

Pacific National Submission to the QCA in Relation to the QCA Draft Decision on the Aurizon Network 2017 Electric Traction DAAU

June 2018

Table of Contents

Pacific National Submission to the QCA in Relation to the QCA Draft Decision on the Aurizon Network 2017 Electric Traction DAAU	1
1. Introduction	3
4. QCA’s Position on Aurizon Network’s DAAU Proposal	5
5. Pacific National Comments on the QCA Position on Aurizon Network’s DAAU Proposal	8
6. The Draft Decision in the Context of the Regulatory Regime.....	11
7. Conclusion.....	13

1. Introduction

Pacific National welcomes the opportunity to make a submission to the Queensland Competition Authority (**QCA**) in relation to the QCA's Draft Decision on the Aurizon Network 2017 Draft Amending Access Undertaking in relation to Electric Traction (the **Electric Traction DAAU**).

Pacific National supports the Draft Decision position to not approve the Electric Traction DAAU, but Pacific National is concerned that some of the positions put forward in Draft Decision indicate that a future submission on this matter may be approved if it addresses QCA concerns with:

-) the mechanism of electric revenue adjustment proposal;
-) take or pay consequences; and
-) incentives for efficient investment in electric infrastructure.

Pacific National believes that as a matter of principle any future submission on this matter cannot be approved if it allows for diesel users to potentially fund electric infrastructure which they do not use.

In preparing this submission, Pacific National is mindful of the factors set out in the *Queensland Competition Authority Act 1997 (Qld)* (**QCA Act**) to which the QCA must have regard in determining to approve the Electric Traction DAAU. Pacific National agrees with the Draft Decision position that, following consideration of the factors set out in the QCA Act, the QCA cannot approve the current Electric Traction DAAU by way of the QCA Final Decision as the DAAU fails to properly meet the relevant objectives and pricing principles of the Act.

This submission is public.

2. Background

As the QCA is aware, Pacific National is a major operator on the Aurizon Network rail infrastructure and transports coal on this rail network via both electric traction and diesel traction trains. The main competitor to Pacific National on the Aurizon Network infrastructure is the Aurizon Operations above rail business, which is a related party to Aurizon Network within the Aurizon Group.

Electric traction and the pricing of electric rail infrastructure have previously been considered by the QCA, most notably in relation to the Aurizon Network¹ 2011 DAAU on Sustainable Electric Traction Pricing. At the time Pacific National² made several responses to the 2011 DAAU and many of the

¹ At the time of the submission of this DAAU in 2011 Aurizon was operating under the name QR National

² At the time of the submission of this DAAU in 2011 Pacific National was a subsidiary of Asciano and submissions made by Pacific National to this DAAU were under the name of Asciano.

positions and findings of this previous regulatory process remain relevant to the QCA's consideration of the current Electric Traction DAAU.

In considering the Electric Traction DAAU and the matter of potential electric infrastructure stranding (which is central to this DAAU), Pacific National has not seen any evidence from Aurizon Network that the issue of electric infrastructure stranding is a real threat. To this point Aurizon Network³ state in their DAAU submission that "*both Blackwater and Goonyella are approaching maximum possible utilisation of electrification assets*" and that⁴ electric utilisation in the Blackwater system has been increasing steadily since 2010 (from below 40% to 75%) and electric utilisation in the Goonyella system has been flat at close to 100% since at least 2004. Pacific National believes that the implicit assumption in the DAAU that electric utilisation rates are expected to decline in the near future, leading to electric infrastructure stranding, must be convincingly supported by Aurizon Network with robust evidence of falling absolute usage (not relative usage) of the infrastructure over multiple periods of time. Pacific National contends that prior to any resubmission of a new Electric Traction DAAU by Aurizon Network such evidence must be provided to the QCA and users for consideration and cross examination, give the criticality of this matter to all stakeholders.

