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Dr Malcolm Roberts
Chairman
Queensland Competition Authority
Level 19, 12 Creek Street
BRISBANE QLD 4000

3 October 2014

Dear Dr Roberts,

Aurizon Holdings welcomes the opportunity to comment on the 2014DAU.

In its Notice to Stakeholders, the QCA has raised the prospect of simplifying the suite of standard agreements which are annexed to Aurizon Network's 2014DAU. It has requested that stakeholders consider the ways in which simplification might be accomplished. This letter is limited to responding to that request.

The QCA's request is cognisant of the extensive submission Aurizon Holdings recently lodged with the Commonwealth's Review of National Competition Policy (the **Harper Review**). In its submission, Aurizon raised as an issue the growing complexity of Australia's regulatory regimes. Aurizon specifically referenced the recent growth in the length and complexity of Aurizon Network's undertaking. Much of that increase has been due to increases in the number and the length of the standard contracts which are annexed to the undertaking.

We therefore welcome the QCA raising complexity as an issue, and look forward to working with stakeholders on addressing it.

There are two parts to the QCA's Notice to Stakeholders:

1. First, the QCA refers, in general, to the simplification of the undertaking, particularly the standard agreements. Aurizon Holdings supports this objective, but for a number of reasons does not consider that impactful reform will be possible in the 2014DAU process.

2. Second, the QCA refers to the prospect of replacing the Standard Operator Access Agreement (**SOAA**) with new agreements based on the End User Access Agreement (**EUAA**) and the Train Operator Agreement (**TOA**). Aurizon Holdings does not support that proposal, for reasons given below.

1. Simplifying regulation is an important objective, but not for the 2014DAU

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

Given those views, Aurizon supports the QCA seeking to simplify Aurizon Network's undertaking, as it would support any other regulator with which it deals doing the same.

However, it is difficult to see how impactful simplification exercise could successfully proceed at the present time. A number of factors could make reform difficult at the moment, including the protracted timetable for UT4, differing views in the industry on the best way forward, and the fact that many of the most complex issues (i.e. SUFA, pricing principles, etc) remain unresolved.

Any further delay to the UT4 process would be particularly concerning. While Aurizon believes that a simplification process should be a shared objective of the entire industry, it is Aurizon's assessment that there is also a low appetite for more regulatory activity at present. If UT4 is resolved conclusively by June 2015 as scheduled, the CQCN regulatory framework would have then been under a process of nearly continual review for nearly seven years.

Moreover, simplification pursued for its own sake could ultimately be counter-productive, and without a strong policy foundation and the support of the industry, would also likely be unsustainable. Aurizon does not believe that simplification is a policy objective – it is the outcome of a policy objective. As such, before any such exercise is attempted, it is important to first be clear on the policy objectives which 'simplification' is intended to achieve.

This is not to say that reform is unnecessary, merely that it needs to be undertaken in a methodical way and at an appropriate time. Aurizon submits that the post-UT4 period, when the QCA will have the benefit of the completed Harper Review (and any additional processes which follow), would be the appropriate time for the QCA to re-establish clear priorities for the evolution of the CQCN regulatory regime (including simplification), set out desired outcomes, and outline a preferred approach.

In this respect, we refer to The Infrastructure Group's submission to the Harper Review,[1] which suggested that regulators consider putting in place long-term strategic plans, in order to provide clarity of focus going forward, limit regulatory creep, and prioritise resources.

2. Standard agreements are an important part of the regulatory framework

Standard agreements are a familiar part of most rail regulatory regimes in Australia,[2] and are generally supported by Aurizon.

Standard agreements are not, nor could they be,[3] the only form in which access seekers and Aurizon Network can contract. Instead, the standard contracts annexed to Aurizon Network's undertaking are perhaps best likened to a QCA-endorsed template - which an access seeker can

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1 Both Aurizon and DBCT were participants in this group.

2 They are less common in other regulated industries, largely because non-price terms and conditions of access are more commercially significant in rail than is the case in most other network industries.

