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Chief Executive Officer
Queensland Competition Authority
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11 March 2019

Dear Charles

Draft Recommendation for Declaration of the Central Queensland Coal Network

Aurizon Network welcomes the opportunity to provide a written response to the Queensland Competition Authority's draft recommendation to declare the service described in section 250(1)(a) of the *Queensland Competition Authority Act 1997* (Qld). Please find enclosed a copy of Aurizon Network's submission.

Should you have any questions in relation to this submission or require further information to complete the review of the declared services please contact Dean Gannaway at dean.gannaway@aurizon.com.au.

Yours sincerely

A handwritten signature in black ink, appearing to read "Michael Riches".

Michael Riches
Group Executive Network

Submission to the Draft Recommendation for Declaration of the Central Queensland Coal Network

11 March 2019



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Submission to the Draft Recommendation for Declaration of the Central Queensland Coal Network

Executive Summary

In summary:

- (a) The analysis undertaken by the Queensland Competition Authority (**QCA**) and on which its Draft Recommendation relies is incomplete and should be further considered because:
 - (i) Section 87A of the *Queensland Competition Authority Act (Qld)* (**QCA Act**) requires the QCA to undertake a complete assessment of all relevant markets, the availability of substitutes for rail transport services within those markets and a positive affirmation of the access criteria for each of those services;
 - (ii) the analysis fails to consider the services identified in Aurizon Network's previous submissions on the declaration review, being services that must, in Aurizon Network's view, be considered by the operation of section 87A of the QCA Act;
 - (iii) the analysis does not go far enough to positively demonstrate that the future economic benefits from declaration exceed the costs associated with continued rights of access under a declaration, including the costs identified in Aurizon Network's previous submissions; and
 - (iv) the analysis fails to fully consider the costs of over-regulation or the economic costs associated with reduced investment incentives.
- (b) Aurizon Network agrees that:
 - (i) access to the service on reasonable terms from declaration is likely to promote competition in the above rail haulage market;
 - (ii) the total foreseeable demand proposed by the QCA of 260 to 300 million tonnes per annum can likely be satisfied at least cost from the existing Central Queensland Coal Network (**CQCN**) facility; and
 - (iii) access on reasonable terms from declaration would likely promote the public interest where the terms of access are determined through commercial negotiation and provide a reasonable commercial return on investment.
- (c) However, Aurizon Network does not agree that:
 - (i) the 2017 Access Undertaking (UT5) represents access on reasonable commercial terms and in that context, UT5 is an example of where declaration would not promote the public interest and would fail to satisfy the requirements for an effective access regime and the object of promoting efficient investment in rail transport infrastructure; or
 - (ii) geographical extensions to the facility should be included within the scope of the declaration because those extensions are contestable.

- (d) Aurizon Network submits that the declaration should be subject to periodic review every ten years to ensure that the declaration criteria continue to be met in a technologically developing market and for consistency with other regulatory arrangements in the rail industry.
- (e) Aurizon Network acknowledges that while the declared service comprises part services which are themselves a service, the use of the CQCN as a single facility is relevant to the rail haulage market. However, the Draft Recommendation's consideration of the declared service comprising the use of the CQCN as a single facility is inconsistent with how the declared service is currently regulated.
- (f) Aurizon Network submits that there are substantial direct and indirect costs associated with:
 - (i) the use of mandatory access undertakings which inhibit or prevent effective negotiation of terms of conditions of access with users of the service;
 - (ii) the regulatory risk and uncertainty of retrospective regulatory decisions;
 - (iii) the lack of incentives to innovate and the asymmetric risk of innovation expenditure (benefit transfer if successful and the economic loss if unsuccessful);
 - (iv) the susceptibility of regulatory decisions to material regulatory error without review and the asymmetric effect of those errors; and
 - (v) the material asymmetry in the economic costs of undercompensating relative to overcompensating,

and that the QCA's analysis and Draft Recommendation fail to fully assess the impact of those costs when considering whether declaration for the regulatory regime would promote the public interest. Aurizon Network submits that the QCA should undertake further analysis in this regard before making a final recommendation.

1. The Process for Reviewing the Declared Service

On 4 April 2018, the QCA notified Aurizon Network¹, as the owner of the declared service described in section 250(1)(a) of the QCA Act, that it had initiated a review of the declared service in accordance with the requirements of section 87A of the QCA Act. Those provisions require the QCA to make a recommendation to the Minister that:

- > the service be declared; or
- > part of the service, that is itself a service, be declared; or
- > the service not be declared.

A staff issues paper² (**QCA Issues Paper**) was published on the QCA's website on the same day to assist stakeholders in making submissions. Aurizon Network responded to the QCA Issues Paper by way of written submission on 30 May 2018 (**Initial Submission**) and made a further submission in response to stakeholder submissions on 16 July 2018 (**Cross Submission**).

