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SUBMISSION TO THE QUEENSLAND COMPETITION AUTHORITY

AURIZON NETWORK FY2014 REVENUE ADJUSTMENT AMOUNTS AND INCREMENTS

7 November 2014

1. Executive Summary

Anglo American Metallurgical Coal Pty Limited (**Anglo American**) thanks the Queensland Competition Authority (**QCA**) for the opportunity to make submissions on Aurizon Network's Explanatory Memorandum in relation to the FY2014 Revenue Adjustment Amounts and Increments.

Anglo American has long noted that incentivising monopoly infrastructure owners to engage in productive efficiency increases and to promote innovation should be a key aspect of appropriately applied monopoly regulation.

However, Anglo American believes that incentive mechanisms should only be applied where they are the result of extensive consideration and approval by the relevant regulatory authority. Anglo American does not believe that the incentive mechanism that Aurizon Network has suggested applying in its submission on the FY2014 Revenue Adjustment Amounts and Increments (ie, the "Increment") is the result of such an approval process.

On the contrary, Anglo American notes that the "Increment" exhibits many characteristics similar to the Draft Incentive Mechanism that Aurizon Network submitted in May 2012, which is yet to receive QCA approval and, during public consultation, received a negative welcome from the industry.

In particular, Anglo American submits that the "Increment" is inappropriate because:

(a) it rewards Aurizon Network for delivering capacity less than the contracted capacity that Aurizon Network has already been rewarded for through both actual revenue and Take or Pay Revenue;

(b) it rewards Aurizon Network for risk that it does not bear under the current form of revenue cap regulation. If Aurizon Network wishes to be rewarded on a volume and throughput basis, Anglo American believes that this should be done by implementing a price cap form of regulation, otherwise Aurizon Network should receive the consistent revenue stream associated with revenue cap regulation; and

(c) Aurizon Network should not be rewarded via a mechanism similar to the Draft Incentive Mechanism which it was required to implement under UT3 and is yet to achieve.

Anglo American has expanded on these submissions in detail below.

2. Risk and the form of regulation

Anglo American has previously made extensive submissions in relation to the form of regulation on the Central Queensland Coal Network (**CQCN**). In particular, Anglo American directs the QCA to:

(a) Anglo American, *Submission to Queensland Competition Authority re Queensland Competition Authority Pricing Papers* (July 2013), in particular see sections 3.2 and 3.4 of that submission;

(b) Anglo American, *Submission to the Queensland Competition Authority re Aurizon Network's 2013 Draft Amending Access Undertaking* (October 2013), in particular see section 10.1 of that submission;

(c) Anglo American, *Submission to the Queensland Competition Authority re Aurizon Network's Reply Submission on the 2013 Draft Access Undertaking* (January 2014), in particular see section 2.1 of that submission; and

(d) Anglo American, *Submission to the Queensland Competition Authority re QR's Rail Access Undertaking* (12 February 2010), in particular see section 2 of the Economic Insights consultant report attached to that submission.

Anglo American's previous comments have centred on the risk that different forms of regulation impose upon the monopolistic business being regulated. Specifically:

(e) "price cap" regulation ensures that where Aurizon Network has specific control over the volume and delivery of contracted capacity, it is appropriately rewarded for the risk that it bears in relation the capacity delivered, and the direct performance of Aurizon Network to increase the delivery of that contracted capacity; whereas

(f) "revenue cap" regulation (as is currently imposed on the CQCN), while not rewarding Aurizon Network for the specific volume of capacity delivered, gives Aurizon Network a clear and regular flow of revenue and profits based on the fact that there is a transparent mechanism for determining Aurizon Network's return on its invested capital.

Anglo American has previously commented both on the benefits and disadvantages of each form of regulation, including the fact that Aurizon Network is clearly incentivised to improve the throughput and delivery of contracted capacity when regulated under a price cap mechanism.

However, over the course of the development of both the 2010 Access Undertaking (**UT3**) and now the 2014 Draft Access Undertaking (**UT4**), Aurizon Network has maintained its desire to have a revenue cap apply to its regulated business activities. Even recently in its submissions as part of the UT4 process, Aurizon Network submitted that the AT_1 component of the Reference Tariff should be included in the revenue cap as "the exclusion of AT_1 from the revenue cap exposes Aurizon Network to volume risk".[1]

While the revenue cap form of regulation means that Aurizon Network is not incentivised to deliver more or less than the yearly contracted capacity, it also shields Aurizon Network from all (or almost all) the volatility and volume risk associated with conducting Aurizon Network's below rail business. This means that Aurizon Network and its shareholders bear little of the volatility that is inherent in the coal industry.