3 In accordance with the terms of the QCA Act, Aurizon Network's undertaking cannot compel access seekers to enter into a "one size fits all" access agreement, nor can it prohibit Aurizon Network from contracting on non-standard terms when an access seeker reasonably requires it. This is because the Act requires that access agreements be commercially negotiated (with recourse to arbitration), and that reasonable efforts be made to satisfy the reasonable, commercial requirements of an access seeker.

use, in whole, in part, or not use at all, depending on their individual commercial requirements and their strategy for competing in dependent markets.

These 'templates' are maintained, and regularly reviewed, for three principal reasons:

- A contractual "standard" gives access seekers a reasonable expectation as to the likely terms and conditions on which access will be contracted, thus promoting certainty, facilitating investment in dependent markets, and promoting new entry.

- Standard form contracts reduce the transaction costs associated with negotiation, and thus (irrespective of regulation) are a common feature in markets characterised by goods or services with homogenous characteristics. In the regulatory context, as such transaction costs may constitute a barrier to entry, standard contracts are used to promote a greater degree of contestability than relying on 'negotiate-arbitrate' alone.

- The QCA's arbitral power is very broad and thus the outcome of an access dispute could be very uncertain. Such uncertainty could discourage legitimate claims, or, equally, could lead to excessive 'testing' of the QCA's position. As neither outcome is desirable, the QCA endorses a benchmark contract, so as to signal its likely views, minimise uncertainty, and obviate the possibility of excessive disputes. This has the added benefit of meaning that the QCA should not have to 'start from scratch' in an arbitration – such that arbitrations should be very expeditious (though one has never occurred).

Maintaining standard agreements for these reasons is consistent with the object of the QCA Act. Some of the QCA's standard contracts, particularly the SOAA, have been widely adopted and used by third parties, and were an important part of facilitating entry into the above-rail market.[4] Aurizon believes there is a policy case to maintain such agreements, given their long and successful track record.

3. The current approach to standard contracts has some clear drawbacks

However, a substantial increase in the length, complexity and number of standard agreements has begun to create real issues for the efficient and timely administration of the regulatory regime. Until comparatively recently, only three standard contracts were attached to Aurizon Network's undertaking (totalling around 300 pages).[5] For a number of reasons, this increased substantially since QR National's privatisation in 2010 – the 2013DAU contained some fifteen[6] separate standard contracts, amounting to about 1,600 pages.

Needless to say, administering a complex regulatory framework is costly. Moreover, it is impractical and unsustainable. An industry that needs to be globally competitive cannot revisit, every four years, the entirety of a regime that is longer than the National Electricity Rules.

In addition to these direct costs, there is an important, underlying question about the *indirect* costs of such extensive regulatory intervention. The export coal sector is not a captive domestic consumer market like the sectors which traditionally require this level of regulation. Instead, it is a trade-exposed export industry that needs to remain competitive relative to its low-cost international competitors. Increasing governmental intervention, red tape and resource-intensive

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4 Non-coal services and non-revenue services, will typically also use the SOAA as a template – but generally require a greater degree of customisation.

5 Standard Operator Access Agreement, Standard Access Holder Agreement, Confidentiality Deed.

6 The 2013DAU contained seven, non-SUFA related contracts: the (i) Standard End User Access Agreement; (ii) Standard Train Operations Agreement; (iii) Standard Operator Access Agreement; (iv) Standard Access Holder Agreement; (v) Standard Studies Funding Agreement (Prefeasibility); (vi) Standard Studies Funding Agreement (Feasibility); (vii) Standard Rail Connection Agreement. The Queensland Resources Council (QRC) has requested that this increase to eight, be re-including a Standard Confidentiality Deed. The SUFA contractual bundle encompassed eight agreements in the 2013DAU.

regulatory regimes will add to cost and decrease the scope for innovation – which would be contrary to the industry's international competitiveness requirements.

