QUEENSLAND resources COUNCIL

Resourcing Queensland's future

10 June 2021

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Queensland Competition Authority
Level 27, 145 Ann Street
Brisbane QLD 4000
(submitted via QCA Online Submission Form)

RE: Aurizon Network Annual Review of Reference Tariffs – FY22

The Queensland Resources Council (**QRC**), on behalf of the QRC's Rail Working Group, welcomes the opportunity to comment on the Queensland Competition Authority's Decision Notice (Draft), regarding Aurizon Network's Annual Review of Reference Tariffs – FY22 (ARRT).

1. Introduction

The Decision Notice (Draft) indicates that the QCA is minded to approve Aurizon Network's proposal. The Rail Working Group has a number of concerns with the ARRT, particularly with the proposed allocation of Newlands system renewals expenditure.

The QCA has indicated that it intends "*to develop a preliminary position paper to provide a framework for Aurizon Network and users to facilitate reaching an agreed approach to the allocation of renewal expenditure in the Newlands system*". The Rail Working Group does not consider it appropriate to approve the ARRT without either resolving this issue or establishing a process which will deliver an outcome within a specified timeframe (with that outcome to have retrospective effect to 1 July 2021). The proposed Position Paper approach appears to rely on agreement being reached between Aurizon Network and customers, which is highly unlikely. A Position Paper will not provide a process in which Aurizon Network is compelled to submit a Draft Amending Access Undertaking (DAAU) to address the issue, nor any obligation on Aurizon Network to amend a DAAU if the QCA does not consider the DAAU appropriate. For this reason, we consider that the QCA should either:

- Complete a thorough investigation of the Newlands renewals issue before making a final decision on the ARRT, such that the final decision reflects the QCA's final views on this issue. We acknowledge that this will delay the approval of revised tariffs beyond 1 July 2021; or

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- Alternatively, do not approve the ARRT, and require Aurizon Network to submit an amended undertaking which incorporates the ARRT but also establishes a process for resolving the Newlands renewals issue.

We note that the QCA's May 2020 Final Decision on the Annual Review of Reference Tariffs for FY21 included the following statement: "*We expect that Aurizon Network will continue to work collaboratively with all participants of the Rail Industry Group in order to develop an appropriate approach to allocate the incremental cost of renewals on the Newlands system due to Goonyella to Abbot Point system traffics bringing forward such capital expenditure*". No progress has been made in the twelve months since the QCA expressed this expectation. A process with a defined decision point is now required.

2. Volume Forecasts

The QRC Rail Working Group's submission of 9th April 2021 outlined our concerns regarding the methodology proposed by Aurizon Network for the development of volume forecasts. Aurizon Network's proposed methodology was to:

- base tonnage forecasts for each system on FY20 actual tonnes.

- allocate that tonnage to individual hauls in proportion to contracted tonnes, where contracted tonnes are amended to reflect changes which Aurizon Network anticipates between FY20 and FY22.

Our concerns were that this method:

- does not seek to reflect any changes between FY20 and FY22 which may impact on total volumes or on the relative contribution of particular mines, except to the extent that the relative contracted tonnes have changed.

- assumes that all mines will rail at the same proportion of contract without any regard to the relative performance of individual mines in the past.

- relies partially on historical performance (for total volumes) and partially on ignoring historical performance (for the relative contribution of mines).

We suggested that the updated forecast should be:

(a) based on railings for FY21 (year to date March or April), extrapolated to form a full year forecast; and

(b) Adjusted for known changes which will occur between FY21 and FY22 after consultation with customers.

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Aurizon Network's response indicated that:

- "*the QRC's suggested approach would fail to take changes in each system's contract composition1 between FY2020 and FY2022 into account*". This is not correct. Such changes would be within the scope of changes which would be considered when adjusting forecasts (item (b) above).

- Volume forecasts under the QRC's proposed methodology would be significantly lower. This is only true if our methodology was based on the first step alone. The outcome under our full proposed methodology is unknown, because the second step required customers to provide information to Aurizon Network on material changes in expected volumes. Aurizon Network declined to receive this feedback.

