

Rio Tinto Coal Australia Pty Limited  
GPO Box 391  
Brisbane Queensland 4001  
Australia  
T +61 (0) 7 3625 3000  
F +61 (0) 7 3625 3001

10 June 2013

**By email**

Mr Paul Bilyk  
Queensland Competition Authority  
GPO Box 2257  
Brisbane, QLD 4001

rail@qca.org.au

Dear Mr Bilyk,

**RTCA response to QR Network's further proposed electric traction DAAU**

Rio Tinto Coal Australia (**RTCA**) welcomes this opportunity to respond to the Authority's request for comments in relation to a further Draft Amending Access Undertaking (**DAAU**) proposed by Aurizon Network dealing with the costs of electrification of the Blackwater system, and an associated modification to the calculation of AT5.

RTCA is profoundly disappointed by the DAAU, which largely amounts to a restatement of its position in the its earlier DAAU, which was withdrawn in January 2013.

The proposed DAAU is not a compromise position and does not involve any meaningful response to the concerns raised by producers to previous processes. The current consultation process is therefore the fourth time in eighteen months that RTCA has responded to substantially the same proposal – in addition to attendance at industry workshops and meetings to discuss it.


RTCA submits that the DAAU is not capable of acceptance, including because it would be inconsistent with section 138(2) of the QCA Act and would have the effect of cross-subsidisation (between diesel and electric traction users) and cost shifting (from Aurizon's above rail operations to Pacific National) – both of which contravene clause 3.2 of UT3 and section 104 of the QCA Act.

Any resolution of this issue will require *genuine* compromise and flexibility from Aurizon Network, which is not yet apparent. At the least, a commercially agreed solution will need to include the following critical issues not reflected in the DAAU:

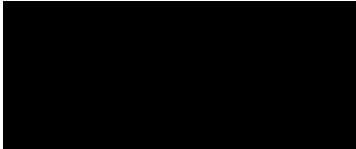
- That the costs associated with the Powerlink contracts were never submitted to producers through CRIMP and so cannot be considered "stranded", even on Aurizon Network's own arguments – and such costs are therefore not appropriate for socialisation across diesel users.
- Any existing diesel services must be grandfathered (this has been accepted by Aurizon Network in the past, but is not reflected in the DAAU).

- That there must be no connection allowed between any proposed electrification of the Rolleston spur line and the Blackwater system electric charging issue, including in terms of any volume assumptions underlying modelling. RTCA vigorously opposes including Rolleston electrification expenditure in the RAB, which would expose Blackwater users to substantial 'single mine' risk and would be directly inconsistent with Aurizon Network's own position in relation to the costs of other customer specific infrastructure under UT4.
- The rules around possible socialisation of remaining electrification costs (i.e. non-Powerlink) need to be clearly specified and commercially agreed – a range of uncertain options is not sufficient.

Finally, and critically, any acceptance by producers that they should “share the pain” of Aurizon Network's inefficient and non-transparent investment needs to be reflected in changes to the customer voting process that are acceptable to all parties – to ensure this kind of outcome does not occur again.

Please refer any questions in relation to this submission to myself on 

Yours sincerely,



**Xiao Fan Zhuang**  
Manager – Infrastructure

## **Rio Tinto Coal Australia**

Submission in response to Aurizon Network's further proposed DAAU in relation to electric traction pricing in the Blackwater system

10 June 2013

## Executive summary

**The DAAU is not a compromise position and does not respond to past industry concerns**

While Aurizon Network claims that its remodelled Electric Traction DAAU (**DAAU**) is a form of compromise in relation to this issue – it is not.

The DAAU does not involve any meaningful response to the concerns raised by producers to previous processes, but simply restates its earlier position under which under-recovery of all Blackwater electric infrastructure costs would be underwritten by non-electric users (either across the Blackwater system or the entire CQCN).

**Aurizon Network misrepresents QCA statements in the January issues paper**

The submission in support of the DAAU relies heavily on statements made by the QCA in its January issues paper. RTCA understands that the issues paper and workshop did not constitute a decision of the QCA and its views in that paper should not (and cannot) dictate its approach to the current DAAU

Aurizon Network also claims that it is “widely accepted” that the current AT5 charge is too high from the point of view of providing efficient traction-choice signals (page 5). RTCA does not accept this proposition and there is no evidence offered to support it.

RTCA maintains the view it has repeatedly put in this process that diesel is a more efficient traction choice on a total cost of ownership basis and that investment in electrification of Blackwater (and the associated Powerlink contracts) were imprudent and inefficient, given falling demand for this traction type.

**RTCA is concerned that Aurizon Network appears to link the DAAU with an assumption that Rolleston will be electrified.**

The investment in electrification of the mine-specific Rolleston spur has not been approved by either users or the QCA and would be vigorously opposed by RTCA.

Any capital investment involved in Rolleston electrification would be significant and would support only one mine, effectively socialising this risk across other users of the system.

RTCA notes that any proposal by Aurizon Network directly to the QCA to electrify the Rolleston spur (which attempts to bypass any user voting process given their objections), should still be made the subject to full stakeholder consultation by the QCA.

**The QCA must take into account the legitimate interest of producers in relation to their substantial sunk investment in diesel locomotives**

The QCA Act and good regulatory practice require that any approach to the AT5 charge must protect sunk investments by rail operators and producers in existing diesel assets and haulage arrangements on the Blackwater system – which must therefore be grandfathered.

This is a principle that has been accepted by Aurizon Network – and was accepted again at the industry workshop in January 2013 – but which it has not reflected in the DAAU.

**The 2007 CRIMP vote did not represent an acceptance by users of demand risk**

Central to Aurizon Network’s claim is its view that the electric traction investment was approved by customers under the 2007 CRIMP process.

