

Position paper

Aurizon Network's 2013 Standard User Funding Agreement Draft Amending Access Undertaking: Rental streams if the CQCN is not a declared service

April 2016

We wish to acknowledge the contribution of the following staff to this report:

SUFA team

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SUBMISSIONS

Closing date for submissions: 26 April 2016

Public involvement is an important element of the decision-making processes of the Queensland Competition Authority (QCA). Therefore, submissions are invited from interested parties concerning its assessment of Aurizon Network's 2013 Standard User Funding Agreement Draft Amending Access Undertaking (2013 SUFA DAAU) specifically in relation to the treatment of SUFA rental streams in the event the central Queensland coal network (CQCN) declaration expires or is revoked. The QCA will take account of all submissions received.

Submissions, comments or inquiries regarding this paper should be directed to:

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Confidentiality

In the interests of transparency and to promote informed discussion, the QCA would prefer submissions to be made publicly available wherever this is reasonable. However, if a person making a submission does not want that submission to be public, that person should claim confidentiality in respect of the document (or any part of the document). Claims for confidentiality should be clearly noted on the front page of the submission and the relevant sections of the submission should be marked as confidential, so that the remainder of the document can be made publicly available. It would also be appreciated if two copies of each version of these submissions (i.e. the complete version and another excising confidential information) could be provided. Where it is unclear why a submission has been marked 'confidential', the status of the submission will be discussed with the person making the submission.

While the QCA will endeavour to identify and protect material claimed as confidential as well as exempt information and information disclosure of which would be contrary to the public interest (within the meaning of the *Right to Information Act 2009* (RTI)), it cannot guarantee that submissions will not be made publicly available.

Public access to submissions

Subject to any confidentiality constraints, submissions will be available for public inspection at the Brisbane office, or on the website at www.qca.org.au. If you experience any difficulty gaining access to documents please contact us on (07) 3222 0555.

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THE ROLE OF THE QCA – TASK, TIMING AND CONTACTS

The Queensland Competition Authority (QCA) is an independent statutory authority to promote competition as the basis for enhancing efficiency and growth in the Queensland economy.

The QCA's primary role is to ensure that monopoly businesses operating in Queensland, particularly in the provision of key infrastructure, do not abuse their market power through unfair pricing or restrictive access arrangements.

On 22 July 2013 Aurizon Network formally withdrew its 2012 SUFA DAAU and submitted its 2013 SUFA DAAU containing the following documents:

- explanatory notes (from its 2012 SUFA DAAU) modified by its submission letter dated 22 July 2013 and related schedule
- regulatory notes (unchanged from its 2012 SUFA DAAU)
- new SUFA template legal agreements
- DAAU (unchanged from its 2012 SUFA DAAU).

We commenced an investigation into Aurizon Network's 2013 SUFA DAAU on 25 July 2013. Consistent with section 138(3)(c) of the QCA Act, we published Aurizon Network's DAAU on our website and invited stakeholders to make submissions. Six submissions were received. On 14 October 2013, we invited all stakeholders to provide reply submissions on all submissions provided to date. Six reply submissions were received.

On 22 May 2014, we released a position paper along with a set of term sheets and a consultant's report commenting on the workability, credibility and bankability of Aurizon Network's proposed 2013 SUFA DAAU. We asked for comments on those documents by 27 June 2014, and received six submissions in response.

We released our draft decision on 31 October 2014, accompanied by drafts of the 12 standardised agreements. We requested parties to provide stakeholder comment on the matters raised in our draft decision and received five submissions in response.

We have also requested stakeholder comment on some examples of the SUFA rental calculation process based upon existing regulatory processes.

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1 SUFA RENTAL STREAMS IF THE CQCN IS NOT A DECLARED SERVICE

1.1 Objective

This position paper sets out our recent thinking on the implications for SUFA rental streams in the event the CQCN declaration expires or is revoked. We are seeking stakeholder views on this prior to publishing our final decision on Aurizon Network's 2013 SUFA DAAU. The subsequent sections of the position paper comprise:

- Aurizon Network's 2013 SUFA DAAU proposal
- Process to date
- Issues to consider
- Alternative options for calculating SUFA rental streams if the CQCN is not a declared service
- Process going forward.

