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7 June 2013

Mr Malcolm Roberts
Chief Executive Officer
Queensland Competition Authority
GPO Box 2257
Brisbane, Queensland 4001

By email: rail@qca.org.au

Dear Malcolm

Aurizon Network's 2013 AT5 DAAU

Thank you for the opportunity to provide a submission on the Aurizon Network 2013 AT5 DAAU.

The AT5 DAAU proposes to include a new Schedule K in the 2010 Access Undertaking (UT3) (and presumably in UT4) which implements the following principles:

1. AN determines an initial fixed AT5 tariff for UT4 and UT5 (ie 8 years of $3.05/'000 egtk)
2. The initial fixed AT5 tariff has been determined based on certain variables under UT3 and would be revised once UT4 (and presumably UT5) are approved (eg WACC and tonnage) and does not reflect the actual average cost of providing electric services.
3. Any revenue shortfalls (arising from fixed AT5 tariff which is designed to encourage use of electric over diesel) during this period are capitalised and recovered at the end of UT4 and UT5 in lump sum amounts via an Under Utilisation Payment (UUP)
4. Because AN believes the imposition of a fixed AT5 tariff rather than a revenue cap exposes it to volume risk (either due to modal choice or overall system volumes being lower), AN proposes to levy a UUP on all users of the Blackwater system at the end of UT4 and UT5 if there is a shortfall in AT5 revenue. The UUP is charged to all users of the Blackwater System regardless of traction choice
5. Whilst not stipulated in the AT5 DAAU, Aurizon has subsequently clarified that it intends to allocate the recovery of the UUP amongst customers in proportion to actual tonnes railed as opposed to contracted tonnages.

Glencore Xstrata (GX) does not support AN's proposed DAAU. GX considers that the AT5 DAAU:

- remains erroneously premised on the assertion that on a Total Cost of Ownership basis electric traction is superior to diesel traction;

- is likely to provide a competitive advantage to, and favour, Aurizon's vertically integrated above rail business which has a pre-existing significant investment in electric consists and that the socialisation amongst diesel users of the UUP will disproportionately injure other operators
- will impose significant cost increases on users (including GX) in circumstances where they may be unlikely to obtain any benefit and are, in fact, being penalised for existing diesel investment decisions (noting those decisions may have been made precisely because there was insufficient electric capacity available at the time the haulage agreements had to be entered and that the lack of the electric capacity was due to poor project management by AN); and
- will impose significant cost increases on users (including GX) that have not in fact contributed to the issue. In particular the allocation of UUP based on tonnes railed as opposed to tonnes contracted would have the perverse effect of penalising those that railed at their contracted levels while leaving those that potentially contributed to the revenue shortfall proportionately better off; and
- shifts all of the cost of poor earlier practices by Aurizon to customers while leaving Aurizon whole.

Electric vs Diesel Efficiency

GX notes that the economic analysis presented by AN in support of the superiority of electric traction has a very narrow scope and is heavily qualified. Indeed the assertion that electric utilisation of the Goonyella system is nearly 100% due to profit-maximising decisions of private firms and that a diesel dominated system would have eventuated had electric traction not been the more efficient traction mode could equally be applied to the justify the dominance of diesel services on the Blackwater system (a situation AN via the AT5 DAAU seeks to artificially and retrospectively alter). Namely profit-maximising decisions of private firms have dictated that diesel is the preferred traction choice on Blackwater, this being the effect of competitive choices exercised by customers and rail operators.

Accordingly, GX reiterates its previously raised concerns that there is far from compelling evidence that electric traction is superior to diesel traction and notes the various compelling earlier submissions on this matter which cast sufficient doubt as to the veracity of this assertion.

Undermining above rail competition

The AT5 DAAU variously seeks to justify the setting of a fixed AT5 charge at a level that does not distort traction choice against electric haulage. If implemented the DAAU will, in fact, distort traction choice against diesel haulage. There is an inherent inequity and inefficiency in such an outcome and the socialisation of an electric revenue shortfall across all Blackwater system users (ie including diesel) would appear to ignore cost reflective pricing principles inherent in National Competition Policy.

However, of greatest concern is that the practical effect of the DAAU will be to undermine above rail competition through the effective cross subsidisation by an operator with proportionately less electric assets than Aurizon operations. Any regulatory outcome that has the effect of lessening competition in above rail market must run counter to the objectives of competition policy and access regime objectives.