This misrepresents what occurred leading up to, and during, the CRIMP process in 2007. In 2006, Aurizon Network (then QR Network) was aware of the decline in utilisation of electric trains in Blackwater. Despite the knowledge of the declining use of electric trains after 2006 it continued to invest substantial sums of money in electric assets.

The 2007 CRIMP document includes clear statements about demand risk that demonstrates that the CRIMP was not a mandate or approval

from users for investment in electric infrastructure – and did not reflect any acceptance that demand risks should be socialised across all users in the system (or CQCN) as is now being proposed in the DAAU.

**There is no basis for holding that the Powerlink contract costs were ‘approved’ or stranded**

Irrespective of the status of the expenditure which was the subject of the original and flawed CRIMP process, Aurizon Network itself concedes (and the QCA has recognised) that the \$400m operational expenditure associated with the Powerlink contract was never disclosed to producers or approved by them under the UT3 process.

These amounts, like any other operational expenditure under UT3, must be established by the QCA as being efficient and prudently incurred in order to be able to be recovered – and, even then, in the absence of any user approval or agreement, it is not appropriate to modify the standard charging arrangements *ex post* to socialise these very significant costs.

**The DAAU proposes implicit cost shifting between below and above rail – contravening both UT3 and section 104 of the QCA Act**

The DAAU is explicitly designed to “equalise” the costs of electric and diesel traction, irrespective of the differences in their underlying capital cost. This outcome clearly favours Aurizon’s above rail operations – which has made substantial past investments in electric rollingstock – over its only current competitor, Pacific National, which runs a diesel fleet on the Blackwater system.

**It is not correct to say that the regulatory WACC does not reflect the risk of optimisation or asset stranding.**

The regulatory WACC is not set on the assumption that, once an asset enters the RAB, cost recovery must be assured in all circumstances. The regulatory WACC clearly compensates Aurizon Network for some level of exposure to risk, as implied by a non-zero equity beta.

The structure of the DAAU is inconsistent with the assumptions underpinning the regulatory WACC, in that it seeks to insulate Aurizon Network from *all* forms of risk to future cost recovery, by ensuring cost recovery in respect of electrification infrastructure in *all* circumstances.

**The DAAU is highly uncertain and therefore not capable of acceptance**

It is not possible for stakeholders to respond meaningfully to the DAAU because the most controversial (and costly) element of the proposal – the proposed approach to socialisation through the UUP - is not clearly articulated.

**RTCA remains open to finding a commercially acceptable solution to the issue faced by Aurizon Network.**

RTCA remains open to finding a commercially acceptable solution to this issue, but considers that it will require compromise and flexibility from Aurizon Network.

Any solution would need to address the following:

- That the costs associated with the Powerlink contracts are not appropriate for socialisation across diesel users, given that they were never submitted to producers through the CRIMP process.
- Any existing diesel services must be grandfathered.
- That there must be no connection allowed between any proposed electrification of the Rolleston spur line and the Blackwater system electric charging issue.
- The rules around possible socialisation of remaining electrification costs (i.e. non-Powerlink) need to be clearly specified and commercially agreed.

## The rationale for this further DAAU remains unsound – diesel users should not pay for infrastructure they did not approve and do not use

The current consultation process is the fourth time in eighteen months that RTCA has responded to substantially the same proposal – in addition to attendance at industry workshops and meetings to discuss it.

Aurizon Network's proposal does not respond meaningfully to any of the issues and concerns raised by producers during earlier processes, and the issues paper workshop held in January 2013. While Aurizon Network suggests (at page 10) that it has tried to "capture" feedback of stakeholders, there is no evidence that the concerns raised by producers have been incorporated.

Instead Aurizon Network in the most recent DAAU submission repeats its past flawed rationale for recovery, which involves the following claims:

- **electric traction is more efficient than diesel traction** – based on its own 'total cost of ownership' analysis which still has not been provided publicly for review and genuinely independent assessment and the results of which are disputed by producers;<sup>1</sup>
- **despite being more efficient, electric traction is more expensive (unless high utilisation is achieved) and pricing therefore needs to be set at a level that ensures a cross subsidy by diesel traction users to force take up** – this means that producers, like RTCA, that invested in diesel traction on the Blackwater system (themselves making an assessment of its relative efficiency benefits) would be required to compensate Aurizon Network for its own inefficient investment;
- **this explicit cross subsidy (and cost shifting to benefit its above rail investments) is justified because users 'approved' the Blackwater investment through the defunct CRIMP process in 2007** – this is despite of the entirely flawed and inadequate disclosure during that process, failure to provide information requested by producers and the most significant expenditure (under the associated Powerlink contract) was never approved through CRIMP; and
- **failure to act would result in "stranding" of its investment in the Blackwater electrification assets** – this would be a 'flawed' pricing outcome that Aurizon Network is not compensated for through the regulatory WACC.

All of these claims are wrong.

RTCA recaps below a number of the reasons that have been previously set out in RTCA and other industry submissions in relation to each. RTCA also refers the QCA to, and relies upon, its other earlier submissions in relation to the electric traction issue, which deal with a number of them in greater detail.

Before returning to these issues, however, RTCA wishes to raise number of additional points that go to the unorthodox and inappropriate approach that appears to have been adopted by Aurizon Network in this case.

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<sup>1</sup> Aurizon Network suggest at page 11 of their submission that its TCO model had been "independently reviewed" by its consultants, Sapere. It is nonsense to suggest that a report commissioned by Aurizon Network could be reasonably viewed as independent. Given the value which is being sought through this process (over \$400m), it is necessary for any review to be undertaken by a consultant commissioned by either the QCA or producers, or both.