1.2 Aurizon Network's 2013 SUFA DAAU proposal

Aurizon Network's proposal for the calculation of SUFA rental streams if the CQCN is not a declared service (i.e. is not regulated) is provided in Schedule 2, Part 2 of the Extension Infrastructure Sub-Lease (EISL) of its 2013 SUFA DAAU proposal.

Aurizon Network's approach has the following two objectives, which are outlined in clause 2.3 of Schedule 2, Part 2 of the EISL:

- pricing of access
- revenue sharing.

The revenue sharing objective states that:

Aurizon will pay to the Trustee the percentage of Capital Revenue attributable to each Section on the basis that would have applied at the time that Aurizon earned that Capital Revenue had the Final Regulatory Regime continued to apply beyond the End Regulation Date.

The term Final Regulatory Regime means the:

Access Legislation and Access Undertaking that applied to Aurizon immediately prior to the End Regulation Date.¹

In the context of the revenue sharing objective, the terms Section and Capital Revenue are of particular relevance to SUFA rental streams, and the pricing of access can be considered in the context of Capital Revenue.

¹ The term End Regulation Date refers to the date that the CQCN ceases to be regulated under access legislation.

What is a Section?

A Section relates to the rail infrastructure between two points where an integrated Aurizon entity provides a customer with access. SUFA infrastructure² could be part of the Section.

What is Capital Revenue?

If the CQCN is not declared, customers will either have an access agreement or a CITS agreement³ associated with a Section. An access agreement relates to provision of below-rail access. A CITS agreement relates to a bundled set of services that comprise below-rail access and other services (e.g. above-rail services such as train services). In terms of the pricing associated with a Section, the following applies:

- A no more favourable pricing regime (from the customer's perspective) for the provision of access or a CITS applies to the SUFA infrastructure within a Section relative to the pricing regime for other assets within the Section on the basis of asset ownership.⁴
- In an access agreement, the pricing for a Section can be below the maximum amount that would have been allowed in the Final Regulatory Regime.
- In a CITS agreement, the pricing for a Section is as an integrated Aurizon entity sees fit.

Against this background, Capital Revenue means:

in respect of a Section:

(a) actual access revenue, where access is provided as a separate commercial service;

(b) Notional Access Revenue where access is provided as part of a CITS; or

(c) a combination of both actual access revenue and Notional Access Revenue,

as applicable for that Section less Aurizon's operating and maintenance expenditure for that Section.

In order to estimate Capital Revenue, CITS revenue streams have to be split into the revenue attributable to below-rail services and other services. This is addressed through the concept of Notional Access Revenue. Notional Access Revenue means:

in respect of the CITS provision relating to a Section, the lesser of:

(a) the access revenue that would have been allowable to Aurizon in respect of that Section at the time of provision of the CITS had the Final Regulatory Regime continued to apply beyond the End Regulation Date, and

(b) the revenue received by the CITS Provider⁵ for the provision of the CITS less the relevant Determined Other Transportation Costs, both being in respect of that Section,

where Determined Other Transportation Costs means:

² SUFA infrastructure is defined as Total Extension Infrastructure in the context of clause 2.3, Schedule 2 of the 2013 SUFA DAAU EISL.

³ A CITS is a commercially integrated transportation service for which the provider incurs both below-rail costs and Other Transportation Costs, and charges its customer an integrated fee for transportation services rendered to it.

⁴ This is taken to mean that all assets within a Section will not be differentiated by whether they have been constructed through the SUFA process.