In any event, as noted by both Pacific National and the QCA (at page 12 of the Draft Decision) if electric utilisation rates were to decline in the near future the current access undertaking includes a provision (see Schedule F, 3.3(n)) whereby any future electric enhancements or investments are included in take or pay arrangements. That is, users that benefit from these electric enhancements will be subject to AT5 as a take or pay component based on contracted volumes in the relevant access agreement. Pacific National believes that this allowance in the current access undertaking is sufficient to address any immediate concerns held by Aurizon Network.

3. QCA's Position on the Implications of Pricing Arrangement for Electric Infrastructure

The Draft Decision includes a broad discussion on the implications of the pricing arrangements for electric infrastructure⁵. In particular, the Draft Decision notes that the proposed DAAU uses a short term (that is, within regulatory period) mechanism to address an asset stranding issue that is likely to be realised across multiple regulatory periods.

³ Aurizon Network, Submission 2017 Electric Traction Draft Amending Access Undertaking, November 2017, page 23

⁴ Aurizon Network, Submission 2017 Electric Traction Draft Amending Access Undertaking, November 2017, page 11

⁵ QCA, 2018, Draft Decision on AN 2017 Electric Traction DAAU pp 8-14

The Draft Decision (at page 14) note that the Electric Traction DAAU will not address persistent declines in electric utilisation across multiple regulatory periods and that this matter will need to be considered by the QCA at each access undertaking review.

Pacific National believes that access undertaking reviews are the appropriate forum for matters of access costs, revenue and pricing (including AT5 pricing) and has no concern with electric traction and AT5 issues being raised in any access undertaking review. Pacific National's position is that reviewing the AT5 pricing arrangements at each regulatory period will provide a degree of flexibility to address issues as they arise (such as changes in traction technology or changes in volumes in each system). If any pricing mechanism that adjusted electric revenue were to be introduced then it should not be "locked in" for multiple regulatory periods as this will remove the ability of pricing to be able to respond to changing circumstances.

Further to the issue of pricing flexibility Pacific National believes that there is merit in exploring whether issues relating to electric infrastructure utilisation and AT5 pricing should be included in the definition of an Endorsed Variation Event (see Schedule F, 5.2). This would then mean that any potential price variation would be reviewed by QCA at the time an Endorsed Variation Event. This would remove the potential that the proposed mechanism in the Electric Traction DAAU is triggered by circumstances which are not central to the matter of electric infrastructure utilisation and AT5 pricing.

4. QCA's Position on Aurizon Network's DAAU Proposal

The substantive amendments proposed by Aurizon Network in the DAAU are amendments to the *Access Undertaking: Schedule F: Reference Tariff Schedules*. It is Pacific National's opinion that these amendments operate as follows:

- J the introduction of a **Variable Connection Charge**, which is a variable charge associated with an electricity connection billed on an electricity consumption basis. This charge would be required to be approved by the QCA each year; and
- J the introduction of an **Electric Revenue Adjustment**. This adjustment would be the lesser of:
 - o the AT5 revenue shortfall amount which occurs when AT5 actual revenue is less than the AT5 revenue allowed under the regulatory system; and
 - o the amount derived by multiplying the following amounts:
 - the AT5 tariff;

- the actual GTK; and
- the amount calculated as follows:
 -) for the Goonyella system – 98%⁶ minus (EGTK / GTK for the Goonyella system; and
 -) for the Blackwater system 75% minus (EGTK / GTK for the Blackwater system.

This Electric Revenue Adjustment is proposed to be recoverable through the AT3 tariff. That is the adjustment is recovered from all Aurizon Network infrastructure users, including diesel users, by way of the existing revenue cap adjustment process.

