QUEENSLAND resources COUNCIL

QRC SUBMISSION

AURIZON NETWORK 2017 ELECTRIC TRACTION DAAU

FEBRUARY 2018

1. Introduction and overview

The Queensland Resources Council (**QRC**) provides this submission on behalf of a number of its coal members.

QRC members have a range of views on the Electric Traction Draft Amending Access Undertaking ("DAAU"), and some members will provide individual submissions.

The proposal has several advantages over Aurizon Network's previous proposals on this issue, which were withdrawn. The proposal would address a significant issue for Aurizon Network, for investors in electric locomotives including Aurizon, and for customers which have made long term commitments to use electric rollingstock. The proposal could also have significant negative impacts on investors in diesel rollingstock and their customers, and will impact on above-rail competition, particularly regarding traction choice.

QRC members would welcome the opportunity to consider and comment on the QCA's preliminary views on this proposal, and we encourage the QCA to release an issues paper or draft decision.

In this submission, we:

- Set out the potential benefits and disadvantages of the proposal **(Section 2)**.
- Provide suggestions on possible improvements to the proposal, which should be considered in the event that the QCA is minded to accept the key concepts proposed by Aurizon Network **(Section 3)**.

2. Benefits and disadvantages of reform

The following table sets out:

- The key benefits of the DAAU, including those presented by Aurizon Network in the DAAU submission.
- Related disadvantages and comments/questions regarding the claimed benefits.

Please note that the 'Disadvantage or comment/question' column is not intended to appear as an answer to, or to negate, the related Benefit, and the table should not be read in this way. The Disadvantages column contains points which:

- Provide an alternative point of view. For example, a Benefit to one party may result in a related Disadvantage to another party.
- Note a consideration which may limit or reduce the Benefit.
- Note a related disadvantage which may flow from the Benefit.

This submission does not reach a conclusion regarding the overall merits of the proposal, or on the relative importance of the Benefits and Disadvantages. We present these effects and alternative points of view for the QCA's consideration, and would welcome the opportunity to comment on the QCA's preliminary views on the proposal.

Benefits	Disadvantage or comment/question
Existing users of electric services (and owners of electric fleet) will no longer face the risk that AT5 could increase dramatically in the event of declining utilisation.	The risk that AT5 could increase with reduced electric utilisation has been a feature of the regulatory arrangements since UT1, as has the separation of pricing of electric/non-electric pricing, which protected diesel users from this risk. Under Aurizon Network's proposal, this risk is socialised across all users. Diesel users/investors did not accept this risk. Diesel users should not pay for a service which they are not using.

Benefits	Disadvantage or comment/question
Customers considering the diesel/electric choice in the future can make this assessment without the concern regarding risks of declining electric utilisation. Each traction type is then equal in this regard. This promotes competition between traction choices.	The proposal interferes in competition between traction choice by eliminating a key competitive advantage of diesel, which is that electric services involve a relatively high fixed cost which will lead to a high unit cost if target utilisation levels are not achieved.
The adoption of current utilisation rates as the 'floor' ensures that the proposal has no impacts unless utilisation rates fall.	The use of current rates as the floor ensures that any minor reduction will trigger the use of the proposed mechanism. This is particularly concerning given that the floor levels are very close to maximum possible utilisation (Aurizon Network DAAU submission, page 23). If the proposal is designed to prevent a catastrophic 'death spiral' situation, then the floor should be set at a reasonable level below current utilisation rates.
The adoption of current utilisation rates as the 'floor' ensures that diesel services only bear a cost where an electric user has exercised the option to switch to diesel.	Diesel users would also bear a cost if utilisation (which is a percentage) falls due to a new customer/mine entering the system with a diesel service. It is not accurate to claim that the mechanism would only cause a socialisation of costs in the case where an existing electric customer switches to diesel.

Benefits	Disadvantage or comment/question
Provided that electric traction remains the dominant traction type, the resulting increase in total access charges for all services (including diesel services) will be minor (Aurizon Network submission, Page 28).	This statement is true, however: • Where a reduction in electric utilisation is substantial, the impacts on diesel services will be substantial. We estimate that the electric MAR, after reallocation of a portion to EC, will be in the order of $85m for the Blackwater System and $68m for the Goonyella System (based on the $/egtk on page 27). All of this cost would transfer to diesel users in the case of zero electric utilisation. • The graphs on page 28 of the Aurizon Network submission are misleading, due to the lagged revenue cap effect and the continual reduction shown in utilisation. For example, the 'with DAAU' diesel costs shown at 60% utilisation actually reflect the impact of the revenue shortfall of the year 2 years prior, when utilisation was 70%.
AT5 will continue to rise or fall based on the cost of electric infrastructure. Therefore, competition between traction choices remains, and electric infrastructure will not continue to be used unless it remains competitive.	The competitive position is significantly altered by the requirement that diesel services share the cost of any decline in electric utilisation. Regulatory pricing should not interfere with competition in this way unless Aurizon Network demonstrates to the QCA's satisfaction that electric traction is the more efficient long-term choice. Aurizon Network has not sought to demonstrate that this is the case in the current submission.

