SUBMISSION TO THE QUEENSLAND COMPETITION AUTHORITY

AURIZON NETWORK
FY2014-15 REVENUE CAP ADJUSTMENT

January 2016

1. Executive Summary

Anglo American Coal (**Anglo American**) thanks the Queensland Competition Authority (**QCA**) for the opportunity to make submissions on Aurizon Network's Explanatory Memorandum in relation to the FY2014-15 Revenue Cap Adjustment.

The submission by Aurizon Network does not provide adequate information on which to base any comments on the Revenue Adjustment Amounts and Anglo American along with other users relies upon the QCA in its assessment of the amount and calculations supporting the proposed adjustments in that regard.

Anglo American also supports the omission of any incentive mechanism claim, in the form of an "Increment" payment to Aurizon Network, as part of its FY2014-15 Revenue Cap Adjustment.

As the QCA is aware, Anglo American has continually supported the concept of incentivising monopoly infrastructure owners to engage in productive efficiency increases and to promote innovation. However, this can only work in specific circumstances. For any incentive mechanism to be effective it must be underpinned by objective measureable and meaningful criteria aimed at delivering efficiency gains by reference to that criteria, including system baseline capacity as the starting point, which the relevant regulated service provider can provide reliable evidence of and be attributed due solely to its contribution to the coal supply chain. Increased volume does not mean there have necessarily been efficiency gains. Integrated supply chain stakeholder activities will be the most powerful means to identify and deliver efficiency gains through coordinated analysis and activities. Any initiatives that might be identified and delivered by a member of the coal supply chain should be something that only that participant can deliver themselves by doing something more than what they are already bound to do.

It has been Anglo American's view that an incentive mechanism is likely to be more effective and therefore more appropriate as part of a "price cap" form of regulation. Anglo American considers that a price cap regulation model is a more appropriate form of regulation for Aurizon Network's below rail operations largely because it would naturally be incentivised to pursue efficiency gains for increased revenue. Notwithstanding this, Aurizon Network continues to seek a revenue cap form of regulation for its below rail operations. Therefore Aurizon Network's decision not to include an Increment is appropriate. This is because:

(a) any Increment would serve to simply reward Aurizon Network for delivering existing capacity (which we note Aurizon Network has already been rewarded for through both actual revenue and Take or Pay Revenue in relation to contracted capacity);

(b) any Increment would reward Aurizon Network for risk that it does not bear under the current revenue cap form of regulation. Anglo American has repeatedly identified that if Aurizon Network wishes to be rewarded on a volume and throughput basis, it should seek to implement a price cap form of regulation. Otherwise, it should continue to 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 implemented under UT3 which the QCA has since decided to remove from the 2014 Draft Access Undertaking (**UT4**) following consultation with industry.

We have addressed these issues further 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**).[1]

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

(a) 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

(b) 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

[1] 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; 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; 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; 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, Submission to the Queensland Competition Authority re Aurizon Network's FY2014 Revenue Adjustment Amounts and Increments (7 November 2014), in particular section 2 of that submission.

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. For completeness, Anglo American has set out these issues below so far as they relate to Aurizon Network's FY2014-15 Revenue Cap Adjustment.

Anglo American notes that throughout the development and negotiation of the 2010 Access Undertaking (**UT3**) and UT4, Aurizon Network has maintained its desire to have a revenue cap form of regulation. As the QCA is aware, this form of regulation means that Aurizon Network is not incentivised to deliver more or less than the yearly contracted capacity. It also protects Aurizon Network against all (or almost all) 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 currently inherent in the coal industry. This should be reflected in Aurizon Network's regulated business profile, in particular, the lack of risk that it adopts in relation to its Regulated Asset Base.

As Aurizon Network rightly points out, previous attempts by Aurizon Network to recover Increments in recent years have been unsuccessful. As previously submitted by Anglo American, this is the correct approach to be adopted by the QCA under a revenue cap form of regulation.