Pacific National understands that the Draft Decision has assessed the above DAAU proposals against the requirements of the QCA Act and the Draft Decision position on these DAAU proposals are as follows:

) the Draft Decision position on the **Variable Connection Charge** is that this provides a more transparent and appropriate allocation of relevant costs but that there are concerns regarding the timing and method of implementation⁷. We acknowledge that the QCA believes the Variable Connection Charge not be accepted. The Draft Decision notes that the QCA has concerns with the timing of the implementation of the proposal as the DAAU, as currently worded, allows for the variable connection charge cost reallocation, but does not actually implement the cost reallocation via amendments to tariffs. This in turn creates uncertainty about the timing and quantum of any reallocation. Aurizon Network must provide updated AT5 and EC tariffs that reflect the proposed reallocation.

) the Draft Decision position on the **Electric Revenue Adjustment** is that the concept of an electric revenue adjustment could be appropriate in some circumstances if measures were adopted such that the socialisation of any AT5 under-recovery could only occur in limited circumstances. The QCA recognises that this position may result in diesel operators and users paying for electric infrastructure which they do not use, but takes the view that, subject to certain conditions:

... a proposal to provide for socialisation could, in principle ... be seen to promote the economically efficient operation and use of, and investment in, relevant networks in a manner consistent with the object of part 5 of the QCA Act in assisting to mitigate asset bypass and asset stranding risks⁸ ...

⁶ These constants of 98% in Goonyella and 75% in Blackwater are based on current electric infrastructure utilisation rates in the respective systems.

⁷ QCA, 2018, Draft Decision on AN 2017 Electric Traction DAAU p 5

⁸ QCA, 2018, Draft Decision on AN 2017 Electric Traction DAAU p 6

However, in relation to the specific DAAU proposal the Draft Decision has raised concerns with the mechanism designed to apply the electric revenue adjustment. These concerns include:

- the socialisation trigger thresholds being too high, as they are at a point above where a demand deterioration spiral is likely to occur (thus favouring electric traction over diesel traction);
- the measure of electric utilisation is too broad, as it focuses on relative usage between traction choices rather than the actual usage of the electric infrastructure; and
- the mechanism makes socialisation a likely outcome, as it is likely to be triggered at a point higher than a point where a demand deterioration spiral is likely to occur. The high likelihood of this socialisation violates the user pays principle.

Consequently, the Draft Decision does not accept the electric revenue adjustment in its current form, noting (at page 29) that it is:

- anti-competitive, favouring electric traction over non-electric traction;
- not in the interests of those who would seek access to the service;
- not consistent with the object of part 5 of the QCA Act; and
- not consistent with the pricing principles.

The Draft Decision advises that to address these concerns Aurizon Network should consider amending utilisation measures and thresholds to balance the user pays principle with socialisation.

In particular, the Draft Decision advises that:

-) the electric traction measure should:
 - provide a reliable proxy for electric traction use;
 - be technology neutral, so that increases in diesel traction, without an associated decline in electric traction, do not result in a measure of lower electric traction utilisation;
 - reflect a persistent decline in electric traction use; and
 - be transparent.
-) the threshold should be set to ensure socialisation of costs only occurs when there is material risk of electric infrastructure bypass. Thus, the threshold should:
 - be low enough to ensure socialisation of costs is not triggered by one-off shocks that do not represent a bypass of electric infrastructure;
 - be high enough so that bypass is avoided;
 - have a time component (potentially across multiple regulatory periods); and
 - be adjusted if new entrants use diesel traction.

The QCA considers that if the above matters were incorporated into the electric revenue adjustment then it is likely to be consistent with sections 138 (2) and 168A of the QCA Act - the electric revenue

adjustment would then be addressing electric bypass rather than preserving the current level of electric traction use.

The QCA notes that if any electric revenue adjustment is adopted:

-) more stringent investment controls would be required for electric infrastructure in order to reduce the amount that diesel users may have to pay. Thus, investments in electric traction infrastructure will require explicit capital expenditure rules that establish the prudence and efficiency of any investment; and
-) it should be collected via a separate tariff component (The collection of the revenue adjustment via the AT3 tariff component as proposed by Aurizon Network has take or pay consequences).

