QUEENSLAND resources COUNCIL

Resourcing Queensland's future

9 April 2021

Mr George Passmore
Queensland Competition Authority
Level 27, 145 Ann Street
Brisbane QLD 4000
(submitted via QCA Online Submission Form)

RE: Aurizon Network Annual Review of Reference Tariffs – FY22

The Queensland Resources Council (**QRC**), on behalf of the QRC's Rail Working Group, welcomes the opportunity to comment on Aurizon Network's Annual Review of Reference Tariffs – FY22.

1. Volume Forecasts

Our understanding of Aurizon Network's methodology for the development of the proposed FY22 volume forecasts is:

- the tonnage forecasts for each system are based on FY20 actual tonnes.

- the tonnage forecast for each system is then allocated to individual hauls in proportions based on contracted tonnes, where contracted tonnes are amended to reflect changes which Aurizon Network anticipates between FY20 and FY22. These tonnes, after allocation to hauls, are used to derive gtk forecasts. Therefore, gtk forecasts do not align with FY20 actuals. We suggest that, if FY20 actual tonnes are the primary basis of the forecast, then an allocation to hauls which is consistent with FY20 actuals is also appropriate, such that the gtk forecasts are equal to FY20 actuals. Adjustments for known changes such as mine closures and new customers could be made to this base.

- a new coal carrying train service in the Newlands systems has been "considered" when developing the forecast. Given that the Newlands tonnage forecast remains consistent with FY20 actual tonnes, we assume that this consideration was limited to the second step above (allocation of tonnage to hauls for the purpose of developing gtk forecasts).

We welcome Aurizon Network's suggestion that a further update of volume forecasts could be completed closer to the end of FY21. We suggest that the updated forecast

ABN 59 050 486 952
Level 13 133 Mary St Brisbane Queensland 4000
T 07 3295 9560 F 07 3295 9570 **E** info@qrc.org.au
www.qrc.org.au

should be:

- based on railings for FY21 (year to date March or April), extrapolated to form a full year forecast.
- Adjusted for known changes which will occur between FY21 and FY22. This would include:
    - adjusting for any major disruptions to throughput which occurred during FY21 (note that no such major disruptions have occurred to date)
    - mine closures or new mines
    - significant expansions or significant reductions in output advised by customers.

We have suggested, and Aurizon Network has agreed, that Aurizon Network makes available to each customer the forecasts for the customer's operations which are included in the overall proposed system forecasts. This will allow individual customers to provide feedback to Aurizon Network and, if necessary, to the QCA.

2. Capital Expenditure Allowable Revenue Adjustments

We rely on the QCA to verify Aurizon Network's calculations of the FY19 and FY20 capital expenditure allowable revenue adjustments. We note that these adjustments are affected by the allocation of capital expenditure between systems. As the QCA is aware, this is a contentious issue in regard to the allocation of renewals expenditure located within the Newlands system between the Newlands and GAPE systems.

We encourage the QCA to consider this issue as part of the current process so that appropriate adjustments can be made to the FY20 capital expenditure allowance revenue adjustment and the FY22 capital indicator. This issue is discussed further in Sections 5 and 6.

3. Maintenance Indicator

We note that the Maintenance Strategy and Budget (MSB) for the Newlands system was not approved by the relevant members of the Rail Industry Group (RIG). This matter is now being considered by the QCA and we understand that a submission has been provided by the RIG.

The issue relates to the efficiency of the proposed rail grinding costs throughout the Central Queensland Coal Network following the sale of the rail grinding business to an external contractor. The RIG understands that the QCA's role in the current process is limited to a review of the Newlands MSB. However, the issue is not specific to Newlands, nor does it have any special impact on Newlands compared to other systems.

We expect that any outcomes from the QCA review of the Newlands MSB will be factored into the outcomes of the Annual review of Reference Tariffs.

4. Capital Indicator

The proposed capital indicators for all systems other than Newlands and GAPE are consistent with budgets approved by the RIG. For Newlands and GAPE, the relevant RIG members did not approve a Renewals Strategy and Budget. The key concern was Aurizon Network's proposed approach to the allocation of Newlands systems renewals between Newlands and GAPE systems. As this issue is relevant to the capital indicator as well as to capital expenditure allowable revenue adjustments and future roll-forward of the RAB, it is discussed separately in Section 5.

