Submission to Queensland Competition Authority

Submission on the 2013 Blackwater Electric Traction Pricing DAAU

Anglo American Metallurgical Coal Pty Ltd

June 2013

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Anglo American Metallurgical Coal Pty Ltd (***Anglo American***) refers to Aurizon Network Pty Ltd's (***Aurizon Network***) 2013 Blackwater Electric Traction Pricing Draft Amending Access Undertaking (***Proposed DAAU***), submitted on 24 April 2013, and to the Queensland Competition Authority's (***QCA***) subsequent letter requesting submissions on the Proposed DAAU. Anglo American considers this an important issue, and welcomes the opportunity to comment on this issue as it is important to deal with the application of AT5 under both the 2010 Access Undertaking (***UT3***) and the 2013 Draft Access Undertaking (***UT4***).

Anglo American strongly opposes the approach to AT_5 and electric traction submitted by Aurizon in its Proposed DAAU.

Anglo American has previously made submissions on fixing or increasing the AT_5 tariff in relation to the 2011 Electric Traction Services Draft Amending Access Undertaking (submitted in April and November 2012). While the drafting in the Proposed DAAU is different, the outcome is the same: inappropriately forcing Blackwater diesel services to cross-subsidise electric services in a way that prejudices competition in the above rail haulage market.

Anglo American maintains its previous submissions, and opposes the Proposed DAAU for the reasons set out below.

1 Aurizon's proposed electric model is flawed

1.1 Overreliance on cycle time

Aurizon Network suggests that electric hauled trains have a lower Total Cost of Ownership (***TCO***) because of a lower cycle time. This is based on the argument that cost is incurred because slower cycle time results in a slower system, causing lower throughput and higher capex and opex.

Aurizon Network has primarily considered the time taken for refuelling diesel locomotives in establishing the less efficient capacity of diesel trains. Provisioning and refuelling are generally undertaken in marshalling yards not on the operating network and consequently should have limited (if any) impact on throughput in the system.

As such, the extra capex and opex that Aurizon Network attributes to diesel locomotives is actually for off-network activities and should have limited (if any) impact on cycle time.

Further, as Aurizon Network has already noted the efficiency of electric traction is only properly realised when greater than 80% of the network operates that system. With any portion less than 80%, electric locomotives are unable to achieve faster cycle times than diesel and Aurizon's claimed benefit for electrification is purely hypothetical.

1.2 No consideration of current (or future) diesel technology

When considering cycle times, Aurizon Network has based the comparison between diesel and electric locomotives on trains owned and operated by its related body corporate running the above rail operations (Aurizon). Aurizon's diesel locomotives do not have modernised EPC braking systems in operation.

Aurizon's trains are not directly comparable to trains utilised by other operators. Pacific National has previously stated that its diesel operated trains (running EPC braking systems) have close to identical sectional run times as electric operated locomotives.

Aurizon Network's comparison also fails to consider any likely developments in technology. That has to be a relevant consideration where Aurizon Network is seeking to fix the AT_5 pricing structure over an eight year period.

Aurizon Network's comparison also remains based on economic modelling using flawed assumptions, such that much of what Aurizon Network asserts as fact has not been adequately substantiated.

As such, the economic modelling Aurizon has completed of TCO is reliant on flawed inputs which will result in a flawed and unrepresentative outcome. Anglo American, therefore, disagrees with Aurizon Network's submission that there is any evidence that diesel operated locomotives cause a drastic difference in cycle time and subsequently TCO.

1.3 Previous contractual positions should not be considered

Aurizon Network's TCO included $400 million for Powerlink break costs. Anglo American submits that it is inappropriate to consider previous or current one-off contractual positions when seeking to determine long-term pricing outcomes. This contractual position may change with further legislation or regulation and any assessment of electric or diesel traction TCO should be made on operating costs and not considering potential contractual remedies arising from Aurizon Network's past commercial negotiations.

1.4 Individual customer spur inclusions

Aurizon Network's TCO analysis also considers the $40 million investment required to electrify the Rolleston branch. That branch is specifically utilised for servicing an Xstrata mine. Under UT3, and now under its proposed UT4, Aurizon has specifically publicly stated that it will not construct or fund customer specific spur lines. As such, it is unclear why Aurizon has considered this $40 million amount in its TCO modelling. The impact of Xstrata funding developments to its own spur line has no impact on the typical TCO of diesel or electric locomotives.

