Professor Flavio Menezes
Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001

Queensland Rail's 2020 Draft Access Undertaking (DAU2)

11 July 2019

Dear Professor Menezes,

Aurizon Bulk welcomes the opportunity to respond the Queensland Competition Authority's (QCA's) Draft Decision (DD) on Queensland Rail's (QR's) 2020 Declaration Review.

Aurizon Bulk welcomes the opportunity to respond to the Queensland Competition Authority's (QCA's) Draft Decision (DD) for Queensland Rail's (QR's) 2020 Draft Amending Undertaking (DAU2) dated April 2019. This submission is further to our submission to the QCA on DAU2 dated 17 October 2018.

Aurizon's above rail operations are conducted in two separate and distinct markets. Aurizon Coal has lodged separate submissions with respect to issues within its areas of interest. This submission relates only to Aurizon Bulk's areas of interest.

Aurizon Bulk is responding by exception. That is, Aurizon Bulk is identifying areas of key concern. Issues raised in DAU2 but not addressed in this document should be taken as either agreed to by Aurizon Bulk, or outside of Aurizon Bulk's area of interest.

In most cases, Aurizon Bulk both manages and holds access rights on behalf of its customers, and on-charges QR's invoiced amounts to its customers without mark-up. That is, Aurizon Bulk's returns, and its cost of managing access rights on behalf of its customers, are recovered through above rail haulage agreements with its customers. As such, the direct cost implications of DAU2 and any decision made by the QCA are largely borne by our customers and Aurizon Bulk makes its submissions in the interests of those customers. It is also in Aurizon's interest to the sustainability of its business to ensure the viability of its customers, and the competitiveness of rail over alternate means of transport.

QR usually conducts negotiations for the right to access its rail network with rail operators like Aurizon, rather than directly with the customer that ultimately pay for the access charges. As such, QR is detached from the market in which it prices, at least in the context of direct commercial dealings with parties ultimately responsible for payment of access charges.

Pricing Rules (Part 3)

The QCA's DD dedicated 63 of the 170 pages to the approach to tariffs in the West Moreton system, and sought economic advice from consultants in determining and evaluating its recommendations for this system. There are extensive, useful explanations for its decisions in the West Moreton system. The pricing rules for all other systems, which are far more geographically expansive and affect a far broader base of ultimate customers and product types, are limited to pages 82 to 87; *six pages* in total.

According to QR's Financial Statements for the year ending 30 June 2018[1], the West Moreton system provided the lowest revenue from access charges of the three categorised rail systems; West Moreton $42.75m, Mt Isa $74.3m and North Coast $46.3m. Aurizon Bulk notes that there are two major customers on the West Moreton system that provide regular rail volumes and that other systems have two or more customers each. The level of price reform and price certainty afforded to customers on the West Moreton line has and remains disproportionately greater than that afforded to any other customer across QR's rail network.

QR's ultimate customers for, and rail operators that use, the rail systems outside of the West Moreton system deserve similar transparency and certainty. This is particularly so given that access charges provided 76% in FY18 and 82% in FY17 of QR's revenue access charges charge revenue for non-passenger services. Customers outside of the West Moreton system have committed significant investments to facilities that support their rail supply chains and remain directly affected by the decisions of this DAAU2. Disappointingly, it appears that the pricing certainty and transparency afforded by the DD to West Moreton rail network users continues to be withheld from non-West Moreton rail network users.

QR's rail pricing across its systems is amongst the highest in Australia on a cost per thousand GTK basis (the common metric used by rail network owners). QR operates in similarly challenging and diverse conditions as other rail network owners across the country. According to its financial statements its costs for these systems continue to increase, in particular in areas not specific to enhancing rail performance, despite the downwards shift in volumes. Meanwhile other rail network owners have maintained more reasonable pricing levels relative to QR, continue to improve their cost to operate relative to QR, all the while improving operating efficiency in their networks. Nothing in QR's submission nor the QCA's DD provides for an obligation on QR to improve its rail performance to a level commensurate with being the amongst the highest priced rail network owners in Australia. Nor is there any requirement imposed on it to adjust its cost to serve relative to any change in volumes.

[1] Queensland Rail Financial Statements for the Year Ended 30 June 2018 page 4.

Floor and Ceiling Price Limits (8.1)

In its submission of 17 October 2018, Aurizon Bulk argued that QR's pricing latitude, the gap between the floor and ceiling, is too significant. Aurizon Bulk's concern related to (and continues to relate to) the pricing structure which QR proposed be carried forward for AU1. This pricing structure seems to have been endorsed, or at least has not yet been queried, by the QCA. Aurizon Bulk put what it considers to be the very reasonable request that the methodology by which the Floor Price for these systems is determined be disclosed. It has not been disclosed, and the Ceiling Revenue Limit remains in place. Aurizon Bulk cannot understand, and has not been provided any information or justification to enable it to understand, the very high Ceiling Revenue Limit afforded to QR. This remains a significant concern for Aurizon Bulk.