5. Allocation of Newlands system renewals between Newlands and GAPE

Aurizon Network's proposes to allocate the cost of renewals which are physically located within the Newlands system to that system, except for the renewal of assets which were originally constructed as part of the GAPE project. For the proposed FY22 renewals budget, this results in the majority of Newlands/GAPE renewals being recovered from the Newlands system ($25m), with minimal allocation to the GAPE system ($0.3m). Aurizon Network proposes to apply a similar approach to approved capital expenditure for the RAB roll-forward. This is despite:

- most train services within the Newlands system originating in the GAPE system.

- a majority of gtks within the Newlands system relating to GAPE services.

- most renewals in the Newlands system relating to asset replacements which are caused by volume/usage rather than being time-dependant. Aurizon Network's DAAU "Reference Tariff for the GAPE System" dated April 2013 clearly acknowledges that with regard to ballast, culvert and track structures in the Newlands system "The degradation of these assets will accelerate given the increase in utilisation and intensity associated with the GAPE project."

Given this, it is unclear why Aurizon would not seek to apportion renewals which are caused by or brought forward by GAPE for the purposes of reference tariffs going forward. The creation of a separate coal system for the GAPE expansion was explicitly created to fit with the commercial arrangements that Aurizon Network had in place for GAPE expansion funding. This structure seems to have created confusion and appears to create opportunities for Aurizon Network to pick and choose principles of expansion versus stand-alone systems to suit their preferred commercial outcomes.

This issue was raised in submissions on the Annual Review of Reference Tariffs for FY21 in the context of the allocation of the FY21 capital indicator. The QCA's May 2020 Final Decision on the Annual Review of Reference Tariffs for FY21 included the following statement: "*We expect that Aurizon Network will continue to work collaboratively with all participants of the Rail Industry Group in order to develop an appropriate approach to allocate the incremental cost of renewals on the Newlands system due to Goonyella to Abbot Point system traffics bringing forward such capital expenditure*".

This consultation has not occurred to any meaningful extent, and Aurizon Network's proposed approach is not consistent with the QCA's suggested approach. That is, Aurizon Network does not propose an appropriate approach "*to allocate the incremental cost of renewals on the Newlands system due to Goonyella to Abbot Point system traffics bringing forward such capital expenditure*".

Aurizon Network has provided a number of claimed justifications for failing to allocate Newlands system renewals on the basis suggested by the QCA. We comment on each of those claims below:

Aurizon Network claim: The Newlands and GAPE Reference Tariffs are each less than the respective stand-alone costs and greater than the respective incremental costs for each system and are therefore consistent with the pricing limits.
QRC Comments:
1. Aurizon Network's analysis of stand-alone and incremental costs is dependent upon an assumption that, in the absence of GAPE, Newlands system users would have elected to upgrade the Newlands system to 26TAL. Aurizon Network offers no evidence that this would have been occurred, nor that such an upgrade would have been a prudent decision for Newlands customers. This upgrade was only proposed as a method of increasing capacity to accommodate GAPE traffic. Aurizon Network did not propose such an upgrade prior to GAPE, and the 20TAL system had sufficient capacity for Newlands traffic (excluding GAPE) without such an upgrade. QR Network's 2009 Coal Rail Infrastructure Master Plan (Section 4.1.6) shows that the capacity of the Newlands system, at 20TAL, was 19mtpa. Current and forecast volumes on the Newlands system remain below this capacity. This confirms that the existing 20TAL Newlands system (pre-GAPE) had sufficient capacity to meet the demands of a stand-alone Newlands system. Aurizon Network highlights in its submission that Newlands customers were paid compensation associated with the upgrade to 26TAL. We consider this further evidence that Newlands customers would not have been incentivised to move to 26TAL in the absence of GAPE.
2. Consistency with pricing limits does not justify a particular approach to pricing. There are many approaches to pricing of services which would be consistent with pricing limits, yet which would be considered unfair and inappropriate. For example, if the most distant mine in a system was required to pay tariffs reflecting its stand-alone costs, with other mines covering the incremental costs of their services, then that most distant mine would be asked to bear the cost of constructing an entire rail line from mine to port. Such an approach would not offend the pricing principles, and yet, would clearly be unfair and detrimental to competition.

ABN 59 050 486 952
Level 13 133 Mary St Brisbane Queensland 4000
T 07 3295 9560 F 07 3295 9570 E info@qrc.org.au
www.qrc.org.au

Aurizon Network claim: The current Newlands RAB is not cost reflective of the 26 tonne axle load (TAL) services currently operating within the Newlands System.
QRC Comments:
The fact that the cost of upgrading to 26TAL was not allocated to Newlands nor shared between Newlands and GAPE suggests that an allocation of this cost to Newlands system was not considered appropriate when the relevant regulatory decisions were made. This reflects the fact that the upgrade was required only to accommodate GAPE services.

