

PACIFIC NATIONAL SUBMISSION

**QCA draft decision - Aurizon Network's 2017 draft
access undertaking**

March 2018

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1. Executive Summary

Pacific National welcomes the opportunity to respond to the Queensland Competition Authority (**QCA**) on the Draft Decision on the Aurizon Network Draft Access Undertaking (**DAU**) published in December 2017 (referred to as the **Draft Decision**). Pacific National supports the QCA's position to not accept the DAU in its current form.

In this submission Pacific National will set out a response on the areas of particular interest drawn out in the Draft Decision, and will also comment on numerous matters relating to the detail of the Draft Decision. Overall, in assessing the DAU, Pacific National seeks that the QCA consider both the efficient operation of the Aurizon Network rail infrastructure, and the promotion of effective competition in the above rail market.

Pacific National believes that a greater focus is needed on the efficient operation and maintenance of the Central Queensland Coal Network (**CQCN**). In particular there needs to be a focus on reducing the cost per train path (achieved either through a reduction in costs or by increasing the volume of paths available). On this basis, Pacific National supports the stance taken by the QCA on operating cost and maintenance cost put forward by the Draft Decision, and the particular focus on reducing costs and increasing efficiency which can ultimately result in improved outcomes for all supply chain participants. In particular, Pacific National supports the efficiency factor proposed to be introduced into the maintenance cost assessments, and would welcome broader use of efficiency factors and efficiency sharing in the regulatory framework.

Pacific National believes that incentive and efficiency mechanisms should be broadened to include incentives for Aurizon Network to efficiently expand network capacity and throughput (including increasing the number of train paths available to users). Pacific National believes the 'revenue cap model' currently in place does not encourage Aurizon Network to efficiently expand network capacity. We contend that as Aurizon Network has a secured revenue source, which provides limited incentives for Aurizon Network to initiate actions to grow volumes for haulage across the CQCN. As an alternative, Pacific National suggests a 'price cap model' would provide a strong incentive for Aurizon Network to increase the throughput of the supply chain. Mechanisms which encourage Aurizon Network to consider innovation and transformation in this way promote more efficient operation and investment in this infrastructure – a central aim of the regulatory framework governed by the QCA. By way of example, Pacific National believes that innovations in train control systems may allow network capacity (and therefore volumes) to be increased without large investments in physical track infrastructure.

The 2016 Aurizon Network access undertaking (referred to as **UT4**) increased the level of performance reporting required to be undertaken by Aurizon Network. However, Pacific National considers that in order for these performance metrics to drive change they must be linked to an appropriate incentive mechanism.

Furthermore, coal supply chain allocative efficiency will be optimised by having Aurizon Network pricing reflect the cost of the infrastructure that the users actually use. Attempts to socialise costs between broad groups of users (such as electric train operators and diesel train operators) will ultimately result in cross subsidies from one group of users to another group of users, and reduce allocative efficiency within the supply chain.

In addition to the issue of efficiency and incentivisation discussed above, Pacific National believes there must be an ongoing focus on the promotion of competition in above rail markets, as competition in these markets is driving productivity gains. To this end the ringfencing and compliance regime which facilitates third party rail access on the Aurizon Network rail infrastructure must be strengthened. The full benefits of above rail competition can only be realised when current and future participants have confidence that a rigorous ringfencing and compliance regime will safeguard their business interests, while promoting effective competition.

Pacific National has keenly scrutinised the actions of Aurizon Network following publication of the Draft Decision, and in particular Aurizon Network's revised approach to maintenance and operations and the impact that this may have on volumes capable of being transported on the CQCN. Pacific National supports all participants following due regulatory process and compliance with their contractual obligations. Aurizon Network acting in a manner assured to reduce volume throughput in response to the Draft Decision, concerns Pacific National. Pacific National is apprehensive that such reductions must:

- not disproportionately impact train operators, notably those not related parties to Aurizon Network; and
- be reflected in a reduced revenue caps and take or pay revenue. In particular where there is a reduction in system throughput due to unilateral decisions made by Aurizon Network, the QCA should seek to reduce Aurizon Network's revenue cap. Pacific National contends that such a reduction should be classified as 'Aurizon Network Cause' (as that term is defined in any relevant Access Agreements) preventing Aurizon Network from having an ability to recovery this forgone revenue ordinarily recoverable from access holders via take or pay provisions in their contractual arrangements.

Throughout the following submission, Pacific National will clarify its position on the above standpoints, and where appropriate illustrate its support for the QCA's position to not accept the DAU in its current form. Pacific National notes this submission contains no confidential information and may be considered a public document suitable for publication by the QCA.

2. Introduction and Background

Pacific National supports the QCA's position as set out in the Draft Decision, to not accept the DAU in its current form and encourages the QCA in continuing their statutory role in applying the *Queensland Competition Authority Act 1997* (the **QCA Act**) to determine whether the DAU is appropriate.

As the QCA is aware, Pacific National is a major operator of coal trains on the Aurizon Network rail infrastructure via third party agreements established under the certified Queensland rail access regime. In addition, Pacific National also has intermodal freight operations in Queensland which utilise sections of Aurizon Network track infrastructure (namely the sections between Parana and Rockland, and between Kaili and Durroburra).

