below rail services for a range of demand scenarios facilitates long term investment markets which will use those services and promote increased efficient investment and utilisation of the declared service.

However, unlike coal supply chains the rail corridors support a diversity of markets and heterogeneous mix of rail operations. The increasingly competitive above rail market increases the complexity of coordinating investment where a market participant does not wish to disclose its operational modelling, design or innovation within an open planning framework. It is likely that in some circumstances an access seeker may prefer to conduct its own studies to evaluate expansion options through consideration of optimising the above and below rail costs (a fundamental source of competitive advantage).

Access seekers are also likely to possess sufficient and relevant expertise to evaluate the likely and possible expansion options through their own studies. However, undertaking these studies requires access to relevant information. In this regard, Aurizon recommends that the access undertaking include a requirement that:



*Queensland Rail not unreasonably withhold information an access seeker requires to assess the relevant costs of expanding and maintaining the facility subject to the access seeker meeting all reasonable costs incurred by Queensland Rail in providing that information.*

Similarly, improved corridor planning practices would also vastly assist access seekers and access holders to understand the short and long term economics of the services they are provided, or wish to be provided, by Queensland Rail.

Aurizon welcomes Queensland Rail's proposal that it will publicly make available a plan or strategy that has been approved by its board or chief executive officer. However, this is highly dependent on Queensland Rail having a relevant plan or strategy. Aurizon would welcome a stronger commitment to prepare and publish corridor strategies which included information contained in Table 1.

**Table 1 Suggested Content for a Rail Corridor Strategy**

Corridor Strategy Content	Use of Information
Base service levels	This should include an adequate description of the current asset performance and define the 'fit for purpose' state funded directly by access charges and/or the Transport Services Contract <sup>9</sup> . Access Seekers and Access Holders should be aware of the implications of any changes to the TSC funding levels on their future service levels.
Corridor Safety Improvements	Current information regarding incident frequency and plans to continuously improve corridor safety.
Corridor Capacity and Capability	Details of current utilisation and capacity availability. Areas of potential capacity constraints and opportunities for improving asset utilisation. Details of any strategies the access provider is undertaking to improve rail modal competitiveness.
Corridor Performance Improvement	Details of any strategies the service provider is pursuing to improve the operational performance or options which could be considered to improve operational performance. Details of the corridor possession strategy and opportunities to improve asset availability
Corridor Asset management plan	Details of, and trends in, asset condition. Details of the forward looking renewals expenditure and initiatives being pursued to improve the efficiency of maintenance and asset renewal practices.

Aurizon does not consider these to be onerous requirements and they should be implicit to good railway management practice<sup>10</sup>. Improving the efficiency and utilisation of rail infrastructure has the effect of improving the competitiveness of rail and increasing the scale of the market for rail transport in Queensland. Economies of scale are an essential factor in promoting competition in the downstream rail haulage market.

<sup>9</sup> In the context of funding limitations, the network is to be maintained to a 'fit for purpose' standard and be monitored through key performance indicators and base service levels. Maintenance funding is to prevent deterioration of the network and limit the potential for this to become a compounding funding liability (Rail Network Strategy <http://www.tmr.qld.gov.au/business-industry/Transport-sectors/Rail-services-and-infrastructure/Rail-Network-Strategy.aspx>)

<sup>10</sup> For example, see the Network Rail route plans for 2014-2019 available at <http://www.networkrail.co.uk/publications/strategic-business-plan-for-cp5/>



### Recommendation

The access undertaking should include a stronger commitment to develop rail corridor strategies which address how it will improve the efficiency and utilisation of that corridor.

#### 3.3.3 Purpose and intent of the capital contribution

The basic concerns for access seekers where capital contributions might be sought on rail corridors for which the relevant access revenue to the access provider is substantially below the revenue ceiling limit (the large majority of the Queensland Rail managed rail infrastructure) is whether:

- the need for the capital contribution is necessary, does not adversely affect their ability to compete in the relevant market and does not create perverse incentives for the access provider; and
- the full economic benefit has been reflected in the price they obtain for access to the service.

Aurizon accepts that the terms and conditions of access should include greater specificity on the service quality and performance metrics. This would also necessitate that those standards are maintained over the term of the access agreement and therefore should also not be adversely affected by the access provider contracting for additional rights.

In granting additional access rights it may therefore be necessary for the access provider to incur additional maintenance costs to maintain contracted services standards, or make improvements to the rail infrastructure which may need to be funded through either government contributions, where this is in the public interest, or through capital contributions from the access seeker. Of particular relevance to determining the reasonableness of the capital contribution is whether it represents the most cost efficient means of providing additional access rights without adversely affecting either the access provider or other access holders and does not represent an opportunistic approach by the access provider to fund unnecessary capital improvements to its assets which primarily benefit future users of the network.

It is also important that Queensland Rail does not possess perverse incentives to withhold or defer maintenance or renewals to improve profitability on the expectation it can obtain capital contributions from future access seekers who obtain additional access rights. For example, where Queensland Rail considers that a mineral project or mineral deposit has a reasonable prospect of development the access provider may seek to delay renewal activities with the intent of having those costs funded via access seeker capital contributions.

In the event of arbitration in relation to additional access rights where the QCA required an access seeker to fund the costs of the expansion, in determining the terms and condition of access the QCA would also be required have regard to the relevant costs and benefits to both the access seekers and access provider.

As a general principle, the access provider should not be required to make a capital contribution where the access provider also obtains benefits from those contributions. In other words, Queensland Rail's financial position should be the same with and without the capital contribution because clearly the NPV of the access charges would have been partially or fully sufficient for the access provider to extend the facility without bearing any of the relevant costs. This is effectively the reciprocal of the no financial disadvantage requirement which ensures an appropriate balance of interests in the negotiation process.

As an example it would be inappropriate for Queensland Rail to seek a capital contribution while simultaneously improving its EBIT or return on assets through the access seeker's access charges. In this example, the value of capital contribution would need to be fully recognised in the determination of the access charge. This is summarised in the indicative example in Box 1.

#### **Box 1. Indicative Example of Capital Contribution**

An access seeker applies for access rights for a term of 5 years. The proposed operations are within the current operational standards of the rail infrastructure and the facility is underutilised. No extensions to the network are required.

The increased gvk is expected to accelerate the physical depreciation on parts of the network at a rate greater than what can be sustained through maintenance practices. The access provider considers the most efficient means of providing the additional access rights would be to improve the standard of infrastructure on those critical sections.

The physical life of these assets extends substantially beyond the term of the access agreement. However, there is considerable uncertainty as to the level of demand at the expiry of the access agreement and the access provider reasonably considers such investment to be uneconomic (i.e. is negative NPV from incremental revenues).

The access provider seeks a capital contribution of \$30 million from the access seeker to fund replacement of timber sleepers with the modern engineering equivalent of concrete sleepers but section run times and axle loads are unchanged.

The incremental maintenance and operating costs, inclusive of provisions for asymmetric risks and appropriate services margin over the contract period has an NPV of approximately \$25 million. The access provider proposes an access charge, in addition to the capital contribution, which has an NPV of approximately \$65 million. The access charges are also supported by appropriate take or pay conditions and covered by satisfactory security.

Under this scenario the access seeker is:

- making an upfront contribution of \$30 million;
- meeting its full incremental costs of \$25 million; and
- contributing to the access provider's profitability by a further \$40 million

The requirement for the access seeker in this indicative example to make the capital contribution would appear unreasonable where the avoided maintenance costs are funded via the capital contribution while the access provider is also increasing its profitability through increased contribution to common costs.

It is probable that the benefits of the capital contribution may be enduring beyond the term of the access rights or renewed access rights. However, revenue from current and unrelated access rights will most likely be attributable to the access provider's own sunk assets. Therefore, it is also necessary to ensure that any future consideration of economic costs takes into account the economic benefit of contributions.

## Recommendation

Taking these issues into account Aurizon therefore suggests that 2015DAU should include obligations to include in the requirements for an Indicative Access Proposal that where an access provider seeks a capital contribution which does not extend the facility then it must provide details which support the presumption that:

- **The contribution is necessary** through an appropriate engineering study as to why the capital works are required;
- **The contribution is efficient** through evidence which demonstrates those works are more efficient than the incremental maintenance costs associated with the additional access rights;
- **The contribution reflects prudently incurred costs** through demonstration of the procurement model will satisfy the commonly applied regulatory standards of prudence in scope, standard and cost (or at a minimum a sufficiently detailed scope of works to allow the access seeker to obtain its own independent estimate of expected prudence);
- **The contribution is fair and reasonable** by providing details of the access revenue and variable costs (including depreciation expense) associated with providing access to the relevant rail corridor over the previous five financial years; and
- **The contribution is appropriately reflected in the access charges** by disclosing the expected incremental costs of providing the proposed access rights and how the contribution has been reflected in the price.

## 4 Negotiation Framework, Standard Access Agreement and Operating Requirements Manual

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This section covers those aspects of the 2015DAU which are broadly characterised by the negotiation and provision of access through an access agreement. Aurizon has addressed four aspects of this process in this submission:

1. **Negotiation framework:** Pivotal to the conduct of an effective access negotiation is the provision of information in a timely manner with sufficient detail to allow the access seeker to assess the proposal;
2. **Primary role of the standard access agreement:** The primary role of the standard access agreement is to address the potential for discriminatory terms and conditions of access between an access seeker and a related operator. As access seekers are not typically seeking to operate passenger services, then the purpose of the standard access agreement is largely to minimise the transaction costs of negotiating access rights. Aurizon however believes that the standardisation of access agreements may also stifle competition and innovation. This can particularly occur where the access provider seeks to the limit the scope of negotiation of access to the standard terms and conditions (on a take or leave it basis). This is often supported by restrictive provisions in the undertaking which only allow for variance from the standard access agreement where both parties agree, without recourse to dispute resolution if the access provider does not agree (i.e. is not prepared to negotiate performance accountability obligations);
3. **Risk, indemnities and liabilities:** The access agreement should represent an appropriate and reasonable allocation of risk between the access provider and the access seeker; and
4. **Operating requirements manual:** The operating requirements manual, and its review and variation plays an important function in determining the rail operators costs of operation. It is also the framework which the access provider may seek to transfer risks to rail operators that are outside their ability to control or influence.

### 4.1 Negotiation Framework

Aurizon notes that the negotiation framework should provide all the information necessary to allow an access seeker to understand how its access charge has been determined, particularly in the context of the market it is operating, and how it is likely to change over time. The information relating to standard, performance and risks associated with the asset condition and reliability are essential for the rail operator to understand the costs of its own operations required to meet the expectations of customers with potential substitutes to rail.

The timeliness of the provision and the reliability of information are of significant importance to an access seeker.

