AURIZON

Charles Millsteed
Director Economic Regulation
Queensland Competition Authority
Level 27, 145 Ann St
Brisbane, QLD 4000

**Response to Stakeholder Notice 11: Short-term Transfer Mechanism**

30 September 2015

Dear Charles

Aurizon Operations (**Aurizon**) welcomes the opportunity to provide comments in response to the Queensland Competition Authority's (**QCA**) request for additional information on Aurizon Network's proposed short term transfer mechanism (**STTM**).

In May 2015, Aurizon submitted material to the QCA in relation to the STTM in response to the supplementary draft decision of 30 April 2015. That submission supported the formalisation of a transfer framework which would provide for the expeditious transfer of access rights to allow industry participants to respond to changing circumstances. However, the submission also raised substantial concerns with the QCA's proposed pricing arrangements that might apply to transferred capacity.

Importantly, the STTM proposal submitted by Aurizon Network does not fundamentally differ from the historical transfer mechanisms. The objective of the framework is to improve the timeliness of the administrative arrangements for execution and the predictability as to whether a transfer would be approved while protecting the interests of the access provider and other access holders who are not a party to the transfer. Aurizon supports this objective and has undertaken capacity transfers in the past to assist its customers manage their production variations. Confidential examples of transfers are provided in Attachment A to this submission.

The primary focus of the Stakeholder Notice 11 (**SN11**) on the STTM is what impact the QCA's proposed transfer pricing arrangements would have on a decision to undertake a transfer.

The transfer of access rights from one access holder to another access holder achieves two reasonably simple objectives. The first is to provide an access holder increased certainty that it will be able to obtain a train path when it submits a train order. The second is to allow an access holder to balance its take or pay liability against its utilisation expectations.

Whether an access holder will require the formal transfer of access rights is largely dependent on the individual circumstances. For example, an access holder may simply rely on being able to secure required train paths through the existing scheduling process and Network Management Principles. Alternatively, the customer may want a greater degree of certainty to align with shipping orders and other contractual obligations.

It is reasonable to expect that the incentive of an access holder to execute a transfer, at potentially increased costs, will be reduced under the QCA's transfer pricing arrangements, particularly where an access holder has a reasonable degree of confidence that its train orders will be fulfilled within existing scheduling and train ordering parameters.

The SN11 also asks whether access holders will game the STTM and whether the QCA's transfer pricing arrangements would address that conduct.

It is unclear from the notice what constitutes 'gaming'. It could be considered gaming to the extent that one party obtains an advantage over another party due to their ability to coordinate or be commercially innovative through interpretation and effective utilisation of contractual mechanisms. It might otherwise also be referred to as competition. In this regard, the focus of the consideration of the STTM under section 138(2) of the QCA Act should be primarily whether the arrangements are likely to improve or reduce efficiency.

***Question 1. Please provide examples of previous transfers or hypothetical examples of transfers that you would not undertake if the transfer was subject to the pricing mechanism outlined in decision 4.1 of our Draft Decision.***

As noted above, the reasons for transfers vary and are influenced by a range of factors. It is a reasonable presumption that any increase in cost arising from the transfer will be a larger disincentive for a transfer relative to one where no cost is involved.

Aurizon Network and industry participants have previously agreed that in order to promote shorter term transfers they should not be subject to a transfer fee. This is reflected in the current access agreement whereby transfers for periods of less than two years incur no transfer fees. Aurizon understands that the term was extended from an initial 12 month term, proposed in the UT3 industry consultation papers, to a term of two years at the request of the industry. In approving these arrangements the QCA noted:

> *The Authority has considered stakeholders' comments in relation to short-term transfers and, in particular, agrees in principle that it would be beneficial, and promote whole-of-coal-chain supply objectives, if fees for short-term transfers were relaxed under all access agreements.*[1]

The practical effect of decision 4.1 is to impose a direct cost on transfers by requiring an access holder to pay an access charge for transferred access rights which differs from its reference tariff. The implications of this decision on a transfer might include:

- an access holder seeking to profit from a transfer by retaining some or all of the difference between a lower transfer price and the higher reference tariff price for transfers from shorter to longer distances; or

- an access holder foregoing a contractual transfer of access rights due to the higher transfer price from a mine with a longer transport distance.

[1] QCA (2010) Final Decision on the 2010 Draft Access Undertaking, p. 138.

Neither of these two scenarios are consistent with the objectives of removing barriers to transfers in order to promote increased levels of utilisation of the supply chain. As the STTM requires the recipient to assume the take or pay liability for the transferred rights, an access holder will be increasingly reluctant to accept a transfer involving increased access charges.