Further, as this is an Xstrata specific development Aurizon has not made it clear why this is being considered in relation to the system-wide alterations to AT_5 (nor indeed in the capital indicator). Including the cost of electrifying the Rolleston branch is effectively cross subsidising the branch and is against the principles and interests of users under UT3 and UT4. Anglo American has been, and remains, strongly opposed to socialising such user-specific costs.

As such, Anglo American submits that Aurizon Network's TCO modelling differentiating electric and diesel services is inherently flawed and needs to be reconsidered prior to a QCA decision on amendments to AT_5. This is particularly important as the amendments to AT_5 form a basis for, and are reflected in, Aurizon Network's proposed UT4.

1.5 Aurizon Network's model does not account for sensitivity to key variables

Aurizon Network's TCO model is built on numerous assumptions. While Anglo American acknowledges that these assumptions are not necessarily incorrect, they are subject to a number of variables that if changed could significantly alter the outcome of the TCO model and impact upon the QCA's decision.

An example of these sensitive variables is Aurizon Network's reliance on set diesel and electricity costs as part of a broader operational cost. The Australian Competition & Consumer Commission (***ACCC***) has outlined a number of factors that might impact upon fuel prices within Australian markets.[1] Fuel prices may be affected by changes to international benchmark prices, the value of the Australian dollar, the origin of the retailer, levels of competition at different stages of the production process, changing taxes, changing governments, and even days of the week. In 2012 Australia had the 5th lowest retail diesel prices among all OECD advanced economies. Further, retail diesel prices currently comprise approximately 37% tax components, which may or may not

[1] ACCC, *Monitoring of the Australian petroleum industry – Report of the ACCC into the prices, costs and profits of unleaded petrol in Australia 2012* (6 December 2012).

change with both Federal and State elections in the next few years. Further, considering the long term nature of infrastructure projects, developments in the Australian economy and particularly the value of the Australian dollar can also impact diesel prices. Over the last 10 years the Australian dollar has fluctuated within a 60 cent margin against the US Dollar; a cost that cannot be predicted or relied on in developing a TCO model.

Anglo American submits that if Aurizon Network continues to seek amendments based on assertions about TCO it should undertake significant further work with the assistance of experienced accounting and finance prediction companies to verify its assumptions on the differing cost of diesel and electric variables and demonstrate the extent to which its conclusions still hold true when key variables change. This should occur before that variable cost is passed though to end users as a fixed portion of AT_5.

2 A hybridised system provides economic security

Anglo American understands that the premise behind Aurizon Network's Proposed DAAU is to incentivise coal producers to invest in electric traction rolling stock. The full benefits of a fixed AT_5 price path will only be realised when all usage of the Blackwater system is by electric traction based services.

Anglo American submits that a pure electric network is not economically secure. Maintaining a hybrid network protects train operations against sustained power outages. Such sustained power outages are not unknown in the Queensland network, particularly with the effects of high rain and flooding that can damage electrified systems while diesel-powered locomotives continue to operate. Anglo American does not believe that Aurizon Network has considered the protection afforded by a hybridised system in its TCO model.

3 Socialisation of costs is inappropriate

Anglo American has previously made extensive submissions on the subject of socialisation. In relation to socialising AT_5, Anglo American maintains its position that socialising the cost of network electrification is inappropriate. That position does not change merely because the Proposed DAAU is now seeking to socialise such costs over a longer period.

Some users utilise the electrified system, others still use the Blackwater system without electrification. These users should not be forced to cover an investment which they receive no benefit from, and thereby cross-subsidise those who do.

Further, socialising costs between the Central Queensland Coal Network systems is similarly inappropriate. Under options two and three of its supporting documentation to the Proposed DAAU, Aurizon would to recover part or all of its investment in electrifying the Blackwater system by socialising the fixed AT_5 cost across the entire Central Queensland Coal Network. All these systems are individual and some users require only portions of each. As such, users should not be required to pay a premium to support imprudent investments by Aurizon Network, or the electric network utilised by a completely different collection of users.

4 Anti-competitive impact on other operators

Current regulation of the Queensland coal chain ensures that the market remains competitive and efficient and is not subject to the unrestricted control of a natural monopolist. In considering the Proposed DAAU, the QCA is required to have regard to the factors in section 138(2) of the *Queensland Competition Authority Act 1997* (Qld), including the public interest in having competition in markets. Right now Pacific National remains one of the only (if not the only) effective competitor that Aurizon faces in the Queensland rail haulage market.