#### 4.1.1 Preliminary Information

Aurizon welcomes Queensland Rail's commitment in clause 2.1.2(c) to make the Preliminary Information publicly available on its website and for that information to be current and accurate.

The relevant information packs currently published on the Queensland Rail website are dated:

- Mt Isa System, May 2007;
- North Coast Line, July 2007;
- Western System, March 2006; and
- Central West, April 2008.

#### Recommendation

The review of these documents does not provide a substantial degree of confidence that information will be maintained to be current and accurate. Aurizon suggests that Queensland Rail amend its proposed access undertaking and provide a stronger commitment that it will review and amend the Preliminary Information within 12 months of the approval date. This commitment should be enforceable by the QCA.

#### 4.1.2 Requirements for an Indicative Access Proposal

The requirements for an indicative access proposal are outlined in clause 2.4.2 of the 2015DAU and should be consistent with the requirements of s.101 of the QCA Act regarding the information the access provider must give an access seeker.

The following table assesses the 2015DAU against the requirements in s.102 of the QCA Act. While clause 2.7.2(a)(i)(B) requires Queensland Rail to provide the information within s.102 this can be made more explicit in the provision of information contained in Table 2 in the IAP.

**Table 2 Consistency of Information Provision with the Requirements of the QCA Act**

QCA Act s.101(2)	2015 DAU	Comment
Information about the price at which the access provider provides the service, including the way in which the price is calculated	2.4.2(d)	The QCA should satisfy itself that the provision of a methodology is consistent with the requirement of providing information on the way the price is calculated. Where the IAP relates to variation of existing access rights it should also be required to outline the change in costs or risks associated with a proposed variation in access charges Where the IAP relates to a renewal of existing access rights it should also be required to provide information relating to the relevant facts or circumstances which result in a change in the way the price has been calculated
Information about the costs of providing the service, including the capital, operation and maintenance costs	5.2.2(k)	The information provided in the annual report should contain information for more than one year in order to provide trend information on costs. Aurizon suggests that the annual report also include data for the previous two years.
Information about the value of the access provider's assets, including the way in which the value is calculated;	5.2.2(k)	This requirement is not addressed in the 2015DAU. At a minimum the IAP should include the written down book values for rail transport infrastructure relevant to the access rights being sought.
An estimate of the spare capacity of the service, including the way in which the spare capacity is calculated;	2.4.2(b)	2015DAU addresses this requirement

A diagram or map of the facility used to provide the service;	Line Diagrams Preliminary Information	2015DAU addresses this requirement
Information about the operation of the facility;	Preliminary Information Quarterly Performance Reports	Unless agreed otherwise, the IAP should provide the following operational information: <ul style="list-style-type: none"> <li>Any reasonable requests made in the application for access to the historical service quality information to assess the reliability of the proposed services</li> <li>Relevant corridor scheduling procedures</li> <li>Possession protocols.</li> </ul>
Information about the safety system for the facility;	Operational Requirements Manual	2015DAU addresses this requirement

#### **Recommendation**

The IAP should include the additional information included in Table 2.

#### 4.1.3 Application of Standard Access Agreement to non-coal services

The 2015DAU is unclear as to the extent to which the standard access agreement would apply to non-coal services. This ambiguity arises because Clause 2.9.4 of the 2015DAU requires that the terms of an access agreement must be consistent with the terms of a standard access agreement applicable to the relevant type of train service.

While the reference tariff for coal carrying train services in the Western System makes it an explicit condition of access that the 'Reference Train Service will operate in accordance with the terms and conditions of the standard access agreement' the standard access agreement also includes provisions which relate to the carriage of dangerous goods.

Given the substantial diversity of traffics and differences in estimates of value of the service to different access seekers Aurizon is strongly opposed to the standardisation of access agreements.

#### **Recommendation**

The 2015DAU should either:

- Establish additional reference tariffs and for which the standard access agreement should apply; or
- Redraft clause 2.9.4 to state that the standard access agreement only applies to a reference tariff approved by the QCA but is intended to provide the indicative and non-binding basis for negotiation for access rights not associated with a reference tariff.

#### 4.1.4 Renewals

Clause 2.9.3 (b) in the undertaking is limited to coal and bulk mineral freight. By removing other bulk and intermodal freight the 2015DAU has increased the uncertainty over long term planning for these products. Queensland Rail has specifically addressed the reason as to why other bulk and freight is excluded noting that the origin and destination points for these products could move over time. Aurizon sees no reason as to why freight is excluded from the renewal provisions in the case where

these origin and destination points have not moved as freight is subject to the same long term planning dynamics that bulk and coal supply chains are subject to. Long term investments include intermodal terminals.

**Recommendation**

Include freight and other bulk in clause 2.9.3(b).

#### 4.1.5 Cost recovery in the event of no access agreement

The inclusion of the cost recovery clause in its current drafting indiscriminately discourages access applications. The submission allows for Queensland Rail to recover its costs and expenses reasonably incurred in dealing with the access seeker's submission. Aurizon believes that this is far too broad an allowance and allows Queensland Rail to allocate overhead costs to this recovery.

**Recommendation**

- Costs reasonably incurred are limited to incremental costs incurred; and
- In the event that there are incremental costs expected to be incurred than Queensland Rail should be obligated to provide a quote for this work

## 4.2 Standard Access Agreement

The standard access agreement should facilitate an efficient and reasonable balance of risks and provide the access holder with an appropriate level of commercial certainty as to the obligations of both parties to the contract. It should also limit the capacity of the access provider to substantially alter the way in which contracted access rights are provided through variations in frameworks and associated documents, obligations or methodologies where sit outside of the access agreement.

### 4.2.1 Access Holders require their Access Agreement to provide long term contracting certainty

Queensland Rail has proposed a standard access agreement that assumes the Operator holds access rights on behalf of its customer. Where the customer elects to, it is entitled to be a party to the standard access agreement as the Operator's Customer, and will then be required to execute the Access Agreement (the agreement), however the proposed standard access agreement does not allow the Operator's Customer to be the Access Holder.

To allow for the customer to be a party to the agreement, Queensland Rail has proposed rights of the Operator's Customer under the standard access agreement. Whilst Aurizon appreciates the intent of Queensland Rail's proposal of introducing the ability for the customer to be a party to the agreement, the drafting of the agreement proposed by Queensland Rail in its current form creates an element of confusion between Party, Customer and Operator's Customer. Aurizon recommends that before the standard access agreement is approved, a detailed review is required to ensure a consistent application of the references to Customer and Operator's Customer.

In addition it is Aurizon's view that the proposed standard access agreement has extended the scope of the agreement beyond that of existing provisions. For example Clause 3.2(c)(ii) of the standard access agreement stipulates that an Operator must reimburse an Operator's Customer for



the costs associated with any delays in the transfer of access rights. Aurizon considers that the commercial agreements between an Operator and its Customer should contemplate any reimbursement of costs or imposition of penalties, and this should not be provided for in the Access Agreement. The access undertaking or an access agreement should not interfere with matters which are associated with, and resolved, through competition in the market for rail haulage.

Aurizon assumes that the proposed standard access agreement can be used as a basis for contracting regardless of whether reference tariffs apply. This has the effect of the SAA being a template for all negotiations, however this does not preclude the Access Seeker from negotiating variations in accordance of Part 2.9.4 of the 2015 DAU. As noted, Aurizon is concerned that Part 2.9.4 of the 2015 DAU does not provide a positive obligation on Queensland Rail to agree to negotiations outside of the standard access agreement. In the absence of allowing the Customer to be the Access Holder, Aurizon considers that there will be a growing demand from Customers for alternatives to the standard access agreement to be negotiated. Furthermore, Aurizon acknowledges that Schedule E (Principles for inclusion in Standard Access Agreement) of the 2008AU has been removed, therefore reducing certainty for Access Seekers about the terms that will be subject to negotiation. Aurizon suggests that Queensland Rail has overlooked the importance of Schedule E, as it provides Access Seekers with certainty about what terms will be subject to change.

Aurizon considers that the Access Undertaking should retain a schedule which outlines the content of an access agreement. Where Queensland Rail seeks to establish binding provisions for non-reference tariff access agreements then these should be included within the relevant schedule as non-negotiable terms.

This approach preserves the intent of the negotiate arbitrate framework while balancing the interests of the access seeker and the service provider in relation to some terms of access which can provide an appropriate level prescription of the allocation on risk between the operator and access provider

#### **Recommendation**

- Removal of provisions within the standard access agreement that introduce a change in the allocation of risk between an Operator and its Customer;
- Review of the standard access agreement for consistency in application of Operator and Operator's Customer; and
- Reintroduction in to the 2015DAU a schedule of principles that are to be included in the negotiation an Access Agreement.

#### **4.2.2 Maintenance of the Network in accordance with the Rollingstock Interface Standards and an Access Holders Train Service Entitlements.**

Queensland Rail has maintained its 2013DAU position that it has the responsibility to maintain the Network such that the Operator can operate Train Services in accordance with their access agreement. However, some aspects of the agreement are subject to influence by matters not specifically addressed in the access agreement such as the Master Train Plan (MTP). Furthermore, Queensland Rail has amended the MTP Principles to no longer obligate Queensland Rail to “*detail the Capacity required for the provision of Train Service Entitlements*” but rather “*indicate the capacity necessary to satisfy all relevant Train Service Entitlements*”. This change has the effect of reducing the certainty as to the standard the Network will be maintained over the period of the access agreement.



To improve Access Holder's certainty and promote innovation to improve supply chain efficiencies, Aurizon recommends that the MTP reflects the Train Service Entitlements in all relevant access agreements. The MTP should reflect the Train Service Entitlements of all Access Holders in the relevant corridor to demonstrate that Queensland Rail has sufficient capacity to meet its contractual obligations.

The absence of an obligation on Queensland Rail to ensure the MTP reflects the capacity required under Schedule 2 of the Access Agreements, may result in the imposition of Possessions and Operational Constraints at the expense of the Access Holder's access rights. Aurizon acknowledges that Queensland Rail has introduced obligations to minimise the adverse impact of Possessions into the Network Management Principles (NMP) (Schedule F Clause 2.3). However it has not addressed recommendations by the QCA and Aurizon for a continuance of Queensland Rail's existing obligation to minimise the disruption of Operational Constraints.

Access Holders are potentially exposed to further losses of access rights due to the reasonable endeavours obligation on Queensland Rail to minimise the adverse impact of a Possession only where train service is "substantially" impacted (Schedule F, Clause 2.3(c)). Clause 6.3 of the SAA and Schedule F, Clause 2.2(i) of the 2015 DAU supports Aurizon's concerns that the current drafting favours Queensland Rail in managing the Network at the potential expense of an Access Holders access rights by:

- Introducing the right to prioritise Compliance matters where there is inconsistency which, under current drafting, may give rise to decisions being made without consideration being given to the impact to an Access Holder; and
- The NMP provides Queensland Rail the right to override any obligation to consult and seek agreement where a variation to the MTP is required in the Daily Train Plan (DTP).