2a. Previous Pacific National Submissions in this Regulatory Process

Pacific National has previously made two (2) substantive submissions to the QCA on this Aurizon Network DAU, being:

- in February 2017, "Pacific National Submission to the QCA on the Aurizon Network 2017 Draft Access Undertaking". This submission raised numerous concerns with the DAU including:
 - a lack of development of a take or pay pooling mechanism and an incentive mechanism; and
 - changes in the drafting relating to the:
 - QCA oversight of negotiated access conditions;
 - processes related to the relinquishment of train service entitlements;
 - processes related to the Aurizon Network unilaterally amending maximum payloads for train services;
 - Aurizon Network's obligations in supply chain group participation;
 - Aurizon Network's obligations in addressing capacity shortfalls; and
 - dispute resolution processes.

- in March 2017, “Pacific National Comments on Proposed Changes to 2017 Draft Access Undertaking Documents”. This submission was complementary to the collaborative stakeholder submission presented by the Queensland Resources Council (**QRC**) and Aurizon Network which sought to resolve several matters relating to changes to the drafting of the DAU. These matters included changes to negotiated access conditions, path transfer and relinquishment processes, supply chain co-ordination, system capacity assessment, dispute resolution and train payload adjustment. Pacific National generally accepted the drafting changes proposed by the QRC and Aurizon Network.

2b. Current Pacific National Submission

This Pacific National submission reiterates, reinforces, and adds to Pacific National’s concerns previously raised with the DAU. Pacific National believes that the QCA must address these matters in the QCA’s Final Decision on the Aurizon Network DAU. In considering these concerns, Pacific National seeks that the QCA continue to ensure that the final Access Undertaking remains consistent with the Object of Part 5 of the QCA Act, being:

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.

In particular, Pacific National requests the QCA to consider both the efficient operation of the Aurizon Network infrastructure and the promotion of effective competition in the above rail market.

In deliberating on the efficient operation of the Aurizon Network track infrastructure, Pacific National believes that the expert report entitled “B&H Assessment of AN’s UT5 Submission” is particularly relevant. This report clearly identifies the lack of productivity and efficiency gains within Aurizon Network with statements such as¹:

A “well run” railway invests in productive machinery that produces higher output at lower cost. A “well run railway” looks for productivity improvements and flexibility in the way it deploys its human and equipment resources. The AN UT5 submission displays none of these attributes. It could have been written in 1999 ...

AN’s UT5 shows little measure of continuous improvement. In fact, it identifies new methods and investments, much like previous submissions, but does not reflect any of the

¹ B&H Assessment of AN’s UT5 Submission December 2017 pages i-ii
<http://www.qca.org.au/getattachment/e59e683a-f210-4c6e-b9d0-3f80dab99f47/B-H-Strategic-Services-Assessment-of-AN-s-UT5-su.aspx>

benefits that were forecast to accrue with the original investments or with the new methods. Costs delivered to customers on a per tonne, gtk or ntk basis are stagnant. Service levels are not dropping to justify increases in expenditure.

For UT5, the efficiency of CQCN maintenance services is the same as it was in UT1. There has been no improvement in efficiency over nearly 20 years, except for FY2017.

The AN UT5 submission contains little if any projected improvement in efficiency ... AN projects a reduction in productive efficiency during UT5, compared to UT3.

Pacific National agrees with these statements, which reflect many of Pacific National's frustrations with Aurizon Network's operating performance over the time during which Pacific National has been operating in the Queensland coal haulage market. These statements made by an expert organisation, privy to data, information and people not otherwise available to industry participants, has served to crystallise Pacific National's thinking - Aurizon Network, and its governing regulatory process, need to re-focus efforts on ensuring the efficient operation and maintenance of the rail network to the benefit of all supply chain participants. In the face of growing global competition in both upstream and downstream markets, it is essential that the central Queensland coal supply chains remain competitive.

Pacific National believes that a greater focus is needed on the productivity of the rail infrastructure including:

- productive efficiency – that is, reducing the cost per train path by reducing costs and increasing the availability of paths. This in turn will reduce the cost of per net tonne of coal transported on the rail infrastructure, which contributes to the ongoing competitiveness of the coal supply chain. Reliability of the rail network is central to this, as the variability of network performance is a factor in increasing the cost of per net tonne of coal transported; and
- allocative efficiency – that is, sending efficient price signals which determine resource allocation by ensuring that access pricing reflects the cost of the infrastructure that the users actually use.

Pacific National believes that both the regulatory and commercial frameworks applying to the CQCN contribute to a lack of productive efficiency. The regulated revenue caps and commercial take or pay arrangements ensure that Aurizon Network is paid regardless of its performance. Thus, Aurizon Network has limited incentive to improve its performance and productivity.

Further to this issue of productivity Pacific National believes that in recent years many of the productivity gains achieved in the rail element of the coal supply chain have come from the actions of the above rail providers (including both Pacific National and Aurizon Operations). Operating improvements such as the introduction of electronically controlled pneumatic (**ECP**) braking, increased locomotive power and safe operation of over-length trains have all been driven by above rail providers. These above rail providers operate in an increasingly competitive market, and it seems evident that competition between the above rail providers (as promoted through the Queensland regulatory regime by the QCA) is driving these productivity gains.

Thus, Pacific National continues to strongly support the need for the QCA and the final Access Undertaking to promote effective competition in the above rail market. To this end the ringfencing and compliance regime which facilitates third party rail access on the Aurizon Network rail infrastructure must continue to be monitored and strengthened. The full benefits of above rail competition can only be realised when current and future participants have confidence that a rigorous ringfencing and compliance regime will safeguard their business interests, while promoting effective competition.