Benefits	Disadvantage or comment/question
The proposal reflects the ‘free option’ which diesel services enjoy to change to electric. This free option adds cost to the electric infrastructure.	• The value of the option has not been assessed, and there is no reason to suspect that the proposal would transfer a cost equal to the option value. • If the option involves a cost, Aurizon Network should offer a form of Access Agreement which excludes the option. Aurizon Network should not claim that the form of Access Agreements creates the problem, while not proposing to address that issue. • In reality, the option has not always existed (see Aurizon Network’s footnote, page 9 of DAAU submission). AN has not been able to provide electric traction to all customers, despite claiming that it is obliged to do so. This failure contributed to investment in diesel locomotives by Pacific National and is the main reason why electric utilisation in the Blackwater System is expected to be limited to around 75% in the medium term.
Addresses a risk faced by Aurizon Network and supports a low WACC outcome.	• The risk transfer is from electric to diesel users, yet any WACC benefit is shared across all users. • Aurizon Network accepted this risk when making the electric investments, and contributed to the risk through a failure to provide sufficient capacity and by undertaking investments without providing customers with meaningful analysis or business cases. Despite this, Aurizon Network proposes to share none of the risk and none of the impacts of its decisions. At a minimum, AN should agree to absorb some portion of the cost of lower utilisation, rather than passing 100% to diesel customers.

Benefits	Disadvantage or comment/question
Proposal does not seek to guarantee the ongoing utilisation of electric infrastructure. The system may still move to an all-diesel outcome if that is most efficient. Therefore, Aurizon Network will continue to face risk and discipline in electric investment decisions.	• This is not entirely true as the proposal alters the relative attractiveness of the options. • Also, Aurizon Network may invest in further electric infrastructure with little concern as to future utilisation. If the proposal is approved, Aurizon Network should be required to seek regulatory pre-approval for all material investment in electric infrastructure, which should be supported by proper business cases and a demonstration that ongoing investment in electric infrastructure is prudent.
Proposal addresses a risk which is partly created by the lack of Take or Pay on AT5.	• Take or Pay does apply on AT5 in the case of Expansion Tariffs. • The lack of Take or Pay on AT5 has been Aurizon Network's proposed arrangement under all undertakings. Aurizon Network has not proposed to alter this arrangement (other than where Expansion Tariffs apply). • Transferring shortfalls on AT5 revenue to AT3 through the revenue cap adjustment creates an increased Take or Pay risk, as AT3 will increase and is subject to Take or Pay. This alters the risk profile of existing contracts.
The proposed pricing mechanism is not a guarantee that the electric assets won't become stranded, or that the QCA could not reach a decision to optimise the assets in the event that they were no longer utilised. Therefore, while this risk is much less likely to materialise under the proposed pricing structure, the residual risk remains with Aurizon Network.	The pricing mechanism would prevent the current Schedule E provisions from applying, as the Schedule E trigger for optimisation relies on 'death spiral' pricing effects. If the proposal is to be approved, Schedule E should be amended. Aurizon Network seeks to make the case for pricing reform to address incentives created by the current pricing arrangements. The solution should not extend to a guarantee that assets which may not be utilised in the future will always remain in the RAB. This should be a matter to be considered if the circumstances arise (noting that this is much less likely to occur under the proposed pricing approach).

Benefits	Disadvantage or comment/question
The Electric Traction DAAU provides that Aurizon Network will only undertake expansion of the electric network where it has obtained pre-approval of prudency and efficiency from the QCA and customers have agreed to underwrite the proposal (Aurizon Network DAAU submission, p32).	The DAAU does not contain such provisions.
Addresses the stranding risk of three rollingstock operators.	Those operators accepted this risk, and it is not appropriate for Aurizon Network to propose regulatory changes to transfer this risk to other parties, particularly where Aurizon Network's related operator would be the largest beneficiary.
DAAU assists in meeting emissions targets.	While this may be true, we note that, on the one hand Aurizon Network claims that the proposal is 'traction neutral', while on the other hand cites the environmental benefits which will flow from the effect which the DAAU is expected to have in promoting electric traction.
Proposal is forward looking and does not impact existing arrangements.	The proposal may add a cost to existing diesel services. Aurizon Network has not proposed effective 'grandfathering'. The use of floor levels less than 100% does not ensure that parties who have made long term commitments to diesel fleet will not bear the costs arising from other parties switching in the future.
The reform provides clarity and certainty on future pricing. This issue has been around for some time, and investors currently face uncertainty regarding the outcome.	Clarity and certainty are not promoted by changes in long established pricing principles. Separation of the MAR and pricing between diesel and electric costs has been a feature of all undertakings.

3. Possible improvements to proposal

This section discusses possible amendments to Aurizon Network's proposal which should be considered in the event that the QCA is minded to support AT5 pricing reform.