Aurizon notes that a considerable driver of the industry position to remove any financial imposts to transfers is the significant sterilising effect the complexity of the transfer fee arrangements has on implementing a transfer. In addition to the complexity of the proposed transfer pricing arrangements in decision 4.1, the decision adds even greater degrees of complexity through the operational and administrative requirements of managing alternate pricing arrangements for identical services. The QCA could obtain relevant information from Aurizon Network in relation to the number of transfers completed under each generation of access agreement and the details of negotiation periods for completed and incomplete transfers.

In addition, it is unclear how decision 4.1 will be given effect. This is particularly relevant where amendments would need to be made to existing access agreements to include a different price for an existing origin within the access agreement.

In this respect, the QCA has also previously noted in relation to implementing alternate transfer mechanisms into existing agreements that:

> *The Authority is reluctant to include this as a direct obligation in the undertaking as, on its own, it would be insufficient to give effect to the overall objective. This is because achieving the desired outcome would require an amendment to existing access agreements and may also require amendments to haulage agreements. The undertaking does not have the ability to require these agreements to be renegotiated*[2].

***Questions 2 to 4. Incentives to Game***

Aurizon recognises that the role of the STTM is to allow access holders to manage their train service entitlements in response to disruptions to their mine's short term production. In a market of reduced demand transfers are superfluous if capacity is readily available. As such, the volume of transfers are likely to be higher where the system is operating closer to full capacity.

Consistent with the current arrangements, a relinquishment/transfer fee should be incurred for transfers which seek to address misalignment between the access rights and production capacity of the mine itself (i.e. over contracted). The STTM could be used to address differences in production capacity as opposed to production disruptions. Aurizon Network's proposal seeks to differentiate the two matters and ensure the STTM provides the right economic signals when contracting for access rights.

Aurizon also notes that decision 4.1 has asymmetric consequences between individual access holders and the system. The system obtains the benefit of higher revenues from the transfer of shorter to longer hauls. However, the party who obtains the benefit of the transferred access rights from a longer to a shorter haul incurs the higher cost.

***Question 5. Please provide any comments on whether the requirement to demonstrate ability to load a train will identify and stop any 'gaming' behaviour identified in response to question 2.***

---

[2] Ibid. p. 138

Aurizon understands this obligation is primarily to ensure the load out capacity is not exceeded. To the extent that the load out capacity materially exceeds the extractive and productive capacity of the mine, then the access provider should be able to seek a supporting statement that the access rights are required to reduce mine stockpiles and/or increased mine production capacity. This should not prevent the transfer but it should be reversible if the evidence is not provided within a specified period of time.

Ultimately, the access provider should have the ability to reject any transfer request where it considers the access rights being transferred cannot be utilised, subject to providing a statement of reasons for that decision. The decision should then be subject to the complaints handling mechanism. This is likely to be more efficient and effective than seeking to define rules for all feasible supply chain scenarios.

***Question 6 and 7. Please provide comments on alternatives to Aurizon Network's proposal that you consider more appropriate. Please provide illustrative example in your response.***

See response to Question 8.

***Question 8. Please provide comments on the appropriate definition of common destination. Please provide illustrative examples in your response.***

Aurizon considers that it is desirable that the framework be sufficiently flexible to accommodate as wide a range of circumstances as possible. For example, whether a port can accommodate additional train services will depend on a range of factors such as whether it is under-contracted, has excess capacity, the in-loader capacity and stockpile exceed the out-load capacity and the duration of the transfer.

Ultimately, the final determination of whether a transfer should occur between multiple ports is the access provider who assumes the financial risks of increasing its contractual obligations to that unloading facility. As such, the assessment and specification of common destination should be strongly guided by the access provider's view of risk.

***Question 9. Please provide comments on the extent to which gaming behaviour identified in your response to question 2 will continue under the pricing mechanism outlined decision 4.1 of our draft decision and why this would be the case?***

The pricing mechanism outlined in decision 4.1 is contrary to industry objectives in relation to short term capacity management. The pricing mechanism also seeks to remove the socialisation of system utilisation risk only in relation to where a transfer occurs. Socialisation of system utilisation risk will remain in place for variations in throughput against contracts where transfers do not occur.

Aurizon does not consider that the pricing mechanism for transfers in decision 4.1 can be considered in isolation of the broader issue of socialisation of system pricing and take or pay arising from variation in system utilisation.

As noted in our response of 29 May 2015, the efficiency of the socialisation of volume and utilisation risk in the CQCN has not been subject to a robust and systematic cost/benefit or impact analysis. The transfer pricing mechanism should be a matter for consideration within that broader review.