¹ <http://www.qca.org.au/getattachment/69838c58-9ab4-4b80-b17f-a28c07fc36ab/Notice-of-Review-and-Notice-of-Investigation-Aur.aspx>

² <http://www.qca.org.au/getattachment/3d21a810-6838-4492-b60e-e4a9d23f32ff/Declaration-Review-Staff-Issues-Paper.aspx>

In summary, the Initial Submission by Aurizon Network noted the statutory requirements that the QCA must be satisfied that all of the access criteria in section 76(2) of the QCA Act must be satisfied in order for the QCA to recommend to the Minister that the relevant service described in section 250(1)(a), or any parts of services that are services themselves, be declared.

As regulation involves substantial direct and indirect costs, the policy objectives of the review of the declared service is to ensure that declaration applies only to a very narrow scope of services that continue to satisfy the access criteria. In this regard, Aurizon Network also submitted that the use of a coal system for the transportation of rail is comprised of numerous part services for which:

- > access on reasonable terms would not promote a material increase in competition in a relevant upstream or downstream market; and that
- > Aurizon Network possesses no enduring market power due to the availability of substitutes for the use of a coal system.

In addition, the review process requires:

- > consideration of all relevant markets and the part services applicable to those markets; and
- > a demonstration that economic regulation, by way of declaration, will provide future net benefits.

The Relevant Markets are Broader than the Coal Market

Aurizon Network largely agrees with the QCA and stakeholder submissions that the starting point for the review is whether a declared service satisfies the criteria on the basis the use of the declared service relates to the operation of a train as summarised in the Draft Recommendation³.

“Generally speaking, rail access rights for one type of above-rail service (e.g. coal) are not easily distinguished from access rights for rail services to transport other commodities or passengers. In each case, the relevant service involves access to a rail network (by acquiring a train path) in order to operate a train. In each case:

- *the facility used to provide the relevant service is the same*
- *there are above-rail services that are dependent on the use of the facility.”*

However, how a train path is used is distinguishable with respect to the relevant downstream market. For example, the National Competition Council’s (NCC) consideration of revocation of the declaration of the Port of Newcastle (PoN) included an assessment of both the coal tenement market and the container port market despite access to the shipping channel being functionally identical in how the shipping channel is used in respect of both markets.⁴

As the demand for above rail services is a derived demand, the consideration of the access criteria in relation to parts of the declared service necessarily starts with the demand for rail transport services in the relevant downstream market and the availability of substitutes for rail transport. The application of

³ Queensland Competition Authority (2018) Draft Recommendation Part A: Aurizon Network Declaration Review, December, p. 10

⁴ National Competition Council (2018) Statement of Preliminary Views: Revocation of the Declaration of the Shipping Channel Service at Port of Newcastle, December, pp 56-59

criterion a) in section 76(2) in respect of the rail haulage market would subsequently require the QCA to assess how the removal of that part service from the scope of the declared service would affect competition in the rail haulage market. For example, in considering the use of CQCN for non-coal services the QCA states⁵:

“Hypothetically, even if all non-coal freight customers switched away from the use of rail in response to a [Significant Non-transitory Increase in Prices] SSNIP in the below rail price, this would have a minor effect on the overall demand by end customers for above rail haulage on the CQCN, with 99 per cent of end customers (i.e. coal miners) constrained to transportation by rail.”

Notwithstanding this conclusion, the Draft Recommendation does not consider the implications on how the use of a coal system for the operation of non-coal services would promote a material increase in competition in the rail haulage market.

Therefore, Aurizon Network considers that the proper consideration of the access criteria requires the QCA to undertake a complete assessment of all relevant markets, the availability of substitutes for rail transport services within those markets and a positive affirmation of the access criteria for each of those services.

The QCA’s Draft Recommendation is incomplete, in that the QCA has not adequately assessed the part services identified by Aurizon Network in the both the Initial Submission and the Cross Submission.

Promoting the Public Interest Requires Demonstration of a Net Benefit

The Initial Submission and the Cross Submission submitted that:

- > access to the service was likely to promote competition in the above rail haulage market for coal carrying train services in the CQCN but that benefits from that competition are diminished as the:
 - expected ongoing efficiency gains from competition are likely to be substantially less than the productivity improvements realised over the period of the original declaration as any inefficiencies associated with prior government ownership have been removed since privatisation; and
 - the coordination and innovation issues associated with multi-operator railways and the prescriptive and inflexible ex-ante regulation of the terms of access will have a material impact on the extent to which future benefits can be obtained
- > access to the service on reasonable terms from declaration was not likely to be in the public interest where the direct and indirect costs of access regulation substantially exceed the benefits from competition in the rail haulage market.

Importantly, Aurizon Network did not advocate that providing access on reasonable terms would not promote competition where the terms and conditions of access are determined through effective bilateral and customer negotiated settlement processes which establish terms of access which are reasonable and mutually beneficial to both the customer and the service provider. However, the substantial direct and indirect costs from declaration under the QCA Act would likely exceed the expected benefits from

⁵ Queensland Competition Authority (2018) Draft Recommendation Part A: Aurizon Network Declaration Review, December, p. 18

marginal allocative efficiency improvements that could be obtained from continuation of the current regulatory framework for which the Draft Recommendation does not formally or adequately evaluate.