Pacific National reiterates the positions made in its February 2017 submission regarding the strengthening of management separation and the treatment of confidential information. Pacific National believes that the QCA acceptance of the Aurizon Network position set out in the DAU as premature. This is particularly so given that in the past six (6) months alone, there have been three (3) notifiable ringfencing breaches by Aurizon Network in respect of Pacific National's commercially sensitive information. As the QCA is aware, Pacific National has noted its alarm at the frequency of these events and the lack of urgency shown by Aurizon Network in taking any effective remedial action. Pacific National believes that the strengthening of management separation and the treatment of confidential information should be reconsidered by the QCA in the Final Decision. The details of Pacific National's stance on this are outlined in section 4d of this submission.

3. Aurizon Network actions following Draft Decision

As the QCA is aware, the release of the Draft Decision has resulted in a series of actions from various industry participants. This section aims to set out Pacific National's position in relation to these actions.

From the time of its announcement to train operators and miners on 30 January 2018 that Aurizon Network would introduce changes to align its operating practices with its interpretation of the requirements of the Draft Decision, Pacific National has echoed the concerns of other users.

These include matters being raised about Aurizon Network pre-empting the QCA's final decision to be informed by and delivered through the regulatory process and, depending on the nature of the system throughput reduction, mis-align with Aurizon Network's contractual obligations regarding access. Pacific National has sought, with little clarity given, and continues to seek clarification from Aurizon Network on the nature of the volume reduction figure provided by Aurizon Network, and whether the figure is a reduction in existing contracted capacity.

Pacific National's view is that a productive and competitive coal supply chain underpinned by a robust regulatory regime is in the interests of all participants. Thus, Pacific National seeks that all participants follow due process and not attempt to predict the outcome of the QCA's Final Decision.

Pacific National believes the key principles for respect of due process in the circumstances are twofold:

- ***A rail network that is genuinely efficient and reliable*** - The rail network must be maintained (as an absolute minimum) to a level sufficient to fulfil contracted volumes, but ideally creating additional capacity through efficient operations and maintenance; and
- ***Regulatory certainty*** – Rail network users should have confidence that there is an effective regulatory regime that facilitates competition. Without stability in the structure and certainty in operation of the regime, volatility will have the affect of decreasing investment in both upstream and downstream markets. This is an unacceptable outcome for all participants in the supply chain.

An additional trepidation for Pacific National, which directly impacts above rail market competition, relates to the potential for Aurizon Network's changes to its operating and maintenance practices, impacting each of the above rail operators in a non-equivalent manner. For example, Aurizon Network may choose to undertake extended infrastructure maintenance at a time when the operations of mines, solely served by Aurizon Operations (Aurizon Network's related above rail party) are also off-line, undergoing maintenance of mine facilities. In such a circumstance Pacific National would be disproportionately impacted by this change in Aurizon Network maintenance practices, either intentionally or unintentionally, as maintenance is scheduled to meet the needs of Aurizon Network's related party's customers. Pacific National will be seeking to monitor any changes to the Aurizon Network maintenance regime to assess its impact on both related above rail operators and independent above rail operators.

Importantly, Pacific National contend that the DAU and Draft Decision do not contemplate a situation where Aurizon Network makes a unilateral decision to effect an action such as altering

their operational and maintenance practices in a way that reduces throughput in the CQCN. Pacific National believes that the QCA should strongly consider amending the DAU to address these types of actions currently not planned or measured under regulation. In particular, the DAU should be amended to:

- place stricter obligations on Aurizon Network to maintain a safe and efficient rail network that will deliver contracted capacity – not merely capable of delivering capacity in theoretical circumstances;
- allow the QCA to re-evaluate Aurizon Network’s revenue cap to reflect the portion of rail capacity that Aurizon Network actually delivers. That is, the QCA should reduce Aurizon Network’s revenue cap if there is a reduction in system throughput due to actions or omissions made by Aurizon Network in its operation of, maintenance of or investment in the infrastructure; and
- any reduction in rail system throughput as a result of any decisions made by Aurizon Network should be classified as ‘Aurizon Network Cause’ (as that term is defined in any relevant Access Agreement) preventing Aurizon Network from having an ability to recover this foregone revenue ordinarily recoverable from access holders via take or pay provisions, and further removing Aurizon Network’s ability to recover this foregone revenue via the revenue cap process and the associated revenue adjustment process.

Stakeholders could not have anticipated these unpredicted actions taken by Aurizon Network, which they have themselves stated will significantly impact the throughput of the CQCN and therefore impact the coal industry, and associated markets within Queensland, including the market for above rail haulage in which Pacific National operates. Given the significance of the infrastructure that is the CQCN, Aurizon Network cannot be allowed to behave as such without consequential adjustments to their allowable revenue under the access undertaking once approved.

As outlined in Section 4a below, Pacific National supports the operating cost and maintenance cost put forward by the Draft Decision, together with the focus on increasing efficiency which ultimately results in improved outcomes for all supply chain participants. Aurizon Network’s current position in relation to changing its maintenance practices as a reaction to the Draft Decision is creating widespread industry concerns regarding the ongoing existing capacity and reliability of the rail network.

4. General Comments on Draft Decision and Regulatory Process

Pacific National has several broader comments on the Draft Decision outlined in the section below.