## **The QCA issues paper is not a binding statement of its view**

The submission in support of the DAAU relies heavily on statements made by the QCA in its issues paper – the conclusions drawn from that paper by Aurizon Network are neither justified nor appropriate.

The January issues paper and workshop process did not constitute a decision of the QCA and its views in that paper should not dictate its approach to the current DAAU

First, Aurizon Network relies upon views expressed by the QCA in its issues paper released following the withdrawal of the earlier Electric Traction DAAU by Aurizon Network in January 2013.

The QCA made clear in that document that the views expressed were preliminary and that the issues paper *“does not represent the finally considered views of the Authority.”* It is certainly not the case, as claimed by Aurizon Network, that the QCA through that issues paper gave any “commitment” to recovery of any particular amounts – either the \$200m in electrification itself or the \$400m in Powerlink costs (which the QCA accepted were never disclosed to or approved by producers).

The issues paper was not a formal decision of the QCA and had not been the subject of consultation or comment. The QCA could not have validly made a decision which would amount to prejudging or fettering its discretion in relation to any subsequent DAAU process, such as the present one. The QCA should not consider itself bound by any of the views expressed in that paper.

## **Linking this DAAU to electrification of Rolleston is inappropriate – any investment in further electrification must be the subject of producer or QCA approval**

RTCA is extremely concerned that the Aurizon Network proposal appears to proceed on an assumption that Rolleston will be electrified. This investment has not been approved by existing users and would be opposed by RTCA – given that the capital investment involved would be significant and at this stage would support only one mine, effectively socialising this risk across other users of the system.

If this investment is to be undertaken, it should be undertaken on a commercial basis between the relevant mine owner and Aurizon Network. This would also be consistent with the approach to investment in branch specific lines (and other assets) which has been proposed by Aurizon Network in all other cases, under UT4, which is that they remain unregulated and subject to commercially-negotiated terms.

It is important to note that Aurizon’s above rail operator has a considerable amount to gain (or lose) from the electrification of the Rolleston spur line given its known haulage arrangements with the relevant mine owner – and its under utilisation of sunk investments in electric rollingstock in the Blackwater system.

This commercial benefit for its above rail business presents a strong incentive for Aurizon Network to depart from its approach for other investments in order to have the cost of any proposed electrification investment included in the Blackwater RAB and associated risks socialised across all system users – reducing the risk which must then be borne by the relevant mine owner.

Any tariff or cost modelling which underlies the proposed AT5 approach in this DAAU must therefore be undertaken on the assumption that Rolleston does **not** proceed. For

example, volumes associated with Rolleston should not be included in any modelling of the likely satisfaction of the 85% electric threshold apparent in the DAAU.

RTCA does not accept – and the QCA should make clear in any decision in relation to this DAAU – that any decision in relation to AT5 and the Blackwater system is separate from, and does not influence, any subsequent decision about the appropriateness of any electrification of Rolleston.

Indeed, to the contrary, RTCA submits that it may be more sensible to delay any consideration of AT5 in the Blackwater system until a commercial arrangement (if any) has been settled in relation to Rolleston. As Rolleston volumes, if any, may influence the likely size of any UUP and therefore the reasonableness of the approach being proposed in the DAAU.

In addition, RTCA notes that it seems likely that Aurizon Network will seek to bypass a customer vote on the electrification of Rolleston (which it would lose) in order to refer the matter directly to the QCA. If this occurs, RTCA submits that the QCA should undertake a full and transparent consultation with all stakeholders, to ensure that further high risk, inefficient and costly electrification is not sought to be imposed on users of the Blackwater system – against their wishes.

## **Any solution must grandfather existing diesel assets**

### **The QCA must take into account the legitimate commercial interest of producers in relation to their substantial sunk investment in diesel locomotives**

It has long been recognised that a settled and certain regulatory environment is critical to efficient investment in infrastructure. This is an issue which RTCA raised in its first submission in response to the original electric traction DAAU in April 2011.

The High Court has recognised the link between predictability in the regulatory process and economic efficiency, stating:<sup>2</sup>

*“The greater the degree of uncertainty and unpredictability in the regulatory process, the greater will be the perceived risk of investment. The greater the perceived risk of investment, the higher will be the returns sought. Various methodologies referred to in the Code must at least not be inconsistent with the principles stated by the legislature, which are directed to economic efficiency.”*

RTCA has previously observed that it invested in diesel locomotives in the Blackwater system in 2007 when it first supported the entry of Pacific National (PN) to the above rail market. As noted in 2011, this decision to underwrite a fleet of trains through a long term (10-15 year) haulage contract is a significant investment.

RTCA did so amongst other things on the understanding that the Queensland regulatory environment would provide a certain and predictable approach to regulated pricing.

RTCA also did so based on its analysis of the economics of different train and traction types and Aurizon Network (at that time, QR Network)'s confirmation that the electrical system in Blackwater could not support AC electric traction (Siemens locomotives that PN were evaluating for the haulage) and that the necessary work to support AC traction would not be completed in time for the project start up in 2009 when RTCA's then current haulage contract expired.

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<sup>2</sup> *East Australian Pipeline Pty Limited v Australian Competition and Consumer Commission* (2007) 233 CLR 229 at [243]



Section 138(2) of the QCA Act requires the QCA to have regard to both the object of Part 5 (including the efficient investment in infrastructure) and the legitimate interests of access seekers, when deciding whether to approve a DAAU. Any modification to charges which has the effect of introducing a substantial cross-subsidy between electric and diesel traction – years after investments in haulage and rolling stock have been sunk – is fundamentally inconsistent with both:

- the object of promoting efficient investment; and
- the legitimate interests of access holders.