In Aurizon Network's view, the Draft Recommendation regarding criterion d) does not objectively assess whether access under terms pursuant to the Queensland Rail Access Regime (**QRAR**) satisfies that requirement. Aurizon Network considers the assessment is largely a comparison of the public interest of access relative to 'no access', as opposed to access from declaration under the QCA Act relative to access on reasonable terms associated with other forms of regulatory instruments.

Other regulatory instruments include:

- > the predominant and successful use of voluntary negotiated settlements in North America; or
- > application for declaration under the National Access Regime; or
- > court enforceable forms of obligations to provide access, such as access protocols or frameworks; or
- > the use of price investigations under either Part IV of the QCA Act or Part IIA of the *Competition and Consumer Act 2010* (Cth) (**CCA**) and the credible threat of regulation provided by price monitoring as concluded by the Productivity Commission's (**PC**) draft report on the Economic Regulation of Airports; and
- > the yet untested operation of section 46 of the CCA following the introduction of an effects test which largely achieves the same purpose as criterion a) of the access criteria.

Nevertheless, Aurizon Network acknowledges the uncertainty as to how one or more of these arrangements would interact to establish a counterfactual that would create a baseline for assessing whether declaration under the QCA Act would promote the public interest. The practical consequence of which is that the QCA's assessment of criterion d) relies on a comparison of access against a hypothetical arrangement with no access. Based on that comparison, access on reasonable terms from declaration under the QCA Act is likely to promote the public interest.

Aurizon Network recognises the difficulty of establishing a counterfactual which would ensure the continuation of access on reasonable terms without declaration under the QCA Act, or even under the QCA Act through an alternative customer negotiated voluntary access undertaking. However, the QCA assessment of criterion d) should positively demonstrate that the 'future' economic benefits (other than issues of equity and redistribution) from declaration exceed the costs identified in the Initial Submission and Cross Submission on the assumption of continued access to the service.

Finally, the conclusions in the Draft Recommendation regarding the public interest are contrary to a large body of literature, including successive reviews by the PC on access regimes and various declaration assessments and appeal processes, on:

- > the costs of over-regulation;
- > the asymmetry of economic costs of reduced incentives to invest; and
- > the propensity for material regulatory error.

These issues are discussed further in section 6.

2. Aurizon Network's Assessment of the Draft Recommendation

Aurizon Network has reviewed the Draft Recommendation on the declared service in section 250(1)(a) of the QCA Act and considers:

- > that access to the service on reasonable terms from declaration is likely to promote competition in the above rail haulage market;
- > that the total foreseeable demand proposed by the QCA of 260 to 300 million tonnes per annum can likely be satisfied at least cost from the existing CQCN facility; and
- > that the CCQN is an integrated coal network that is of significance to the Queensland economy.

In addition, access on reasonable terms from declaration would likely promote the public interest where the terms of access are determined through commercial negotiation and provide a reasonable commercial return on investment provided that:

- > the period of for review of the declaration does not exceed a period of 10 years;
- > geographical extensions to the facility are contestable and are therefore excluded from the scope of the declaration; and
- > the facility providing the declared service is a single facility comprising the four coal systems listed in section 250(3)(a) of the QCA Act.

Aurizon Network does not consider that access on terms under the 2017 Access Undertaking (UT5) represents access on reasonable terms.

As such, declaration will not promote the public interest as the QRAR would not satisfy the requirements for an effective access regime specifically:

- > the terms are not agreed between the owner of the facility and the person seeking access as required under clause 6(4)(a) of the Competition Principles Agreement; and
- > the terms are contrary to the objects of section 44AA of the CCA regarding promoting efficient investment in rail transport infrastructure and a consistent approach to regulation across the rail industry.

The remainder of this submission addresses the factors relevant to declaration discussed above.

3. Declaration should be Subject to Periodic Review not exceeding 10 Years

The Draft Recommendation recognises the importance of the declaration being periodically reviewed. In this regard⁶:

“the QCA considers a 15-year declaration period allows the QCA to make sufficiently robust predictions about the future market conditions, while also providing an opportunity for review”.

Aurizon Network notes that this position is contrary to the position adopted for the Dalrymple Bay Coal Terminal (DBCT) for which the QCA has recommended a period of declaration of 10 years. The key difference between the two positions appears related to certainty with the Draft Recommendation⁷ stating:

⁶ Ibid, p. 19

⁷ Ibid, p. 19

“the QCA considers it has balanced the need for access seekers and holders to have certainty over the period of declaration with the legitimate business interests of Aurizon Network to have its service declared for only as long as is considered necessary”.

Aurizon Network contends that extending the term of the declaration is unnecessary to address any concerns regarding certainty. In addition to the matters discussed in the Initial Submission and Cross Submission:

- > the availability for revocation removes any certainty benefits where the QCA has the discretion to make its own recommendation to the Minister to revoke declaration under section 88 of the QCA Act; and
- > to the extent that the prevailing market conditions at the time of making the recommendation to declare also prevail in the subsequent review process, there is little uncertainty regarding the outcome from that subsequent review.