⁵ A CITS Provider refers to Aurizon or any related body corporate of it that provides CITS to a customer.

the determined quantum of Other Transportation Costs⁶ that the CITS Provider would have avoided had it not provided the Other Transportation Elements⁷, including:

- (a) operating costs of providing the Other Transportation Elements;*
- (b) administrative costs related to the provision of Other Transportation Elements; and*
- (c) an appropriate allowance for the capital costs of providing the Other Transportation Elements, which allowance must reflect the opportunity costs of the CITS Provider's relevant assets (which may not be new assets), comprising both depreciation and return on assets.*

Through applying this process and set of definitions, an integrated Aurizon entity will obtain an estimate of Capital Revenue for below-rail access. In effect, this estimate is the residual element of the revenue stream for a Section once all other costs have been accounted for. A proportion of Capital Revenue will be allocated to any relevant SUFA infrastructure.

In terms of the ability of a SUFA Trustee or preference unit holders to challenge an integrated Aurizon entity's application of this process, Schedule 2, Part 2 of the 2013 SUFA DAAU contains a drafting note alluding to the development of a special dispute resolution process. Our understanding is that this dispute process has not been developed.

1.3 Process to date

Since the submission of the 2013 SUFA DAAU, all stakeholders have had various opportunities to express their views on the calculation of SUFA rental streams if the CQCN declaration expires or is revoked through submissions on:

- the 2013 SUFA DAAU
- the QCA's position paper on the 2013 SUFA DAAU
- the QCA's draft decision on the 2013 SUFA DAAU.

The intention of this position paper is not to detail these views in depth but to provide stakeholders with the opportunity to comment on our recent thinking in relation to SUFA rental streams if the CQCN declaration expires or is revoked.⁸ It is, however, useful to place the discussion in this position paper in the context of our position in our draft decision on this matter—that is, the SUFA framework should allow:

- for parties to remain on their regulated contract (under section 95 of the QCA Act), given neither party is materially disadvantaged
- the linked access agreements for SUFA assets to include a schedule setting out access charges in the event that an asset is no longer declared.

1.4 Issues to consider

We consider that the implications of the ability of an integrated Aurizon entity to bundle services if the CQCN declaration expires or is revoked requires further assessment. In particular, we consider the following issues would benefit from more consideration:

⁶ Other Transportation Costs refers to costs other than below-rail costs incurred by the CITS Provider in providing the CITS.

⁷ Other Transportation Elements refers to all elements of the CITS other than the below-rail element.

⁸ More detailed discussion of stakeholder views can be found in the QCA position paper and draft decision on the 2013 SUFA DAAU respectively.

- the relationship between CITS agreements, the QCA Act and SUFA security arrangements
- the potential implications of Aurizon Network's proposal.

The relationship between CITS agreements, the QCA Act and SUFA security arrangements

Section 95(c) of the QCA Act states the expiry of a declaration, or the revocation of a declaration of a service or part of a service, does not affect:

the operation of an access agreement, or a right acquired, or liability incurred, under an access agreement, that was entered into before the expiry or revocation.

An access agreement is different from a CITS-type agreement. In our view, the QCA Act may not have any force with respect to CITS-type agreements. In the event of expiry or revocation of the CQCN declaration we consider that an integrated Aurizon entity has an incentive to offer bundled above- and below-rail train services in a manner which encourages customers to accept the bundled service rather than just below-rail services. If customers chose the bundled service, they would likely exit their access agreement (signed with Aurizon Network) and enter into a new agreement for a bundled service (a CITS-type agreement). In such a scenario, section 95(c) of the QCA Act may be ineffective.

Further, the security requirements⁹ included as part of our SUFA draft decision documents refer to access agreements (specifically the Extension Access Agreement and Specified Access Agreement), with 'security' relating to the direction-to-pay under these access agreements. As drafted, this security would not appear to extend to CITS-type agreements.

Overall, we consider that the protections afforded to SUFA rental streams via the QCA Act in the event the CQCN declaration expires or is revoked are likely to be weaker than initially anticipated in an industrial structure where there is the possibility of bundling services.