If the QCA is minded to permit some form of recovery of Blackwater electrification costs, RTCA submits that it is inconsistent with the QCA Act and good regulatory practice for this to apply to existing diesel assets and haulage arrangements – which must therefore be grandfathered. This is also required in order to comply with section 138(2)(e), which requires the QCA to be satisfied that any DAAU adequately protects the rights of users (in this case producers using diesel assets) which are adversely affected:

*the interests of persons who may seek access to the service, including whether adequate provision has been made for compensation if the rights of users of the service are adversely affected;*

This is a principle that has been accepted by Aurizon Network – and was accepted again at the industry workshop in January 2013<sup>3</sup> – but which it has not currently reflected in the DAAU.

### **The 2007 CRIMP process did not ‘approve’ all system or CQCN users accepting a socialisation of demand risk for electric assets**

Central to Aurizon Network’s claim is its view that the electric traction investment was approved by customers under the 2007 CRIMP process. This is so because, without such approval, it has no regulatory basis to support a claim for reimbursement or to argue that any such investment has been “stranded”.

Being a regulated entity does not grant a firm a blanket indemnity from poor investment decisions made outside of the regulated framework and without either the approval of, or consultation with, your customers or regulator. To face the cost of those bad decisions is not “stranding” – it is the natural and appropriate consequence of poor management and customer engagement.

RTCA (together with other producers) have consistently rejected the claim by Aurizon Network that the CRIMP process relied upon by Aurizon Network in 2009 constituted a valid “approval” of the electrification investment under UT3.

As RTCA noted in its submission in April 2012, the use of electric trains in the Blackwater system has steadily declined over time. QRN were aware of the declining utilisation of electric trains in Blackwater in 2006. To encourage utilisation of electric trains in 2006 Aurizon Network (then QR Network) lowered the AT5 charge in the hope that it would encourage higher utilisation of electric trains. Despite artificially reducing the AT5 charge, the use of electric trains in Blackwater has continued to fall - the market made its choice and Blackwater users have been shown to predominantly prefer diesel trains (and have committed to contracts on that basis).

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<sup>3</sup> See QCA minutes at page 3.

In 2006 in its submissions in relation to UT2, Aurizon Network noted that if it was unsuccessful in encouraging higher utilisation of electric trains in Blackwater, the appropriate outcome would be optimisation of some of the assets:

*"It is QR's expectation that the use of electric consists in Blackwater will increase in subsequent regulatory periods.*

*Given current market factors are contributing to the lower than expected utilisation of electric assets in Blackwater, QR has decided to adopt a long term perspective in resolving industry concerns with respect to Blackwater's AT5 tariff. Specifically, in the 9 June 2006 Version, QR has sculpted the depreciation profile of Blackwater's electric assets in response to the expected utilisation of the assets over the life of the assets whilst still enabling QR to recover the legitimate commercial costs of its electrification assets.*

*This means QR has reduced the depreciation charged on the assets during the period of low utilisation in the 2005 regulatory period, with the expectation that as utilisation subsequently increases (in future regulatory periods), the depreciation profile will be accordingly accelerated. The main impact of this approach is to smooth the price of Blackwater's electric assets between regulatory periods.*

*QR's proposal to sculpt the depreciation schedule has been specifically developed in response to industry concerns regarding the increase in the AT5 tariff over the 2005 regulatory period. QR is aware that this proposal may affect its future ability to fully recover the legitimate commercial costs of its electrification assets over the life of the assets. Such an outcome might occur if QR's expected future increase in the utilisation of Blackwater electric assets is not forthcoming in subsequently regulatory periods. Under this scenario, I acknowledge that the Blackwater's electric assets could meet the criteria in Paragraph 1.4(b) of Schedule FB, thus leading to the QCA potentially requiring a reduction in the value of the assets in the Regulatory Asset Base."*

This clearly shows that:

- in 2006, Aurizon Network were well aware of the decline in utilisation of electric trains in Blackwater; and
- despite the knowledge of the declining use of electric trains after 2006 QRN have continued to invest substantial sums of money in electric assets.

RTCA notes the following in relation to that \$200m capital expenditure component of electric infrastructure that was deemed to be 'approved' by users of the Blackwater system through the CRIMP process:

- The 'approval' was passive in that the relevant CRIMP votes were deemed approved by parties not voting against the items.
- Aurizon Network provided extremely limited information in the CRIMP documentation – and did not provide the additional information requested by producers during the process.
- Critically – the CRIMP documentation did not deal with threshold questions such as the demand for electric traction. As such, in reviewing CRIMP documents, users could not have been expected to check the suitability of infrastructure enhancements against current demands, which is clearly the role of Aurizon Network.

Furthermore, the 2007 CRIMP document expressly acknowledged that demand for electric infrastructure was not certain and would be the subject of further consideration by QRN.

In section 7.3.3 of the 2007 CRIMP document (a section titled “Commercial Dilemma”) Aurizon Network stated:

**“7.3.3 Commercial Dilemma**

*The electrification decision is contingent upon the resolution of the following commercial dilemmas:*

1. *QR Network Access should not further electrify the network if it cannot be sure that the operator(s) will use electric traction thereon*
2. *The operators should not only buy electric if they cannot be sure that the coal network will be fully electrified ..”*

This statement demonstrates that the CRIMP was not a mandate or approval from users for investment in electric infrastructure – and did not reflect any acceptance that demand risks should be socialised across all users in the system (or CQCN) as is now being proposed in the DAAU.

### **The QCA has no basis under UT3 or the QCA Act for treating Powerlink costs as if they were CRIMP approved**

Irrespective of the status of the expenditure which was the subject of the original and flawed CRIMP process, Aurizon Network concedes (and the QCA has recognised) that the \$400m operational expenditure associated with the Powerlink contract was **never** disclosed to producers or approved by them under the UT3 process.