The draft decision on the STTM does not demonstrate how it improves efficiency relative to Aurizon Network's proposal. There is no demonstrated economic problem or perverse economic incentive that decision 4.1 is intended to address (i.e. what problem would have been avoided over the last 5 years had decision 4.1 been in place). The information notice reverses the frame of reference from: what identified problem is it intended to address, to: what problems would occur if implemented.

***Question 10. Please provide comments on the practical requirements of adopting the pricing mechanism outlined in decision 4.1 of our draft decision, the impact these may have and why. Please provide illustrative examples in your response.***

Aurizon has previously provided details of the issues associated with the QCA transfer pricing mechanism in our 29 May response. For completeness, those matters are expanded as follows.

1. The transfer pricing mechanism requires variation to an access agreement and the negotiation of a new access charge.

The transfer pricing mechanism requires the consideration and negotiation of a new access charge to be included in an access agreement. This can cause delays in implementing a transfer and increase the likelihood of an access dispute. This is contrary to the objective of providing a timely and low transaction cost mechanism for the transfer of access rights.

The nominated train service configuration may also differ between the transferred access rights. In establishing a revenue equivalent access charge, further adjustments would be made to accommodate variances in consist information. This is particularly problematic where transferred access rights are being transferred not just from one origin to another but also from one operator to another. This would potentially require Aurizon Network to disclose commercially sensitive operational data in order for the access holder to verify that the transfer price has been calculated correctly.

It is also unclear as to what tariff component would be adjusted and how that would impact on the calculation of take or pay.

2. The transfer price is different to that of an existing service.

The access holder who is receiving the transferred access rights may already hold access rights for that origin. The transfer pricing proposal would require the inclusion in the access agreement of two different access charges for the same origin. This gives rise to numerous administrative complexities, including whether:

- a weighted access charge should apply;
- the transferred access rights be assumed to be used first or last; or
- the highest or lowest of the access charges payable for that origin that apply first?

The answers to these questions have varying implications on incentives to transfer given the different consequences for the cost of access rights used and the potential costs of access rights which are not used (for example, an access holder may not use all of the transferred capacity).

3. The transfer price materially increases billing complexity.

If the access holder is subject to multiple access charges for the same origin, then it is unclear whether significant changes to billing systems would be required in order for the billing system to correctly apply the correct access charge to the relevant service. This increases the potential for billing errors and raises the access provider's compliance risks.

It is also highly uncertain what arrangements would need to apply to subsequent transfers. Assuming access rights can be transferred from one access holder to another, and that access holder is able to subsequently transfer those rights to another access holder, what transfer price should apply to the final access holder? That is, should it be determined with reference to the first or second access holder price.

4. The transfer price is inconsistent with the underlying pricing input assumptions.

If the access rights extended into the next financial year, or are transferred prior to the commencement of, but will operate within, the next financial year, then what gtk and ntk assumptions should be employed in the annual review process. For example, if the transfer gtk/ntk assumptions are employed, then the system price will be adjusted to reflect the difference in gtk or ntk. This would lead to an error in the estimation of the transfer price as it would no longer be an unbiased forecast. Alternatively, the pricing model would need to incorporate the adjusted revenue but calculate the gtk and ntk from the original service. This substantially increases the complexity of the regulatory financial model.

Similarly, if there is a change to the system price, then the transfer prices will need to be re-estimated to reflect the revenue differential for the forthcoming billing periods. It is not readily apparent that the scale of the economic problem the QCA is seeking to address warrants this level of complexity.

5. The transfer price is inconsistent with existing contractual obligations on transfers.

The no-cost transfer provisions for transfers of a period less than two years only applies to UT3 agreements. Existing UT1 and UT2 agreements retain the requirement to pay a transfer fee as required in the standard access agreement applicable to those undertakings. As a consequence, and without Aurizon Network's ability to waive those fees, the pricing mechanism in decision 4.1 may require one access holder to pay the transfer fee while that access holder or another access holder is also required to pay the adjusted equivalent access charge without any recognition of the value of the transfer fee. Requiring the transfer price to include a further adjustment for any transfer fees paid only further exacerbates the complexity of the model.

In summary, a transfer model without administrative or transaction costs will always promote increased transfers relative to one that does. To the extent that the QCA identifies problems with how the STTM creates perverse incentives which actually lowers efficiency then it should seek to address those problems in a way which does not impose undue costs or financial penalties.

Should you have any questions in relation to this submission please contact Dean Gannaway, Principal Regulatory Economist by phone on (07) 3019 2055 or by email at dean.gannaway@aurizon.com.au.

Kind regards,

for

John Short
Vice President National Policy