4a. Treatment of Costs

Overview: While Pacific National is an access holder on the Aurizon Network rail infrastructure, it passes through these all associated costs to the end users. However, in its capacity as an above rail haulage operator Pacific National will be impacted by the final Access Undertaking pricing and revenue positions in several ways, including:

- allowances relating to operating and maintenance costs will directly impact on both current and future Pacific National above rail operations on the Aurizon Network infrastructure;
- allowances relating to current and future capital expenditure impact on future Pacific National above rail operations on the Aurizon Network infrastructure;
- assumptions and forecasts relating to volumes will have an impact as an input to both Pacific National decisions and external decisions which impact on current and future Pacific National above rail operations on the Aurizon Network infrastructure;
- allowances and assumptions relating to asset valuation, depreciation and rate of return will act as an input to external decisions which impact on current and future Pacific National above rail operations on the Aurizon Network infrastructure; and
- pricing structures and pricing levels may incentivise certain types of train operations, for example they may encourage the operation of larger trains.

Given the impact that pricing and revenue have on Pacific National's operations, Pacific National is concerned that regulatory decisions on the revenue components are consistent with the QCA Act.

Pacific National supports the allowed revenue proposed by the QCA in the Draft Decision and believes that it meets the requirements of QCA Act and in particular meets the requirements of sections 69E and 168A of the QCA Act that the allowed revenue cover efficient costs of providing the access service.

Operating and Maintenance Costs: Pacific National's position on operating and maintenance costs is outlined in its February 2017 submission (page 6), namely:

Pacific National supports maintenance costs levels which are efficient and which ensure safe and efficient train operations on the Aurizon Network at the current contracted capacity.

Thus, as required by the QCA Act, Aurizon Network should only be allowed to recover its efficient operating and maintenance costs.

In considering operating and maintenance costs the QCA sought expert advice from both GHD and B&H Strategic Services, which resulted in the Draft Decision allowing:

- operating costs of \$743 million over four years, which is \$112 million less than Aurizon Network sought in its DAU; and
- maintenance costs of \$817 million over four years, which is \$104 million less than Aurizon Network sought in its DAU.

Pacific National supports these lower operating costs. In particular Pacific National supports the \$36 million reduction in corporate overheads contained in the operating costs. Clause 137 (1A) of the QCA Act states that any access undertaking for a service owned or operated by a related access provider (such as the Aurizon Network access undertaking) must include provisions for:

.. preventing the related access provider recovering, through the price of access to the service, costs that are not reasonably attributable to the provision of the service.

When Aurizon corporate costs are over-allocated to Aurizon's rail network they have several impacts on competition and efficiency, namely:

- they are inefficient as they shift access tariffs further away from being cost reflective efficient tariffs; and
- they act contrary to competition as they provide a cost advantage to Aurizon Network's related above rail operator, given this operator no longer has to carry an allocation of corporate costs, thus providing them with a competitive advantage compared with other above rail providers who cannot 'cost-shift'.

Pacific National welcomes the Draft Decision's position to closely scrutinise Aurizon Network's allocations of corporate costs and believes that there must be ongoing scrutiny of Aurizon Network corporate cost allocations in order to ensure users of Aurizon Network are not subsidising broader Aurizon activities. Pacific National supports the reduction in corporate overheads allocated to Aurizon Network under the DAU.

Overall, Pacific National believes that the lower operating costs allowed under the Draft Decision are more reflective of an efficient below rail operator than the costs submitted by Aurizon Network in its DAU.

In considering maintenance costs the Draft Decision requires a reduction in maintenance costs of \$104 million over four years. The main drivers of this cost reduction are the treatment of ballast undercutting and the introduction of an efficiency factor.

The efficiency factor will allow Aurizon Network to retain efficiency gains greater than the 2% efficiency target level. Pacific National strongly supports the introduction of this efficiency factor as it will provide Aurizon Network with a stronger incentive to develop more efficient and innovative approaches to maintenance.

Overall, Pacific National believes that the lower operating and maintenance costs allowed under the Draft Decision are more reflective of an efficient below rail operator than the costs submitted by Aurizon Network in its DAU, and these costs should be maintained in the Final Decision.

4b. Efficiency and Incentives

Pacific National strongly welcomes the Draft Decision position on implementing an efficiency factor in the Access Undertaking, with a 2% per annum efficiency target from financial years 2019 to 2021 inclusive. Pacific National notes that while a 2% per annum efficiency target is to be implemented, the Draft Decision notes (on page xix) that efficiency gains of 3% per annum of total maintenance costs are achievable. Given 3% per annum is considered achievable, Pacific National believe this should provide Aurizon Network with sufficient incentive to meet the 2% per annum target.

The Draft Decision (on pages xv - xvi) explicitly seeks comment on an efficiency sharing mechanism. Under the 'revenue cap model' currently in place any cost savings made by Aurizon Network are retained by Aurizon Network for the duration of the access undertaking. Pacific National believes this provides an incentive for Aurizon Network to reduce costs, but these cost reductions are not passed through to end users (as expected to occur in a competitive market). Pacific National believes that an efficiency sharing mechanism designed to distribute these benefits amongst Aurizon Network and its customers would result in a more balanced approach.

Such an efficiency sharing mechanism needs to be supported by an effective performance regime (KPIs). This will strike the right balance between continued cost savings and preserving the standard of the rail network's performance.