Nonetheless, and taking into account the comment above about the limited nature of the issues paper, the QCA goes on to say (at page 3):

*Users approved the scope of the electric assets in question, although it could fairly be argued that they were not aware of the additional capital expenditure proposed by Powerlink which they would also have to pay as an operating charge. The Powerlink information may have changed the vote although that is by no means certain given users’ demand for capacity at that time.*

This conclusion seems to suggest that the Powerlink costs were to be treated ‘as if’ they had been approved by users, because it as “by no means certain” whether disclosure of those amounts would have changed the vote. On that basis, Aurizon Network in its DAAU has assumed that they should also be included in any guaranteed right of recovery through the UUP.

With respect, this is a remarkable and legally incorrect finding. There is no basis at law for treating the Powerlink expenditure as approved by users. Such expenditure was never approved. Moreover, given that the value of those contracts was \$400m and the electrification infrastructure the subject of a CRIMP vote was half that value, it could not be reasonably assumed that producers would have approved this contract (or the rest of the investment) had it been included.

In the circumstances therefore there is no regulatory basis for arguing that this expenditure was in any way “stranded”. These amounts, like any other operational expenditure, must be established by the QCA as being efficient and prudently incurred in order to be able to be recovered – and, even then, in the absence of any user approval or

agreement, it is not appropriate to modify the standard charging arrangements to socialise these very significant costs.

The QCA should only impose the costs associated with the Powerlink contract on users where this is consistent with the object of Part 5 of the QCA Act, section 138(2) and the pricing principles in s.168A.

RTCA submits that there is no reasonable basis for the QCA to view the Powerlink contract as having been *approved* by producers or otherwise in compliance with UT3. As such, these costs could not be considered “stranded”.

At most, therefore, any DAAU which deals with, at intends to socialise, Blackwater electric traction cost recovery across diesel users must not include the cost of associated Powerlink contracts.

### **Assets are not being “optimised out of the asset base” and no additional premium is justified to the WACC**

In its January issues paper, the QCA referred on a number of occasions to the claim that the consequence of the current price outcome was that electric assets in Blackwater would be “optimised out of the asset base”. This was said to be inconsistent with the optimisation process under Schedule A of UT3.

Several things should be said in response to that claim:

- **Producers (including RTCA) are not seeking removal of any assets from the asset base under Schedule A of UT3.** There is no optimisation of assets. Rather, the value of electric assets is simply unlikely to be recovered over the originally anticipated investment timeframe based on the maximum ceiling price reflected in AT5, because of a lack of sufficient demand (a risk which Aurizon Network was aware of when it undertook the investment). The value of assets remains in the asset base and it is open to Aurizon Network to recover that value at a later point in time if, or when, demand picks up.
- **The WACC assumes optimisation can only occur at the time that assets are first included in the asset base (QCA paper at page 3).** The current WACC reflects the balance of risk set out in current terms of UT3. A conclusion that optimisation can only occur under UT3 at the time assets are included in the asset base is inconsistent with the optimisation rules in clause 1.4 of Schedule A to UT3, which provides:
  - 1.4 *The QCA will not require the value of assets contained in the Regulatory Asset Base to be reduced unless:*
    - (a) *the QCA made its decision to accept the expenditure in the regulatory Asset Base on the basis of information provided by QR Network that QR Network knew, or should have known, was false or misleading at the time it provided the information;*
    - (b) *circumstances arise in the future where demand has deteriorated to such an extent that regulated prices on an unoptimised asset would result in a further decline in demand;*
    - (c) *it becomes clear that there is a possibility of actual (not hypothetical) bypass; or*

- (d) *an End of Period Assessment conducted in accordance with clause 5 of this Schedule determines that the Rail Infrastructure has deteriorated by more than would have been the case had good operating practice and prudent and effective maintenance and asset replacement policies and practices been pursued.*

Evidently, all of these circumstances are contemplated to occur *after* the time that the investment is made. No further ‘investment risk premium’ is appropriate or justified, and this would be inconsistent with any regulatory precedent in any other regulated industry.

Even if it was accepted that some form of stranding may occur, given the state of demand for electric trains, this would not justify any adjustment to the WACC. The recovery of depreciation on substantial network assets of Telstra was “stranded” by the ACCC decision in relation to its fixed services pricing in 2010. In that case, the ACCC price model held demand constant for the purpose of setting prices when evidence showed that actual demand would fall materially over the relevant period. This approach (of holding demand constant in a way that stranded allowable depreciation) was not seen to permit any kind of adjustment to reflect stranding risk.<sup>4</sup>

Put simply, there is no regulatory precedent to support:

- the view that Aurizon Network should be immune from volume or demand risks which it accepted when undertaking expenditure that was not approved by the QCA or customers; and
- the introduction of any kind of ‘investment premium’ to reflect stranding or optimisation risks.

To the contrary, such proposals would amount to an inefficient regulatory pricing framework – and one that encouraged unauthorised and imprudent investments in the network.

### **The DAAU proposes implicit cost shifting between below and above rail – contravening both UT3 and section 104 of the QCA Act**

Clause 3.2(c) of UT3 prohibits any outcome that would result in cost shifting or cross subsidies between Aurizon’s below and above rail operations, in the following terms:

*QR Network must not engage in any activity or conduct (or agree to engage in such activity or conduct), either independently or with Related Operators, which has the purpose of, or results in or creates, or is likely to result in or create:*

- (i) *anti-competitive cost shifting;*
- (ii) *anti-competitive cross-subsidies;*
- (iii) *anti-competitive price or margin squeezing.*

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<sup>4</sup> See the Fixed Line Services Model, included with the ACCC final decision, *Inquiry to make final access determinations for the declared fixed line services*, July 2011 (demand dealt with at Chapter 12).