Aurizon Network claim: The inclusion of the Newlands asset replacement expenditure in the Newlands Reference Tariff progressively transitions the price of the legacy 20TAL system to the more efficient 26TAL cost of service delivery over a long period of time.
QRC Comments:
Charging Newlands services for a level of service which they did not require and do not necessarily benefit from does not become any more acceptable due to the passage of time. At the time of the upgrade to 26TAL and the introduction of GAPE traffic, Aurizon Network paid compensation to operators/customers. We do not know the details of the calculation or basis for this compensation, although the compensation presumably reflected a detriment experienced by operators/customers. The existence of compensation is not consistent with Aurizon Network's view that Newlands customers have received a significant benefit in the form of the 'free' upgrade to 26TAL. Aurizon Network proposes to transition Newlands customers towards a 26TAL cost of service over time, via an allocation of renewals expenditure which is not cost reflective (i.e. by allocating costs which are caused by GAPE services to Newlands customers). This would effectively undo the effect of the compensation which was deemed necessary at the time of the introduction of GAPE services to the Newlands system.

Aurizon Network claim: The annual net impact on the Newlands RAB value and the Newlands System Allowable Revenues does not result in material price shocks and therefore does *[we assume this was intended as "does not"]* materially affect allocative or productive efficiency.
QRC Comments:
Aurizon Network's proposed approach will, over time, result in a significantly larger RAB and higher tariffs for the Newlands system. It is unlikely that Aurizon Network has obtained expert advice to determine the level of tariff distortion which customers can bear before there is an impact on allocative or productive efficiency. In any case, the lack of such an impact does not justify an unfair allocation of costs. The principle that each service in the CQCN should at least contribute revenue sufficient to cover the incremental costs which it causes is well established and customers expect that this principle will be applied. Phasing in a subsidy over time does not make the subsidy any more appropriate.

Aurizon Network claim: The resultant GAPE Reference Tariff provides stronger price incentives to maintain and increase the utilisation of the Newlands Coal System at expiry of the GAPE contractual arrangements.
QRC Comments:
This statement seems to be based on an underlying assumption that GAPE mines are less competitive than Newlands mines, and so are more likely to maintain utilisation with the benefit of a subsidised tariff. While it is true that the difference in access charges, taken alone, does reduce the competitiveness of GAPE mines relative to mines in other systems, it does not necessarily follow that these mines are less competitive. To reach this conclusion, Aurizon Network would need to undertake an analysis of each of the mines, taking into account factors such as mining costs, coal qualities and customer relationships. In the absence of such analysis, Aurizon Network's claim that shifting costs to Newlands customers will increase utilisation is pure guesswork.

Aurizon Network claim: The contract and demand positions of Newlands Users materially differ from the pre-GAPE Newlands contracted positions. It is both inefficient and inequitable for new or additional demand to maintain access at an access price which is not reflective of the cost of service delivery.
QRC Comments:
To the extent that this comment is accepted, it applies only to new (post-GAPE) Newlands customers, yet Aurizon Network has not proposed any differentiation between pre-GAPE and post-GAPE Newlands customers (such as applying a 26TAL stand-alone cost to post-GAPE customers only). Whether such a differentiated approach is appropriate depends on whether the move to 26TAL would have been required by post-GAPE Newlands customers in the absence of GAPE. This is likely to have been considered only at the point where demand from Newlands mines exceeded the capacity of the Newlands system (without GAPE traffic) at 20TAL. To conclude that the additional Newlands traffic would, at that point, have triggered the upgrade to 26TAL would require an assessment of alternative expansion options which would have been available and analysis to demonstrate that the 26TAL upgrade would have been the most efficient option.

Aurizon Network claim: GAPE project costs are not included in the Newlands Reference Tariff and therefore, Aurizon Network's approach satisfies and remains consistent with the approved cost allocation methodology for the GAPE Project Costs.
QRC Comments:
The approved allocation methodology for the GAPE Project Costs involved the cost of the 26TAL upgrade being allocated to the GAPE system. Aurizon Network now seeks to use a Newlands stand-alone cost which includes the cost of upgrading to 26TAL to justify a non cost-reflective approach to allocating renewals. This is not consistent with the decision to allocate the cost of the 26TAL upgrade to GAPE. The approved allocation methodology for GAPE was based on the principle that GAPE services should pay a tariff which at least reflects the incremental costs which they cause to be incurred. This should include incremental renewals costs.