This is a legitimate decision that Aurizon Network has clearly made for the benefit of the consistency of its revenue stream and, assumedly, for the security of its shareholders, however, it means that Aurizon Network's regulated business profile should reflect the lack of risk that it adopts in relation to its Regulated Asset Base. In light of the ongoing revenue cap structure that applies to the Aurizon Network business, specifically the CQCN, Anglo American disagrees with Aurizon Network's submissions in relation to the FY2014 Revenue Adjustment Amounts and Increments. In particular, Anglo American is opposed to rewarding Aurizon Network with a 2% increment to the total $AT_{2\text{-}4}$, System Allowable Revenue. Incentives, and in particular what Aurizon Network claims is the "Increment" as an incentive for Aurizon Network.

Further, Anglo American notes that the "Increment" that Aurizon Network has outlined in section 5 of its submissions in relation to the FY2014 Revenue Adjustment Amounts and Increments appears to be similar to certain elements of the Draft Incentive Mechanism that Aurizon Network unsuccessfully submitted to the QCA in May 2012. Aurizon Network does acknowledge that neither the majority of respondents in the consultation process, nor the QCA itself has shown support for the Draft Incentive Mechanism as submitted by Aurizon Network. As such, it is inappropriate for Aurizon Network to attempt to include elements of that unsuccessful submission in its Revenue Cap adjustments as the Draft Incentive Mechanism, and subsequently the "Increment", are not approved elements of Aurizon Network's revenue cap regulation.

As an additional consideration, Anglo American notes that whilst Aurizon Network has transported approximately 90% of contracted capacity this still does not meet the contracted

[1] Aurizon Network, *2013 Draft Access Undertaking Volume 2: The 2013 Undertaking Proposal* (April 2013) 17-18.

capacity that Aurizon Network has already been rewarded for (through actual revenue or Take or Pay Revenue). Under the Take or Pay contracts that Aurizon Network has in place with all users of the CQCN, it receives a return equal to 100% of contracted capacity on the CQCN. As such, Aurizon Network's submissions to receive an additional 2% of the AT_{2-4} of System Allowable Revenue means that Aurizon Network will receive a return of 102% of System Allowable Revenue, while only delivering greater than 90% of contracted capacity in seven and four months respectively on the Blackwater and Goonyella Systems.

In its submissions, Aurizon Network has specifically stated that:

> due to the revenue cap framework, benefits accrued substantially to other supply chain participants (predominantly Train Operators and coal industry customers) rather than Aurizon Network.[2]

Further, Aurizon Network states that:

> due to the revenue framework, Aurizon Network will only earn a regulated return on the value of these projects (yet substantial benefits have accrued to other supply chain participants through improvements in network efficiency).[3]

These submissions ignore the fact that users and Train Operators bear the risks involved with volatility of demand and pricing in relation to coal export through the CQCN. Regulatory mechanisms like (by way of example) Review Events (including the large CAPEX, OPEX and maintenance payments for the 2011 and 2013 floods), 100% Take or Pay contracts on the CQCN, and adjustment mechanisms exactly the same as this Revenue Cap adjustment process, ensure that users indemnify Aurizon Network and it is assured of its regulated return on its investment in the CQCN. As such, it is inappropriate for Aurizon Network to suggest that users and Train Operators who bear full volume and price volatility risk on the capacity delivered through the CQCN must pay an incentive payment to Aurizon Network to deliver what it has already contracted to deliver.

Finally, Anglo American points out that:

(a) the "Increment" seems similar to the "operational throughput performance incentive" and the "supply chain coordination and efficiency incentive" in the Draft Incentive Mechanism which offer benefits to Aurizon Network for delivery contracted capacity, but offer no realistic downside where Aurizon Network does not improve efficiency;

[2] Aurizon Network, *Explanatory Memorandum FY2014 Revenue Adjustment Amounts and Increments* (30 September 2014) 18.
[3] Aurizon Network, *Explanatory Memorandum FY2014 Revenue Adjustment Amounts and Increments* (30 September 2014) 19.

(b) Aurizon Network's current "Increment" does not appear to be based off how Aurizon Network is rewarded (ie, delivery of contracted capacity and Aurizon Network's Take or Pay mechanisms), but off Aurizon Network's improvements in delivery of capacity against previous years (which may still not be anywhere near the contracted capacity that users have paid for);

(c) UT3 specifically provides for the development of a Draft Incentive Mechanism and Anglo American believes that any performance incentive payment should only be made based upon an approved process and outcome; and

(d) there is no evidence that the service attributes being incentivised by the application of the "Increment" are those that are most prized by users, or more importantly are of most benefit to the broader supply chain.

In summary, Anglo American reiterates its submission that the revenue cap form of regulation passes volume and price risk to end users and it is inappropriate for Aurizon Network to obtain a performance incentive payment of approximately $9 million where it has not delivered above contracted capacity and the global price of coal has dropped dramatically, leaving coal producers exposed to risk and volatility.