



17 February 2017

Professor Roy Green  
Chairman  
Queensland Competition Authority  
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Dear Professor Green,

### **Aurizon Network's 2017 Draft Access Undertaking – First round of submissions**

BHP Billiton Mitsubishi Alliance (BMA) welcomes the opportunity to provide a submission to the Queensland Competition Authority's (QCA) on Aurizon Network's 2017 Draft Access Undertaking (2017DAU) and provides this submission on behalf of both BMA and BHP Mitsui Coal (BMC).

BMA's overall conclusion is the 2017DAU should not be approved in its current form. Once QCA's consideration progresses however, BMA is confident more balanced terms and conditions will result.

BMA has considered the arrangements in its joint capacity as an access holder with a portfolio of mines and rail operator (and holder of a Train Operating Agreement (TOA)) on the central Queensland Coal Network (CQCN).

BMA supports the comments made by the Queensland Resource Council (QRC) in its submission to the QCA on Aurizon Network's 2017DAU. In the interests of not restating QRC's detailed comments and analysis, BMA has sought to provide additional comments on particular aspects only where it believes necessary. These comments are provided separately for price and non-price matters (**Attachment 1**).

BMA is hopeful the 2017DAU assessment and approval process will progress in a timely manner and BMA looks forward to working with stakeholders, including Aurizon Network, during the post submission consultation phase with a view to limiting (or at least narrowing the scope) of contentious matters for consideration as part of this process.

BMA confirms this submission is not confidential and is able to be published on the QCA's website in its current form. If you have any queries or require further information, please feel free to contact Emma Green on (07) 3229 2585.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Geoff Streeton', with a long horizontal flourish extending to the right.

Geoff Streeton  
Head of Business Development  
BHP Billiton Mitsubishi Alliance

# Attachment 1

## 2017DAU – Price matters

BMA agrees with the summary provided in Aurizon Network’s 2017DAU submission on market conditions – notably, the volatility faced in recent times by coal industry participants (and the sector more broadly). It is also true that coal producers’ unequivocal focus has (and will continue) to be firmly set on cost minimisation and productivity – in fact, various independent studies point to Australian coal miners being among the most effective worldwide at reducing production costs in response to market conditions<sup>1</sup>.

Given this, industry finds it difficult to genuinely support Aurizon Network’s response to such conditions, as set out in its 2017DAU. Markedly different from industry’s proven response, Aurizon Network proposed an 11% increase in average CQCN tariffs during the UT5 regulatory period, despite frequently relying on a similar geography of suppliers, labour markets and other cost inputs as the Queensland coal industry. In addition, Aurizon Network considers the circumstances support increasing its annual revenues to compensate it for the volatile conditions faced, including due to the consequential increase in customer risk caused by this volatility.

BMA supports the QRC’s analysis and comments on all price aspects of the 2017DAU and welcomes the QCA’s more in depth review of the supporting information Aurizon Network has provided as evidence the 2017DAU tariffs are reasonable and reflective of efficient and appropriate underlying costs.

### No supporting evidence for changes in approach – the case of WACC and inflation

Aurizon Network has modified parameters that impact the level of access charges in the 2017DAU – notably its proposed approach to WACC (parameters) and inflation.

BMA does not support deviating from accepted approaches and methodologies generally, except where there has been a material change in circumstances, information or reasoning to justify it. BMA does not believe this to be the case with regard to Aurizon Network’s approach to:

- WACC (parameters) – where change appears to rely less on recent assessments and relevant regulatory decisions (including the supporting evidence used to form them)<sup>2</sup> and more on ensuring a desired (higher) level of return is achieved; and
- forecast inflation – where Aurizon Network has shifted from using the accepted approach (mid-point RBA estimate) in favour of its own (lower) estimate, which again appears to rely less on recent assessments and decisions and more on improving cash flows when calculating annual revenues.<sup>3</sup>

In both cases (i.e. WACC and inflation), BMA strongly supports the QRC’s more detailed comments on these matters and continues to support the QCA’s consistent application of accepted methodologies and parameters, unless it is satisfied an alternative (such as Aurizon Network has proposed) is demonstrably more appropriate. This is important for regulatory certainty, which has broad implications including on future investment and decision-making for all stakeholders, including Aurizon Network.

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<sup>1</sup> Reserve Bank of Australia (2015), ‘Developments in Thermal Coal Markets’, Quarterly Bulletin, June, p. 26-27. Note, Bulletin focuses on issues facing the thermal coal market and discusses matters facing the coal industry (and producers) more broadly.