The standard access agreement requires that where an Operator is unable to use the scheduled train time, then Queensland Rail will attempt to provide an alternate scheduled time, but does not obligate Queensland Rail to provide an alternative schedule time where Queensland Rail is unable to meet the scheduled time. In utilising an alternate scheduled time an Operator should limit any liability (take or pay) from the cancellation of a scheduled service. However, the current provisions in the NMP and Clause 7.6 allows Queensland Rail to identify a train path which could operate a train service from the origin to destination without consideration of the Operator's ability to provide crew and rolling stock to operate a train service on that path. Effectively, it assumes that an Operator, if it wants to avoid take or pay attributable to below rail cancellation should maintain a standby train set and crew to use the alternate train path the Queensland Rail considers would facilitate a train service. This is not a reasonable expectation, nor is it an efficient outcome.

#### **Recommendation**

- Clarification of the meaning of "applicable corridor scheduling procedures" referred to in Schedule D, Clause 3.1(g)(ii) of the 2015 DAU and, where relevant, a process by which these are consulted and agreed with access seekers/holders. In addition, these corridor scheduling procedures should be detailed in an IAP;
- The Master Train Planning Principles are changed to reflect the importance of the MTP such that it should detail the capacity necessary to satisfy all relevant Train Service Entitlements;

- Revision of Queensland Rail's obligation to ensure that the Network is maintained in accordance with the NMP such that the Infrastructure is consistent with the Rolling stock Interface Standards and an Operator can operate Train Services in accordance with its Scheduled Times;
- Removal of the ability for Queensland Rail or an Operator to prioritise Compliance matters (Clause 6.3 and 7.3) where there is inconsistency to ensure consistency of obligations in the drafting provisions in all relevant documents;
- The removal of Clause 2.2(i) from the NMP from the 2015 DAU;
- Clause 2.3 of the NMP should be updated to include an obligation on Queensland Rail to minimise the adverse impact of Operational Constraints and the removal of "substantial" from Cl2.3(c) to better reflect the existing provisions in Schedule E of 2008AU;
- A definition for an Alternate Schedule Time is included in the standard access agreement and NMP and this term is introduced into the NMP where Queensland Rail schedules a DTP in variation away from the MTP or modifies the DTP once scheduled:

***Alternative Schedule Time** means a proposed Scheduled Time by Queensland Rail that is a Usable Scheduled Time, to replace a Scheduled Time for a Train Service that is not able to operate due to Queensland Rail failing to make the Network available to operate the Train Service.*

*Where **Usable Scheduled Time** means a proposed Scheduled Time that considers an Operator's ability to utilise rolling stock and crew (as contemplated in the Operating Plan for the Train Service) to operate on that proposed Scheduled Time. Queensland Rail must also consider as part of the development of the Schedule the Operator's ability to operate any connecting Train Services.*

#### 4.2.3 Suspension, Default and Termination

The proposed standard access agreement has the effect of significantly expanding Queensland Rail's rights to suspend or terminate services. This has had a material impact on the certainty of contractual rights for an Access Holder. Aurizon has identified a number of changes that have this effect, including:

- Under clause 14.1(a)(iii) Queensland Rail will be permitted to suspend the agreement where, in its opinion, the Operator will fail to comply with obligation under the standard access agreement;
- Under clause 14.1(a) Queensland Rail is entitled to, without notice, immediately suspend an Operator's right to operate services;
- The scope of the right to suspend under clause 14.1(a)(iii)(B) does not distinguish between obligations which have had have a material adverse impact; and
- Under clause 15.1(a) Queensland Rail is entitled, without notice, to immediately terminate an access agreement.

Aurizon's opinion is that these changes will unnecessarily force the Access Holder to rely on dispute resolution mechanisms rather than act to remedy within an appropriate timeframe.

### Recommendation

- Reintroduction of reasonable response times to remedy notices within the standard access agreement;
- Suspension and Termination rights under the standard access agreement are limited to situations where a party can demonstrate a material adverse impact; and
- Termination provisions such as Clause 7.4(c)(iv)(A)&(B) are removed and where appropriate addressed in Clause 14 and 15.

#### 4.2.4 Operator's ability to help improve Supply Chain efficiency

Aurizon has undergone a substantial review of the operational performance of its rollingstock. Part of that process has been exploration of innovative alternatives to current operations, and more specifically to operate longer trains and different configurations. The testing of these innovative solutions have required temporary authority for the purpose of undertaking testing in a safe environment.

Clause 7.9 Authorisation of Rollingstock and Train Configurations of the standard access agreement is drafted such that it assumes all variations requested to existing approved configurations would be a permanent variation and as such warrant a review of potential additional costs incurred by Queensland Rail and a change to the access charges where agreed to by the parties. Aurizon's view is that there should be a distinction made between permanent variations and temporary ones for the purpose of undertaking testing.

Queensland Rail's current drafting incentivises Queensland Rail to amend access charges where there is any temporary reduction in volumes relating to the testing in order to maintain its revenue stream which should be effectively covered by take or pay. Where the changes sought are expected to be permanent, Aurizon believes Queensland Rail must be required to demonstrate the increase in its costs that are associated with the operational changes that an Operator is seeking to make. Aurizon is concerned that without this obligation, Queensland Rail could seek to obtain a greater benefit from an Operator's innovation than it has contributed. That is, the requirement to negotiate a variation to an access agreement provides an ability for the service provider to extract the value of the operator's efficiency gains.

Furthermore, Aurizon is concerned that where an Operator is seeking to implement operational efficiencies that have the effect of reducing the number of Train Service Entitlements to deliver the same volumes, the reduction of paths will be subject to a relinquishment fee for the required full value of the Access Charges over the remaining term.

Aurizon has previously submitted in response to the QCA Draft Decision on Aurizon Network's 2014DAU the impairments to efficiency associated with relinquishment fees where the size of the fee is disproportionate to the associated potential loss in access revenue. Aurizon considers that relinquishment fees should be capped so as to not exceed the reduction in revenue associated with the variation in an access agreement arising from improving the productivity of train services. Aurizon maintains that relinquishment fees which exceed the costs, or lost revenue, to the access provider are inconsistent with the requirements of s.168A(d) of the QCA Act which requires that prices include incentives for efficiency.

#### Recommendation

- Amendment to Clause 7.9(b) to distinguish between temporary and permanent variations to rollingstock configurations, and the methodology, rates or other inputs for calculating access charges should only apply to permanent rollingstock configuration changes where Queensland Rail has proven increases in costs will be incurred as a result; and
- Amendment to the provisions relating to relinquishment fees to cap the obligation to pay a relinquishment fee associated with a variance to train service entitlements and rollingstock configuration to the variation in access revenue arising from that change.

#### 4.2.5 Queensland Rail Cause

Where a Train Service fails to operate and consumes a Train Service Entitlement, Access Holders generally have two means of remedy where the Network is not available for contracted train services:

- Reduction in take or pay liability; or
- Make a claim against Queensland Rail for either a non-provision of access for delays in the provisions of Trains Services.

A reduction in take or pay liability would apply where it is attributable to Queensland Rail Cause (as per the definition of Queensland Rail Cause in Clause 28.1 of the standard access agreement), reducing the access charges payable to Queensland Rail. The current drafting of the Queensland Rail Cause definition in the standard access agreement lacks balance in exposure to who is primarily attributable to a Train Service not operating, such that an Access Holder would still pay take or pay where Queensland Rail was primarily the cause for a derailment (but not solely). In previous submissions, Aurizon has suggested that “solely” and “in any way attributable” be replaced with “primarily attributable” to best reflect the apportionment of cause.

Further, delays in train movements due to the imposition of Operational Constraints can cause for a Train Service scheduled time to not be met due to rollingstock not being able to make its next scheduled departure time. Where this occurs in timetabled traffic an Operator is often exposed to the liability of take or pay on the “return path” as the impact of an Operational Constraint or Possession is limited to the “Forward path”.

Aurizon is concerned that the Queensland Rail Cause definition, when read in conjunction with Clause 5.7 Interim Take or Pay notices of the standard access agreement, does not appropriately apportion the liability for a lost Train Service. The standard access agreement does not propose an appropriate process for allocating unresolved cancellations whilst investigations are ongoing. Aurizon feels that this will lead to difficulty in the practical application of Clause 5.7 and will lead to disputes` in most cases. The current drafting of Clause 5.7 proposes that Interim Take or Pay notices are only subject to correction by Queensland Rail and in all cases the most recent Interim Take or Pay notice provided by Queensland Rail is final and pending dispute.

#### Recommendation

- The Queensland Rail Cause definition should be revised such that, “primarily attributable” replaces the following terms; “solely”, “in any way attributable” and “or any other person”;
- The Queensland Rail Cause definition should replace the following terms; Planned Possession, Urgent Possession or Emergency Possession with Operational Constraint;

- Clause 5.7 Interim Take or Pay notice clause of the standard access agreement is removed or replaced with a good faith obligation to resolve outstanding take or pay monthly but all cases by year end; and
- Amendment to the definition of Alternate Scheduled Time in the standard access agreement as discussed in section 4.2.2.

#### 4.2.6 Impact of Material Change on Access Charges

Clause 18.2, Adjustment for Material Change, entitles Queensland Rail to review access charges where there has been a Material Change. While Aurizon acknowledges a large portion of Queensland Rail's infrastructure is supported by Government funding Aurizon does not agree that in all cases any change in government funding should automatically result in an access charge review.

This issue was previously addressed in the 2013DAU by allowing Queensland Rail to review access charges which were priced below the revenue floor where there was a change in Transport Services Contract ("TSC") revenue. The 2015DAU has the effect of expanding this to access charges for all train services operating over TSC supported infrastructure where there is a change in TSC funding. This occurs by the 'Change to Credit' definition included in the scope of a material change in the standard access agreement.

Aurizon considers that access holders are not parties to negotiations with the government in relation to either the funding or the standard of infrastructure that funding is intended to provide and it is unreasonable to transfer the risk of changes in this funding to an access holder as it largely outside of its reasonable control to mitigate.

Aurizon considers that the circumstances where access charges can be reviewed for a Change in Credit associated with 'any change in the funding or other support received by Queensland Rail from any Authority in relation to any relevant part of the Network' should be limited to access charges below the Floor Revenue Limit as per the 2013DAU proposal.