Uncertainty is, therefore, a function of the market conditions, not the term of the declaration.

Aurizon Network also considers that once a service has been effectively reviewed against the access criteria, as the QCA is currently doing, then it is reasonable to expect that the service will continue to satisfy the access criteria in the absence of any material change in market conditions. In this regard, while it might be expected that the service will be declared for a period beyond 10 years this should not preclude reviewing the declaration within ten years to ensure that market conditions may not be expected to change in the period beyond ten years. This is important as the access criteria requires consideration of the expected market conditions to prevail over the period.

Aurizon Network considers that while it might be expected that the access criteria would be satisfied for a period beyond 10 years the Draft Recommendation does not establish the economic principles for extending the period for ‘review’ of the declaration beyond ten years. The Draft Recommendation:

- > is not consistent with relevant rail precedents for declaration and certification;
- > overstates the economic significance of the regulatory certainty in extending the period of review of market conditions in excess of 10 years; and
- > does not consider the rail industry technology developments which may substantially impact on market boundaries.

The Draft Recommendation is inconsistent with relevant rail declaration and certification precedents

In supporting the conclusion for a 15-year review period, the Draft Recommendation states⁸:

“The QCA notes other declarations of rail access services have typically been for longer periods of time (at least 10 years). For instance, the QRC noted the service provided by the Tasmanian Railway was declared under Part IIIA for 10 years, while the service provided by the Goldsworthy Railway (Western Australia) was declared for 20 years.”

Aurizon Network observes that the facts do not support this statement as shown in the following summary of declaration and certification decisions for rail access.

⁸ Ibid, p. 20

Table 1. Rail Declaration and Certification Periods

Regime	Declaration/Certification	Period
Queensland Rail Access Regime	Declaration and Certification	10 years
Western Australian Rail Access Regime*	Certification	5 years
South Australian Rail Access Regime	Coverage	5 years
	Certification	10 years
Tasmania Rail Network	Declaration	10 years
Goldsworthy Rail Line	Declaration	20 years

* While the Western Australian Rail Access Regime has no fixed declaration period the regime includes provision for reviewing the *Railways (Access) Code 2000 (WA)* every 5 years. This review includes Schedule 1 which specifies the Routes to which the code applies.

The only rail access regime subject to a review period greater than 10 years is the Goldsworthy railway. In referring to this decision the Draft Recommendation does not address the material differences between the CQCN and the Pilbara with respect to the mining tenement market. In the CQCN, Aurizon Network has no incentive to deny access to existing or future coal production as it is not a competitor in the market for coal exports.

In addition, the Draft Recommendation does not consider the importance and accepted regulatory best practice of period review of both the *performance* and *need* for regulation. The Initial Submission and Cross Submission identified deficiencies associated with the performance of the current regulatory framework. However, the Draft Recommendation does not contemplate that a review of the performance of access regulation could, or would likely, occur within ten years. This is emphasised in PC’s 2013 Review of National Access Regime which notes⁹:

“The long-term efficiency consequences and effectiveness of the Regime as a whole require ongoing assessment.

The Commission considers that a further review of the Regime, including any related initiatives endorsed by COAG, would be warranted no more than ten years after the Australian Government releases its formal response to this inquiry’s final report.”

The certainty benefits of a longer review period are not well established

A key difference in the Draft Recommendations on the period for assessing the total foreseeable demand for the DBCT service and the CQCN service is the contractual terms for an access agreement. In this

⁹ Productivity Commission (2013) Inquiry Report. Review of the National Access Regime, p.339, Canberra

respect, access agreements for the CQCN are typically for a term of 10 years or less. DBCT is subject to rolling 10-year agreements on notification.

The presumption of this comparison is that in the last year of a 10-year declaration the DBCT access agreement would still have a further 10 years. In contrast, a review period of 10 years for the CQCN would mean that all current access agreements within the CQCN would expire before the review period and where certainty is required, would be extended within the term well beyond the review date. In this regard, Aurizon Network does not consider the distinction between the term of declaration between the DBCT and the CQCN in respect of the coal tenement market to be material to warrant the different approaches to the review period. Similarly, if certainty was a particularly important attribute to coal producers, this would be demonstrated by high demand for contract periods exceeding 10 years.