<sup>2</sup> The QRC’s submission sets out the detailed particulars of the 2017DAU WACC proposal. BMA strongly supports the assessment and conclusions presented in QRC’s submission.

<sup>3</sup> Inflation was a matter assessed by the QCA recently as part of the DBCT regulatory arrangements.



## Maintenance costs

Akin to other cost aspects, BMA finds Aurizon Network's proposal with respect to maintenance costs genuinely difficult to support.

BMA acknowledges Aurizon Network's efforts to increase transparency, information on maintenance planning, performance and forecasting, including the workshop it held prior to submitting the 2017DAU – however, a complete assessment can only be made by the QCA, using information forming the basis of the proposed maintenance cost build up industry is not privy to.

BMA has completed a cursory review of key cost inputs using the aggregate cost information and scopes provided. In general, BMA finds it challenging to understand how various improvements, productivity initiatives, technology advancements and better information have not impacted (reduced) the overall level of costs proposed, or resulted in significant scope increases able to be performed at the same level of costs.

In addition, in proposing scopes for key maintenance cost activities (the basis for determining overall costs), it is not clear whether past performance has been taken into account. This is important given actual delivery of maintenance scope has been a concern for industry in the past – specifically, Aurizon Network's performance of actual to planned scope was a key issue highlighted in assessing UT4 maintenance costs, with comparisons showing distinct differences (under-performance).

## The case of Ballast Undercutting

Aurizon Network has raised concerns with the appropriateness of using the UT4 QCA approved scopes (in km) for mainline ballast undercutting as part of its 2017DAU proposal – its view was UT4 scopes were too low and, based on its assessment using GPR data<sup>4</sup>, not sufficient to maintain the current condition of the network. In addition, BMA notes the 2017DAU ballast undercutting costs include the 'catch-up' scope from FY15-FY17 (the difference between QCA approved scopes and Aurizon Network's (preferred) GPR based scopes).

Assuming Aurizon Network's assessment of the required scope is correct (BMA is not in a position to comment otherwise), there is no insight provided on actual performance against either the QCA approved or its GPR preferred scope and how this forms part of the 2017DAU proposal.

The 2017DAU proposed cost for ballast undercutting is 12% higher (in real terms, 19% in nominal terms) compared with the approved UT4 allowance, noting the cost is based on:

- a unit rate of \$400k/km (UT4 approved) which Aurizon Network believes insufficient to cover costs required for an effective regime<sup>5</sup> (however, Aurizon Network says it will accept this rate to expedite the assessment process);
- the costs associated with the 18km of 'catch-up' scope<sup>6</sup> included in the final two years of the regulatory period (FY20 and FY21)<sup>7</sup>; and
- the introduction of the new ballast machine, in conjunction with the purchase of 24 additional spoil wagons in UT4, which Aurizon Network says increases its capability and allows it to achieve: greater production efficiencies due to: spoil wagons not having to be emptied as often; and cost efficiencies due to: reducing the need to use the more expensive excavator for undercutting<sup>8</sup>.

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<sup>4</sup> Ground Penetrating Radar (GPR)

<sup>5</sup> 2016, Aurizon Network Submission – 2017 Draft Access Undertaking: 167

<sup>6</sup> From FY16 and FY17

<sup>7</sup> 2016, Aurizon Network Submission – 2017 Draft Access Undertaking: 166

<sup>8</sup> 2016, Aurizon Network Submission – 2017 Draft Access Undertaking: 169



Together, this information raises a number of questions around whether the scope and costs proposed in the 2017DAU are reasonable:

- has Aurizon Network achieved the scope it was compensated for under the UT4 maintenance cost allowance such that industry can be satisfied it is appropriate to include ‘backlog’ scope and costs in the 2017DAU?;
- is there benefit in using an alternate approach to set the scope – for instance, setting a base scope based on the information available (the last GPR run in 2014) and reassessing scopes mid period (prior to commencement of the new ballast undercutting machine)? This would allow Aurizon Network to, consistent with its stated goals, use a ‘data driven, evidence based’ approach in determining its ballast undercutting program? (noting the next GPR run planned FY19);
- how are the efficiencies of introducing the new ballast machine accounted for in the cost estimates, including from a holistic perspective incorporating the associated indirect costs (return on assets)?; and
- is Aurizon Network proactively managing its portfolio of goods and services suppliers to ensure the lowest possible costs are being accessed and passed onto its customers?