Pacific National believes that the in subsequent access undertakings incentives for efficiency can be further increased through a change in the nature of the regulatory framework and the introduction of a more comprehensive incentive mechanism. Pacific National strongly believes that in order to meet Object of Part 5 of the QCA Act (as outlined in section 2b of this submission) an incentive mechanism must be put in place which drives Aurizon Network to efficiently operate and invest in rail infrastructure in such a way that promotes effective competition in the supply chain. Similarly, section 168A (d) of the QCA Act outlines that one principle underpinning the pricing of access is that the price should:

...provide incentives to reduce costs or otherwise improve productivity.

Given this QCA Act objective, Pacific National believes that Aurizon Network incentive and efficiency mechanisms must be broadened to include incentives for Aurizon Network to efficiently expand network existing capacity and throughput (including increasing the number of train paths). In particular, the development and implementation of an incentive mechanism with a linkage to access pricing would provide incentives for productivity increases.

The current 'revenue cap model' does not encourage Aurizon Network to efficiently expand existing network capacity as Aurizon Network is assured revenue with limited incentives to increase volumes for transportation through the CQCN. Aurizon Network currently acts to minimise any risks to revenue recovery, protected by a revenue cap² and take or pay arrangements. The access undertaking also allows Aurizon Network to voluntarily submit changes throughout the term of the Access Undertaking to address any other risk factors that arise. These regulatory and commercial frameworks provide little incentive for improvements in efficiency and as such are not aligned with the Object of Part 5 of the QCA Act.

Pacific National believes that the revenue cap regulatory model should be reconsidered in future access undertakings. The revenue cap model does not encourage efficiency as the CQCN is guaranteed to generate revenue for Aurizon Network with limited incentives to grow volumes or improve the efficiency of operations to the benefit of all parties. As an alternative, a 'price cap model' would secure a price for Aurizon Network, and as volumes increased the recoverable revenue would increase proportionately. This would provide a strong incentive for Aurizon Network to increase the throughput of the supply chain. By way of example, Pacific National believes that innovations in train control systems may allow network capacity (and therefore volumes) to be increased without large investments in physical track infrastructure. Mechanisms which encourage Aurizon Network to consider innovation and transformation in this way promote more efficient

² The Aurizon Network revenue cap was introduced in UT2 in 2007, prior to this it was a price cap.

operation and investment in this infrastructure – a central aim of the regulatory framework governed by the QCA.

Pacific National has continually promoted the need for the Aurizon Network Access Undertaking to include an incentive mechanism³. Pacific National has consistently taken the position that Aurizon Network does not have sufficient incentive to seek improvements in operating efficiency and that an incentive mechanism⁴ is required to drive efficiency improvements in Aurizon Network's operations and the broader supply chain. Pacific National's February 2017 submission (on page 18) on the DAU restated this concern:

Pacific National remains concerned with the ongoing lack of an effective Aurizon Network KPI regime and the lack of an effective Aurizon Network incentive mechanism. Pacific National believes that a genuinely efficient central Queensland coal supply chain will only be achieved with a well designed and mandatory incentive mechanism which ensures that Aurizon Network has strong incentives to reduce costs while maintaining and improving service quality and track quality.

Pacific National believes that a well-designed incentive mechanism would have the following broad attributes:

- Key Performance Indicators which are linked to general performance, contracted access entitlements, throughput and are relevant to the coal supply chain. Pacific National recognises that the current access undertaking (known as UT4) increased the level of performance reporting required to be undertaken by Aurizon Network. In order for these performance metrics to drive change they must be linked to incentives through an appropriate incentive mechanism; and
- Incentive mechanism which link to individual operators rather than whole of system performance – this will ensure that differential treatment of operators is not concealed by aggregated performance metrics.

³ See for example the submissions below (at the time of the submissions below Pacific National was a subsidiary of Asciano and submissions made by Pacific National were under the name of Asciano):

- August 2012 Asciano Submission to the QCA in Relation to the Q Network Proposed DAAU Relating to an Incentive Mechanism
- October 2013 Asciano Submission to the QCA in Relation to the 2013 Aurizon Network Draft access Undertaking pp36 -39

⁴ Such an incentive mechanism must ensure all access holders are treated in a non-discriminatory manner and that operational efficiencies driven by the incentive mechanism must not unduly favour Aurizon Network's related party train operator

As a minimum Pacific National believes that the Access Undertaking should include a requirement to submit an incentive mechanism proposal during the term of the access undertaking. Pacific National notes that UT3 contained such a requirement.

4c. Pricing

Pacific National has several points of principle to make regarding access pricing in the DAU:

- the current access pricing structure remains unnecessarily complex and should be revised in the near future (perhaps the next access undertaking). This will ensure that price signals are clear and encourage train operators and end users to operate in the most efficient manner; and
- Pacific National continues to strongly support the principle that in order for infrastructure pricing to be efficient the pricing should reflect the cost of the infrastructure that the users actually use. Attempts to socialise costs across broad groups of users will ultimately result in cross subsidies from one group of users to another group of users. Thus, Aurizon Network customers and access holders should only pay for Aurizon Network infrastructure that they use. This matter is further discussed in section 4e of this submission and in Pacific National's recent submission to the QCA on Aurizon Network's Electric Traction proposal⁵.

4d. Treatment of Matters Previously Raised by Pacific National

In its February 2017 submission, Pacific National raised numerous concerns. Some of these concerns have been addressed in the collaborative submission process in March 2017⁶ and some have been addressed in the Draft Decision⁷. There remains several matters that Pacific National seeks to make further comment on.

Ringfencing: Pacific National in its February 2017 submission raised concerns regarding ringfencing and the disclosure of confidential information in sections 3.3 c) and 3.1.3 h). In particular the DAU allows Aurizon Network to disclose confidential information to Aurizon Network's related operator's employees involved in corporate governance, accounting, taxation, risk assessment, financing and similar functions.

