Working together for a shared future

**QRC submission to the QCA**

**Aurizon Network FY2014 Revenue Adjustment Amounts and Increments**

**November 2014**

1. Background

QRC welcomes the opportunity to comment on Aurizon Network’s submission regarding FY2014 Revenue Adjustment Amounts and Increments.

This submission does not contain confidential information, and may be published on the QCA’s website.

1. Summary

The QRC relies on the QCA to assess Aurizon Network’s claims and adjustments in regard to Revenue Adjustment Amounts. QRC does not have adequate information on which to base any comments on the Revenue Adjustment Amounts.

This submission is therefore limited to comments on the claimed Increment. We consider that the Increment should not be approved because:

* The requirements for claiming an Increment under UT3 have not been met.
* Even if the requirements had been met, it is inappropriate, and inconsistent with the approach being taken to revenue related matters under UT4, to claim an Increment under UT3 terms during FY2014 (which, for the purposes of revenue related matters, is effectively part of the UT4 period).

QRC welcomes the efficiency initiatives which have been documented by Aurizon Network. These projects offer a range of benefits including possible cost savings in various elements of the supply chain, and possible longer term capacity enhancements. However, we do not consider that the efficiency initiatives caused or allowed the volume forecast to be exceeded in FY2014. Therefore the undertaking requirements for claiming an Increment have not been met.

The claim does not meet the requirements for an Increment under UT3 because:

* The cause of volumes exceeding forecasts was higher than expected mine output and unusually low rainfall, not efficiency improvements as claimed by Aurizon Network. This is confirmed by Energy Economics in its April 2014 report to the QCA.
* Efficiency improvements, while welcomed, cannot be said to directly cause, in whole or in part, additional volumes, when volumes remain substantially below contract. Coal producers are paying for an amount of below rail capacity which significantly exceeds the volumes achieved in FY2014. Aurizon Network is contractually bound to provide this level of capacity. Therefore, while the efficiency improvements are beneficial, it is not possible to conclude that the volumes achieved could not have been achieved in the absence of these initiatives.

We also consider that a claim for an Increment for the FY2014 year should not be considered under the terms of UT3. It is intended that Maximum Allowable Revenues and tariff related matters for the FY2014 year will be assessed as part of UT4 and, if necessary, adjusted over the remaining term of UT4. The question of whether Aurizon Network can claim an Increment for FY2014 should therefore be assessed under UT4, based on the final approved terms of UT4. Aurizon Network has proposed this approach in regard to adjustments to FY2014 maintenance costs, MCI, electricity connection costs, and operating costs. The final adjustments for these matters will be determined based on UT4 terms, including, for example, the use of UT4 approved escalation mechanisms. Aurizon Network’s proposal to claim an Increment for FY2014 based on UT3 terms is inconsistent with this approach.

In this regard, QRC considers that UT4 should not offer an increment until a symmetrical set of incentive arrangements is developed. This was a requirement under UT3, but was not achieved, in part because Aurizon Network submitted a proposal which was not symmetrical and therefore did not comply with the requirements of the UT3 “Draft Incentive Mechanism” and could not be approved. The proposal was never formally rejected by the QCA, and therefore stalled, presumably due to conflicting demands from UT4 and other undertaking processes. Continuing to apply the UT3 Increment in FY2014 would reward Aurizon Network for the failure to comply with the UT3 Draft Incentive Mechanism requirement, and for its part in the delayed finalisation of UT4.

1. What caused volumes to exceed forecasts?

QRC considers that the cause of volumes exceeding forecasts during FY2014 was higher than expected mine output and unusually low rainfall.

The volumes reflected in the FY2014 forecast were not constrained by considerations of above rail, below rail or port capacity. Rather, the volumes reflected expected mine output. This was appropriate given that the forecast mine outputs were well below the contracted capacity of each element of the rail and port infrastructure. With this as the basis of the forecast, we do not consider that innovation in above rail, below rail or port services ought to have been required to exceed the forecast.

Energy Economics, in its April 2014 report to the QCA, increased its forecast for FY2014 from 190.6mt (2013 report) to 211mt (2014 report). Energy Economics identified the top four causes of the additional throughput, three of which relate to mining performance, with the remaining item being unusually low rainfall. Energy Economics did not identify below rail efficiencies as a contributing factor.



Source: Energy Economics April 2014 report to QCA, page 3.