In this respect, there are a number of reasons to suspect that the current approach to standard contracts may be coming at an indirect cost to competitiveness and economic efficiency:

- Most simply, the standard contracts may be displacing lower-cost, incentive-based regulation. Aurizon accepts that there are specific public policy reasons justifying a limited number of standard contracts which are essential to promoting above-rail competition. However, there is a weaker policy case for the regulator to pre-approve every conceivable commercial agreement between Aurizon Network and third parties. That this level of oversight has become necessary suggests a deeper problem – as well-functioning incentive-based regulation should make that level of intervention unnecessary.

- The nexus between the standard agreements and the competition policy rationale underpinning the rail access regime is increasingly uncertain. Much of the standard agreement framework is now directed at broader industry productivity, planning or investment issues. These issues - while vitally important to both Aurizon and its customers - fit awkwardly and often ineffectively into essential facilities legislation.

- The use of standard agreements has, in part, required the QCA to deal ex ante with issues that might otherwise have been dealt with commercially. This may have made the regulatory process more expansive than necessary, as issues which could have been amenable to commercial resolution have instead been dealt with by the QCA. The alternative would have been for greater reliance to be placed on unidentified deficiencies in the standard contracts being resolved commercially or, if necessary, referred only in their material aspects for QCA arbitration.

- The 'shadow' negotiation of contracts in regulatory proceedings has proven to be more time-consuming than ought to be the case. In part, this is because participants in a regulatory process are not usually subject to the opportunity cost of delay. As there is little value at stake in negotiating a non-binding template, there is little incentive to agree on workable documents or to limit negotiation to material issues.

- As the standard contracts have expanded in their coverage, the QCA's role as a public interest regulator risks being crowded out by the need for it to make what are essentially business judgments. The QCA is not a participant in the markets it regulates – so it cannot, nor should it, be put in the position of having to resolve every business strategy or operational issue which may arise between Aurizon Network and its customers. In this respect, reviewing detailed, complex commercial agreements for pre-approval risks undermining the QCA's independent arbitral and policymaking role, reduces the emphasis on incentive-based regulation, and increases the chance of regulatory error.

- Last, there is some prospect that the use of standard agreements has reduced dynamic competition. Promoting the standardisation of some aspects of Aurizon Network's commercial relationships has helped promote contestability in the above-rail market. However, it has also blunted the incentive of access seekers to incur the cost of negotiating non-standard terms with Aurizon Network. This may have reduced innovation or other dynamic effects in relevant markets, with potential negative impacts on industry competitiveness.

4. Simplification will required a clear and principled policy

As noted above, Aurizon supports the QCA's objective in asking stakeholders to consider how the agreements might be simplified. However, Aurizon believes that impactful simplification will

require some considerable re-evaluation of how standard agreements are used, and their role in the overall Queensland regulatory landscape. To that end, there are a number of fundamental policy questions that may need to be considered before any reform can realistically proceed, and would raise the following policy questions for consideration:

- ***Would simplification means optimising ex ante and ex post intervention?*** All regulatory action sits on a continuum between ex ante and ex post intervention:

    - ex ante intervention (e.g. imposing a standard agreement or a term in the undertaking) aims to reduce Type 2 regulatory error (i.e. failing to identify and remedy anticompetitive behaviour), but it does so at the risk of Type 1 regulatory error (i.e. mistakenly prohibiting procompetitive behaviour);

    - ex post intervention (e.g. imposing a penalty) is the opposite – giving latitude to market forces minimises Type 1 regulatory error, but at the risk of Type 2 regulatory error.

  Neither option is inherently superior – ex post and ex ante intervention are complementary forms of regulation, with different benefits, risks and costs.

  In theory, the CQCN should be a good environment in which to rely on ex post, rather than ex ante, regulation. Access seekers and end-users are well-resourced businesses with a much higher degree of countervailing power than in most other regulated industries. Further, the market is characterised by low information asymmetry, given a small number of firms, in a single geographic region, an often common workforce, and readily discoverable reference pricing. These features of the CQCN contribute to an environment where the risk of Type 2 error should be low – as anticompetitive conduct should be much more readily detectable and remediable by ex post intervention than in, say, consumer markets.