Aurizon Network claim: It better reflects the significant indirect benefits provided to Newlands Users from the increased above rail efficiency seen through an increase in the average train payload between FY10 and FY20 of 45% and a material increase in competition from system interoperability.
QRC Comments:
The introduction of GAPE services required substantial increases in below-rail transit times for existing Newlands customers. Aurizon Network has not provided evidence that the net effect of the longer transit times and the increased payload was a reduction in above-rail costs. The existence of compensation payments suggests the opposite.

Aurizon Network proposes to allocate renewals costs in the Newlands in a way which is not cost-reflective. It is clear that GAPE services increase and bring forward renewals costs in Newlands. Any proposal which seeks to impose on one group of customers costs which are caused by another group requires rigorous analysis and justification. Aurizon Network's justifications appear to be underpinned by unsubstantiated assumptions, including:

- Newlands system, in the absence of GAPE, would have upgraded to 26TAL (a position which is inconsistent with the allocation of GAPE project costs).
- GAPE customers require lower access charges in order to maintain volumes.
- Newlands customers can bear higher access charges without their competitiveness being impacted.

Aurizon Network's position relies heavily on a claim that Newlands customers are receiving a standard of service which is not reflected in their costs. A similar issue arose in regard to the question of whether existing users of the Blackwater system received a benefit from the Wiggins Island Rail Project (WIRP) and should therefore share in the costs. In relation to WIRP, the QCA stated that an allocation of WIRP capital costs to existing users would be appropriate if "*there is clear benefit to existing users based on the evidence provided, and existing users have stated they want the benefit and are willing to pay for it*".[1] The QCA said that "*While Aurizon Network and WIRP customers said that existing Blackwater and Moura system users derive a benefit from the WIRP infrastructure, we are of the view that neither has provided sufficient evidence to justify this claim or quantify the extent of any such benefits to existing users*." In the current case, Aurizon has made no attempt to demonstrate or measure a 'clear benefit' to existing users. Existing users did not ask for the claimed benefit, and certainly did not agree to pay for it.

We note that this issue is impacted by the existence of the GAPE Deed. Aurizon Network explained the impacts of the GAPE Deed on Page 34 of a June 2016 Investor Presentation[2]. Based on this presentation, it appears that Aurizon Network's total revenue, and the total costs paid by GAPE customers, are unaffected by increases in

[1] Queensland Competition Authority, Supplementary Draft Decision, Aurizon Network 2014 DAU: Reference Tariffs for Wiggins Island Rail Project Train Services, July 2015, page 30

[2] https://www.asx.com.au/asxpdf/20160601/pdf/437mm8vgcd8ph2.pdf

ABN 59 050 486 952
Level 13 133 Mary St Brisbane Queensland 4000
T 07 3295 9560 F 07 3295 9570 E info@qrc.org.au
www.qrc.org.au

regulatory revenue, because such increases are offset by reductions in charges under the GAPE Deed. This has two important implications:

- First, any concerns that higher GAPE tariffs may disincentivise utilisation of GAPE (and therefore Newlands) appear to have no validity during the term of the GAPE Deed.

- Second, it highlights that Aurizon Network has a strong financial incentive to shift cost allocation and revenue recovery out of the GAPE system and towards the Newlands system wherever possible. Aurizon Network is not a disinterested party proposing outcomes to which it is neutral. In this context, Aurizon Network's claimed justifications for moving away from cost-reflective pricing require rigorous testing.

We consider that the QCA should obtain expert advice on the drivers for each item of renewals expenditure in the Newlands system, and, to the extent that renewals costs are caused by or brought forward by GAPE traffic, such costs should be allocated to the GAPE system.

6. Process for resolution of Newlands/GAPE allocation question

Customers have been concerned about the Newlands/GAPE allocation issue for some time.

The issue was raised in the FY21 Annual Review of Reference Tariffs process. In the QCA's Final Decision of May 28th (pages 4-5) the QCA said:

"In relation to matters raised as to the allocation of renewals expenditure between the Goonyella to Abbot Point system and the Newlands system, <u>this will be determined as part of the assessment of subsequent capital expenditure claims (schedule E).</u> In doing so, it is expected that Aurizon Network will outline the extent to which capital expenditure incurred on the Newlands system is an 'incremental cost' as defined in Aurizon Network's 2017 AU. We note that incremental costs include both renewal and expansion capital costs that would not be incurred (including the costs of bringing expenditure forward in time) if the train service did not operate. (underlining added)

Despite the underlined comment above, when the issue was again raised in the consultation process on the capital expenditure claim for FY20 capex, the QCA did not address the issue, but referred to expectations regarding ongoing consultation (Decision of 19 February 2021) ahead of the RAB Rollforward and Annual Review of Reference Tariffs processes.