The Draft Recommendation also concludes that rollingstock are sunk assets with a physical life of 20 to 30 years and therefore, rail operators require longer term certainty to invest in rail operations. There are a number of deficiencies inherent in this argument, specifically:

- > the size of the investment in above rail facilities is insignificant relative to the size of the Regulatory Asset Base (**RAB**) for below rail infrastructure or as an amortised cost as a proportion of mining input costs/income. Furthermore, the Draft Recommendation does not establish the materiality of any exit costs;
- > the rail haulage market is workably competitive which, by economic definition, requires limited barriers to entry or exit in order for criterion a) to be satisfied. That is, it is a *necessary* condition for barriers to exit to be low in order to facilitate entry, or the threat of entry, to promote a 'material' increase in competition in the rail haulage market;
- > competitive and technology stranding risks for rollingstock investment are far more significant than regulatory risks associated with declaration reviews. The competitive stranding risk means a rail operator has no certainty of utilisation beyond the term of the rail haulage contract (which is typically 10 years or less);
- > the Draft Recommendation does not consider the scale and liquidity of the market for narrow gauge rollingstock that is not life expired, the opportunity to utilise those assets in other markets, or the technical feasibility of gauge conversion (and therefore the extent to which the assets are sunk);
- > submissions to the review process have not provided any relevant information in relation to the payback period for rollingstock investments, nor the assumed rate of economic depreciation that would enable the QCA to assess the financial risks to rail operators from a 10-year review period. In addition, the Draft Recommendation does not consider the rollingstock capacities against the total foreseeable demand to determine whether rollingstock investment over the declaration period would be substantive.

Technological developments in the global rail industry necessitate a shorter review period

The Draft Recommendation does not consider the rate of technological development within the rail industry, or the potential disruptive implications from those developments on railway operations. Recent developments in the automation of railways, such as Rio Tinto's Autohaul project, have accelerated the review and implementation of technology in the rail sector. For example, the Association of American

Railroads¹⁰ submission to the Federal Railroad Authority's request for information on automation in the railroad industry notes:

“Fully automated trains (with or without humans on board) are certainly in the future - for at least some operations on some railroads. Given the development of automation in other more complex settings, automating locomotives is an entirely realistic endeavor. Trains' paths are constrained by their tracks, and access to the railroad rights-of-way by others is limited and controlled. Thus, in a world where the automation of millions of interacting trucks and cars is being vigorously pursued, the similar – and in many cases simpler – automation of train operations should come as no surprise.”

These technologies have significant implications for the market boundaries between the above and below rail services with automation involving below rail control of train movements being characterised more accurately as an integrated rail transport service.

While Aurizon Network does not envisage that automation of the CQCN will occur in the foreseeable future, it will still be necessary to consider the scope of the declared service and market boundaries beyond the 10-year review period as these technologies evolve over the next decade.

4. Geographical Extensions of the Facility Should be Excluded from the Scope of the Declaration

Section 250(4) of the QCA Act provides that the CQCN service includes future extensions to the rail transport infrastructure, provided that three conditions are met:

- > the extension is built on or after 30 July 2010;
- > the extension 'does not directly connect the coal system to a coal basin to which the coal system was not directly connected on 30 July 2010'; and
- > the extension is owned or leased by the owner or lessee of the CQCN or a related body corporate (i.e. Aurizon Network).

In respect of these provisions, the Initial Submission stated¹¹:

“the QCA should not make a recommendation to declare a service which would utilise rail transport infrastructure that is not currently part of a coal system on the basis that the access criteria might be satisfied in some circumstances and not others such as geographical extensions to a coal system.”

Aurizon Network notes that the Draft Recommendation does not assess whether a *geographical* extension of the CQCN that is owned or leased by Aurizon Network and does not directly connect the coal system to a coal basin that was not directly connected as of 30 July 2010 satisfies the access criteria.

Aurizon Network recognises that this matter may not have been given sufficient prominence within the Initial Submission. Nevertheless, Aurizon Network considers that including geographical extensions of the network is inconsistent with promoting facilities-based competition and would be contrary to ensuring the scope of the declaration narrowly applies only to those services for which the access criteria are satisfied.

¹⁰ <https://www.aar.org/wp-content/uploads/2018/05/AAR-Automation-comments.pdf>

¹¹ Aurizon Network (2018) Submission to QCA on Review of Declared Services in the Central Queensland Coal Network. May, p. 9

In this regard, including geographical extensions of rail transport infrastructure is unlikely to satisfy the access criteria as:

- > Aurizon Network's ownership and lease of the declared facility is not relevant to whether the foreseeable demand for that extension can be met at least cost by ownership or lease by Aurizon Network (the extension is not a natural monopoly);
- > the public interest is advanced by promoting competition in the market for rail construction and infrastructure management;
- > the interests of Aurizon Network are not protected where it is unable to effectively compete in the market for construction and operation of geographical extensions if ownership by Aurizon Network regulates the extension compared to ownership by a third party which is unregulated;
- > there is a workably competitive market for rail infrastructure manager services and observable evidence of third-party ownership and management;
- > the contestability of significant network extensions is observed with Adani's proposed construction and operation of the Carmichael Rail Line;
- > the exclusion of geographical extensions is consistent with the observed practices for ownership and management in other rail network's (such as is evident in both Queensland Rail and ARTC line diagrams); and
- > geographical extensions of rail infrastructure are comparable to the exclusion of connecting infrastructure (including line works) from the scope of regulation in the electricity sector where significant economic reforms of network extensions have resulted in deregulation and contestable services¹².

Where a party subsequently seeks a right to negotiate access to a geographical extension then it should be necessary for that party to apply for declaration to ensure the access criteria is satisfied. Similarly, where it is likely that a geographical extension would satisfy the access criteria then the QCA would also have the power to direct the extension under section 118 of the QCA Act.