Using the aggregate cost and scope information provided in Aurizon Network’s submission, BMA compiled a summary of ballast undercutting metrics below. This shows – for direct costs, the unit rate is higher than the UT4 approved rate (in real terms) and there is no material improvement between unit rates achieved pre and post introducing the new ballast cleaning machine (<1%). In addition, indirect costs increase by 37% due to the return on assets associated with the new (ballast undercutting) machine.

**Table 1: Summary of information supporting 2017DAU Ballast Undercutting Costs**

Cost Category	2017DAU Key ballast undercutting metrics	First 2 years (FY18 and FY19)	Last 2 Years (FY20 and FY21)	Difference
<b>Direct Costs</b>	<b>Average spend (\$M Real)</b>	\$62.0M	\$65.6M	+\$3.6M
	<b>Avg scope (km)</b>	140	149	+9km
	<b>BMA Calculated average unit rate (\$M / km)</b>	\$0.443M / km	\$0.441M / km	-\$0.002M / km [-0.5%]
<b>Indirect Costs</b>	<b>Return on Assets</b>	\$5.75M	\$7.85M	+2.1M [+37%]

Source: Direct cost and scopes Aurizon Network submission (Table 27 and 28: 166), Indirect costs (Table 39: 189).

These metrics however must also be considered against Aurizon Network’s views that the unit rates:

- are insufficient in FY18 and FY19 (and it will not be able to meet them and perform all required activities); and
- may be achieved in FY20 and FY21 if introducing the new ballast cleaning machine delivers the anticipated efficiencies.

If this is the basis on which forecast scopes and costs are determined, it is not clear how efficiencies or productivity improvements can be monitored, analysed and (ultimately) presented in support of its cost proposals, both now and in future – further, while increased scopes are built into the cost estimates, it is not clear how likely they are to be achieved. An overall cost / benefit analysis is required to piece together individual components and provide a logical, evidence driven outcome industry can comfortably support.



This issue is not new or specific to the forthcoming regulatory period. This considered, perhaps the overall regime needs to be reviewed for appropriateness going forward: stakeholders are locked in a one way cycle only involving intense scrutiny of maintenance costs and scopes in advance of an undertaking approval, with no mechanism to consider performance during the period (including to assist forming views on subsequent regulatory periods).

For the same reason, it is not clear whether overlooking past performance in favour of using a 'base year' is an appropriate way to determine future costs, particularly when the regime does not provide for mid-term updates. In this approach, the base year may provide a poor reflection of years to come.

Accordingly, BMA relies on the QCA to form its own views on the efficiency and appropriateness of Aurizon Network's 2017DAU maintenance cost proposal, based on detailed information and specialist assessment.

## **Non-price matters**

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BMA supports Aurizon Network's efforts to minimise the extent of amendments / shifts in policy in approaching the 2017DAU and focussing on addressing matters of practicality, workability and/or efficiency. This is an appropriate approach given the time and effort (by all) contributing to the UT4 approval process finalised quite recently.

That said, BMA is mindful this criteria is somewhat difficult to apply in the context of UT4. In light of the relative timeframe over which an objective assessment of practicality, workability and efficiency can be made (UT4 was approved in October 2016), 2017DAU amendments proposed to address such criteria must be carefully considered.

BMA supports the QRC's analysis and comments on all non-price aspects of the 2017DAU and welcomes the QCA's more in depth review of the supporting information Aurizon Network has provided as evidence the 2017DAU arrangements are reasonable and reflective of an appropriate balance of interests between parties.

## **Relinquishment provisions and payloads**

BMA supports the inclusion of mechanisms within the regulatory arrangements to encourage and appropriately account for productivity improvements across the supply chain. Such progression is required and, over time, will result in gradual amendments to arrangements to reflect the evolution of Aurizon Network (as a service provider) and industry (as users' of the regulated network).

A key consideration in relation to any regime introduced, is understanding how the changes impact all stakeholders, both at an underlying principal level and from an ongoing operational perspective. It is BMA's view the proposed package of amendments relating to payloads and relinquishment introduces changes at both levels.

Train paths are currently the primary capacity currency for accessing the network (and have been under previous regulatory arrangements). Given this, related mechanisms in the undertaking regarding capacity management from an ongoing operational perspective, including relinquishment (and transfer) provisions, were designed to reflect this – i.e. contracts include an access holders' capacity entitlement in terms of train paths, the resumption test allows Aurizon Network to reduce an access holders' train paths in the event of ongoing underutilisation (similarly, transfer provisions provide the ability to exchange train path usage between load points and customers). There was not a mechanism included to allow access holders to update operational parameters, including for changes to payloads.