Similarly, section 104 of the QCA Act prohibits an access provider from providing access to a declared service to itself (or a related body corporate) on more favourable terms than the terms on which provides access to a competitor.<sup>5</sup>

The current DAAU results in:

- anti competitive cost shifting between Aurizon Network and its above rail operations; and
- cross subsidisation of electric services from users of diesel services (through the UUP) – which has the effect of favouring Aurizon’s above rail operations.

The DAAU is explicitly designed to “equalise” the costs of electric and diesel traction, irrespective of the differences in their underlying capital cost.

To the extent that this equalisation results in under-recovery, the DAAU proposes an **explicit cross-subsidy** be paid by other non-electric users (either diesel users of the Blackwater system or all users of the CQCN).

As the QCA is aware, Aurizon’s above rail operations have invested heavily in electric locomotives, whereas its competitor (Pacific National) currently runs diesel trains on this system. The cross subsidy is therefore one that directly and anti-competitively seeks to “equalise” the costs of both traction types through a cross subsidy, in a manner that has the effect of favouring its own downstream operation.

The UUP also produces **anti-competitive cost shifting** – in that it shifts the cost and risk of underutilisation of electric assets (including rollingstock) from Aurizon’s above rail business to other users, forced to subsidise a high level of electric utilisation (i.e. 85%). That is, it shifts costs from electric to diesel users in a manner that ensures that Aurizon’s above rail electric fleet is not disadvantaged vis a vis the lower cost diesel alternative.

For the same reasons, the DAAU contravenes sub-sections 104(2) and (3) of the QCA Act, which provides:

- (2) *An access provider who is the owner or operator of a declared service engages in conduct for preventing or hindering a user’s access to the declared service if, having regard to the relevant criterion, the access provider provides, or proposes to provide, access to the declared service to itself, or a related body corporate of the access provider, on more favourable terms than the terms on which the access provider provides, or proposes to provide, access to the declared service to a competitor of the access provider.*
- (3) *For subsection (2), the relevant criterion is the terms, taken as a whole, on which the access provider provides, or proposes to provide, access to the declared service to itself and the competitor having regard, in particular, to—*
  - (a) *the fees, tariffs or other payments to be made for access to the declared service by the access provider and the competitor; and*
  - (b) *the nature and quality of the declared service provided, or proposed to be provided, to the access provider and competitor.*

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<sup>5</sup> QCA Act, s 104(1) and (2).

In this case, Aurizon Network proposes an adjustment to the pricing framework to “equalise” the costs of electric and diesel traction – in circumstances where it understands that its own above rail operations have already undertaken investment in electric rolling stock and its competitor has (successfully) entered the market using a diesel fleet.

It is no response to this argument to claim, as Aurizon Network’s expert Mr Mike Smart appears to do (at page 6 of his report), that all users benefit from an increased ability to switch at a later stage. To the contrary – this lower switching cost highlights that the pricing framework intentionally places Aurizon’s above rail business in a stronger competitive position to win future contracts than Pacific National, which needs to then invest in new electric rollingstock (stranding its own investment in diesel).

As well as not being allowable under section 138(2) of the QCA Act, RTCA therefore submits that approving and implementing the new pricing structure would therefore be unlawful – contravening fundamental non-discrimination requirements in UT3 and section 104 of the QCA Act.

### **The proposed approach to AT5 pricing does not reflect an “efficient” traction choice**

RTCA has consistently maintained (in its responses to the QCA in April, September and November 2012) that electric traction is not a more efficient traction choice and does not have a lower total cost of ownership.

The QCA has previously expressed the view that Aurizon Network has not sufficiently established the case of the efficiency benefits of electric over diesel traction. RTCA notes that there is no new evidence associated with the current DAAU upon which the QCA could reasonably form a view that Aurizon Network’s claims about the relative efficiency benefits of the two traction types could be justified.

RTCA also repeats its submissions made in April and November 2012 in this regard – including that it would not be appropriate for the QCA to reach any conclusion about efficiency based on “total cost of ownership” modelling by Aurizon Network which has not been made publicly available – so that stakeholders can properly and rigorously test the analysis, which clearly produces results different to their own.

### **It is not correct to say that the regulatory WACC does not reflect the risk of optimisation or asset stranding.**

Arguing that the regulatory WACC does not allow for **any** asset stranding risk is tantamount to suggesting that the regulatory WACC entitles Aurizon Network to full recovery of all capital expenditure – no matter how inefficient or imprudently occurred and even where, as in this case, it was undertaken outside the regulatory framework which could be used to test and ensure its prudence (i.e. QCA pre-approval or the customer vote).

The regulatory WACC rewards investment in prudent capital expenditure and includes a clear process to enable Aurizon Network to be able to identify at the time of investment if that is the case. It is agreed that it did not do so for Powerlink expenditure (and this expenditure has not otherwise been found to be prudent by the QCA as operational expenditure) and, as noted above, the 2007 deemed vote in relation to the capital expenditure component was so flawed and incomplete that it did not constitute a valid CRIMP approval in any event – and certainly did not amount to an approval of users accepting demand risk in respect of the investment.