We have no objection to the volume forecasts which the QCA proposes to approve, as we are aware of several mine-specific changes which may bring FY22 volumes closer to FY20 levels, despite year-to-date FY21 performance being at lower levels. We do find Aurizon Network's refusal to engage in any consultation with customers on this question extremely disappointing. We understand that Aurizon Network needs to make its own decisions on proposed volume forecasts and that Aurizon Network would not necessarily reflect all feedback received from customers in the forecasts, but it is concerning that Aurizon Network instead declined the opportunity to receive this information from its customers.

3. Maintenance Indicator

The Maintenance Strategy and Budget (MSB) for the Newlands system was not approved by the relevant members of the Rail Industry Group (RIG) due to concerns about the efficiency of Aurizon Network's rail grinding costs, following the sale of the rail grinding business by Aurizon Operations to Loram and Aurizon Network's decision to enter into a contract with Loram which includes significant cost increases.

This matter has now been considered by the QCA and the QCA has approved this MSB.

In reaching this decision, the QCA has relied on information provided by Aurizon Network, which the QCA has been unable to publish due to confidentiality claims. Clearly in these circumstances, we are prevented from commenting on or challenging the information provided by Aurizon Network. We agree with the QCA's observation that this is not ideal.

Interestingly, the QCA states (page 4 of the Decision) that "*We also considered analysis undertaken by Aurizon Network before it entered into the relevant contract, including its analysis of insourcing rail grinding activities and market-equivalent grinding cost benchmarks*". The analysis of the insourcing alternative was one of the pieces of information sought by members of the RIG, but no information on this was provided by Aurizon Network. We are surprised to learn that such analysis exists, and of course we are prevented from commenting on it by Aurizon Network's confidentiality claim. One observation that we can make is that, if the analysis was based on a 'greenfield' approach in which Aurizon Network hired staff and purchased new machines, rather than procuring these from Aurizon Operations, then it is not surprising that this option did not appear efficient.

4. Allocation of Newlands system renewals between Newlands and GAPE

As was discussed in the introduction, we do not consider that it is appropriate to approve the ARRT without either resolving the Newlands renewals allocation issue, or establishing a defined process for its resolution, where that process gives the QCA power to impose an outcome.

Aurizon Network has provided a 22-page response to stakeholder submissions on this issue. We do not consider that it will be constructive to respond to those 22 pages in detail at this stage of the process. However, we will make the following observations:

- Aurizon Network is proposing a novel allocation methodology for Newlands renewals which, taken in isolation, is inherently unfair to non-GAPE users of the Newlands system. It is clear that GAPE services increase and bring forward renewals costs in Newlands. Any proposal which seeks to impose on one group of customers costs which are caused by another group requires rigorous analysis and justification. We accept that the overall pricing arrangement may be fair to Newlands customers when the full package of pricing issues is considered, but:
  - Customers do not have the data required to confirm this.
  - The onus to establish that this novel and seemingly unfair approach to renewals allocations is in fact acceptable clearly falls to the party which proposes such an unusual approach.
- We agree that the counterfactual assessment of what Stand-Alone Costs would be in FY22 for a 20TAL Newlands System without GAPE is a hypothetical construct. As was discussed above, the allocation method for Newlands renewals is inherently unfair, taken alone. When Aurizon Network assures customers that this is offset by other considerations such that Newlands customers are, on balance, better off than they would have been in the absence of GAPE, then we need a way to test that claim. We are open to considering other approaches (as alternatives to the counterfactual assessment of Stand-Alone Costs) which demonstrate that Newlands customers are not, on balance, worse off due to the existence of GAPE.
- Aurizon Network seeks to establish an exceptionally high standard for testing any question which customers suggest needs to be assessed, involving, for example, detailed engineering assessments. In contrast, we are expected to accept Aurizon Network's proposal based on the high-level observation that Newlands customers have received benefits which may be equal to or greater than the additional cost of renewals caused by GAPE customers.
- We accept that Newlands customers may receive benefits from the GAPE project which are not reflected in Newlands access prices, however Aurizon Network has not demonstrated these benefits nor whether those benefits have a value which is at least equal to the additional renewals costs which are caused by GAPE traffic and (under Aurizon Network's proposal) are to be paid by Newlands customers (including renewals costs allocated to Newlands customers in recent years). Also,

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we would expect that the value of any benefits which are not reflected in Newlands access prices will decline over time, while the impacts of the renewals allocation on Newlands customers will continue to compound. We need to establish a methodology which can be applied into the future.