Further, for the security arrangements proposed in our draft decision to be effective, it is likely that they need to apply to both CITS-type agreements and the relevant access agreements. In our view, the intent of the security arrangements is to be effective regardless of whether the CQCN is declared or not, and they should be amended to ensure this is the case.

Potential implications of Aurizon Network's proposal

In our view, Aurizon Network's 2013 SUFA DAAU proposal is likely to provide an integrated Aurizon entity with complete discretion over the value it attributes to below-rail services, should the CQCN no longer be declared. The reasons for our view are as follows:

- (1) The pricing of the individual services offered by an integrated Aurizon entity need not be cost reflective.
- (2) The decision of what constitutes a Section if the CQCN declaration expires or is revoked is at the discretion of an integrated Aurizon entity. If, for instance, the CQCN, at the time of the Final Regulatory Regime, was split into systems (as in the case under the existing regulatory system) the access revenue attributable to each system would be calculated. A Section, however, need not correspond to the systems adopted under the Final Regulatory Regime. It is unclear how, in such circumstances, an integrated Aurizon entity would calculate the access revenue that would have been attributable to a Section if the Final Regulatory Regime applied.

⁹ This primarily relates to the Specific Security Agreement and aspects of the EISL of our draft decision SUFA documents.

- (3) The process of cost allocation to obtain an estimate for the Capital Revenue associated with below-rail service lacks transparency. The definitions and assumptions adopted appear to be at the discretion of the integrated Aurizon entity.

In our view, if the amount of rent an integrated Aurizon entity has to pay SUFA funders is directly related to the Capital Revenue associated with below-rail services, it may have an incentive to downgrade the value it places on below-rail services in its product portfolio in order to reduce SUFA rental payments. A possible effect of this is that the Capital Revenue attributed to below-rail services may not reflect the actual value of these services to an integrated Aurizon entity's business in an industrial structure that allows for bundling after an initial period of regulation. Despite the implications for SUFA funders' rental streams, the only recourse that SUFA funders have is with respect to an unspecified special dispute resolution process.

Against this background, we consider that Aurizon Network's proposal provides SUFA funders with very little or no certainty over SUFA rental streams in the event the CQCN declaration expires or is revoked.

1.5 Alternative options for calculating SUFA rental streams if the CQCN is not a declared service

In light of the above issues, we are of the view that the calculation of SUFA rental streams if the CQCN declaration expires or is revoked requires consideration of alternative options. Further, we are of the view that the development of alternative options can be guided by the following:

- Investors in heavy infrastructure industries generally only consider investing if they are sufficiently confident of the return of the value of their investment within an appropriate timeframe. This is the case regardless of whether the industry is regulated or not.
- SUFA funders have a legitimate expectation that if the CQCN declaration expires or is revoked they will receive a suitable return attributable to their investment, subject to prevailing market conditions.
- The regulatory process prior to the CQCN declaration expiring or being revoked would, based on the regulatory principles and assumptions in place at that time, be capable of identifying a notional benchmark SUFA rental stream that would ensure SUFA funders recoup the value of their investment.

In our view, the best estimate of a notional benchmark SUFA rental stream is the estimate which would apply on the basis of the regulatory principles and assumptions in place just prior to the CQCN declaration expiring or being revoked.

This leads us to consider there are broadly four possible options for each SUFA agreement:

- negotiate an outcome
- pay out SUFA funders
- pay SUFA funders a defined rental stream
- pay SUFA funders a variable rental stream related to the CQCN return on assets.

Each of these is considered below and it should be noted that we consider it possible for more than one option to exist if the CQCN declaration expires or is revoked.

We have intentionally not considered the precise details of each option. We are of the view such details would need to be agreed once it became apparent that the CQCN declaration was going to expire or be revoked.

Negotiate an outcome

Rather than include specific approaches/principles within the SUFA documents, an integrated Aurizon entity and SUFA Trustees could negotiate an agreed rental stream, subject to an appropriate dispute resolution mechanism being included in the SUFA documents. The notional benchmark SUFA rental stream that would have applied based on the regulatory principles and assumptions in place prior to the CQCN declaration expiring or being revoked could be adopted as the starting point for negotiations.