QR argues that it is disincentivised to price unreasonably due to the implications of the loss of business from rail on its networks. According to its own statements, QR continues to enjoy earnings above the Floor Limit despite access revenue decreasing due directly to lost rail volumes in key corridors, including the Mt Isa line. QR has not adjusted its access charges in response to the declining volumes. QR has done the reverse; it has taken advantage of the latitude afforded to it under the present structure on numerous occasions by increasing the cost of access to users substantially.

By way of example, consider 'Customer A' which is heavily invested in supply chain assets dedicated to rail in the Mt Isa system and has been for more than a decade. Customer A's access renewal price is proposed to increase by 23% despite an improvement in rail efficiency provided by its rail operators improvements in design (28% increase on a like for like basis). Customer A's opportunity to shift volumes to road is limited given the scale of its sunk rail investment. It cannot economically switch due to the impact on profits and disruption to production whilst it modifies facilities to support a road solution and disposes of its redundant rail assets. Customer A's products are unique to other producers in the same region so QR is no under no obligation to consider price differentiation rules influenced by the precedent of other existing access agreements. Customer A's products are not as valuable as other producers on the Mt Isa line yet they have been priced, on a price per thousand GTK basis, at the same levels as producers whose products sell for up to 750% to 1,500% per tonne more than Customer A's product sale price. It Aurizon Bulk's understanding that Customer A's annual business planning processes did not contemplate such as substantial increase in the cost of its rail supply chain. QR has demonstrated a complete unwillingness to negotiate a more reasonable increase. QR advised that QR believes the customer can afford the increase. Customer A can either:

- absorb the increase provided by QR and reduce its annual earnings,
- subject itself to the expense of facility upgrades, potential interruptions to production and other business risks, and potential negative community and Government sentiment, to transfer to a road-based supply chain; or
- close their business.

If a road-based supply chain is not viable (which could occur even if it was projected to be a lower cost solution), and the Customer A is unwilling or unable (for example, because of supply contracts) to close its business, it has no alternative but to absorb the substantial increase. This is not a negotiation and nor is it flexible stated on page 84 of the DD.

Customer A's business requires certainty and consistency over the costs of its operation in order to make the long-term decisions it needs to be sustainable. Customer A enjoys an environment of competitive tension for the majority of its other contracted services and therefore has confidence in its business planning processes, but for the pricing behaviour of its monopoly service providers. Customer A is a large employer both directly and indirectly and its survival is in the public interests of Queenslanders, particularly those in the region in which it operates. Customer A's circumstances are not an isolated case. There are numerous examples of QR increasing prices substantially when provided the opportunity.

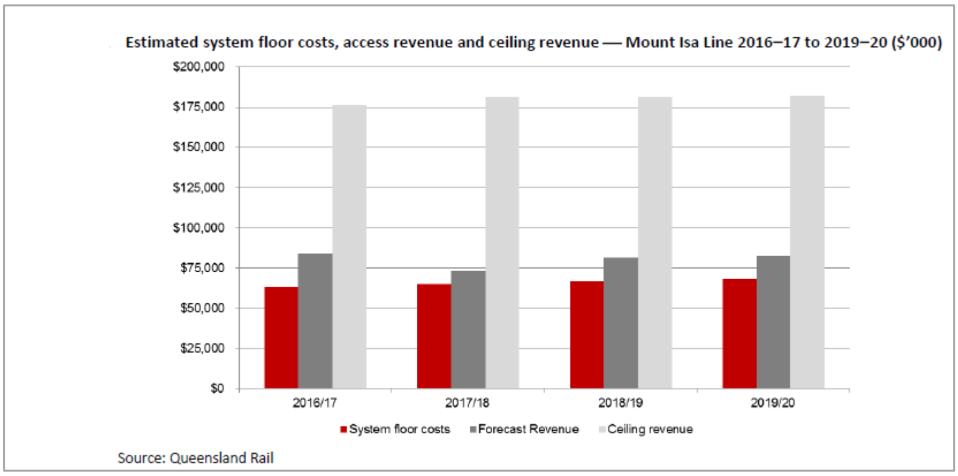
West Moreton customers are not exposed to this level of price increase except where volumes significantly shift across the rail network in which it operates. West Moreton customers can prepare business plans with far greater certainty than users in other QR rail systems.