We note (as we did in our April submission on the ARRT) that this issue is impacted by the existence of the GAPE Deed and that Aurizon Network's public statements (Page 34 of a June 2016 Investor Presentation[1]) indicate that Aurizon Network's total revenue is unaffected by increases in regulatory GAPE revenue, because such increases are offset by reductions in non-regulated charges under the GAPE Deed. This means that Aurizon Network has a strong financial incentive to shift cost allocation and revenue recovery out of the GAPE system and towards the Newlands system wherever possible.

Customers remain willing to work with Aurizon Network to resolve this issue. However, we cannot accept the continued deferral of the issue nor reliance on a process which has no end date and does not provide the QCA with the ability to impose an outcome.

5. NAPE deferral

Rio Tinto's submission requested that in relation to the deferred NAPE capex "*the QCA should consider the extent to which GAPE Users have already been required to cover the cost of the NAPE infrastructure*". Aurizon Network's response (page 22) included:

- "*Aurizon Network has not stated that it will seek to recover the full amount comprising the deferred NAPE capex*"; and

- "*Aurizon Network's objectives with respect to the deferred NAPE capex is not to 'double dip but to ensure that the return on its invested capital is commensurate with the outcomes it expected when it entered into those commercial arrangements*".

The first comment provides little, if any, reassurance, as it does not say that Aurizon Network will not seek to recover the full amount of the deferred NAPE capex, nor provide any indication of what factors Aurizon Network may consider relevant when determining the amount it will seek. The second comment may have been reassuring, had it ended with the comment that Aurizon Network does not intend to 'double dip', however, the additional words seem to indicate that some amount of double-dipping may be considered appropriate where Aurizon Network finds that its expectations elsewhere in the commercial arrangements have not been fully met. If this is the case then it indicates that certain risks accepted by Aurizon Network under the GAPE/NAPE Deed have materialised and reduced Aurizon Network's returns. We would question whether double-dipping on the NAPE capex in order to compensate Aurizon Network for a risk which it accepted under a commercial agreement is appropriate.

[1] https://www.asx.com.au/asxpdf/20160601/pdf/437mm8vgcd8ph2.pdf

As Aurizon Network has not outlined its plans nor commenced consultation on this matter, customers have no understanding of Aurizon Network's intentions nor of the process which will resolve this issue.

Aurizon Network has indicated that it is willing to provide a copy of the GAPE Deed to assist in the QCA's consideration of this issue. We suggest that it would be useful for the QCA to request the GAPE and NAPE Deeds and review these as one of the first steps in this process.

6. Conclusion:

The Rail Working Group does not support the approval of the ARRT without a clear pathway for resolving the Newlands renewals issue. We consider that the QCA should either:

- Complete a thorough investigation of the Newlands renewals issue before making a final decision on the ARRT, such that the final decision reflects the QCA's final views on this issue; or

- Alternatively, do not approve the ARRT, and require Aurizon Network to submit an amended undertaking which establishes a process for resolving the Newlands renewals issue (following which it would be appropriate to approve the ARRT).

We also note that a range of issues have now emerged in which consultation between Aurizon Network and customers has fallen short of the standard which is required if the benefits of the "UT5 Agreement" (amendments to UT5 supported by customers) are to be realised. These include:

- The process through which rail grinding was divested by the Aurizon group and through which Aurizon Network entered into a new contract for rail grinding services;

- Aurion Network's failure to genuinely engage with customers on the Newlands renewals issue over the past 12 months;

- Slow progress towards providing the RIG with adequate detailed information and a continuing tendency to finalise analysis and reports internally (within Aurizon) before sharing information with the RIG, rather than sharing preliminary or draft information as would occur where two parties are genuinely working together in a cooperative relationship.

The members of the Rail Working Group hope to see improvement in this engagement during the remainder of this year. Failure to achieve this improvement, or any further attempt to outsource core functions or divest key maintenance/renewal assets without genuine consultation and input from customers, would demonstrate that the expectations of the 'UT5 Agreement' have in this respect not been met. It is possible that customers may then prefer to disengage from the RIG process so that the QCA resumes its previous rigorous process of assessing Aurizon Network's maintenance and renewals budgets with the assistance of expert consultants.

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Thank you for the opportunity to provide this submission.

Yours sincerely

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