#### **Recommendation**

Amend the material change clause to only permit the review of access charges for a change in funding from an Authority where the access charge is below the revenue floor limit.

### 4.3 Risk, Liabilities and Indemnities

#### 4.3.1 The role of the Interface Risk Management Plan (IRMP)

Clause 6.3 and 7.3 of the Undertaking obligates the Operator and Queensland Rail to comply with the IRMP. Further to Section 4.2.2 of this document, Aurizon is concerned that the Clause 6.3 and 7.3 of the SAA allows prioritisation of compliance between the Law, the Agreement and the IRMP. Clause 9.1(b) obligates the Operator to use reasonable endeavours to not cause, permit or contribute to any act or omission which may give rise to Interface Risks that are not addressed in the IRMP and Clause 9.2 imposes a 12 month period for review of an IRMP to ensure all Interface Risks are effectively managed under the IRMP. The concern for Aurizon is where provisions are inconsistent between the lawful requirements of authorities and documents listed in Clause 6.3 and 7.3, Queensland Rail will not be incentivised to ensure consistency in drafting and the importance of the IRMP, NMP and ORM, with respect to ensuring access rights certainty may be diminished.

Aurizon is satisfied with obligations of both parties and the objective of the IRMP, however Aurizon has concerns where Queensland Rail is introducing prescriptive risk management provisions in the Operating Requirements Manual (ORM) relating to High Consequence Dangerous Goods and Queensland Rail electrified railway corridors. The IRMP should inform all reasonably identifiable and relevant interface risks and appropriate safety systems and controls, whilst also stipulating which party is best placed to implement and manage that control. The IRMP may also reference any applicable statutory obligation that a Party may be obligated to adhere to, if required to support the control system.

The introduction of prioritisation of compliance through Clause 6.3(h) and 7.3(a) (x) and prescriptive risk management provisions in the ORM give rise to situations where a Party has inconsistent obligations across the different lawful requirements and access related documents. For this reason Aurizon suggests that the access undertaking and ORM should not be prescriptive in relation to the management of specific risks and controls where legislation provides sufficient incentive to comply, but rather reinforce the importance of IRMP compliance.

#### **Recommendation**

Removal of prescriptive provisions in the Undertaking where the IRMP would satisfactorily provide the framework to manage these risks and controls including:

- Clauses 2.3, 3.3 and 3.4 of the ORM; and
- Clause 10.5 of the standard access agreement that may reference compliance to applicable laws.

#### **4.3.2 Dangerous Goods and Incident Management**

As stated above Aurizon firmly supports the importance of the IRMP in managing risks and controls by the party that is best placed to manage those controls, or where relevant, joint management of risks that have been identified. Where an Operator's performance is affected by the performance of a Network Provider, it is important that all remedies required under the IRMP reflect the existence of those interface complexities. The liability and indemnity provisions in the SAA that relate to Dangerous Goods liability obligate the Operator, as the sole party, to indemnify all other parties of claims (including claims of consequential loss) brought against them. Aurizon maintains the view from its 2013DAU (February 2013) submission (section 4.1) that liability of Dangerous Goods could be a negotiable position taking into consideration the information asymmetry of both parties and the risk applicable to the class of dangerous goods (noting however that Queensland Rail have defined Dangerous Goods as any substance it may deem to be dangerous irrespective of the Dangerous Goods Code classification of that substance).

Clause 4.3 of the ORM states that Queensland Rail is responsible for the overall co-ordination and management of the response to a Network Incident. Whilst there are clear obligations of an Operator under Restoration and Recovery in relation to mitigation prevention and compliance to Queensland Rail direction, there should be a mutual obligation for Queensland Rail to also "*minimise and mitigate potential or actual damage or injury to persons, property ....*". As slow release of a substance is not an insurable event, incident recovery is the best opportunity to mitigate exposure to further damage to persons, property and the environment. Where Queensland Rail fails to comply with this obligation, it should be required to accept an appropriate share in the liability for costs or claims relating to the incident.

#### **Recommendation**

- The definition of Dangerous Goods should be amended to reflect only the classification under the Dangerous Goods Code; and
- Review of Liability and Indemnity clauses to best reflect apportionment of cause in relation to claims.

#### 4.3.3 Third Party Works

In Clause 6.1(c), Queensland Rail has maintained its DAU2013 position to not accept liability to another party should costs, expenses, losses or damages occur in relation to Third Party Works, even if Queensland Rail have authorised access to the rail corridor. While Aurizon acknowledges that Queensland Rail may have no option but to authorise access to the corridor, Access Holders should not be exposed to risks where Queensland Rail has acted negligently or by omission or where there is a contractual relationship between Queensland Rail and the Third Party. The current drafting of this clause would have the effect of an operator not being able to reduce take or pay liability and have no right to claim in respect of delays to train movements or non-provision of access.

#### **Recommendation**

Clause 6.1(c) and the liability and Indemnity provisions should be amended to reflect liability of Queensland Rail for incidents where any act or omission of Queensland Rail has adversely impacted a rail operator.

#### 4.3.4 Amendments to Operating Requirements Manual (ORM)

In general Aurizon supports the provision of the 2015DAU ORM, associated documents and the removal of the dispute limitations in the 2013DAU ORM. The ORM should provide transparency to Access Seekers and Access Holders of operational parameters and obligations during the term of the contract, providing it does not impact on obligations in the existing access agreements, or create inconsistencies between the documents and the associate access rights of the Access Holder.

Clause 8.1 of the SAA attempts to address stakeholder concerns regarding future amendments of the ORM however fails to continue the need for consultation in relation to changes in the ORM for matters concerning safety and material change. In addition, uncertainty over future costs is increased by the inclusion of Clause 8.1(c) which expands the definition of a change for safety matters to include those “arising as a result of another matter” and the removal of a clause which obligates Queensland Rail to limit the financial impact on an Operator.



#### **Recommendation**

- Redrafting of Clause 8.1(c) of the SAA to limit the waiver of compensation to the extent of the safety matter and not the entire change;
- Introduction of the requirement for Queensland Rail to enter into negotiations in good faith where amendments are required to the ORM so that Operators are not forced to rely on the costly and lengthy dispute resolution clauses of the agreement; and
- Introduction of an obligation on Queensland Rail to limit the financial impact of changes to the ORM on an Operator.

#### **4.3.5 Insurance Provisions**

In review of Clause 16, Aurizon has identified a number of concerns with respect to an access holders ability to comply with respect to the responsibilities under the Access Agreement. Aurizon has previously stated in its DAU2013 (February) submission that insurance policies will always have exclusions and it is not for another party to determine what the acceptable exclusions are for insurance, provided it is consistent with industry standard. The expectation of Queensland Rail that an access holder will be able to hold insurance that satisfies all proposed liabilities and indemnities is not practical. Additionally the expectation of an access holder to provide copies of its insurances as opposed to certificates of currency is unreasonable.

#### **Recommendation**

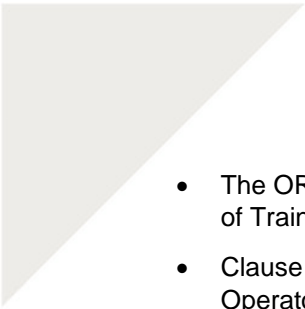
- Amendment of Clause 16 to reflect more reasonable and feasible insurance policy obligations. Aurizon can arrange for its Insurance team to provide advice on appropriate drafting where relevant; and
- Aurizon suggests that all reference to “maximum deductibles” are removed as these are often dictated by the insurance market.

#### **4.4 Operating Requirements Manual**

Aurizon’s submission has already raised issues surrounding prescription in the ORM in relation to risks that would be addressed in the IRMP. To ensure the ORM has the appropriate level of transparency and relevant information to enable both the Operator and Queensland Rail to perform its obligation, and in addition to Aurizon’s existing comments and suggestions, Aurizon has the following recommendations for the ORM:

- Assurance that all standards referenced in the ORM will be readily available to an Access Seeker and Access Holder to ensure compliance (via portal site);
- Clause 4, Emergency Response, requires the inclusion of specific procedure references (i.e. procedure numbers) in relation to emergency response and environmental matters to provide clarity on the obligations of the Operator;
- Clause 4.2(f), clarification on what constitutes an “Unreasonable Obstruction” with respect to the Queensland Rail operations;



- 
- The ORM requires balancing with respect to Queensland Rail's responsibility for the security of Train Services irrespective of the goods on the Train Service;
  - Clause 4.4.5 should obligate Queensland Rail to provide information requested by the Operator (if relevant to its Train Services) in relation to an incident to assist with internal investigation of an incident;
  - Aurizon suggests the removal of Operator to provide information in Clause 6.6(b)(ii)(A)-(C) and Clause 6.6(c)(i) (A)-(C), relating to accreditation, Access Agreement and consist authorisation, as the information provided in (D) – (K) (in the respective clauses) will inform Queensland Rail of this information;
  - Aurizon suggests an increased obligation on Queensland Rail in Clause 7.1. to “must” as opposed to “may” to provide Safety Alerts and Train Notices where in Queensland Rail’s opinion a safety incident has or may occur;
  - Clause 7.2 to be mutual and limited to position and contact details; and
  - The Comparison Train Length amended to include “or as otherwise agreed between the parties”.

## 5 Pricing Principles

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Aurizon considers the pricing principles in Part 3 to be broadly consistent with those in the Australian Rail Track Corporation 2013 Interstate Access Undertaking and has minor comments.

### 5.1 Maximum Access Charge

The network utilisation provisions in clause 3.1.2 permit that where capacity is constrained Queensland Rail may quote the highest access charge to access seekers in respect of that available capacity. This generally reflects the principle that there is an opportunity cost associated with a train path where there is alternate demand.

The application of these clauses is unclear given the application of the preserved train paths in the Transport Infrastructure Act. Aurizon notes that the policy objective of preserved paths is to protect the ongoing transportation of particular commodities where there is demand by other commodities with substantially higher capacity to pay.

Aurizon seeks confirmation that the application of clause 3.1.2(b) would operate such that:

- The maximum access charge which could be quoted for a preserved train path is the highest charge being paid for a preserved train path; and
- Queensland Rail is deemed to 'choose to allocate available capacity associated with preserved train paths.

Aurizon acknowledges that Queensland Rail is not required to quote the maximum access charge to an access seeker.

### 5.2 Capital Contributions

As noted in section 3, the pricing principles should include a requirement to maintain a capital contributions register and those contributions should be reflected in the determination of the Ceiling Revenue Limit.

### 5.3 Reference Tariffs

Aurizon notes that the 2015DAU does not include provisions requiring Queensland Rail to submit to the QCA a reference tariff. Queensland Rail contends that the inclusion of provisions which permit the QCA to require amendment to an approved access undertaking are inconsistent with the QCA Act.