The Draft Decision (on page 332) acknowledges these concerns but accepts the current DAU wording. Pacific National's concerns have increased in the interim due to the occurrence of three (3) notifiable ringfencing breaches in the past six (6) months (as outlined in Section 2b of this

⁵ Pacific National Submission to the QCA in relation to the Aurizon Network 2017 Electric Traction DAAU

⁶ The collaborative submissions largely addressed Pacific National concerns with DAU section 6.13, 7.4.3, 7A3, 7A4.3 and the SAA and TOD Sections 10, 11 and 12

⁷ The Draft Decision largely addressed Pacific National concerns with DAU section 7A4.2, 8.7.1, 8.8.3, 8.9.3

submission) which involve the disclosure of Pacific National's confidential information. Given the occurrence of these breaches, Pacific National seeks that the QCA reconsider its position on ringfencing and confidential information in the Final Decision⁸. In particular, as outlined in Pacific National's February 2017 submission Pacific National seeks that the ringfencing provisions be strengthened by:

- increasing the level of independence and separation of the Aurizon Network board and management;
- ensuring the Ultimate Holding Company Support Deed has sufficiently strong consequences for Aurizon to act as a deterrent to breaching the Deed;
- redrafting section 3.13 c) of the DAU. Pacific National believes that Aurizon Network disclosure of confidential information to a third party should be on terms which are enforceable by the owner of the confidential information. This section should be strengthened by returning to the wording proposed in the QCA's Final Decision on the 2016 access undertaking; and
- redrafting section 3.13 h) of the DAU. The DAU currently allows Aurizon Network to disclose confidential information to Aurizon Network's related operator's employees involved in corporate governance, accounting, taxation, risk assessment, financing and similar functions. Pacific National is concerned that given this broad exemption. This section should be strengthened by returning to the wording proposed in the QCA's Final Decision on the 2016 access undertaking.

Take or Pay Pooling: Pacific National in its February 2017 submission supported take or pay pooling, whereby under-utilised train service entitlements from one 'origin to destination' pair in an access agreement could be used to offset over-utilised train service entitlements from a different origin and destination pair in the same access agreement.

The Draft Decision (on page 315) determines that it is not appropriate to include take or pay pooling in the access undertaking as the short-term transfer provisions have only been in operation for a short period of time and the QCA continues to have concerns with that proposed regime.

Pacific National continues to strongly support take or pay pooling and urges the QCA to reconsider its position. Pacific National is encouraged that Aurizon Network has indicated that it may consider take or pay pooling as part of a future Draft Amending Access Undertaking.

⁸ Aurizon Network has engaged a consultant to review its ring fencing processes. Pacific National believes that any findings arising from this review could assist in informing the QCA on the potential strengthening of the ring fencing and confidential information provisions.

Ultimate Holding Company Support Deed: Pacific National in its February 2017 submission expressed its concerns regarding the Ultimate Holding Company Support Deed, and in particular its concerns that any breach of the Deed did not have sufficiently strong consequences for Aurizon to act as a deterrent to breaching the Deed.

The Draft Decision (on page 326) supports the Aurizon Network proposal that the Deed in its current form is appropriate. Irrespective, Pacific National continues to have concerns about the effectiveness of the Deed.

Ongoing Impact of UT1 Access Agreements: Pacific National in its February 2017 submission expressed its concerns that the remaining UT1 access agreement take or pay obligations may be socialised across access holders who hold access agreements signed under later access undertakings. Further, Pacific National proposed that the matter of differing take or pay treatments in different access agreements needed to be addressed.

The Draft Decision (on page 314) recognises this matter but indicates that in the absence of further information the current arrangements are appropriate. Pacific National continues to hold its current position on this matter but has no further information to add.

Furthermore, the Draft Decision states that based on information provide by Aurizon Network most UT1 access agreements will expire during the current UT4 period. Pacific National is seeking that Aurizon Network and the QCA provide further clarification on the number of UT1 access agreements which remain on foot, the expected expiry dates of these agreements and the approximate tonnages linked to these agreements. The provision of this information to industry may contribute to the resolution of this matter.

4e. Interaction of the Draft Access Undertaking with Other Regulatory Processes

Pacific National has several concerns with the interaction between the DAU and other regulatory processes.

i. Aurizon Network Electric Traction Draft Amending Access Undertaking

As the QCA is aware, in December 2017 Aurizon Network submitted a Draft Amending Access Undertaking to the QCA under UT4. This amendment proposes changes to the electric infrastructure component of the reference tariff. Pacific National recognises that this matter is now before the QCA in a separate regulatory process.

Pacific National has strong concerns about this Draft Amending Access Undertaking and is seeking clarity from the QCA as to how any final decision on the UT4 amendment may be incorporated into the Final Decision on the DAU.

Pacific National believes that the current DAU should be considered as a single proposal subject to a single regulatory process, whereby the different elements of the proposal must be assessed within the regulatory process and that decisions should not be made in isolation on any one element.