In taking the above position the QCA has not proposed a preferred alternative, but has set out principles for how the mechanism should be developed.

Pacific National does not agree with the position that the potential for diesel users to fund electric infrastructure is consistent with the QCA Act.

5. Pacific National Comments on the QCA Position on Aurizon Network's DAAU Proposal

Pacific National's positions on the QCA's Draft Decision positions are outlined below.

Variable Connection Charge

Pacific National has no major concerns with the concept underpinning Aurizon Network's proposed Variable Connection Charge. Pacific National notes that the Draft Decision position is that the Variable Connection Charge not be accepted. The Draft Decision requires Aurizon Network to provide updated AT5 and EC tariffs that reflect the proposed reallocation.

Pacific National supports the Draft Decision position. If the issues relating to the provision and implementation of the updated AT5 and EC tariffs were addressed then Pacific National does not anticipate major concerns with the proposal if it is executed in a transparent manner and the actual charges reflect costs incurred. Nevertheless, Pacific National will reserve its position until the updated tariffs are provided to stakeholders for consideration and cross examination.

Electric Revenue Adjustment

As outlined in its February 2018 submission on the DAAU, Pacific National has major concerns with Aurizon Network's proposed Electric Revenue Adjustment. These concerns included:

-) inconsistency with cost reflective pricing principles;
-) transfer of risk from electric users to diesel users;
-) the asymmetry of the proposed mechanism - AT5 under-recovery is socialised across diesel and electric users, AT5 over-recovery is returned to electric traction users only;
-) take or pay impacts via changes to the AT3 tariff; and
-) encouragement for inefficient investment in electric infrastructure.

Pacific National welcomes the position that the QCA has taken regarding Pacific National's concerns about take or pay impacts and the incentives for inefficient investment in electric infrastructure. In addition, Pacific National recognises that the QCA principles relating to the electric revenue adjustment measures and thresholds seek to address some of the flaws in the DAAU which were identified by Pacific National in its previous submission.

However, Pacific National is genuinely concerned that the QCA is providing a degree of qualified support to the concept that diesel users should fund investments in electric infrastructure that they are not going to use. Pacific National continues to strongly support the principle that users of Aurizon Network rail should only be charged for infrastructure that they actually use, and that charging users for infrastructure that they do not use results in allocative inefficiency and price distortions.

In particular, Pacific National remains concerned that

-) Aurizon Network's efforts to require diesel users to fund electric infrastructure ultimately act to benefit Aurizon Operations in the Blackwater system where Pacific National primarily operates diesel trains and Aurizon Operations primarily operates electric trains. Aurizon Network's effort to shift electric infrastructure costs on to Pacific National diesel trains continues to raise concerns - the perception is that the train operator which primarily operates electric traction is being favoured over the train operator which primarily operates diesel traction. The effect of any mechanism, which transfers electric costs to diesel users, will be to favour one market participant over any other participants.

Pacific National's concern is that any form of electric revenue adjustment will ultimately favour Aurizon Operations (given the traction mix in the market) and so is counter to section 138 2) and 168A c) of the QCA Act.

- J an electric revenue adjustment, in any form, locks in electric traction via overhead electric infrastructure as the preferred form of traction and operators adopting any new and more efficient form of traction technology will be required to subsidise the infrastructure required to operate a less efficient form of traction technology;
- J an electric revenue adjustment process will be backwards looking, penalising diesel users for past traction choices. To this end Pacific National is disappointed that the Draft Decision did not consider the matter of grandfathering in more detail. The Draft Decision⁹ takes the position that if QCA's position on trigger events and the like, is ultimately adopted then socialisation is unlikely to occur and so grandfathering is not needed. Pacific National believes that grandfathering of diesel locomotives may be a clearer and simpler means of ensuring current diesel operators (particularly on the Blackwater system) are not penalised for past traction investments. Proposals for a trigger event at a certain percentage of system use may not necessarily protect the potential grandfathered assets; and
- J an electric revenue adjustment process will also require numerous additional "carve-outs" for various reasons, such as services which can only operate as diesel services due to a lack of electric infrastructure, operational requirements or instances where electric infrastructure is not available due to maintenance or damage.