While Aurizon supports this argument, it does acknowledge that the process for establishing a reference tariff is complex and time consuming and there is limited incentive for the access provider to include a reference tariff in a voluntary access undertaking.

The requirement for the development of a reference tariff should have demonstrable benefits which warrant the cost and resources, and the associated risks of regulatory error. Aurizon does not consider that there is a suitable test for the QCA to form this view.

In contrast, where an access seeker has sought to arbitrate a price outcome then it can be reasonably concluded that there is sufficient interest in a price determination. Aurizon considers an alternative to requiring the service provider to submit a reference tariff is for the undertaking to include an obligation for the service provider to quote the arbitrated price to access seekers for the same service. The duration and variation of this price would be consistent with the arbitration

outcome. This also ensures that the party seeking the price determination is sufficiently incentivised and bears an appropriate proportion of the costs in obtaining a proxy reference tariff (as opposed to seeking a reference tariff by transferring the negotiation costs to other parties).

**Recommendation**

The 2015DAU should require Queensland Rail to offer the negotiated terms and conditions of access from an arbitration proceeding to access seekers for the same service.

#### **5.4 Rate Review Provisions**

Aurizon welcomes the inclusion in section 3.6 for the ability of an access seeker to require the access agreement to include appropriate level of detail regarding the methodology as to how that access charge would be adjusted over the term of the access agreement.

Aurizon considers that it would also assist in promoting investment if an access seeker is able to obtain longer term certainty as to how the access charge would be amended over the life of its project. In this regard, the access seeker should also be able to negotiate that the renewal provisions in an access agreement include a requirement for the renewed access agreement be consistent with the agreed pricing methodology.

**Recommendation**

The rate review provisions should allow an access seeker to negotiate renewal of access rights which apply an agreed long term pricing methodology.

#### **5.5 Cost allocation and Below Rail Financial Statements**

The 2015DAU does not include a requirement for Queensland Rail to prepare below rail financial statements in accordance with the cost allocation manual. This is contrary to the provisions in the current 2008AU which was not exempted due to the operation of the transfer notice.

Section 163 of the QCA Act requires that an access provider of a declared service must keep, in a form approved by the QCA, accounting records for the service separately from the accounting records relating to other operations of the access provider.

Queensland Rail has not detailed why those records should not be published in a form consistent with the approved cost manual. While Queensland Rail has agreed to report the maintenance, operating and capital expenditure for each system it has not agreed to the revenue and relevant asset value for those respective systems.

The cost allocation manual is necessary to ensure the operating, maintenance and capital expenditure amounts reported in Part 5 of the 2015DAU are consistent over time and not subject to changes in the allocation assumptions.

**Recommendation**

The 2015DAU should require Queensland Rail prepare below rail financial statements in accordance with the approved cost allocation manual.

## 6 Western System Reference Tariff

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Queensland Rail proposes a reference tariff equivalent of \$19.41 per thousand gross tonne kilometres (000 gtk). On the basis of Queensland Rail's estimate of the building blocks this tariff is materially below the purported ceiling price of \$34.92 per 000 gtk.

The proposed reference tariff is consistent with the CPI escalation of the current reference tariff in the extended 2008AU which Queensland Rail represents is consistent with access seekers and holders willing to pay as evidenced by their continued operations at this price.

There are a range of reasons why an access holder would continue to operate at the proposed rate of \$19.41 per 000 gtk. Most notably, other parts of the supply also contain substantial fixed costs and will continue to operate with economic losses. The proposed tariff should not be interpreted as representing an efficient price for the purpose of the objects of the Act or one which is consistent with the sustainable and continued operation of rail transportation services on this corridor. It should not be assumed that an access application for the recommencement of the Wilkie Creek mine implies production will in fact recommence at the proposed tariff.

The inherent conflict in Queensland Rail's pricing proposal is that it would preserve its own economic returns (on unspecified investments as opposed to an arbitrary and ambiguous estimate of replacement cost) at the expense of other supply chain participants while simultaneously reserving the right to improve its economic returns if market conditions improved.

In circumstances where the access provider is seeking to preserve the regulatory compact regarding the return on its investments via the RAB then access pricing should be independent of market conditions with the users managing the commodity price risk. This is not to say that the service provider cannot assume commodity price risk but that should occur via a negotiated price, not a reference tariff.

In relation to the proposal, Queensland Rail's own consultant has noted:

*The use of the transparent and repeatable building block approach will provide a degree of revenue/cost certainty going forward, for Queensland Rail and Access Seekers. It is also a fairly conventional and uncontroversial approach.*

However, the consultant also noted:

*This supports an approach whereby the reference tariff applied could, in the future, adjust should more favourable market conditions allow, but still within the confines of the regulator determined ceiling rate.*

It is difficult to reconcile how the potential for future access charges to fall anywhere within the band of \$19.41 to \$34.82 (and potentially much higher given asset renewals and restoration of 'normal' financial market conditions) can provide access seekers a degree of cost/revenue certainty going forward.

The tariff proposal in the 2015DAU does not provide the required level of predictability or certainty to promote efficient investment in supply chain infrastructure.

Aurizon considers the QCA should determine the appropriate reference tariff having regard to the efficient costs of providing the service based on an appropriate valuation of the Western System assets commensurate with the methodology applied in the draft decision and have regard to the additional factors in part 7 of this submission.

If, following consideration of the efficient costs, the consequential tariff derived from the building block methodology exceeds the proposed reference tariff of \$19.41, Aurizon submits that the QCA should accept the argument that pricing above that level would further reduce demand for the service and, therefore, the QCA should accept the proposed tariff and capitalise any losses.

Aurizon considers that the capitalisation of losses should only apply to the investments the QCA deems Queensland Rail is required to earn a return commensurate with the commercial and regulatory risks. While Aurizon agrees with PWC that loss capitalisation should not apply where there is little or no prospect of future demand being able to recover those losses this should not occur where the initial valuation of RAB represents an appropriate line in the sand having taken the likelihood of future demand into account.

Loss capitalisation is preferable to RAB optimisation. However recovery of loss capitalisation should only occur through increase in demand for the service and not through higher prices to baseline demand or through recovery of take or pay for utilised train paths.

Aurizon notes that Queensland Rail has submitted additional information and revised costs to support the building blocks out to 2020. The supporting information is subject to a confidentiality claim which precludes any meaningful scrutiny of efficiency by affected stakeholders. The consultation period also does not provide sufficient time for stakeholders to thoroughly assess the prudence of the proposal or the costs. Accordingly, Aurizon comments are restricted to those matters it has been able to discern and form a view from the little information that was published.

## 6.1 Volume forecasts

The current contracted volume are an observable input parameter and therefore provides a reasonable lower bound estimate of forecast coal volumes where those contracts include take or pay with appropriate security. In addition, to contracted coal volumes existing coal producers have strong incentives to operate additional adhoc coal services using available capacity without the need to incur additional take or pay liability. The QCA should obtain coal production estimates from existing mines and to the extent necessary test the veracity of those forecasts in order to obtain an estimate of forecast coal volumes.

Aurizon acknowledges that the number of non-coal train paths in the Western System has declined. A key driver for the shift from contracted to non-contracted services is the difficulty of obtaining the financial support from end users to enter into medium term take or pay. There is also a reasonable expectation of capacity being available in the weekly train plan to avoid the need to obtain contractual certainty of those paths. This is accommodated by the application of the preserved train paths which are unable to be contracted to coal services (notwithstanding the absence of competing demand).

The decline in non-coal services is attributable to a range of factors associated with rail's competitiveness with road. The progressive escalation of rail access charges in line with CPI or other reference data is divergent from the sub-economic, non-locational, non-distance based charging of road access pricing which has been subject to real price declines in recent years.

The comparatively slow rate of change in rail productivity, inferior and increasing transit times and poor on-time performance associated with declining infrastructure standards (which are not fit for purpose when assessed against the competitive road service) also reduces demand for rail access.

Aurizon considers that current non-coal demand is a consequence of drought conditions over the 2014 period which have increased over recent months. It may be reasonable to expect that demand for non-coal train services may increase with improved growing conditions.

### Recommendation

- The QCA should obtain coal production estimates from existing coal mines and where necessary confirm those estimates against mine production capacity assessments; and
- The QCA should verify non-coal service level forecasts against current utilisation rates and request Queensland Rail to provide its own, or third party, projections of expected grain crop yields.

## 6.2 Maintenance

Aurizon recognises that the age, location and condition of rail infrastructure on the West Moreton systems represents engineering challenges. This represents one of the primary factors as to why it would be incorrect to apply modern replacement cost valuation methodologies.

As noted above, the 2015DAU submission lacks sufficient detail for stakeholders to assess the reasonableness of Queensland Rail's costs or asset management practices. Notwithstanding, it is reasonably evident from a comparison of both the 2013DAU and 2015DAU Queensland Rail has proposed a **25% increase in maintenance costs** at the same time **as volumes used to estimate the tariff have declined by 37%** as shown in the tables below.

**Table 3 West Moreton Proposed Maintenance Costs (excluding mechanised resleepering)**

	2013DAU Average	2015DAU Average	Variance
Track	\$15,661	\$17,561	12%
Structures	\$2,277	\$4,074	79%
Trackside	\$2,068	\$2,235	8%
Other	\$153	\$1,325	N/A
Total	\$20,159	\$25,195	25%

**Table 4 West Moreton Proposed Gross Tonne Kilometres (Rosewood to Jondaryan)**

	2013DAU Average	2015DAU Average	Variance
Coal	2,490,288	1,697,139	-32%
Non-coal	244,982	30,916	-87%
Total	2,735,270	1,728,055	-37%

In fact there appears to have been no consideration as to the impact of lower volumes on the maintenance requirements at all. Mainline rail grinding in the 2013DAU for FY16 was 106.9 km and for the same year the 2015DAU states a scope of 107.25. Rail grinding is highly correlated to rail wear associated with gross tonnage yet there is no reference to lower volumes in determining the scope.

There is also limited consideration, or discussion of any efficiency improvements or initiatives arising from capital expenditure projects. For example, previous submissions have noted that track inspection and maintenance on the Toowoomba range is associated with the tight radii and track stresses. However, current and future capital expenditure has upgraded the capping layer, concrete sleepers and a new design for check rails which will eliminate bolt shear failures.

Aurizon retains concerns that the asset management strategies utilised by Queensland Rail do not optimise life cycle costs.

### 6.3 Capital Expenditure

Capital expenditure should have clear and identifiable benefits, or risk mitigations. That is the costs of asset failure should exceed the costs of installation. Substantially extending the physical life of assets is essential on a low volume rail corridor. Capital expenditure proposals should therefore include a reasonably detailed risk assessment associated with the consequence of the project not proceeding, or what maintenance costs would be avoided.