Pacific National assert that by separating out a single pricing element, such as the adjusting of tariffs for potential electric infrastructure under recovery, and making a decision solely on this element, compromises the integrity of the decision making process, in turn leading to undesirable outcomes for all stakeholders. Thus, Pacific National is concerned that a decision made by the QCA under a different regulatory process may be incorporated into the Final Decision on the DAU.

ii. Recent Ringfencing Breaches by Aurizon Network

As noted in Section 2b above, there have been three (3) ringfencing breaches by Aurizon Network in the past six (6) months. Pacific National is concerned that these breaches are indicative of systemic flaws in the in the Aurizon Network ringfencing compliance system. Due to the frequency of these breaches, Aurizon Network has engaged a consultant to review its ringfencing systems. Pacific National is seeking that, if appropriate, recommendations arising from the review are considered for incorporation into the Final Decision on this DAU.

Furthermore, given the occurrence of these breaches, the QCA should reconsider its approach to the broader monitoring and auditing functions including ringfencing compliance. Pacific National will recognise that this may not be a matter suitable for resolution in this access undertaking process. However, to this end Pacific National is seeking that provisions relating to the transfer of information between Aurizon Group entities, and the disclosure of confidential information be subject to annual compliance audits over the term of this access undertaking.

5. Comments on Details of the Draft Decision

This section includes comments of the detail of the Draft Decision. In addition, the Draft Decision indicated numerous areas that would benefit from stakeholder views. This section of Pacific National's submission seeks to also address some of these areas specifically identified by the QCA in the Draft Decision.

Treatment of WIRP and Deferrals: Aurizon Network proposed that revenue deferrals be discontinued in WIRP Blackwater, but suggested deferrals remain in place for WIRP Moura and NAPE. This will result in additional revenues being recovered from WIRP users. The Draft Decision indicates that this position is likely to be accepted.

Pacific National supports revenue deferrals where appropriate. Pacific National has no position on whether the revenue deferrals be discontinued in WIRP Blackwater, but seeks that any WIRP Blackwater or expansion tariffs only be paid by WIRP or expansion users. Existing users should not be subject to reference tariff increases as a result of expansions unless there is evidence that they benefit from such expansions.

Inflation: Aurizon Network proposed that the inflation parameter be based on the inflation implied by the difference between inflation-indexed bonds and nominal bonds. Pacific National understands that while this approach has been previously used in regulatory decisions, the lack of depth in the inflation-indexed bond markets has raised some concerns.

Pacific National does not have a preferred approach to deriving inflation but believes that for a four year regulatory period, such as that applying to this access undertaking, the inflation variable should sit within the RBA target band in the absence of compelling evidence to the contrary.

The Draft Decision also proposes to use forecast inflation to index the regulatory asset base rather than use actual inflation on an *ex post* basis. Pacific National has a concern that such an approach could artificially inflate, or deflate, the regulatory asset base if the inflation forecast was substantially inaccurate. Pacific National recognises that in the current low inflation environment, with RBA targeting inflation, any inflation forecasting is likely to have a reasonable degree of accuracy.

Forecast capital expenditure: The Draft Decision indicates that the QCA is considering a switch from an *ex post* annual assessment process for capital expenditure to an *ex ante* process for renewals capital expenditure.

Pacific National believes that such an approach will provide both increased incentives for efficient capital investment and potentially greater certainty for capital expenditure allowed. Given the incentives for efficient capital investment, this is supported by Pacific National.

Pacific National's main concern with such an approach is the potential for the *ex ante* capital expenditure to not be fully spent (due to exploitation of the regulatory process, changes in market conditions or efficiencies in capital renewals processes). Pacific National believes that the QCA

should establish a monitoring regime (perhaps similar to the current *ex post* process) to assess differences between capital expenditure forecast and capital expenditure undertaken. Pacific National's concern is that forecast capital expenditure allowed by the QCA will not be spent by Aurizon Network.

Pacific National believes that any *ex ante* Aurizon Network capital expenditures should be approved by a formal users group (by way of example, similar to the Rail Capacity Group in operation in the Hunter Valley which is established under the ARTC Hunter Valley Access Undertaking). Pacific National recognises that Section 8 and Schedule F of the DAU allow for the formal involvement of users in capital expansion projects but believe that the involvement of a formal users capital expenditure review group will result in more efficient capital expenditure on projects of most value to users. To this end, Pacific National notes that Aurizon Network's capital expenditure was previously endorsed by users under the Coal Rail Infrastructure Master Plan (CRIMP) but that this process has been replaced by the process in Schedule F for specific capital projects. Pacific National believes that the re-establishment of a formal users group has merit, particularly in a regulatory framework with *ex ante* capital expenditure process.

Volumes: The QCA believes that Aurizon Network's volume forecast is too conservative, with the QCA forecast ranging from 235.4 to 264.3 million tonnes per annum whereas Aurizon Network forecast 225.7 to 228.4 million tonnes per annum. Pacific National is concerned with the discrepancy between these forecasts. In particular, Pacific National is concerned that while the higher volume forecasts may reduce the reference tariffs but users subject to take or pay at the end of the year may have a higher amount to pay if forecast volumes are not realised.

Note that Pacific National has made the above high-level assessment based on the limited information available. Pacific National seeks more information (ideally at a mine or branch line level) of the volume forecast. Assessing whether the volume forecast is appropriate cannot be done accurately at the system level.

In addition, the reduction in volumes of 20 million tonnes per annum as foreshadowed by Aurizon Network on 12 February 2018 should be assessed by the QCA and potentially this reduction should be factored into any volume forecast.

Access Conditions: The DAU allows for Aurizon Network and an access seeker to agree to access conditions which differ from the standard access agreement and submit these to the QCA for approval. The Draft Decision (page 372) indicates that minor variations to payment terms or insurance requirements are considered immaterial and would not be considered by the QCA.