On 8th April 2021, the QCA approved Aurizon Network's RAB Rollforward proposal for FY20 capex, without offering any opportunity for stakeholders to make submissions on Aurizon Network's proposal.

At no point in the process to date have stakeholders been provided with an opportunity to provide input to the allocation of capital expenditure between systems. There is also no evidence of Aurizon Network justifying its allocation approach through these processes, nor of the QCA assessing the issue.

ABN 59 050 486 952
Level 13 133 Mary St Brisbane Queensland 4000
T 07 3295 9560 F 07 3295 9570 E info@qrc.org.au
www.qrc.org.au

We can only conclude from this that the allocation of capital expenditure to a RAB is viewed as a mechanical process based on physical locations of projects, with cost recovery (return on capital and depreciation) between systems being a separate decision to be determined through the Annual Review of Reference Tariffs. We therefore look to the QCA to resolve this issue through the current process and expect that stakeholders will be provided with an opportunity to comment on the QCA's initial assessment of this issue, via a draft decision or issues paper process.

7. New coal-carrying Train Service, Newlands system

We note that Aurizon Network's proposal includes the introduction of a new coal-carrying train service in the Newlands system. We understand that this new service relates to the Carmichael Mine. The Bravus website indicates that first coal from the Carmichael Mine will be produced in 2021, that the Carmichael Rail Network will be completed in 2021, and that this will connect to the existing rail network.

Aurizon Network's proposed volume forecasts for Newlands are consistent with FY20 actual tonnes: this is an outcome of Aurizon Network's methodology, and therefore provides no information on the extent to which the new service will increase throughput in the Newlands system. In order for Newlands customers to gain some understanding of the impact of the new service on future tariffs, it is critical that Aurizon Network provides updated volume forecasts which are prepared on a more realistic basis.

Table 23 of Aurizon Network's submission indicates that, upon approval of the Private Incremental Costs for the new service, the new service may move to payment of the Minimum Revenue Contribution, triggering a 35% increase in AT3 and AT4 for all mines in the Newlands system. This is clearly a material impact on existing users.

The QRC does not believe that the introduction of a new project on the scale of the Carmichael Mine should be treated as a routine matter under the undertaking. The discount for Private Incremental Costs was not intended to be applied to major projects such as the 200km Carmichael Rail Network. We suggest that Aurizon Network should consult with stakeholders on the implications of the introduction of this new service, and should prepare a Draft Amending Access Undertaking to deal with the issue, rather than mechanistically applying provisions of the existing undertaking which may not be appropriate for the current circumstances. A DAAU approach will allow all stakeholders to have meaningful input and will allow the QCA to consider the full range of issues. Examples of the types of issues which will need to be considered include:

- Is it appropriate to apply the standard approach for Private Incremental Costs to a project of this scale?

- How does the scale of the Carmichael Rail Network compare to the actual capacity contracted with Aurizon Network?

- Is the Minimum Revenue Contribution (MRC) sufficient in the Newlands system?

ABN 59 050 486 952
Level 13 133 Mary St Brisbane Queensland 4000
T 07 3295 9560 F 07 3295 9570 E info@qrc.org.au

www.qrc.org.au

- Should the MRC be calculated using the reference tariffs which applied prior to the introduction of the new service, or using reference tariffs which reflect the contribution of the new service (which is a circular calculation)?

- How will subsequent expansions of the Carmichael Mine be treated, given that these may require expansion of capacity in the Newlands system?

- What will be the implications if other potential new mines in the Galilee Basin elect to use the Carmichael Rail Network?

- What does the introduction of a new service in the Newlands system mean for the deferred NAPE costs? Based on the information provided in the Aurizon investor briefing discussed above, it appears that additional regulatory revenue earned by ceasing the deferral may provide Aurizon Network will no net benefit during the term of the GAPE Deed. If this is the case, then Aurizon Network has an incentive to continue the deferral until the GAPE Deed nears the end of its term – at which time ceasing the deferral may result in a double recovery of costs already recovered under the GAPE Deed. Given the potential effects the GAPE Deed may have on Aurizon Network's proposals in the regulatory setting, it is important that QCA continues to monitor this issue and take appropriate actions.

This is not an exhaustive list of the issues which should be considered in the current circumstances. We understand that these issues do not need to be resolved for the Annual Review of Reference Tariffs, but we encourage Aurizon Network and the QCA to provide guidance on an appropriate process for resolving these issues as soon as possible.

Thank you for the opportunity to provide this submission.

Yours sincerely

Andrew Barger
Queensland Resources Council