The practical effect of the DAAU is therefore to shift all investment risk on to users. This is made clear by Aurizon Network in its supporting submission, which states:<sup>6</sup>

*The scheme proposed in the DAAU restores the revenue adequacy that the existing arrangements were designed to provide...*

*This proposed scheme achieves cost recovery for Aurizon Network in all circumstances. Hence it eliminates any need for Aurizon Network to reopen the electric charging issue with the QCA because of revenue inadequacy. [emphasis added]*

Aurizon Network appears to consider this appropriate because the WACC approved for UT3 “does not compensate Aurizon Network for asset-stranding risk in relation to customer-approved assets”.<sup>7</sup>

### **Electric traction assets were not genuinely “customer-approved”**

As noted above, it is wrong to characterise electric traction assets as “customer-approved” under the CRIMP process. RTCA considers that customer approval processes were not properly complied with, and were not engaged at all by Aurizon Network in relation to the Powerlink contracts.

In circumstances where customer approval processes under UT3 were either not used, or not complied with, it is entirely appropriate that Aurizon Network should bear cost recovery risk. Users should not bear the risk associated with decisions by Aurizon Network which may have been imprudent or commercially unsound.

Therefore RTCA submits that the design of the DAAU, which assures cost recovery in respect of electric traction assets in all circumstances, is fundamentally flawed. It is simply not appropriate for all cost recovery risks (including risks associated with imprudent investment) to be shifted onto users in this way.

### **Aurizon Network’s WACC compensates it for exposure to market-wide risk factors**

RTCA also disagrees with the proposition that the WACC does not compensate Aurizon Network for the types of cost recovery risks that it is now seeking to shift onto users.

Clearly the WACC compensates Aurizon Network for some level of exposure to market-wide risk factors, in that it incorporates an equity beta that is greater than zero. The types of market-wide risk factors that are compensated for include fluctuations in economic activity which may affect demand in downstream markets (and in turn, demand for rail capacity).

RTCA has previously noted that the various amendments that have been made to the regulatory framework in recent years mean that Aurizon Network’s exposure to market risk is in fact likely to be limited – for example the expansion of take or pay arrangements means that exposure to demand risk is likely to be more limited than in previous periods.<sup>8</sup> This means that if anything, Aurizon Network’s current equity beta is likely to overcompensate it for exposure to market risk.

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<sup>6</sup> Aurizon Network submission, p 13.

<sup>7</sup> Aurizon Network submission, p 4.

<sup>8</sup> RTCA response to the QCA’s Cost of Capital Methodology Review, 5 April 2013, p 4.



Indeed, Aurizon itself in recent public announcements has sought to raise debt on the basis of its favourable regulatory environment that shelters it from risk.<sup>9</sup>

Given that Aurizon Network receives compensation for exposure to market risk, the regulatory framework should not be designed in a way that immunises it from such risks.

***If Aurizon Network's exposure is to be reduced (or eliminated), including through some form of premium as claimed by Aurizon Network, then its equity beta ought to be reduced.***

### **Compensation for risk in the UT3 WACC**

RTCA does not understand the UT3 WACC to be set on the assumption that, once an asset enters the RAB, cost recovery must be assured in all circumstances. RTCA understands the UT3 WACC to assume some level of exposure to market risk, as implied by a non-zero equity beta.

In submissions to the QCA in relation to the UT3 WACC, QR Network argued that while the regulatory framework provided some protection against short to medium term demand risks (principally through take or pay arrangements), some exposure to longer term risks remained. QR Network and its consultant Synergies therefore argued that long run uncertainty in the demand for coal should be considered when estimating the asset beta and equity beta. QR Network noted that some of the key uncertainties around long term demand included technological change and shifts in environmental policy.<sup>10</sup>

It was accepted by the QCA in the context of UT3 that to the extent there is some positive probability of risks to long term demand materialising, the asset beta (and hence equity beta) may need to be adjusted accordingly if there is some change to covariance risk.<sup>11</sup> In effect, the QCA accepted that the equity beta should (and would) take into account risks to long term cost recovery.

The QCA did acknowledge that some forms of risk were not compensated for through the CAPM framework, which is used to estimate the cost of equity component of the WACC. However these were limited to events that are properly characterised as *asymmetric risks*. The QCA noted that where these risk factors are present, they are best accounted for outside the WACC framework, for example through accelerated depreciation.<sup>12</sup>

### **Conflict between the existing WACC framework and the DAAU**

As noted above, the Electric Traction DAAU seeks to insulate Aurizon Network from *all* forms of risk to future cost recovery, by ensuring cost recovery in respect of electrification infrastructure in *all* circumstances.

This is inconsistent with the framework for risk compensation under UT3, which assumes some level of exposure to market-wide risk factors. The WACC provides compensation for risk associated with long term demand uncertainty (e.g. uncertainty around technological change and shifts in environmental policy). Consistent with the way in which Aurizon Network is compensated for risk, the DAAU must reflect that Aurizon Network is exposed to long-term demand risk (and this is underlined by the statements in the 2007 CRIMP).

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<sup>9</sup> Aurizon Progresses its Debt Refinancing, *ASX Announcement*, 28 May 2013

<sup>10</sup> QR Network, *QR Network's Access Undertaking (2009): Response to QCA draft decision, Volume 2 – Pricing related matters*, 15 February 2010, pp 20-30.

<sup>11</sup> QCA, *Draft Decision: QR Network's 2010 DAU - Tariffs and Schedule F*, June 2010, p 48.

<sup>12</sup> QCA, *Draft Decision: QR Network's 2010 DAU - Tariffs and Schedule F*, June 2010, p 48.

Alternatively, if the regulatory framework is to be designed in such a way that, once an asset enters the RAB cost recovery is assured in all circumstances, then the equity beta must be reduced to reflect this. An equity beta of 0.8 is clearly too high for a business with such a high degree of protection against market-wide risk factors.