On a more practical level Pacific National remains concerned that the QCA Draft Decision was not prescriptive in identifying numerical values for any appropriate measures and thresholds for an electric revenue adjustment mechanism. In setting any values there are several additional points Pacific National believes should be considered, namely:

- J while the Draft Decision recognises the impact that a new user using diesel traction may have on the trigger, it should also recognise what the closure of a mine and removal of a user of electric traction, may have on the trigger. It may be that a user utilising electric traction closes its relevant mining operations for reasons unrelated to traction choice or costs, but the departure of this user triggers the mechanism. Pacific National does believe it is appropriate for the mechanism to be triggered by a mine closure; and
- J the impact that the size and length of relevant access agreements have on the trigger should be considered. For example, if a change in a single agreement could trigger the mechanism this would be of greater concern that if changes in at least two access agreements were needed to trigger the mechanism.

⁹ QCA, 2018, Draft Decision on AN 2017 Electric Traction DAAU p 29

Pacific National is concerned that following the Draft Decision Aurizon Network will propose revised threshold levels which continue to be too high and static. Pacific National believes that the QCA should provide more concrete guidance on an acceptable value for the trigger. Any threshold must be set at levels substantially lower than the current usage levels (and the threshold should be a total usage figure rather than a percentage usage figure) and only be triggered in the event of reductions over multiple years.

6. The Draft Decision in the Context of the Regulatory Regime

The Queensland rail access regime is largely governed by the QCA Act. In particular, sections 138, 143 and 168A of the QCA Act require the QCA to consider various factors when assessing the DAAU pricing proposal.

The object of Part 5 (sections 138 and 143) of the QCA Act is to promote the economically efficient operation of, use of and investment in, infrastructure by which services are provided, with the effect of promoting effective competition in upstream and downstream markets. Section 168A of the QCA Act requires that pricing for a service should generate expected revenue for the service that is at least enough to meet the efficient cost of providing access to the service.

Pacific National makes the following comments in relation to the requirements of the QCA Act relevant to the Draft Decision. In particular, these comments are made with a focus on the fact that the Draft Decision has provided a degree of qualified support to the concept that diesel users should potentially fund investments in electric infrastructure. Pacific National does not agree with the proposition that diesel users should potentially fund investments in electric infrastructure.

Table 2: Comparison of Electric Traction DAAU Proposal with QCA Act Requirements

Requirement of the Act	Pacific National Comment on the Draft Decision
s138 – Consider the object of Part 5 of the QCA Act to promote the economically efficient operation of, use of and investment in, significant infrastructure by which services are provided, with the effect of promoting effective competition in upstream and downstream markets.	<p>To the extent that the Draft Decision provides support for the concept that diesel users should pay for electric infrastructure then the Draft Decision does not encourage efficient operation of, use of or investment in below rail assets as the pricing for electric infrastructure is not cost reflective and has the potential to create cross subsidies.</p> <p>In addition to the extent the Draft Decision locks in electric traction via electric infrastructure as the preferred traction choice, the Draft Decision removes incentives for</p>