Aurizon Bulk's submissions have not opposed QR's right to a reasonable return. Aurizon Bulk notes section 168A(a) of the Pricing Principles under the QCA Act 1997, which state "The pricing principles in relation to the price of access to a service are that the price should—

(a) generate expected revenue for the service that is at least enough to meet the efficient costs of providing access to the service and include a return on investment commensurate with the regulatory and commercial risks involved;"

QR's graph shows that it is entitled to earn up to $175mpa in access charges for the Mt Isa line, 230% more than it earnt in FY18. This is level of earning potential is unreasonable.

Figure 1 - QR Mt Isa Line Estimated Floor & Ceiling Revenue Capacity Based on Forecast Volumes



Aurizon Bulk restates its previous submission that the methodology for calculating the Ceiling Revenue Limit is too generous to QR. It is also inappropriate as it contemplates below rail rates that are substantially above what the market can bear. A floor and ceiling approach to setting rates is reasonable provided that the floor and ceiling are reasonable. In setting floor and ceiling rates, regard must be had to market conditions for each of the rail systems that QR manages, and a reasonable rate of return for each (refer **Error! Reference source not found.**). The formula for calculating the floor and the ceiling rates must be disclosed to users and potential users of the rail networks to which the floor and ceiling rates apply.

Further, it is reasonable to assume that the Floor Limit calculation in AU1 and DAAU2 is a function of both rate and volume, that is, a floor limit is achieved by the combination of both rate and volume not one lever in isolation. QR does not appear focused on responding to market signals by changing its price structure to suit. It relies on merely distributing more of the cost through price to existing customers. Presumably, in most open markets, declining volumes where price is a factor would see service providers respond accordingly. Perhaps the clue in QR's approach to its pricing structure is contained in their response to submissions on DAAU2 where they claim that they ought not be required to redistribute the benefits of any revenue growth afforded to it to the customer base. Notably this is different to users of the West Moreton system.

The Queensland Government has recognised that the cost of rail, particularly on the Mt Isa line, is too high and has announced $20m per annum in funding to rail users. This further calls into question the appropriateness of QR's pricing structure. Aurizon Bulk does not agree with the current or proposed approach, and this view is shared by Aurizon Bulk's customers that use its rail networks.

Price Differentiation (8.2)

Aurizon Bulk remains concerned that QR could develop a process to support a bidding war for access, and for the reasons described above, does not agree that the Ceiling Revenue Limit in its proposed form is reasonable. The argument the QCA discusses on page 86 of the DD is very similar to the example provided above. Aurizon Bulk agrees in principle with the approach taken by QR to improve the rigour around price differentiation rules, but this must be done in conjunction with a more reasonable restraint on price flexibility.

Operating Requirements

Removing the Manual from DAU (9.1.1)

Aurizon Bulk seeks an explanation, including examples, of minor amendments to the Operating Requirements Manual that may sit outside the schedules in DAAU2.

Network Management Principles

Special Events (9.3)

We do not agree that QR should be able to amend the MTP or DTP in the way described for Special Events as it does not consider the impacts to rail users and does not force a strong enough consultation process. The current process typically favours the interests of passenger services over non-passengers services.

On-time Windows (9.6)

We agree and recommend that the latitude proposed in the 15 minute structure be limited to areas outside of the Brisbane Metro network.

Train Priority (9.7)

We do not agree with the DD in respect of train priority. For practical reasons a controller is not consulting the Undertaking when making decisions. There is no reporting mechanism that allows operators to challenge decisions made by controllers, nor is there a requirement for the rail operator to be provided information from QR. Poor decision making in train control leads to additional costs for rail operators, such as additional crew hours required to move products, excess overtime, increased risk of fatigue and potential penalties with customers in meeting KPI targets.

In Aurizon Bulk's experience, QR's responses to questions about its decision making are often general and vague, to the point that it creates ambiguity for rail operators around future decision-making processes. This forces rail operators to bear the financial consequences of being unable to plan in the context of a known decision framework. It is unreasonable that this decision-making does not have to be explained to, and is unable to be challenged by, rail operators. There should be transparency, and an opportunity for rail operators to participate in improving QR's processes for the benefit of all users.

Reporting

Quarterly Network Performance Report (10.1)

We agree provided it is 15 minutes.

Aurizon Bulk remains available for discussion on matters relating to its DAAU2 submissions by the QCA and QR and notes that the current process has been the subject of limited consultation beyond the process of formal submissions to the QCA. QR's engagement, whilst initially proactive, has diminished. As such the gaps between QR's expectations and those of users remain. Aruizon Bulk firmly recommends that stakeholders be provided an opportunity to engage in a direct forum in order to achieve an AU2 that is workable for QR and its users and achieves the objectives of the QCA. We note Aurizon Network's collaborative approach with coal users and other stakeholders in resolving UT5 and encourage QR to follow suit.

Kind regards,

David Wright
Commercial Manager
Aurizon Bulk