Introducing the contemplated package of amendments (in a form largely reflective of the proposed approach), changes the way capacity is considered. It expands capacity (in terms of train paths) to include access holder driven performance factors (i.e. payloads).

On one hand, if Aurizon Network's service product is a train path (and this is the basis on which access holders have contracted), some would argue the amount of tonnes carried on that train path is irrelevant and maximising the usage of each train path (or not) is the customers prerogative (within the boundaries of network requirements). As such, while contracts could be updated to reflect actual operating parameters (increasing payloads), there should not be a trigger for varying train paths in the event of increased payloads. Overall, customers haul more and, all other things being equal, total throughput increases and efficiencies result by doing this with no change (increased) consumption of capacity (train paths).

The proposed regime introduces alternate dynamics and views. With a new variable considered in the mix, the new capacity currency is now tonnage, with train paths the by-product – i.e. train paths are determined by reference to the amount required to haul the customers' desired tonnage. As such, contracts would be updated to reflect actual operating parameters, along with consequential amendments to match the number of train paths now required. Overall, customers haul the same, all other things being equal, but create efficiencies by using less paths to do so.

BMA is not suggesting one regime is preferable to the other, each have unique advantages / disadvantages when considered in the context of creating efficiencies on the network. The key is – which of the two regimes will encourage and incentivise behaviour most effectively to create the overall system performance improvements desired by all.

Aurizon Network has rightly stated operators and access holders have greater control over the train payload employed to utilise access rights. Given this, and the fact an access holder would need to actively seek means to increase payloads (often at a cost), BMA believes any mechanism introduced should provide access holders with the right to decide whether train paths in their contracts are retained (or reduced) in the event of updates to operating parameters – with reductions creating available capacity in the system to be contracted by other users. This ensures efficiencies can be accounted for with regard to the party that has been able (and responsible) for creating them.

BMA is also of the view access holders should have the right to relinquish train paths free of charge as a result of creating operating efficiencies. If an access holder must pay to effectively operate more efficiently (i.e. haul the same tonnes using less train paths), there is no incentive to change from the status quo and make (sometimes costly) improvements that ultimately free up capacity for the overall benefit of the network.

BMA recognises this view is not held by all because of concerns the fee, if not paid by the relinquishing party, may need to be recovered by other users' on the system via the revenue cap mechanism. However, the views expressed by BMA in assessing and approving the UT4 arrangements remain unchanged – similar forms of cost spreading already exist and form part of the price and revenue cap regime in operation. For example, the revenue cap mechanism combines revenue differentials (under / over recoveries in the revenue cap) and recoups / returns these across all users of the system, regardless of the extent to which individual variations contributed.

### **Transfer Provisions – process separation and return of 2 year fee free period**

BMA supports having separate processes for short-term, permanent and customer initiated transfers of access rights. While the intent of UT4 (which has been mostly duplicated in 2017DAU arrangements) was to streamline arrangements and reduce complexity, the combining of processes has not had the

desired result. Until such time as an alternative can be agreed, including with the broad support of parties using the process, returning to arrangements that separately identify the process to be followed according to the type of transfer sought (per UT3 arrangements) would be BMA's preference.

In addition, BMA supports having a fee-free period for short-term transfers, but remains of the view the 1 year period proposed in the 2017DAU (introduced in UT4) is too short. The views expressed by BMA in assessing and approving the UT4 arrangements remain unchanged – that is, a 2 year fee-free period (per UT3 arrangements) increases flexibility and allows BMA to better manage the inevitable mis-alignment between mine production to customer (port) requirements. Also, this time period provides sufficient time to assess performance and allow for informed decisions on whether other alternatives (such as a permanent transfer) should be made to address ongoing mis-alignment.

BMA notes discussions between Aurizon Network and industry on 2017DAU policy matters, particularly how transfer options are set out more specifically within the undertaking and the length of the fee-free period, is likely to be an area where progress can be made.

### **Access Conditions**

BMA is supportive of 2017DAU amendments to the extent they clarify the scope of access condition arrangements – i.e. if current provisions unintentionally expand the application of access condition arrangements (to cover all non-standard terms agreed, not only those considered material in nature), changes need to be made so the provisions operate as practically intended.

BMA is otherwise not supportive of amendments impacting the process or scope of QCA review and approval of access conditions and strongly supports the views presented by the QRC on this matter.