Aurizon expects that in addition to the summary rationale submitted in support of capital expenditure projects the QCA will undertake the same level of scrutiny and governance standards regarding capital expenditure scope and costs that it applies to Aurizon Network.

In reviewing the completed capital expenditure projects for the FY14 and FY15 years and the projected capital expenditure for the duration of the 2015DAU the QCA should also exclude investment associated with optimised rail infrastructure. Aurizon recommends that the QCA review the original DORC valuation to confirm the optimised asset configuration particularly in relation to:

- Signalling; and
- The duplicated section between Rosewood and Helidon.

In relation to the duplicated section between Rosewood and Helidon Aurizon notes that Queensland has and will undertake bridge replacement on both the up and down roads. Where the optimised asset configuration includes only the down road then the bridge replacement on the up road should not be included in the RAB.

### 6.4 Metropolitan Adjustment

The adjustment for train path losses associated with path availability due to the interaction between freight and passenger services in the metropolitan network has become an overly complex procedure which is not reflective of the underlying principle of path losses.

The starting point for the capacity analysis is to assume that the metropolitan constraint does not exist and that the bottleneck in the system is the number of available train paths in the bottleneck. In the case of the West Moreton system the constrained section is the Toowoomba range. The number of available train paths should be modelled only on the maintenance losses and an interface loss factor representing an efficient supply chain (i.e. 75% utilisation after maintenance possessions).

The capacity losses attributable to the metro interface should simply be the difference between the theoretical number of **usable** train paths with and without the metropolitan interface. This would also be a more transparent approach to stakeholders. Aurizon has methodological concerns the current approach relating to determining losses associated with peak period passenger services as this may understate losses where the base capacity assumption is not first established without an unconstrained metropolitan network.



Aurizon also considers that the continuation of the variable gtk rate to the metropolitan system remains appropriate and may substantially exceed the incremental costs of coal trains operating on the metropolitan network having regard to:

- Network configuration is driven by passenger peak capacity and therefore coal services imposes little or no capital requirement on the network;
- The Corinda to Yeerongpilly section provides passenger route diversion benefits;
- Significant portions of the coal route are shared with other freight services, including interstate freight services; and
- The metropolitan system is maintained to a much higher standard than required for 15.75 tal freight services thus reducing the physical asset depreciation rates of coal trains operating in that system.

## 6.5 Form of Regulation

Aurizon considers the price cap form of regulation remains appropriate where the asset valuation is based on a line in the sand and provides Queensland Rail financial incentives to make additional paths available or to improve the productivity (gross tonne kilometres to train kilometre ratio) of existing train paths. However, as the pricing principles in s.168A require that prices should include incentives for promoting efficiency and the increased utilisation of rail infrastructure the price cap should only reward increased gtk per tkm or increased utilisation of train paths.

For example:

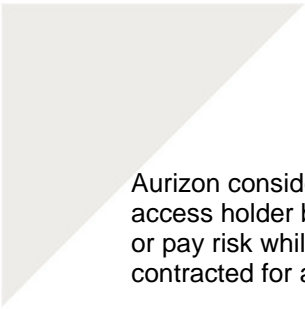
- If the outturn train paths exceed the forecast volumes then Queensland Rail should be permitted to retain the access revenue which exceeds the target revenue (and reduce the value of the loss capitalisation account where relevant);
- If the outturn train paths do not exceed forecast volumes but the access and take or pay revenue exceeds the target revenue then Queensland Rail should not be permitted to retain take or pay amounts above the target revenue (as this would be inconsistent with providing incentives to improve efficiency or asset utilisation); and
- If the outturn train paths do not exceed forecast volumes but the access and take or pay revenue exceeds the target revenue but the revenue is associated with an increase in gtk per tkm (i.e. longer train or increased axle load) then Queensland Rail should be permitted to a portion of those amounts, including 50% of the take or pay to provide incentives to improve the productivity of existing train paths (50% provides an efficiency sharing mechanism to ensure access holders also have incentives to improve efficiency).

## 6.6 Take or Pay

Aurizon considers that notwithstanding that where a reference tariff is set below the building blocks component take or pay should be capped. That is, Queensland Rail should not obtain both access revenue and take or pay revenue for the same train path.

Where access revenue from actual train services exceeds what is required from contracted train services then take or pay should not be payable. This ensures that Queensland Rail does not earn revenue in excess of what it would have expected to earn from its contracted services without asset utilisation exceeding those contracted levels.





Aurizon considers that in an environment of excess capacity there is little or no prospect of another access holder being willing to accept a volume transfer to allow an access holder to manage its take or pay risk while another user of system can operate above contract service levels without contracted for additional volumes (i.e. via a transfer).

In the absence of take or pay capping and with excess capacity access seekers have stronger incentives to under contract for access rights and increase the use of adhoc train paths.

## 7 Valuation of the Regulatory Asset Base

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The valuation of the Regulatory Asset Base for rail infrastructure between Rosewood and Columboola has been a matter of contention and theoretical debate. The relevant rail infrastructure within this rail corridor is quite unique in that it possesses the following characteristics:

- is one of Australia's oldest rail corridors with substantial investment in the land and corridor alignment occurring over 100 years ago;
- rail operations of 15.75 tonne axle load fall well below the performance of modern engineering equivalents;
- the corridor is shared with freight services with legislated rights of access without an ability to pay access charges commensurate with the opportunity cost for the use of those paths;
- the annual throughput level is insufficient to fund upgrades to the existing facility or support the development of alternate rail transport corridors; and
- the services interact with a major metropolitan transit network.

As a high fixed cost asset, the value assigned to the Regulatory Asset Base is of significant importance in determining the allowable revenue through the building block components of a return on asset and depreciation. The majority of regulatory frameworks within Australia do not maintain regulatory asset values based on a Depreciated Optimised Replacement Cost (**DORC**) methodology. Rather, the regulatory asset values are maintained on the basis of Depreciated Actual Cost (**DAC**) in order to preserve the principle of financial capital maintenance and prudent and efficient investment is included in the RAB at cost. The application of the DAC approach is contingent upon the setting of the Initial Capital Base (**ICB**). In most instances the determination of the ICB has occurred through the consideration of the replacement costs of providing the service.

As a rail infrastructure owner, Aurizon is acutely aware of the importance and need for regulatory revenues to provide a reasonable commercial return on shareholders' investment in the regulated asset. Of significant importance in determining the ICB is the expectations underpinning the original investment decision or acquisition of the rights where the asset is subsequently sold. Therefore, replacement cost comprises one matter relevant to the setting the ICB.

In the context of the Western System regulatory asset base it is not possible to directly ascertain the investment expectations prior to the application of the principles of corporatisation of publicly owned assets and no transaction has occurred to establish a value for those assets which would necessarily inform the legitimate interests of the service provider, and its shareholders.

### 7.1.1 Queensland Rail's 2013DAU

The 2013DAU proposed to roll-forward the DORC based valuation of the Western System in the QCA's draft decision of June 2010. The service provider proposed a reference tariff with an equivalence of \$22.22 per 000 gtk which aligned to the 'ceiling price' taking into account various non-coal attributions.

The 2013DAU also included significant changes in the costs of maintaining and renewing the rail infrastructure which were not contemplated in the assessment of the draft determination on the initial asset value.

Queensland Rail's 2015DAU seeks to redefine the role and purpose of the ICB from being that of a price determinant to a conceptual bypass price by noting:

*The focus has shifted to the **actual value of the asset** and the **actual price** that should be charged for that asset. While the actual reference tariff that will apply clearly needs to be determined, the first task is to establish an opening asset value for the purpose of setting the ceiling price.<sup>11</sup>*

The suggestion that the role of setting the value of regulatory asset base for the sole purpose of establishing a ceiling price, particularly given the material disparity between the proposed price and Queensland Rail's ceiling price, renders the exercise of determining the value somewhat esoteric.

The role of a ceiling price, or the concept of stand-alone cost, is primarily related to ensuring:

- prices are not sufficiently high to promote inefficient duplication of the facility; and
- a cross subsidy does not exist between different services.

Neither of these two issues have been identified by Queensland Rail as a matter relevant to the setting of the Western System Reference Tariff. The matter before the QCA is what should form the basis of the ICB for the purpose of determining current and future coal access charges and providing the necessary level of regulatory predictability and certainty to promote efficient utilisation and investment within the Western Moreton coal supply chain (and therefore efficient investment and utilisation of the rail infrastructure) while ensuring Queensland Rail is able to achieve the required level of revenue adequacy to earn an appropriate commercial return on its investments.

#### 7.1.2 Aurizon's consideration of Queensland Rail's 2013DAU

Aurizon's submission in response to the June 2013 Western System Reference Tariff proposal and the QCA's consultation paper raised a number of concerns regarding the efficacy and sustainability of relying on a DORC valuation and the concern that that 2009 valuation contained material errors. The arguments in these submissions remain relevant and applicable to the 2015DAU and copies of both these submissions are appended to this submission at Appendix 1 and 2 respectively.

In summary, Aurizon expressed concerns that:

- the initial valuation exercise included substantial errors in the condition based assessment as evident in the service quality, maintenance and asset renewal requirements;
- the application of DORC is not appropriate to a material disparity in standard between the existing assets and the modern engineering equivalent;
- the incorrect application of actual maintenance costs rather than efficient costs associated with the modern engineering equivalent used in the DORC valuation;
- the application of DORC to low volume corridors would only be appropriate where there is a reasonable prospect that demand would increase over time to fund not only the incremental investments but the initial asset valuation (loss capitalisation);
- the sustainability of the tariff with a projected real increase in the asset value and revenue requirement on a static demand forecast; and
- the substantial disincentives for the service provider to invest in ongoing productivity improvements where incremental revenues would not be sufficient given the level of cost recovery on existing assets.

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<sup>11</sup> Queensland Rail (2015) 2015DAU, Vol. 2 p. 32

In particular, Aurizon was critical of the inclusion of tunnels in the valuation given the date of original installation, the absence of any requirement for their replacement or alternate use, the implications on tariffs and the consequential impact on the capacity for other parts of the supply chain to fund productivity improvements and asset replacement.

### 7.1.3 Draft Decision

The QCA draft decision considered these issues and other stakeholder concerns and made further adjustments to the 2009 valuation to account for this additional information. In particular, the QCA took into account the relative materiality of the capex and maintenance to RAB ratio, the historical age of much of the rail infrastructure and the probability that asset replacement expenditure will have been recovered and therefore its inclusion in the valuation would amount to recovery of those costs twice.