Most coal producers will make operational decisions based on projected costs. If they are forced to pay a fixed premium (by way of AT_5) for using diesel trains on an electric network where they receive no benefit they will move away from using that service. As haulage agreements typically pass through costs of access to coal producers, this directly impacts on coal producers' choice of operators. Recently Pacific National has made considerable investments in diesel rolling stock. This can be compared with Aurizon's most recent investments into electric locomotives. Rolling stock have longer useful lives than the typical 10 year term of access agreements in the Central Queensland Coal Network; in making previous investment decisions operators would have had to make assumptions about the structure of future access pricing. Operators make long term investments considering the nature of the market that they are in and the impact of AT_5 may be to make uneconomic Pacific National's recent investments in diesel locomotives.

While Pacific National might still be able to compete in the market, the Proposed DAAU will certainly impact upon Pacific National's profit margin and, therefore, the economic viability of it operating trains on Aurizon Network's network. Without Pacific National, Aurizon will be an effective natural monopolist in the above rail haulage market as well as the below rail access market and this change would be felt by customers. Even if Pacific National can continue to compete, the fixed AT_5 price path and resulting socialisation will certainly deter any smaller above rail operators from entering the market (as diesel is typically going to be a safer mode of entry for new entrants as it can be used to service a wider range of customers).

As such, Anglo American believes that fixing the electric AT_5 tariff is likely to have a detrimental effect on competition in the Queensland coal haulage market.

The clear anti-competitive effect of the Proposed DAAU also raises serious questions about whether Aurizon Network's proposal is primarily to benefit its related operator (rather than on efficiency grounds), and whether the regulatory framework needs to be strengthened to prevent such behaviour.

5 Impact on regulatory framework

5.1 Risk of changes during regulatory periods

Anglo American strongly objects to Aurizon Network being allowed to make material changes to the structure of its reference tariffs during a single regulatory period, particularly while negotiations for the next regulatory period are underway.

Regulatory certainty is the primary reason behind establishing a fixed regulatory period. As Anglo American has submitted previously, it is a fundamental principle of good regulatory practice that regulation should be certain and that changes to regulation should not be made lightly without considering all possible impacts on parties operating in that regulated industry. Aurizon Network continues to submit draft amending access undertakings in an attempt to change the rules in its favour, showing a complete disregard for regulatory certainty and imposing substantive costs on users (considering and having to constantly respond to such submissions).

Aurizon Network's Proposed DAAU is planned to extend over an 8 year period. Currently, there can be no certainty whether this 8 year period will be regulated using extensions to UT3, an accepted UT4 or another form of regulation. Nonetheless, Aurizon Network proposes to make users liable for a fixed electric maintenance charge over this period.

Over the regulatory period of UT3 users and operators have made significant investments for long term projects based on the certainty of UT3 regulation. As such, there is a legitimate expectation that the imposed tariffs will not be altered in a way that damages the value of those long term investments. Further, given the long term nature of the industry and the quantum of the investments made by users and operators, good regulatory practice would demand that the tariff framework remain substantially similar for consecutive regulatory periods unless there was a clearly identified reason to implement changes. Those changes should then be applied over an extended period of time so that users and operators do not lose substantial value on their investments. Noticeably, Aurizon does not suffer from the same impact through AT_5 alterations due to its long term investments in electrified rolling stock.

If the QCA approves Aurizon Network's substantial mid regulatory period alterations, it will affect the confidence of users and operators in the overall regulation of the industry. This will result in a shorter industry focus and inefficient investments that reflect the industry's fear of regulatory changes at any time.

5.2 Changing risk profile and form of regulation without changing other pricing parameters

As recognised in the QCA's recently published pricing papers, the form of regulation impacts on the risk and, therefore, should logically impact on the return generated by regulated entities. The Proposed DAAU, in effect, insulates Aurizon Network from the small amount of risk that it would otherwise have under UT3 (such as the potential for optimisation of the electric traction infrastructure regulated asset base where demand for its use deteriorated). Despite the reduction in such risk, Aurizon proposes to leave its regulated rate of return unchanged. That is a completely unbalanced position and demonstrates that it is not appropriate to change pricing structures in this manner without considering all other pricing issues (as will more appropriately occur in discussions on UT4).