Inequitable Imposition of Costs

There are three general concerns under this heading:

1. Investment Certainty Impinged

   The imposition of costs on diesel users ignores the fact that investment decisions were made in the context of available traction capacity at the relevant time and in the expectation that stand alone cost reflective pricing principles would continue to be applied by the regulator.

   In consultation Aurizon noted this was a concern and undertook to provide protection to users where such investment decisions were made. No such recognition is contained within the AT5DAAU.

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2. Revenue shortfall recovery is skewed in favour of those that potentially most contributed to the issue.

   The UUP allocation basis is not stipulated by AN (beyond noting a preference to socialise the charge across all Blackwater System users). However, the Sapere report notes (at page 14) that "the proposed allocation by net tonnes is the best option". If UUP is allocated on net tonnes railed as opposed to contracted this would have the perverse effect, that even if a user does not contribute to the shortfall (ie they rail at contract and even use electric services) they will pay a higher proportion of the UUP than a producer that under –railed and used diesel.

   If there is to be any revenue recovery adjustment mechanism then it must be allocated by reference to contracted capacity not net tonnes railed. In addition, where an access agreement stipulates electric paths the revenue adjustment should be applied first to against the short-run electric paths then more broadly.

3. Aurizon obtains a risk free outcome for poor prior decisions and project management.

   In consultation Aurizon acknowledged that their project management of the Blackwater power system upgrade project was not well managed by them. If the delays experienced in the full delivery of the project have contributed to the reduced usage of electric traction on the Blackwater system (including because operators/users, had no choice but to select diesel), Aurizon should bear some of this risk.

   The AT5 DAAU cites the QCA staff discussion paper as noting that the AN regulated WACC does not compensate AN for asset stranding risk for customer approved investments.

   Industry has consistently raised concerns with the CRIMP process and paucity of verifiable information. Accordingly, while the power upgrade project may not have received a negative vote, it is industry's contention that insufficient information was provided as part of the approval process to make a fully informed decision. This should therefore not absolve AN fully from asset stranding risk.

   As a general observation, if AN is not exposed to stranding risk, volume risk, performance risk or optimisation risk it is difficult to understand why their regulated WACC does not equate to the risk free rate rather than closer to 10%pa.

In summary GX believes the QCA should reject AN's AT5 DAAU because:

- We do not believe any change in the regulatory arrangements surrounding electric traction are required as AN could address the 'issue' by simply lowering the rates and encouraging more electric assets on the network
- AN should consider writing down the asset given their acknowledged complicity in the way the investment decision and approval was handled and their mismanagement in delivering the electric capacity 2 years late (which resulted in producers having no choice but to contract diesel trains in the meantime)
- The proposal to socialize any shortfall across all system users (other than those that contracted diesel services due to the delay in delivery of the electric capacity) is inequitable and creates a dangerous precedent.
- We are also concerned that AN seems to be adopting the concepts proposed by the QCA in its Issues Paper on this topic notwithstanding that the QCA clearly indicated that the issues paper did not represent the final considered views of the QCA. AN appears to be of the view that a submission in line with the Issues Paper would be supported by the QCA.

However, if notwithstanding the objections of stakeholders, the QCA is minded to approve a modified form of the UT5 DAAU, GX submits that the following principles must be incorporated in any amendments to the UT5DAAU:

- AN must bear a reasonable proportion of the risk of under-recovery given their role in the various factors that have led to this outcome;
- Any UUP must first be applied to underutilised contracted (on Take or Pay basis) electric paths before any remaining shortfall is allocated to diesel users;
- Allocation to diesel users must be based on contracted capacity not net tonnes railed;
- The application of such a mechanism must not be seen as precedent for resolution of future stranding risk issues, nor should this been seen as any endorsement of cross subsidisation generally.

Finally, GX remains of the view that there are more pressing matters to be addressed such as the SUFA (including the extension process), UT4 and system rules. We believe the AT5 issue should not be singled out for urgent resolution; rather it should be managed as part of the UT4 process.

If you would like to discuss any aspect of this submission further, please contact Dierdre Mikkelson on 3115 5396.

Yours sincerely

[redacted]

Anthony Pitt
Glencore