Aurizon Network recommends that the final recommendation to the Minister should exclude geographical extensions to the existing facility other than those extensions that have been directed under an access determination.

5. The Regulatory Framework is Inconsistent with a Single Declared Service

The Initial Submission and Cross Submission identified a number of part services that are themselves a service in respect of various upstream and downstream markets for which the QCA should be required to ensure satisfy the access criteria. Among those services include the use of more than one coal system. Aurizon Network noted that this would include services for which Aurizon Network possess little or no market power due to the availability of a substitute regulated below rail service. The most prominent example of this is the use of both the Goonyella and Newlands coal systems for the transportation of coal from Goonyella to Abbott Point (otherwise known as GAPE) services.

The GAPE services are of relevance as the prospective demand for these services shares the same catchments as the demand for services provided by DBCT. In this regard, to the extent that Abbot Point is not an economic substitute service for the total foreseeable demand for DBCT then it cannot be

¹² For example, see Australian Energy Market Commission, Rule Change ERC0001 and ERC0192

concluded that GAPE services are an economic substitute for the use of the Goonyella coal system for export through either of the coal terminals located at Hay Point.

The Draft Recommendation does not consider that the use of both the Goonyella and Newlands coal systems for the transportation of coal from Goonyella to Abbott Point to be a part service for the purpose of the access criteria. In reaching the conclusion, the QCA considers that the CQCN is an operationally integrated network which allows rail operators to switch between systems and therefore, the market for the service is the CQCN. Specifically, the QCA note¹³:

“However, the primary market for use of below rail access rights on the CQCN is made up of above-rail haulage operators. These operators do have the ability to switch their rollingstock between different parts of the CQCN depending on the demand for rail transportation from mine owners. The ability of rail operators to switch between different parts of Aurizon Network’s interconnected rail system is a powerful indicator that the use of the CQCN is a service provided in a single geographic market. The fact that some mine owners can and do use more than one rail system further supports this conclusion.”

Aurizon Network acknowledges the operational benefits which arise from switching as these has been observable with rail operators readily switching electric locomotives between the Goonyella and Blackwater systems. In this regard, Aurizon Network agrees that the use of the CQCN would comprise a single facility with respect to the downstream rail haulage market. However, the Draft Recommendation’s conclusion on part services is not well developed and does not represent an adequate assessment of the contestability, substitutability and lack of any enduring market power for either:

- > the use of both the Goonyella and Newlands coal systems for the transportation of coal from Goonyella to Abbott Point; or
- > the use of overhead power system for the transportation of coal.

The Draft Recommendation consideration of the declared service comprising the use of the CQCN as a single facility is inconsistent with how the declared service is currently regulated

While Aurizon Network recognises these benefits the consideration of the declared service being a single service comprising the use of the CQCN as a single facility is not reconcilable to how the QCA currently regulates that single service. This is evident in terms of how the approved access undertaking addresses the following:

- > prices access to the CQCN via discrete regulatory coal system asset bases;
- > prices do not incorporate the value of any positive externalities from increased competition or private economic benefits from the ability to ‘switch’ locomotives between these systems;
- > prices do not reflect the value of rerouting or redirecting services to address disruptions from force majeure events; and

¹³ Queensland Competition Authority (2018) Draft Recommendation Part A: Aurizon Network Declaration Review, December, p. 15

- > an assumption that material changes in the price of access for electric traction services are economically acceptable and have no impact on competition in the downstream rail haulage market.¹⁴

Furthermore, the differential approach to the service between the consideration of a single declared service provided by the whole of the CQCN and the discrete cost-based pricing of multiple services under the undertaking would give rise to an inconsistency within the certified Queensland Rail Access Regime (comprising the QCA Act, the declaration and the access undertaking).

The QCA's final recommendation to the Minister will need to either reconcile these differences, or in respect of the relevant part services, demonstrate how access to a service which:

- > has little, or no foreseeable demand; or
- > or is not necessary to transport freight by rail,

will promote competition in rail haulage market, or how not recommending declaration would result in material decrease in competition in that market.

6. The Regulatory Regime is not Promoting the Public Interest

The Initial Submission and Cross Submission evaluated the performance of the regulatory regime and contended that the current regulatory framework imposed substantial direct and indirect costs associated with:

- > the use of mandatory access undertakings which inhibit or prevent effective negotiation of terms of conditions of access with users of the service;
- > the regulatory risk and uncertainty of retrospective regulatory decisions;
- > the lack of incentives to innovate and the asymmetric risk of innovation expenditure (benefit transfer if successful and the economic loss if unsuccessful);
- > the susceptibility of regulatory decisions to material regulatory error without review and the asymmetric effect of those errors; and
- > the material asymmetry in the economic costs of undercompensating relative to overcompensating.

Aurizon Network considers that the Draft Recommendation's assessment of the public interest with respect to these matters is incomplete and does not objectively assess the costs and benefits of declaration under the QCA Act. It does not consider the improved economic outcomes associated with the avoidance or removal of these direct and indirect costs. To the extent that gains from the improved economic outcomes exceed the benefits from competition, then there would be no net benefit from declaration.