  However, in more than a decade of regulation, there are very few, if any, examples of the QCA using its extensive ex post intervention powers (i.e. its investigative, dispute resolution, arbitration, penalty, and compliance powers). Meanwhile, there are many examples of the QCA opting to increase levels of ex ante regulation, including by increasing the number of standard agreements.[7]

  A winding back or simplification of ex ante forms of intervention like the standard agreements, is unlikely to be acceptable to stakeholders without effective ex post intervention. This suggests that a practical prerequisite to simplification may be removing any roadblocks (i.e. practical, legal, etc) to the use of ex post mechanisms.

- ***Is there a need to recommit to a clear focus and direction for CQCN regulation?*** As noted above, Aurizon believes there is considerable merit to undertaking a simplification process after a strategic review of CQCN regulation is completed, and a clear set of priorities is established. Similar reviews undertaken by the ACCC or by international regulators (e.g. Ofcom), have proven to be valuable in other industries at re-establishing the optimal scope of regulatory intervention.

- ***Is there a need for a more pragmatic view on the standard of scrutiny?*** Simplifying the standard agreements may require re-visiting the standard of scrutiny that is applied by the QCA to standard agreements. In the last few years, significant time has been spent reviewing these documents, even though it remains open for any material deficiencies to be identified and corrected through negotiation and dispute

[7] This is a somewhat counterintuitive outcome, because it is usually systematic over-use of ex post remedies that is the best indicator that ex ante intervention is appropriate. For example, a large number of access disputes would suggest the need for additional ex ante controls.

resolution, rather than dealt with ex ante. This has often put the treatment of standard agreements at odds with the QCA Act, which envisages that regulatory proceedings will be short (e.g. s 147A), and that they will not be delayed by minor and inconsequential issues (e.g. s 139(6)). Achieving these objects may require a new, pragmatic view of the standard of scrutiny that can realistically be brought to bear in a 6 month period. As noted by the Prime Minister's Export Infrastructure Taskforce in 2006, it is vitally important that regulatory process not be *'distracted'* by a *'search for optimality and precision'* – the *'regulatory task … is not to determine whether what has been proposed … is optimal, but whether it is reasonable'*.[8]

- ***Should the QCA focus only on key terms, rather than full contracts?*** There is a question about whether, in cost-benefit terms, it is better for the QCA to approve a fully-drafted contract, or to approve only key terms and then rely on parties to translate those terms into an actual contract. While there is no doubt likely to be a diversity of views on that question, it is at least worth exploring whether the QCA limiting its role to just reviewing and approving commercially material terms in an agreement would be worthwhile.

- ***Is it possible to establish a pathway to transition mature agreements out of the undertaking?*** It is likely that most of the public benefit in the QCA approving standard agreements is realised at the time when the agreement is first developed (or perhaps, when it is first used by an access seeker). This is because the benefit of QCA oversight is probably in the QCA adjudicating an overall commercial bargain and risk allocation, not in supervising subsequent minor changes. While keeping standard agreements up to date is important, it is hard to see that there is much public benefit (in terms of promoting additional efficiency or competition) in this ongoing activity.

  There would therefore seem to be scope to consider transitioning mature contracts out of the undertaking (and perhaps onto a public website), likely in conjunction with the QCA's continued supervision of key terms, very clear protection for access seekers in terms of recourse to dispute resolution, and an option to bring them back into the undertaking if Aurizon Network's market conduct requires it.

- ***Should a threshold be set for the creation of new agreements?*** The large number of standard agreements which were created in the UT3 period has lowered the threshold for the development of new standard agreements (which was previously quite high), such that new agreements have been proposed by Aurizon Network in the 2013DAU without the regulator requiring it. There may thus be merit in the QCA providing fresh guidance as to when new standard agreements are necessary e.g. the QCA might reasonably determine that a new standard agreement is only necessary after multiple access disputes, or where there is a material concern about the effectiveness of negotiation.