Pacific National has a concern with this Draft Decision position given both the related party nature of Aurizon Network and Aurizon Operations and the competitive nature of the above rail market. Given the nature of the market a minor variation in payment terms, insurances or some other variable considered to be immaterial may be sufficient to win an above rail haulage agreement from an end user. Pacific National believes that all variations between the related parties should be considered material if favour the Aurizon Operations more than the Standard Access Agreement provides for.

Capacity Assessments: The Draft decision (page 392) has proposed transitional provisions in the event that the baseline capacity assessment is not completed prior to the commencement of UT5. The lack of progress on the baseline capacity assessment is a concern for Pacific National as this assessment is fundamentally related to confirming whether Aurizon Network has the capacity to deliver the volumes which they are contracted to deliver. Any further delay in producing this assessment would be disappointing and given the reduction in volumes of 20 million tonnes per annum as foreshadowed by Aurizon Network on 12 February 2018 such a capacity assessment may be of increased importance in considering potential next steps in this matter.

In addition, the Draft Decision (page 394) states that the annual system capacity assessments will take account of reasonable requirements in respect of maintenance and repair of elements of the supply chain and reasonably foreseeable delays in the supply chain. PN supports the position that the annual capacity assessment should take into account for supply chain constraints as this ensures that the assessment reflects a more accurate view of actual available capacity (i.e. usable train paths rather than theoretical system paths).

The Draft Decision (page 397) also proposes changes relating to capacity deficits so that access holders and access seekers are involved in decisions regarding capacity deficits. Pacific National welcomes this change and suggests that train operators should also be involved in capacity deficit decision making where relevant.

The Draft Decision (page 400) also proposes that annual capacity assessments be subject to review by an independent expert rather than an audit. Pacific National supports this Draft Decision position.

Network Expansion: The Draft Decision (page 415) proposes Aurizon Network be held accountable for capacity shortfalls that have arisen as a result of an Aurizon Network default or negligent act. Pacific National strongly supports this Draft Decision position.

The Draft Decision (page 422) also proposes that the DAU be amended to include a clear process for the development of SUFA, including a means by which the QCA ensures that the process is ultimately implemented. Pacific National supports this Draft Decision position if the SUFA can be finalised quickly. Pacific National notes that the development of the SUFA has been a protracted process with the initial SUFA Draft Amending Access Undertaking being submitted by Aurizon Network to the QCA in December 2010. Pacific National's view is that the SUFA process to date has resulted in substantial effort from all industry participants but no concrete outcome. Consequently Pacific National is seeking that the SUFA be finalised quickly so that more focus is given to issues such as efficiency improvements in the network.

Dispute Resolution: The Draft Decision (on page 445) proposes to allow parties to commence disputes in relation to Aurizon Network's obligations under the access undertaking (as well as disputes in relation to access agreements) and include a broader scope of disputes which are subject to the dispute resolution provisions. Pacific National strongly supports this Draft Decision position.

6. Conclusion

Pacific National supports the QCA's position to not accept the DAU in its current form. In assessing the DAU, Pacific National seeks that the QCA consider both the efficient operation of the Aurizon Network rail infrastructure, and the promotion of effective competition in the above rail market.

Pacific National believes that a greater focus is needed on the efficient operation and maintenance of the CQCN. In particular there needs to be a focus on reducing the cost per train path. On this basis, Pacific National supports the stance taken by the QCA on operating cost and maintenance cost put forward by the Draft Decision, and the particular focus on reducing costs and increasing efficiency which can ultimately result in improved outcomes for all supply chain participants. In particular, Pacific National supports the efficiency factor proposed to be introduced into the maintenance cost assessments, and would welcome broader use of efficiency factors and efficiency sharing in the regulatory framework.

Pacific National believes that incentive and efficiency mechanisms should be broadened to include incentives for Aurizon Network to efficiently expand network capacity. Pacific National believes the 'revenue cap model' currently in place does not encourage Aurizon Network to efficiently expand network capacity.

In addition to the issue of efficiency, Pacific National believes there must be an ongoing focus on the promotion of competition in above rail markets, as competition in these markets is driving

productivity gains. To this end the ringfencing and compliance regime which facilitates third party rail access on the Aurizon Network rail infrastructure must be strengthened. The full benefits of above rail competition can only be realised when current and future participants have confidence that a rigorous ringfencing and compliance regime will safeguard their business interests, while promoting effective competition.

Pacific National has keenly scrutinised the actions of Aurizon Network following publication of the Draft Decision, and in particular Aurizon Network's revised approach to maintenance and operations and the impact that this may have on volumes capable of being transported on the CQCN. Pacific National supports all participants following due regulatory process and compliance with their contractual obligations. Pacific National is seeks that that such reductions must:

- not disproportionately impact train operators, notably those not related parties to Aurizon Network; and
- be reflected in a reduced revenue caps and take or pay revenue. In particular where there is a reduction in system throughput due to unilateral decisions made by Aurizon Network, the QCA should seek to reduce Aurizon Network's revenue cap. Pacific National contends that such a reduction should be classified as 'Aurizon Network Cause' (as that term is defined in any relevant Access Agreements) preventing Aurizon Network from having an ability to recovery this forgone revenue ordinarily recoverable from access holders via take or pay provisions in their contractual arrangements.

In addition Pacific National seeks that the QCA take into account Pacific National's comments on numerous matters relating to the detail of the Draft Decision.