1. Comments on the Activities and Initiatives

QRC accepts that a number of the initiatives documented by Aurizon Network provided benefits to the coal chain. These benefits may include lower operating costs in various elements of the chain, and possibly (although this is yet to be tested) additional system capacity. QRC appreciates the efforts of Aurizon Network in implementing these initiatives. However, the relevant question for assessing the claim of the Increment is whether the additional revenue arose, in whole or in part, as a direct result of these initiatives. QRC does not consider it credible to suggest that the result achieved in FY2014 could not have been achieved in the absence of these initiatives. We base this view on the fact that:

* the constraining factor which lead to forecast volumes being at the levels chosen was mine output. Had the constraining factor been below rail capacity, then it may be reasonable to conclude that system efficiency improvements could directly cause forecasts to be exceeded. This was not the case.
* volumes achieved remain significantly below contracted tonnages. Aurizon Network has committed to deliver contracted tonnages, and has invested capital, the cost of which is serviced by coal producers, to ensure that the system can deliver these tonnages. We understand that Clause 3.3 of Schedule F does not require that contract tonnages be exceeded in order to claim an Increment, however, the existence of significant ‘spare’ capacity (where actual tonnages are significantly below contract) raises serious doubts about whether the volumes achieved can be said to have been a direct result of the Activities and Initiatives.

FY2014 actual volumes were 214.5mt (Central Queensland total, as per Page 16 of Aurizon submission). This would include domestic tonnages. Contracted volumes are 268mt excluding domestic tonnes (Page 11 of volume 3 of Aurizon Network April 2013 UT4 submission). Therefore actual railings were at least 20% below contracted tonnage and were at least 23% below if domestic contracts are assumed to be 10mtpa or more. With more than 23% (or around 60mt) spare capacity, in addition to all allowances included in Aurizon Network’s capacity modelling, it ought to have been possible to rail 214.5mt with or without the efficiency initiatives. We do not have specific data regarding contracted tonnages in the Blackwater and Goonyella systems, although we note from Aurizon Network’s submission that throughput reached 95% of contract in only one month in Goonyella and in only three months in Blackwater.

Aurizon Network, in its 2013 DAU submission (Volume 3, page 10), made the following comments in regard to FY2014 tariffs:

 “*a major driver of the current tariffs is the under-utilisation of the network relative to contract*” and “*were the network to rail at contract (268.0 million tonnes), tariffs (excluding the AT1 and EC components) for the financial year would be, on average, 27% lower”*.

Two points are worth noting in regard to these statements:

* Firstly, “*under-utilisation*” clearly suggests an ability to handle additional throughput if this is made available by the customers, which is what happened. It does not suggest an immediate need for Activities and Initiatives in order to handle this tonnage.
* Secondly, the suggestion that tariffs could be 27% lower “*were the network to rail at contract*” implies a belief on Aurizon Network’s part that this is possible. It is difficult to believe that 214.5mt could not have been handled without the Activities and Initiatives given Aurizon Network’s belief that 268mt could be handled.

Aurizon Network bases its claim largely on evidence of throughput records (page 15 of Aurizon Network’s submission). The misconception that record throughput necessarily indicates improved performance is a concern. Firstly, as was discussed above, record throughput was a result of record mining production, which resulted in existing rail capacity being more fully utilised. Secondly, when investments are made (and the cost borne by coal producers) to expand the capacity of the supply chain, it should be expected that throughput records can be broken – this indicates nothing about efficiency.

In this context, we note that Aurizon Network includes three capital projects in its list of Initiatives. Aurizon Network notes that they “*will only earn a regulated return on the value of these projects….yet substantial benefits have accrued to other supply chain participants*”. The QCA has determined that the WACC is the appropriate return for these investments. Earning “only” a regulated return does not indicate that an additional payment is required, as the QCA has determined that the providers of debt and equity should find the regulated WACC an acceptable return. It is to be expected that “*substantial benefits have accrued to other supply chain participants*” because it is other supply chain participants (coal producers) who service the full cost of these investments. The purpose of the Increment is to reward Aurizon Network when its activities and initiatives result in more efficient use of assets and this causes throughput to increase, not to provide an additional margin on capital expenditure simply because that expenditure increases capacity.

1. Conclusion

QRC appreciates the efforts of Aurizon Network in regard to the improvements documented in the submission, but considers that the claimed Increment should be rejected for either or both of the following reasons:

* The UT3 requirements for an Increment have not been met.
* Any Increment for FY2014 should be assessed based on the final terms of UT4.

QRC supports the development of effective incentive arrangements under UT4. The need for such arrangements was recognised in UT3, in part, in our view, due to the inappropriateness of retaining the non-symmetrical Increment as the sole incentive.