5. Removal of the Standard Operator Access Agreement

Aurizon Holdings does not support the SOAA being removed from the undertaking at this time, and two new contracts developed instead.

This change will not promote a less costly, or simpler, set of access arrangements. Indeed, it seems incongruous to suggest that the best way to simplify the undertaking is to remove the uncontroversial, stable, and well-understood SOAA, and replace it with an untested set of new agreements. Such a change would introduce new commercial complexity and risk, discussed below, while also being unlikely to improve the timeliness of regulatory proceedings. This is

[8] Exports and Infrastructure Taskforce, Australia's Export Infrastructure: Report to the Prime Minister, (May 2005), p.2.

because, once one access agreement is approved (usually the SOAA), approving the rest should be relatively straightforward because most of the terms are common.

This is not to say that this removing the SOAA will never be possible, merely that – in isolation – this change will not result in any real benefit, and has unclear commercial implications if it is undertaken without a clear, principled strategy.

Aurizon submits that:

- There is a substantial market demand from coal customers for operators to hold access rights under the standard operator access agreement. The SOAA has been around for more than a decade, is well understood by customers, and can be negotiated at very low cost. The overwhelming majority of Aurizon Operations' current rail haulage contracts contemplate that the operator will enter into a SOAA with Network. We do not see any reason to remove a very stable agreement for which there is market demand, when the incremental cost for its approval and review are marginal.

- A simple, clear and easily understood contracting structure between above and below rail is critical to realising productivity improvement in the supply-chain. Suggesting that operators enter into two access agreements, rather than one, does not appear to have a clear commercial basis or result in any additional value.

- The EUAA and TOA are written on the assumption that there is a tripartite commercial structure. If it is in fact a bilateral structure between an operator and Aurizon Network, many of the provisions in the EUAA/TOA are redundant. Assuming these clauses would be removed or ignored, then the outcome is effectively to split the existing SOAA across two contracts – which begs the question, as to why remove the SOAA at all.

- The SOAA forms the practical template for the contracting of non-coal access rights, as well as maintenance/non-revenue traffic. In proposing just the EUAA and TOA be retained, one expects that regard is being had to the Hunter Valley Access Undertaking, which only contains a EUAA and TOA. However, this comparison perhaps fails to account for the ACCC requiring the ARTC to maintain a SOAA in its other undertaking. The SOAA in the interstate access undertaking was the main reason for not including an SOAA in the HVCN access undertaking.

- The change has unclear competitive neutrality implications as between operators. If the SOAA is removed, an operator who prefers to contract using a non-standard form of access agreement (as permitted to do so under the QCA Act) may be placed at a competitive disadvantage to an operator who willing to use a modified EUAA and TOA. The costs associated with developing these standardised agreements is socialised in the reference tariff and the QCA levy, whereas a rail operator who prefers to contract on the basis of a single access agreement needs to incur the costs associated with negotiating and maintaining that agreement. They will also bear regulatory risk, as the QCA will be unaware of the non-standard contract.

- It is presumed that the variations to the EUAA which allow an operator to enter into it would need to be approved by the QCA and form part of the suite of standard agreements. This is likely to be more time consuming than approval of the already prepared and submitted SOAA (whose costs are already largely sunk), and would probably end up resulting in four SAAs anyway - comprising two variants of the EUAA and TOA.

6. Concluding comments

Aurizon strongly supports simplifying Aurizon Network's undertaking. However, this should form part of a thorough review of the QCA's objectives and the spelling out of the Authority's priorities for the regulatory regime applying to the CQCN. Aurizon further believes that this work should be informed by the outcome of the Harper Review, and any process which follows.

I would welcome the opportunity to discuss any of the above with you. If you have any queries on this letter, do not hesitate to contact me directly, or via Samuel McSkimming (Samuel.McSkimming@aurizon.com.au or on (07) 3019 9024).

Yours faithfully,

John Short
VP National Policy