Anglo American notes Aurizon Network's assertion that it would have been entitled to an Incremental claim up to $9.6 million (being 2% of its System Allowable Revenue across both the Blackwater and Goonyella systems). Further, Aurizon Network claims that the tonnes railed significantly exceeded the QCA-approved transitional systems forecast in the Blackwater and Goonyella systems and that such performance reflects the sustained efforts and aligned planning by all supply chain participants including mines, port, train operators and Aurizon Network. Whilst Anglo American recognises the coordination of the supply chain as a whole this should not transcend into the adoption of an incentive mechanism for Aurizon Network. This is, most notably, because:

(a) the revenue cap form of regulation that applies to the Aurizon Network business, specifically the CQCN;

(b) increased volume does not demonstrated efficiency gains. As previously identified, the best way to identify efficiency gains would be through the identification and implementation of supply chain stakeholder activities by Aurizon Network in addition to Aurizon Network providing its current contracted below rail services;

(c) any Increment would serve to simply reward Aurizon Network for delivering existing capacity (which we note Aurizon Network has already been rewarded for through both actual revenue and Take or Pay Revenue in relation to contracted capacity); and

(d) users and Train Operators bear the risks involved with volatility of demand and pricing in relation to coal export through the CQCN. Regulatory mechanisms, such as Review Events for CAPEX, OPEX and maintenance payments for the 2011, 2013 and 2015 floods, 100% Take or Pay contracts on the CQCN, and this Revenue Adjustment Process protect and indemnify Aurizon Network against risk and it is assured of its regulated return on its investment in the CQCN. As such, it is inappropriate that users and Train Operators would be required to pay an incentive payment to Aurizon Network to deliver what it has already contracted to deliver.

3. Incentive mechanism forming part of UT4 (not UT3)

Aurizon Network also identifies claims by industry that it is inappropriate for Aurizon Network to claim an Increment under the terms of UT3 for a year that form part of the UT4 period. Anglo American agrees with the Queensland Resources Council on the basis that it is intended that Aurizon Network's Maximum Allowable Revenues and tariff adjustments for the FY2015 year will be assessed as part of UT4 and, where necessary, adjusted over the remaining term of UT4.

4. Increment / Incentives regime under UT4

Similar to the Queensland Resources Council, Anglo American supports the QCA's consolidated draft decision on UT4 to remove the framework for an incentive mechanism. In its submission to the QCA's draft decision, Anglo American noted that an incentive mechanism is inappropriate under the current revenue cap form of regulation and that the QCA may move to a truer form of regulation for Aurizon Network's below rail operations, being a price cap regulation for future undertakings. Anglo American therefore is agreeable to the absence of an Increment forming part of Aurizon Network's FY2014-15 Revenue Cap Adjustment.

5. Reference Tariff and SAR calculations

Given the lack of granularity in the information provided by Aurizon Network, Anglo American is unable to make detailed submissions on whether the escalation approach adopted by Aurizon Network is justifiable and requests the QCA to:

(a) review to ensure the basis for the proposed adjustment is calculated correctly and the appropriate methodology applied; and

(b) review any escalation calculations in the Aurizon Network Submission across the relevant period to ensure they are consistent with the recent QCA Consolidated Draft Decision (December 2015) regarding the treatment of escalation for UT4 based Reference Tariffs, (i.e. mid-point of period, as opposed to end of year).

6. Treatment of the 2013 Flood Review Event Recovery amounts

In relation to the 2013 Flood Review Event, Anglo American requests the QCA to:

(a) confirm that the Adjustment amounts previously approved by the QCA are accounted for and calculated correctly in the proposed SAR calculations; and

(b) ensure that Aurizon Network recalculates the previously QCA endorsed Adjustment Amounts to ensure consistency with the recent QCA Consolidated Draft Decision regarding the treatment of escalation for UT4 based Reference Tariffs, (i.e. mid-point of period, as opposed to end of year), if this has not been done.

7. Conclusion

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 therefore inappropriate for Aurizon Network to obtain a performance incentive payment based on increased throughput. Accordingly, Anglo American agrees with the omission of an Incentive mechanism in Aurizon Network's FY2014-15 Revenue Cap Adjustment for the reasons set out above. Otherwise, Anglo American relies upon the QCA's review of the calculations provided by Aurizon Network in the proper assessment of the revenue cap adjustment claim.