## **The DAAU is highly uncertain and therefore not capable of acceptance**

The DAAU proposed by Aurizon Network is not capable of acceptance by the QCA, because its intended operation is uncertain. Put simply, it is not possible for stakeholders to respond meaningfully to the DAAU because the most controversial (and costly) element of the proposal involves three separate options.

The most controversial element of the DAAU is the payment of an “under-utilisation payment” (**UUP**) where the modified AT5 charge does not provide for recovery of all electric costs during the relevant UT period. However, the DAAU does not make clear the basis upon which this UUP would be recovered, but instead sets out three alternatives:

- all users of the Blackwater system (electric and diesel);
- all users of the Central Queensland Coal Network (**CQCN**); and
- a combination of these, where a UUP is levied on Blackwater system users at the end of UT4 and any remaining UUP is recovered from all CQCN users at the end of UT5.

RTCA considers all three options are flawed, for reasons set out below. However, RTCA also considers that the *process* is uncertain because the DAAU does not specify which of the options will be used to provide for any UUP.

RTCA considers that stakeholders will only be fairly in a position to respond to the DAAU when the proposed approach to applying the UUP has been clearly articulated, all assumptions are published for stakeholders (including volume forecasts for electric services, which is a critical component for understanding the likely value of any UUP) and which of the three socialisation options is proposed to be applied.

## **Approval of the DAAU would be inconsistent with the QCA Act requirements**

For the various reasons set out above, as well as those previously raised by RTCA and other stakeholders in submissions as part of the earlier 2012 processes, RTCA submits that the DAAU proposed by Aurizon Network is not capable of acceptance.

The table below highlights the ways in which the proposed approach fails to comply the QCA Act requirements – including under section 138(2), section 104 and the pricing principles in section 168A.

## **Conclusions**

### **RTCA remains open to finding a commercially acceptable solution to the issue faced by Aurizon Network.**

In light of the issues set out above, including its inconsistency with both section 104 and 138(2), the DAAU cannot be accepted by the QCA.

The DAAU needs to either be rejected or withdrawn, leaving Aurizon Network to engage commercially with industry about AT5 pricing in Blackwater. RTCA is open to a commercially negotiated solution, but notes that this must involve genuine compromise and flexibility from Aurizon Network – not yet apparent in the DAAU.

RTCA considers that any commercial solution must respond to the four key concerns of industry, which have not been addressed in the DAAU.

These are:

- The costs associated with the Powerlink contracts were never submitted to producers through CRIMP and their prudency has not been QCA approved (and is disputed) – so they are not appropriate for socialisation across diesel users.
- The rules around possible socialisation of any remaining costs (i.e. non-Powerlink) electrification need to be clearly specified and commercially agreed. The way in which this has been dealt with in the DAAU – by reference to a range of uncertain options – is not sufficient.
- Any existing diesel services must be grandfathered (this has been accepted by Aurizon Network in the past, but is not reflected in the DAAU).
- That there must be no connection between any proposed electrification of the Rolleston spur line and the Blackwater system electric charging issue, including in terms of any volume assumptions underlying modelling. RTCA vigorously opposes including Rolleston electrification expenditure in the RAB, which would expose Blackwater users to substantial 'single mine' risk and would be directly inconsistent with Aurizon Network's own position in relation to the costs of other customer specific infrastructure under UT4.

RTCA remains hopeful that it will be possible to engage constructively with Aurizon Network on these issues.

## Annex - Inconsistency between revised electric traction DAAU and QCA Act requirements

Section	QCA Act requirement	RTCA comment	Submission page ref
104	Non discrimination	The DAAU provides for cross subsidisation of electric services from users of diesel services and allows for anti-competitive cost shifting between above and below rail operations.	11-12
138(2)(a) and 69E	Promote the economically efficient operation of and investment in infrastructure	Cross subsidisation of electric services from users of diesel services will not promote efficient investment decisions as between diesel and electric. In order to preserve incentives for efficient investment, the QCA must provide certainty in relation to producers' sunk investment in diesel locomotives.	6-7
	Effect of promoting competition in upstream or downstream markets	Further, providing for socialisation of costs associated with projects that have not been subject to proper approval processes and which have not been demonstrated to be prudent will not promote efficient investment in infrastructure.  Competition in related markets will only be promoted to the extent that there is efficient investment infrastructure. For the reasons above, the DAAU does not provide for this.	9-10
138(2)(d)	The public interest	The public interest will be promoted by certainty and predictability in the regulatory regime, and efficient investment in infrastructure. For the reasons above, the DAAU does not provide for this.	
138(2)(e)	The interests of persons who may seek access to the service, including whether adequate provision has been made for compensation if the rights of users of the service are adversely affected;	The DAAU does not adequately take into account the legitimate commercial interest of producers in relation to their substantial sunk investment in diesel locomotives.	6-7

Section	QCA Act requirement	RTCA comment	Submission page ref
<b>138(2)(g) and 168A</b>	<p>Reflects a price that should:</p> <p>(a) generate expected revenue for the service that 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</p>	<p>The DAAU potentially provides for recovery of significantly more than the efficient cost of providing access. The DAAU provides for recovery of costs associated with projects that have not been subject to proper approval processes and which have not been demonstrated to be prudent and efficient.</p>	9-10
	<p>(c) not allow a related access provider to set terms and conditions that discriminate in favour of the downstream operations of the access provider or a related body corporate of the access provider, except to the extent the cost of providing access to other operators is higher</p>	<p>The DAAU allows for anti-competitive cost shifting between above and below rail operations.</p>	11-12
	<p>(d) provide incentives to reduce costs or otherwise improve productivity</p>	<p>Aurizon Network will have no incentive to reduce costs or otherwise improve productivity where it is assured of recovering all costs (including those not subject to approval processes), in all circumstances.</p>	9-10