Requirement of the Act	Pacific National Comment on the Draft Decision
	<p>prudent and efficient investment in new technology.</p> <p>In addition, to the extent the Draft Decision provides support for the concept that diesel users should pay for electric infrastructure then the Draft Decision does not promote effective competition in upstream or downstream markets given the locomotive fleets active on the Aurizon Network infrastructure (particularly the Blackwater system).</p>
<p>s138 - Consider the public interest, including the public interest in having competition in markets (whether or not in Australia).</p>	<p>To the extent that the Draft Decision provides support for the concept that diesel users should pay for electric infrastructure then the Draft Decision does not promote the public interest in competition as it may potentially favour one rail operator over another given the locomotive fleets active on the Aurizon Network infrastructure (particularly the Blackwater system).</p>
<p>s138 - Consider the interests of persons who may seek access to the service, including whether adequate provision has been made for compensation if the rights of users of the service are adversely affected.</p>	<p>To the extent that the Draft Decision provides support for the concept that diesel users should pay for electric infrastructure then the Draft Decision does not promote the interests of access seekers as it leads to pricing uncertainty.</p>
<p>s168A - Pricing principles – price of access to a service should achieve generate expected revenue for the service sufficient to meet the efficient cost of providing access to the service and include a return on investment.</p>	<p>To the extent that the Draft Decision provides support for the concept that diesel users should pay for electric infrastructure then the Draft Decision does not reflect the efficient cost of a service as diesel users will be cross subsidizing electric users.</p>
<p>s168A -Pricing principles – price of access to a service should not allow a related access provider to set terms and conditions that discriminate in favour of the downstream operations of the access provider or a related body corporate of the access provider, except to the extent that the cost of providing access to the other operators is higher.</p>	<p>To the extent that the Draft Decision provides support for the concept that diesel users should pay for electric infrastructure then the Draft Decision has the potential to favour Aurizon Operations over Pacific National, even though the cost of providing access to both operators is similar.</p>
<p>s168A -Pricing principles – price of access to a service should provide incentives to reduce costs or otherwise improve productivity.</p>	<p>The Draft Decision may provide disincentives to invest in new traction technologies (which may improve productivity).</p>

Overall Pacific National supports the Draft Decision to not approve the Electric Traction DAAU but is concerned that the Draft Decision contemplates the possibility that a revised electric revenue

adjustment could be approved by the QCA, where such a revised electric revenue adjustment would continue to include the potential for diesel users to fund electric infrastructure in certain circumstances. This is a major concern to Pacific National, and Pacific National believes that such a revised electric revenue adjustment would continue to fail to meet the criteria in sections 138 and 168A of the QCA Act.

Given this Pacific National seeks that the QCA Final Decision be more definitive in stating that any DAAU proposal that includes the potential for diesel users to fund electric infrastructure in some circumstances will not meet the criteria in sections 138 and 168A of the QCA Act.

7. Conclusion

Overall Pacific National has no major concerns with the concept underpinning Aurizon Network's proposed Variable Connection Charge.

Pacific National has major concerns with Aurizon Network's proposed Electric Revenue Adjustment as outlined in its previous submission. Pacific National welcomes the position that the QCA has taken regarding some of these concerns, however Pacific National is acutely concerned that the QCA is providing a degree of qualified support to the concept that diesel users should fund investments in electric infrastructure that they are not going to use. Pacific National continues to strongly support the principle that users of Aurizon Network rail should only be charged for infrastructure that they actually use, and that charging users for infrastructure that they do not use results in allocative inefficiency and price distortions. Pacific National believes that such a revised electric revenue adjustment would continue to be unlikely to meet the criteria in sections 138 and 168A of the QCA Act.

In addition to this matter of principle Pacific National is concerned that:

-) Aurizon Network's proposal to require diesel users to fund electric infrastructure ultimately acts to benefit Aurizon Operations in the Blackwater system;
-) Aurizon Network's proposal locks in electric traction via overhead electric infrastructure as the preferred form of traction and disadvantages new technologies; and
-) Aurizon Network's proposal penalises current diesel users for past traction choices. To this end Pacific National is disappointed that the Draft Decision did not consider the matter of grandfathering in more detail.

Pacific National seeks that the QCA Final Decision be more definitive in stating that any proposal that includes the potential for diesel users to fund electric infrastructure will not meet the criteria in

the QCA Act. More broadly in relation to the matter of electric traction Pacific National believes that the issue of grandfathering should be considered in more detail.