(a) Contribution by Aurizon Network:

The DAAU transfers a portion of the risk of lower electric utilisation from electric users to diesel users. It also significantly reduces a risk faced by Aurizon Network. This risk arose because of Aurizon Network's past investment decisions, some of which were supported by customers who were required to vote on projects (or be deemed to have voted) based on insufficient information. Passing risk and cost to parties who are not using electric infrastructure is a significant change to regulatory arrangements. QRC members consider that it is unreasonable for Aurizon Network to propose such a solution while making no contribution to the solution itself. Aurizon Network has been extremely effective in transferring risk to customers through changes to successive undertakings, and now bears minimal risk, including risk arising from its own performance. In the current case, we would welcome any proposal from Aurizon Network to contribute to the solution rather than pass all costs to others. For example, Aurizon Network could consider absorbing the first x% of reduction in utilisation, rather than immediately seeking to impose this costs on parties who cannot manage and did not accept this risk.

(b) Establish floor utilisation levels which do not reflect current maximum utilisation:

The proposed floor utilisation levels are close to the levels which Aurizon Network has described as the maximum utilisation levels, taking into account existing diesel fleet. This means that the mechanism will be relatively easily triggered. The mechanism would continue to achieve its claimed benefits if floor utilisation levels were set at a level below existing levels, and this would avoid causing the mechanism to be triggered by small fluctuations in utilisation.

(c) Improved pre-approval processes for electric infrastructure:

Approval of the DAAU would reduce the risks faced by Aurizon Network when investing in electric infrastructure. This may reduce the incentive for rigorous analysis of the prudency of the projects. Given that the DAAU would socialise the risk of investment in electric infrastructure across all users, it is important that this issue be addressed. The pre-approval provisions discussed on Page 32 of Aurizon Network's proposal, if reflected in the DAAU, would address this issue in regard to expansion of the below rail electric network.

We consider that similar pre-approval requirements should apply to any material sustaining capital expenditure, including the expenditure discussed in Section 2.3.2. The DAAU submission does not present a business case for this expenditure, and we accept that this DAAU is not the appropriate document for such a business case. However, we do consider that the information provided in support of previous investment in electric infrastructure has been deficient (see section 3(a)) and that this needs to be addressed.

(d) AT5 MAR should exclude all variable costs: Aurizon Network has proposed to recover variable transmission charges via EC. We suggest that all costs which are variable in the short or medium term should be recovered via EC, rather than via AT5. We rely on the QCA to consider whether the transfer of variable transmission charges alone achieves this outcome.

(e) Costs transferred to AT3 should not be subject to Take or Pay: In order to avoid increasing take or pay under existing contracts, the portion of AT3 which arises from prior AT5 revenue shortfalls should not be subject to take or pay. For example, where an AT5 shortfall increases AT3 from $5.00/'000 gtk to $5.50/'000 gtk, take or pay should be calculated based on $5.00/'000gtk (and any remaining revenue shortfall would be recoverable in the usual way under the revenue cap).

(f) Schedule E should be amended: As discussed above, the trigger for reduction in the value of assets under Schedule E, 1.2(b)(ii)(B) will not be effective, in the event that the DAAU is approved and electric assets are ultimately not utilised. We consider that the purpose of the DAAU is to address a risk and an incentive issue, not to provide Aurizon Network with a guarantee that the value of electric assets will never be reduced even if they are no longer used. The appropriate regulatory response to that situation, if it occurs, (which we acknowledge will be far less likely under the proposed pricing mechanism), should be considered by the QCA at the relevant time.

(g) Ongoing transparency:

The revised undertaking should contain drafting which ensures that Aurizon Network provides transparency regarding:

- The component of EC which relates to costs which, in the absence of this reform, would have been recovered through AT5.
- The component of AT3 which relates to AT5 revenue shortfalls of a prior year.

This is necessary for a range of reasons, including ensuring that the commercial intent of existing above rail agreements (which contain a variety of approaches to charging for access) can be achieved.

(h) Drafting changes required for consistency with Aurizon Network's submission:

Aurizon Network's submission contains the following statements which are not reflected in the drafting of the DAAU:

- (referring to expansion of the below rail electric network): "*The Electric Traction DAAU provides that Aurizon Network will only undertake such expansion investment where it has sought and received pre-approval from the QCA that the investment is prudent and that the scope is efficient. Further, in order to demonstrate prudency of the expansion investment, any proposal to expand the below rail electric network must be accompanied by a commitment from customers to underwrite the project, so that the expansion does not increase the exposure of other users to a requirement to contribute to the recovery of sunk below rail electric investments*". (page 32). It is not clear to us that the current DAAU provides these commitments.

- "*any revenue adjustment due to electric utilisation falling below the current utilisation – which will be defined as the 'Electric Utilisation Floor', will be recovered equally from all users of the system, using a revenue cap adjustment framework to adjust the AT3 tariff*" (page 26). Schedule F does not currently specify how adjustments to Second Year Allowable Revenue are allocated between AT2-4. We consider that Schedule F would require amendment to reflect the intention that the Electric Revenue Adjustment will be recovered via AT3 alone.

- Aurizon Network's submission states (4.1.4) that the floor utilisation levels will be used in determining AT5 charges. Schedule F will require amendment to clarify that the floor utilisation levels will be used in place of forecast utilisation levels in the annual review of reference tariffs.