## 7.2 Statutory requirements for the asset valuation

The consideration of the valuation of assets for the purpose of approving an access undertaking must be consistent with the relevant statutory requirements in the *Queensland Competition Authority Act 1997*. The provisions most relevant to this assessment are:

- the objects clause in **s.69e** of promoting efficient investment and utilisation of rail infrastructure;
- the legitimate business interests of the owner or operator of the service (**s.138(2)(b)**);
- the effect of excluding existing assets for pricing purposes (**s.138(2)(f)**);
- that prices should generate expected revenue for the service which 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 (**s.168A(a)**); and
- that prices should provide incentives to improve efficiency (**s.168A(d)**).

The explanatory documents for the 2015DAU raises a range of concerns with respect to the QCA's draft decision. The proposal concludes that in relation to the draft decision:

*The QCA has not undertaken any investigation of whether Queensland Rail has actually fully recovered a return on and of capital for these assets.*

*The QCA's proposed outcome may prevent Queensland Rail from fully recovering its sunk investments and also provides a significant disincentive to undertake new investment.*

Aurizon considers that the purpose of the draft decision arising from the QCA's investigation of the 2013DAU under s.185 of the QCA Act was to elicit the necessary information to answer the question of what sunk investments Queensland Rail needs to be appropriately compensated. The withdrawal of the 2013DAU prevented the necessary investigation from continuing.

While the submission canvasses a range of academic and regulatory precedents, arguments and applications of DORC it does not address how the decision would contribute to Queensland Rail not fully recovering its sunk investments. This is readily apparent in the fact that the proposed tariff is substantially below that implied by Queensland Rail's proposed DORC valuation and that there is no prospect of that value being recovered from coal access charges.

Given that Queensland Rail intends to invest in the network with access charges substantially below its own ceiling price then it is a reasonable presumption that there is a value of sunk investment less

than the DORC valuation which is applicable to assessing the price against the statutory requirements.

### 7.2.1 Return on investment

Aurizon considers that the investment expectations made by the access provider at the time the investment decision was made or the basis on which an asset was acquired is of paramount importance in ensuring that the statutory requirements of Part 5 of the QCA Act are satisfied. Essential in the decision to invest is that the decision will not adversely affect the ability to recover its previous investments. As a consequence decisions regarding the valuation of existing assets can have adverse impacts on incentives to invest.

The inherent problem in applying the statutory requirements to the valuation of Western System assets is that the expectations at the time of the investment are unknown and there is no private shareholder interest to protect. Assuming that the majority of investment occurred prior to the commencement of coal carrying train services and there was no expectation of coal carrying train services commencing then the primary mechanism by which the determination of the ICB can impact incentives to invest is where the investments do not generate sufficient incremental revenue and the investment is funded through the recovery of past investments.

This issue was considered in the determination of the initial regulatory asset base for the United Kingdom rail infrastructure assets now managed by Network Rail. The regulator explicitly rejected the use of replacement costs in the determination of the RAB as stated below:

*The regulator confirms that in estimating the value which should be placed on Railtrack's assets he will base it on the money actually paid by shareholders and not the net replacement cost of its assets. There is no obvious case for initial shareholders to earn a return on an asset base in excess of the finance actually invested in the company.*

*The key issue, given the regulator's section 4 duties as set out in the Railways Act 1993, is whether an uplift is required to give Rail track appropriate incentives to invest in projects to develop the railway network. The regulator considers that this depends not on the valuation of the initial RAB, but on the basis on which enhancement investment is incorporated into the RAB. The regulator also recognises that the ability of Railtrack to finance its activities may depend in part on its financial profile (for example, in terms of interest and dividend cover) rather than simply the return on capital. However, this is appropriately dealt within in developing proposals for the levelling and profiling of future charges rather than establishing the initial RAB<sup>12</sup>.*

Importantly, the regulator correctly recognises that the appropriate method for providing a return on investment is to properly consider the forward looking capital expenditure requirements and revenues, not through the artificial inflation of existing asset values.

The proposal also suggests that the QCA's approach to valuation in the draft decision fundamentally changes the methodology from a forward looking to a backward looking assessment. The more fundamental principle in consideration of the initial asset valuation is not the value ascribed to the existing assets but the implications of the valuation for prices over the life of the assets. While Queensland Rail considers there is demand for capacity at its proposed price, a point which will most likely be responded to by affected coal producers, this is not to say that the implications from capital expenditure on future prices would not have an adverse effect on that demand.

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<sup>12</sup> Office of Rail Regulation (1998) The Periodic Review of Railtrack's Access Charges: Second Consultation Paper, pp. 54-55

A forward looking assessment for the ICB would have regard to whether that valuation would provide sufficient revenue to provide a return on investment on asset replacement expenditure and productivity improvements, in addition the recovery of the ICB over the foreseeable demand. The valuation methodology is neither forward nor backward looking. It is the implications of that valuation which is forward looking and whether the statutory requirements have been satisfied.

For the purpose of assessing whether prices generate expected revenue for the service which 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, the access provider should clearly identify the past investments this should apply in order to ensure the requirement can also be satisfied for asset replacement expenditure.

### 7.2.2 Recovery of historical costs

The statutory requirements explicitly require that in considering the proposal the QCA needs to have regard to the effect of excluding assets for pricing purposes. The inclusion of this requirement in s.138(2) of the QCA Act is intended to protect the legitimate business interests of the operator or owner of the facility arising from optimisation of the value of the regulatory asset base on grounds that were not foreseeable at the time the investment decision was made (or procured) or is contradictory to the conditions applicable to investment or procurement decisions. This is largely reflected in the regulatory compact that once an asset has been included in the value of the regulatory asset base it will only be excluded on highly exceptional circumstances.

A key variation between Queensland Rail's proposal and the draft decision is the asset valuation methodology and the opening asset value. The largest components of this variation relating to the valuation of long term sunk assets which are not subject to replacement or asset renewal at zero value. Aurizon notes that this would have the same effect as valuing these assets using a DAC approach (rolling forward based on original construction costs and installation dates). In this regard, the 2015DAU does not explicitly address what 'effects' the QCA's draft decision would have in valuing certain assets at book value (or zero).

The premise that these assets have been 'fully depreciated and including them would amount to double counting' remains a second order issue as to whether recognition of some value for those assets within the tariff serves any economic purpose or that their exclusion creates perverse incentives for efficiency or competition. Nevertheless, in the absence of an endorsed regulatory asset base the consideration of whether past investments might have been fully recovered is relevant to assessing the exclusion of assets,

The QCA recognition that a proportion of those assets installed prior to 1995 would have been funded via past access charges is likely to be a valid proposition given the scope of maintenance costs being proposed within the 2015DAU and those incurred during the term of the 2008AU.

Where an asset has been replaced through a capitalised expense it would be necessary to include a value for those assets to ensure the access provider is appropriately compensated from ongoing revenue. In practice, this has mainly occurred within the Western System where an asset has been increased to a higher standard (i.e. timber to concrete sleepers or installation of heavier weighted rail/turnouts). The replacement of like for like assets has typically occurred through maintenance expenditure<sup>13</sup>. Given the likely original installation dates it is therefore reasonable to assume that any replacement of timber or steel sleepers since installation has been captured within historical

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<sup>13</sup> For example, the Queensland Rail Network 2008 draft access undertaking included approximately \$11 million in sleeper replacement and Queensland Rail's proposed 2013DAU includes approximately \$24 million in resleeper costs.

maintenance budgets. It may also be presumed that expenditure was recovered through past access charges.

The following table also responds to selected comments made in the expert report on asset valuation included as Appendix 2 to Volume 2 of the 2015DAU<sup>14</sup>.

**Table 5 PWC comments on application of DORC to the Western System**

Comment	Response
<p>The rationale for using DORC to value assets is that it provides a greater indication of the opportunity cost to the owner of the asset and is therefore more consistent with the value of the asset in a competitive market.</p>	<p>The proposal does not provide an assessment of the opportunity cost to Queensland Rail of excluding selected sunk assets (i.e. tunnels) which have no alternate use. The proposal also does not provide any quantitative assessment that the DORC value is commensurate with a feasible market value.</p>
<p>The Tribunal also expressed strong reservations about the use of accounting concepts of depreciation for the purpose of a DORC valuation, particularly straight line depreciation:</p> <p><i>DORC is a forward looking concept and the 'depreciation' concerned is economic depreciation. There is no support for the valuation to be adjusted to take account of past events particularly based upon accounting concepts of depreciation, and to do so is wrong in principle.</i></p>	<p>The valuation exercise undertaken in 2009 was in fact a simplistic age based depreciation profile reflecting (arbitrarily) selected installation dates and straight line depreciation.</p> <p>The Tribunal refers to economic depreciation which has not been applied in the proposed DORC value.</p> <p>Aurizon also contends that it cannot be concluded that given the material differences between the service which was subject to the appeal and the West Moreton service that an aspect of the Tribunal's decision can be applied without broader reference to the context it is proposed to apply.</p>

PWC also state that DORC should be appropriate as it is:

- Consistent with the price that a firm with a given service requirement would pay for existing assets in preference to replicating the assets; and
- Associated with the value the firm can realise from selling their assets if the returns are insufficient to cover the regulatory and commercial risks involved in the infrastructure.

These views are consistent with the conclusion that the setting of the ICB is a proxy for the market value of an asset which is unable to be observed via a transaction. This is contradictory to Queensland Rail's tariff level which is substantially below the implied DORC ceiling price.

Aurizon has undertaken indicative modelling based on the CPI escalation of the proposed tariff over a period of ten years for both:

- the forecast volume level of 6.1 million tonnes per annum ; and
- the theoretical maximum utilisation of 10.6 million tonnes per annum if all 109 weekly paths were utilised for coal services.

<sup>14</sup> PWC (2015) Asset Valuation of the West Moreton Network, Supporting analysis for submission to the QCA, May.



The maintenance and capital expenditure is consistent with the amounts included in the West Moreton Asset management plan. A complete list of assumptions and modelling is provided at Attachment A.

The analysis shows that the indicative net present value of the cash flow to assets (revenue less O&M) over the ten year period for the proposed DORC value is \$429 million. The forecast volumes and escalated tariffs provides a comparable indicative net present value of only \$69 million and the high utilisation scenario represents an NPV of \$304 million.

Accordingly, even under the most favourable scenario an investor would not be prepared to pay \$361 million for the assets and the proposed tariffs and demand would represent a value of \$126 million. These values are materially different from the proposed DORC valuation of \$487 million as at 1 June 2015.

### 7.2.3 Access charges should promote competition

Rail transportation services are currently provided in the Western Moreton coal system with legacy assets appropriate for operation at 15.75 tonne axle load which are increasingly dwindling in availability due to life expiry. Given the limited global demand for these type of assets (due to the poor capital productivity) acquisition of replacement assets may need to be bespoke and priced to reflect the low economies of scale in production.