Pay out SUFA funders

An integrated Aurizon entity could pay out the SUFA Trustee in the event that the CQCN declaration expires or is revoked. We consider that the value of this pay-out could be the net present value of the notional rental stream calculated for that specific SUFA. This should ensure that SUFA funders recover the value of their investment, in a manner subject to the assumptions and methodological process adopted to calculate the notional SUFA rental stream.

Pay SUFA funders a defined rental stream

An integrated Aurizon entity could pay a defined monthly rental stream through time to the SUFA Trustee. We consider that the notional rental stream calculated for that specific SUFA could be adopted in this case. Again, this should ensure that SUFA funders recover the value of their investment, in a manner subject to the assumptions and methodological process adopted to calculate the notional SUFA rental stream.

Pay SUFA funders a variable rental stream related to the CQCN return on assets

An integrated Aurizon entity could initially pay the SUFA Trustee a monthly rental based on the notional rental stream calculated for that specific SUFA. Thereafter, at the end of each financial year, this could be adjusted to reflect the actual return on CQCN assets. This option means that SUFA rental streams vary depending upon the financial performance of the CQCN. In such circumstances SUFA funders may recover an amount that is more than, less than, or equal to the value of their investment, relative to the notional rental stream calculated for that specific SUFA.

Whilst this approach may be more reflective of evolving market conditions than the other options discussed, there has to be confidence that it will be applied in a fair and reasonable manner by an integrated Aurizon entity. We consider this would be the most complex approach to apply, albeit potentially less so than Aurizon Network's 2013 SUFA DAAU proposal.

In particular, this option requires:

- the approach to adjusting the notional rental stream to be defined at the outset
- the time period over which mechanism would apply to be defined at the outset
- the methodology for calculating the CQCN return on assets to be defined at the outset
- the CQCN return on assets to be calculated yearly.

Against this background, we consider that the yearly calculation of the actual return on CQCN assets, as well as the adjustment mechanism, time period for which it applies and methodological approach for calculating the CQCN return on assets, would need to be subject to binding dispute resolution by expert independent parties.

We also consider that if the expert independent parties are of the view that either or all of the methodology for calculating the CQCN return on assets, the adjustment mechanism and the time period for implementation proposed by an integrated Aurizon entity is/are unreasonable, the expert independent parties can either amend it/them or require the SUFA Trustee be paid out or

be paid a defined rental stream based on the notional rental stream. We are of view that this is necessary to ensure an integrated Aurizon entity has sufficient incentives to ensure its proposals are fair and reasonable.

Overall, we consider that this approach avoids attempts to allocate costs in an environment where the prices attached to specific services need not be cost reflective. Further, by focusing on the CQCN as a whole (above- and below-rail services), the approach does not provide an incentive to appropriate the value attributable to the below-rail service to other services.

1.6 Process going forward

In the context of this discussion of our recent thinking regarding SUFA rental streams in the event of the CQCN declaration expiring or being revoked, we would welcome stakeholder views on:

- the extent to which they consider the CQCN declaration expiring or being revoked may have implications for
 - the application of section 95 of the QCA Act
 - the Specific Security Agreement and EISL in our Draft Decision SUFA documents,in the context of an environment which includes both access agreements and CITS-type agreements
- the options outlined for the calculation of SUFA rental streams if the CQCN declaration expires or is revoked
- any other options stakeholders may consider relevant if the CQCN declaration expires or is revoked.

The closing date for submissions is Tuesday 26 April 2016.

ACRONYMS

A**B****C**

CQCN Central Queensland Coal Network

CITS A commercially integrated transportation service for which the provider incurs both below-rail costs and Other Transportation Costs and charges its customer an integrated fee for transportation services rendered to it.

D**E**

EISL Extension Infrastructure Sub-Lease

F**G****H****I****J****K****L****M****N****O****P**

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