The primary benefit, and the fundamental objective, of declaration is to promote economic efficiency in terms of the provision of rail transport services noting that competition is the means to that end, not regulation. The Draft Recommendation assessment of these benefits is largely backward looking rather than considering the expected future benefits from access by declaration noting any future benefits arising from declaration will not be substantive relative to the benefits obtained following the

¹⁴ See impacts on Blackwater AT5 tariff at the QCA proposed utilisation threshold presented in Aurizon Network's response to the Draft Decision on 2018 Electric Traction DAAU.

commencement of the QRAR and privatisation (outcomes are largely distributive rather than efficient). This view aligns to the those of Professor Ergas and Professor Fels in their response to the 2014 Competition Policy Review¹⁵:

“There can be no assurance that mandated third party access will result in competition benefits, or that such benefits will outweigh the corresponding costs. While mandated access may increase social welfare and economic efficiency, it will not, if the gains from competition as a result of third-party access are small relative to the costs (in terms of losses in economic efficiency) this entails.”

Consistent with the Initial Submission and Cross Submission, Aurizon Network considers that the adverse economic effects described above can largely be avoided or overcome where the access framework places greater importance and primacy on achieving commercially negotiated outcomes.

As part of its recent review of the economic regulation of airports, the **PC** found the light-handed approach to regulation has performed well.¹⁶ A key aspect of this has been that the credible threat to airports of increased regulation (such as declaration under the National Access Regime) acts as a deterrent against the exercise of market power. The PC were satisfied that airports have not systematically exercised their market power in commercial negotiations with airlines to the detriment of the community.¹⁷ This is due to several reasons¹⁸ including:

- > airports have strong incentives to reach agreements with airlines;
- > negotiating agreements is information intensive and some airports have taken steps to improve the flow of timely and relevant information to airlines;
- > the PC had insufficient evidence to conclude that airport operators make take-it-or-leave-it offers to airlines and that airlines are compelled to accept them; and
- > the operational and financial performance of the four monitored airports does not indicate they are systematically exercising their market power by setting aeronautical charges above efficient levels.

The most important of these findings is the incentives airports face, which parallel those of Aurizon Network. Aurizon Network have strong incentives to reach agreements with users of the CQCN; whether it be in relation to providing access to existing capacity or services, or expansion of the network.

However, unlike airports, the currently mandatory access undertaking process effectively prevents Aurizon Network from pursuing any such meaningful negotiation with its customers. This is a direct result of the QCA assessment process and timeframes involved. For example, UT5 was first submitted in November 2016 despite UT4 Access Undertaking having only just been approved by the QCA in October 2016. UT5 has only recently been approved almost two years after the commencement of the regulatory period to which it applies. Any operational incentives or otherwise are potentially muted given the uncertainty in the QCA's approval of Aurizon Network's proposals and its ability to effectively respond to such incentives prior to expiry of the regulatory term.

By not facilitating and promoting meaningful commercial negotiation between Aurizon Network and its customers, the current regulatory framework has effectively outsourced this role to the QCA. This has

¹⁵ Ergas, J, and Fels, A (2014) Submission to the Competition Policy Review, November, p. iii.

¹⁶ Productivity Commission (2019) .Draft Report: Economic Regulation of Airports, Canberra

¹⁷ Ibid.

¹⁸ Ibid.

resulted in an access determination consisting of complex commercial terms to be addressed by a regulator with imperfect information – increasing the risk of regulatory error¹⁹.

As commercially negotiated settlements ensure reasonable terms of access they are also likely to:

- > determine an appropriate commercial return with low risk of that return being in error; and
- > avoid the adverse economic consequences of undercompensating the access provider.

As noted by the PC, where long-lived investments in essential infrastructure are involved, the costs of regulatory error can be substantial.²⁰ The PC go on to note²¹ that:

- *“regulatory interventions risk dampening incentives for cost saving, innovation and entrepreneurship in regulated firms, or those depending on them; and*
- *Regulators may also feel constrained by the precedents set by their own past decisions. Apart from a natural reluctance to admit error the regulator must consider the potential for subsequent litigation where past errors have imposed substantial costs on particular businesses. To avoid this risk any correction in regulatory behaviour is likely to be incremental and defended in terms of new circumstances.”*

In submission to the Federal Government’s Competition Policy Review, Professor Ergas and Professor Fels note that²²:

“While regulators have precedent and experience to draw on in setting prices for the services provided by facilities in the utilities sector, this is unambiguously not the case for vertically integrated and complex commercial facilities. In addition, regulated access prices are a poor tool for coordinating the shared use of complex facilities, making it likely that (inflexible) administrative rules and controls will be applied. Overall, the risk of regulatory errors with all the inefficiencies that would flow from these is considerable. On a dynamic analysis, mandated third party access chills the incentive of a potential access provider to invest or innovate in markets where a first mover investor may be deemed to have acquired market power, and, conversely on the part of the access seeker who can gain, at least in the short term, by ‘free-riding’ on the access provider’s investment. As a result, the risk is that, first, investment, and more broadly, genuine head-to-head competition are reduced over the longer term.”