Access charges which provide compensation on assets which will never be replaced will have direct impacts on competition in downstream markets. This concern is emphasised in the following concluding statements of Professor Menezes<sup>15</sup>:

*I now turn to the DORC valuation proposed in the Draft Decision. The DORC approach, as discussed in Section 3 above, is a theoretical construct. As such, it is subjective in nature. This is especially the case for the Western System where a DORC-equivalent asset would simply not be built. Instead, a new system would have characteristics that are markedly different from the existing system, which is old, outdated and not of the quality of a new, optimised equivalent system. This means that a DORC valuation would allow Queensland Rail to earn returns on an asset that will never be built.*

*This, per se, may not be inefficient. As long as the prices associated with a DORC valuation do not affect competition in relevant markets.*

In order for above rail competition to be promoted below rail charges need to provide sufficient capacity for rail operators to price their service at replacement cost given the need to eventually fund replacement. The more fundamental question in the determination of the access charge is the whether the service provider should be able to earn a return on assets which will never be replaced relative to other competitive elements of the supply chain which have much shorter lived assets which do need to be replaced.

### 7.2.4 Regulatory Precedent

Aurizon supports the recognition of regulatory precedents in regulatory determinations to promote regulatory certainty and predictability. It is also acknowledged that DORC has been widely employed in the determination of the value of assets owned by regulated businesses, including its own.

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<sup>15</sup> Menezes, F (2015) A preliminary view: Regulatory economics assessment of the proposed Western System asset valuation approaches, A report prepared for the Queensland Competition Authority, April, University of Queensland, p. 24.

The expert report on asset valuation included as Appendix 2 to Volume 2 of the 2015DAU summarises a list of assets to which DORC has been applied to determine the ICB. However, the report does not seek to assess or demonstrate what characteristics of the Western System are relevant to why that precedent is applicable. Common characteristics among the sample which are not evident with the 2015DAU proposal are that:

- the services are at full revenue recovery or would expect to fully recover the valuation from growth in demand;
- the facilities are commensurate with the modern engineering equivalent;
- it would be feasible to duplicate the facility;
- prices are non-distortionary in terms of geographical relativities and consistent with those prevailing among peer benchmarks or competing supply chains.

The service provider has not demonstrated how these regulatory precedents are applicable given the material differences in the circumstances to which they have been applied. The selective sample also does not address the issue that many of the decisions were hybrid where assets such as easements are not valued using DORC. Nor does it include relevant decisions such as Network Rail where DORC was not applied.

### 7.3 Applying a Line in the Sand

Prices for access to the service can have impacts on the demand for the service and if set too low can lead to excess demand and promote inefficient investment. Given the relative constraints on the system there does not appear to be a highly likelihood that the access charges at levels in the QCA's draft decision would lead to excess demand for coal carrying train services which necessitates a capacity expansion.

Aurizon's objectives for the Western System are to provide a line in the sand approach to the Western System to support sustainable ongoing investment in asset productivity improvements and to provide an increased level of regulatory certainty to allow evaluation of economic trade-offs from alternate investment options across the supply chain.

While Aurizon does not necessarily consider that access charges should be strongly influenced by the price of the underlying commodity the determination of the relevant inputs to the line in the sand should have regard to the prices that might prevail in hypothetically competitive markets. In terms of the Western System this becomes a complex exercise as there is no evidence that it would be profitable for anyone to replicate the service, even assuming away any constraints. This occurs as the application of a replacement cost methodology would either:

- yield a price which would not promote sufficient demand to recover the investment; or
- the scale of the market is not sufficient to support demand which establishes the price promoting the necessary demand.

As Aurizon has previously stated, the application of DORC based methodology for low volume and substandard infrastructure is unlikely to provide incentives for efficient investment and utilisation of that infrastructure. This necessitates a line-in-the-sand approach where the commercial and economic viability of further investment can be adequately assessed on an incremental basis. The significant and material change in maintenance and capital expenditure without any corresponding increase in volumes between past pricing periods and the proposed 2015DAU provides an extreme example of the importance of establishing that line-in-the sand correctly. Where the line in the sand is set:

- too low then the business may lack the funds necessary to sustain the asset and support increased throughput at the margin; or
- too high and incremental productivity improving investment is crowded out by returns on sunk assets (as the constraints on increasing incremental revenue through higher prices does not permit recovery of incremental costs).

The objective of promoting efficient investment and utilisation of rail infrastructure requires that increased weight should be given to improving the standard and capacity of the rail infrastructure relative to providing a return on tunnels, land and civils where the original costs were incurred over a century ago.

**Recommendation**

The QCA should establish value for the RAB which provides a line in the sand in which to assess the prudence and efficiency of subsequent investments.

**7.4 Maintaining the Regulatory Asset Base**

The maintenance of the regulatory asset base is broadly consistent with the relevant provisions in the 2008AU. A key difference is that the schedule does not include a more formal customer voting process. This raises a number of issues as to the prudence of including investments initiated by an access holder within the regulatory asset base which has the potential to transfer the liability of s.168A(1) of the QCA Act (Queensland Rail’s expectation of revenue adequacy) if it has not made appropriate commercial arrangements with that party. This is evident in clause 3.2(a) of schedule E which states:

*Queensland Rail may request the QCA to, and the QCA will, accept the scope of a capital expenditure project as prudent if it is Customer or Access Holder specific capital expenditure (provided it is an Access Holder who has no Customer) for a branch line to a mine which is to be included as a loading point for a Reference Tariff, and the scope of the capital expenditure has been accepted by that Customer or Access Holder.*

The clause requires the QCA to accept the prudence of the investment even if that investment would have the effect of increasing the reference tariff to existing access holders who were not consulted on that investment.

Aurizon considers that the drafting is inconsistent with the requirements of s.138(2)(e) if the rights of users of the service are adversely affected and Queensland Rail should be required to consult with any party who may be affected by the inclusion of those investments within the RAB.

**Recommendation**

The inclusion of investments in a regulatory asset base for an individual access seeker which may affect the reference tariff of existing access holders must have the agreement of those access holders.

## 8 Attachment A Building Block Analysis

**Table A1. 2015DAU Tariff and Revenue Proposal**

	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25
Volumes (gtk)	2,110,378	2,110,378	2,110,378	2,110,378	2,110,378	2,110,378	2,110,378	2,110,378	2,110,378	2,110,378
Tariff (\$/ 000 gtk)	19.41	19.90	20.39	20.90	21.43	21.96	22.51	23.07	23.65	24.24
Revenue (\$)	40,962,437	41,986,498	43,036,160	44,112,064	45,214,866	46,345,238	47,503,869	48,691,465	49,908,752	51,156,471
Implied Av. \$ per nt	6.66	6.82	6.99	7.17	7.35	7.53	7.72	7.91	8.11	8.31

**Table A2. Implied RAB Roll-forward for 2015DAU Ceiling Price (\$,000s)**

	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25
OAV	487,500	495,245	507,052	522,452	532,368	539,267	544,679	549,252	552,923	555,623
Capex	26,945	30,807	31,600	27,116	25,399	26,034	26,685	27,352	28,036	28,737
Inflation	12,500	12,800	13,100	13,400	13,600	13,805	13,948	14,071	14,171	14,248
Depreciation	31,700	31,800	29,300	30,600	32,100	34,427	36,060	37,753	39,507	41,326
CAV	495,245	507,052	522,452	532,368	539,267	544,679	549,252	552,923	555,623	557,281

**Table A3. Key Assumptions**

	WACC	Inflation	Gearing	Cost of Debt	Tax Rate	Imputation	Tax Depreciation	Capex Life
Assumption	6.93%	2.5%	55%	6.05%	30%	50%	4.00%	35 Years

**Table A4. Implied Annual Revenue Requirement for 2015DAU Ceiling Price (\$'000s)**

	<b>FY16</b>	<b>FY17</b>	<b>FY18</b>	<b>FY19</b>	<b>FY20</b>	<b>FY21</b>	<b>FY22</b>	<b>FY23</b>	<b>FY24</b>	<b>FY25</b>
Return on Assets	34,702	35,370	36,215	37,130	37,758	38,258	38,655	38,995	39,273	39,484
Inflation	12,500	12,800	13,100	13,400	13,600	13,805	13,948	14,071	14,171	14,248
Depreciation	31,700	31,800	29,300	30,600	32,100	34,427	36,060	37,753	39,507	41,326
Maintenance	39,521	20,706	26,339	19,755	21,968	25,135	43,158	26,407	27,068	27,744
Operating Costs	6,900	7,073	7,249	7,431	7,616	7,807	8,002	8,202	8,407	8,617
Tax Payable	6,371	6,312	5,296	5,605	6,047	6,803	7,334	7,895	8,488	9,113
Imputation	3,186	3,156	2,648	2,803	3,024	3,402	3,667	3,947	4,244	4,557
<b>Revenue Requirement</b>	<b>103,508</b>	<b>85,305</b>	<b>88,652</b>	<b>84,318</b>	<b>88,866</b>	<b>95,224</b>	<b>115,594</b>	<b>101,233</b>	<b>104,327</b>	<b>107,480</b>
Cash Flow to Assets	57,087	57,526	55,063	57,132	59,282	62,282	64,434	66,624	68,852	71,119
<b>NPV of CF to Assets</b>	<b>\$429,858</b>									

**Table A5. Indicative Full Utilisation Scenario (000s)**

	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25
Volume (nt)	10,681	10,681	10,681	10,681	10,681	10,681	10,681	10,681	10,681	10,681
Revenue	\$71,097	\$72,875	\$74,697	\$76,564	\$78,478	\$80,440	\$82,451	\$84,512	\$86,625	\$88,791
CF to Assets	\$24,676	\$45,096	\$41,108	\$49,378	\$48,894	\$47,498	\$31,291	\$49,903	\$51,150	\$52,430
NPV of CF to Assets		<b>\$304,245</b>								
Variance to Revenue Requirement		(\$125,613)								

**Table A6. Projected NPV of 2015DAU Western System Revenue at proposed Tariff of \$19.41 /000 gtk**

	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25
Volume (nt)	6,154	6,154	6,154	6,154	6,154	6,154	6,154	6,154	6,154	6,154
Revenue	\$71,097	\$72,875	\$74,697	\$76,564	\$78,478	\$80,440	\$82,451	\$84,512	\$86,625	\$88,791
CF to Assets	40,962	41,986	43,036	44,112	45,215	46,345	47,504	48,691	49,909	51,156
NPV of CF to Assets		<b>\$69,563</b>								
Variance to Revenue Requirement		(\$360,295)								