Regardless of whether the CQCN was a declared service or not, Aurizon Network would still be required to enter into agreements with its customers for access to its network. The current intervention by the QCA in the negotiation of these agreements in accordance with Part 5 of the QCA Act, while requiring the QCA to have consideration of a wide range of factors, still requires the QCA to exercise a substantial level of judgement across various elements of the undertaking and this raises the prospect of regulatory error.

The probability and materiality of regulatory error is greater where the regulator possesses imperfect information and the relevant costs are not directly observable, measurable or obtainable. The determination of the weighted average cost of capital provides a useful example to this problem. As there are no pureplay listed coal export infrastructure businesses globally, it is necessary to infer the appropriate commercial rate of return using idiosyncratic methods (i.e. the use of comparators outside of

¹⁹ Vertigan, M. (2014) Independent Cost-Benefit Analysis of Broadband and a Review of Regulation, Statutory review under section 152EOA of the Competition and Consumer Act 2010, June, p.53

²⁰ Productivity Commission (Banks, G Chairman), Competition regulation of infrastructure: getting the balance right. March 2002.

²¹ Ibid.

²² Ergas, J, and Fels, A (2014) Submission to the Competition Policy Review, November, p. iv.

the same industry with materially different business risks), and to apply models or assumptions with low explanatory power.

As a direct result, there is a substantial risk that regulatory error would occur, resulting in lower investment returns and reduced incentives to invest in capacity or innovation.

There are significant asymmetric consequences of reduced incentives to invest in the facility

Economic literature on access and price regulation commonly refers to the challenge facing a regulatory body of ensuring that prices are set neither too high nor too low. Critically, setting prices too low could deter new investment in the facilities themselves or result in delayed investment required to maintain, extend or replace existing infrastructure. However, these effects are far more critical in consumer-based regulation, where the impacts of pricing effect downstream consumption decisions.

As discussed above, and foreshadowed through the UT5 assessment process, Aurizon Network consider the proposed rate of return for the UT5 period effectively reduces any incentive to invest in the facility over the short term or at least until the next regulatory period where it will be reset.

In considering the consequences of reduced incentives to invest in the facility, the QCA, in making its Draft Recommendation, has unduly assumed that:

- > the economic impacts of under and over compensation are relatively symmetric;
- > there are no significant and avoidable transaction costs associated with applying an untested, theoretically-based, user funding framework;
- > investment will proceed in the facility independently of the actual returns on that investment to either Aurizon Network or the access seeker; and has
- > failed to adequately address the impact on innovation and other risks that are necessary to promote dynamic efficiency in the provision of rail freight services in a complex coordinated supply chain.

While Aurizon Network acknowledge the significant investment that was the GAPE extension and WIRP upgrades, these investments were made almost 10 and 5 years ago respectively and have not been without their risks. For example, Aurizon Network has been required to defer the recovery of its WIRP investment following changes in the market, which adversely impacted those customers whom initially sought the expansion. This directly impacts Aurizon Network's cashflows and requires Aurizon Network to underwrite most of the investment in the system.

Further, Aurizon Network agree demand for the CQCN service derives from demand for above-rail haulage services, chiefly driven by requirements of users to transport coal by rail to port facilities. As discussed above, Aurizon Network have strong incentives to reach agreements with its customers in relation to providing access to the CQCN.

Aurizon Network also notes that no evidence has been presented to demonstrate that the commercially agreed rate of return in the 2010 Hunter Valley Access Undertaking had any adverse impact on incentives to invest in any upstream or downstream market over the term of that undertaking. Furthermore, as demand for access is a derived demand and costs are passed through to end users with relatively inelastic demand, then the below rail access price has no effect on competition in the rail haulage market.

Given the downside risks associated with lower asset availability and reliability with associated economic costs from lower export income relative to slightly higher access prices it is neither unusual or irrational to observe that commercially agreed rates of return exceed regulatory prescribed outcomes.

For example, the Canadian Pipeline Association observes material differences between the negotiated returns and the those obtained from regulatory determinations²³:

“Pipelines and their customers often negotiate an explicit ROE [Return on Equity] for a new or an existing pipeline. These ROEs are invariably higher than the formula ROEs at the time. The ROE negotiated in a single settlement reflects a negotiated trade-off between ROE and other risk factors. However, the fact that all settled ROEs are significantly higher than the alternative formula ROE suggests that pipelines and their customers are able to agree that formula ROEs do not appropriately reflect the cost of equity capital.”

These observations are broadly consistent with the views of both the PC and the NCC that the matter of most relevance to declaration is the improvements in efficiency from increased competition, not the redistribution of income arising from prescribed regulatory terms.

²³ <https://www.cepa.com/wp-content/uploads/2011/06/CEPA-Perspectives-on-Canadian-Gas-Pipeline-ROE.pdf>