

QRC

submission

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**QRC submission to the QCA
Aurizon Network 2014 Draft Access
Undertaking – Maximum Allowable Revenue
December 2014**

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BACKGROUND

QRC welcomes the opportunity to comment on the QCA's draft decision on Maximum Allowable Revenues under Aurizon Network's 2014 Draft Access Undertaking ("the Draft Decision").

We have adopted numbering and headings for this document which are aligned with numbering and headings of the Draft Decision.

This submission does not contain confidential information, and may be published on the QCA's website.

EXECUTIVE SUMMARY

The MAR claim submitted by Aurizon Network under the 2014 DAU was an ambit claim, and the draft decision proposes to go some way towards addressing this. We support the QCA's draft decisions in many areas and we acknowledge the considerable effort which the QCA has made to assess Aurizon Network's claims and to bring the MAR closer to an efficient cost.

The majority of our remaining concerns relate to the QCA:

- providing conservative allowances in cases where information is lacking
- adopting 'reasonable costs' as a proxy for efficient costs
- favouring retention of previous allowances in cases where expert evidence favours a reduction, on the basis of conservatism.

We do not consider that a bias towards "conservative" allowances is appropriate or that the consequences of underestimating a MAR element are necessarily worse than the consequences of overestimation. For example, an underestimation of WACC may, in theory (and if we ignore the practice of requiring Access Conditions for major projects), dis-incentivise investment by Aurizon Network. However, overestimation will increase costs of customers above an efficient level and will dis-incentivise investment in mines, rail and ports, and also place existing operations at risk. We therefore consider that the QCA's best estimate of each parameter, rather than a conservative or upwardly biased estimate, would best meet the criteria of the Act.

Key areas of concern are:

- that the revised operating costs, overheads and maintenance costs are not efficient. The allowances do not reflect the cost reductions available to Aurizon Network, taking into account Aurizon Network's continuing transition as a former Government owned entity and the input cost savings available in the current market for services and materials used by Aurizon Network.
- the use of 'reasonable costs' is likely to result in excessive cost allowances.
- Aurizon Network's costs remain significantly above those of relevant benchmarks in a number of areas.



- The QCA and SKM find that maintenance scope has been under-delivered in UT3, yet no adjustment is proposed by QCA to reflect this or to prevent customers from paying twice for the same scope.
- The QCA appears to have applied an inconsistent approach to the assessment of the WACC. QCA proposes to substantially increase the market risk premium based on limited market data which indicates that the chosen number (6.5%) is at the upper end of a reasonable range, yet does not adopt the equity beta recommended by its consultant due to concerns regarding “regulatory certainty” and “caution in changing from a previous position”.

Despite the remaining concerns, QRC appreciates the efforts of the QCA to rigorously assess the MAR and apply the criteria of the Act in a balanced manner.

We have sought to limit our responses to key points and we have avoided burdening the process with further expert reports. We understand that Aurizon Network may take a different approach and we rely on the QCA to consider whether an opportunity to comment on new information is required.

1. INTRODUCTION

1.1 The market context

QRC concurs with the comments of the QCA regarding the coal market context. In fact, the short term outlook has deteriorated further since the time of the publication of the draft decision. A significant number of coal producers operate at a loss. Aurizon Network remains unaffected by these market conditions, due to the protected nature of its revenues. This outcome is a feature of the regulatory regime and is generally accepted. The situation does, however, highlight:

- That Aurizon’s Network’s WACC should not reflect any claimed exposure to coal markets and that betas of coal producers or of other entities which face an exposure to coal markets are not relevant to the assessment of Aurizon Network’s beta.
- That Aurizon Network is not exposed to any ‘market discipline’ which would drive Aurizon Network to pursue efficient costs (capital or operating) or efficient utilisation of assets. We therefore rely on a combination of voluntary cooperation from Aurizon Network, and effective regulation. In this context, we welcome the QCA’s efforts to diligently review and assess Aurizon Network’s claimed MAR.

1.2 A focus on efficient costs

Coal producers continue to reduce costs in all areas within their control. Access Charges are a significant element of the cost structure, and we rely on Aurizon Network to diligently pursue efficient cost reductions, and on the QCA to ensure that tariffs reflect only efficient costs. In the current environment, cost reductions, including those expected to arise from



efficiency improvements during the term of the undertaking, must be reflected in the UT4 MAR. The industry's efforts to remain competitive will be impeded if Aurizon Network can secure the approval of current costs (or costs based on prior periods), then retain the benefits of efficiency improvements achieved since that time or during the term. This is particularly important in Aurizon Network's case, as the business is still on a path of transition following privatisation. As a recently Government-owned entity, there remains significant scope for improvement. This would not be an issue if the MAR cost allowances were based on efficient costs, but it is a significant issue given that Aurizon Network's claims, and the QCA's assessment, is based on or significantly influenced by Aurizon Network's past actual costs.

1.3 Aurizon Network as a private company

Aurizon Network shares some alignment of interests with its customers, particularly due to the related ownership of the largest provider of rail haulage services in Queensland. This provides only limited comfort to QRC's members, given that the earnings of Aurizon Holdings and of Aurizon Network have showed little, if any, sensitivity to coal market conditions in recent years.

1.4 QCA's approach – a focus on costs and revenues

QRC supports the approach being taken by the QCA.

2. MAXIMUM ALLOWABLE REVENUE AND INDICATIVE TARIFFS

2.1 UT4 Maximum Allowable Revenue

QRC understands that the QCA's draft decision is made having regard to the criteria set out in section 138(2) of the Act. We support the QCA's suggested 'additional considerations' under section 132(2)(h), being predictability and the economic climate. We agree that it is in the public interest for Queensland's mining industry to be as competitive as possible. This will be possible only if the MAR reflects efficient costs including all cost reduction initiatives which can reasonably be expected to be achieved during the term of UT4.

Reasonable costs versus efficient costs

We are disappointed that the QCA proposes to adopt the concept of 'reasonable costs' as a proxy for efficient costs. There is clearly potential for a significant gap between the level of efficient costs, and the level of costs that would lead to a conclusion that costs are 'unreasonable'. For example, it would be unlikely that an independent review of the costs of Australian coal mines conducted in 2011 would have concluded that costs were 'unreasonable', or that 'reasonable costs' were more than 30% below the costs being incurred at that time. Yet, faced with difficult market conditions and an urgent need to achieve the most efficient costs possible, rather than reasonable costs, coal producers have generally achieved cost reductions in excess of 30%. Aurizon Network does not experience



similar pressures. Our concerns are reinforced by the fact that reasonableness is often established by benchmarking costs against other similar entities, which also do not face competitive pressures. The reasonableness of the costs of these entities can then be established by reference to comparisons with Aurizon Network.

We understand the difficulties faced by the QCA given “*the absence of robust, evidence-based benchmarks for assessing efficient costs in the CQCN*”. We would welcome discussions with QCA and Aurizon Network regarding how this can be addressed ahead of the preparation of UT5. We do not consider that consultant reports commissioned by Aurizon Network, which are not independent, are a useful starting point.

For UT4, we accept that the QCA must soon make a decision based on the available information. To the extent that the QCA is forced to accept reasonable costs in the absence of clear evidence of efficient costs, then we consider that a CPI-x factor ought to apply in order to drive costs towards efficient costs.

Draft Decision

QRC supports the QCA’s draft decision to refuse to approve the 2014 DAU insofar as it relates to the MAR.

2.2 Indicative tariffs

QRC appreciates QCA’s efforts to present indicative tariffs to assist customers in understanding the effects of the draft decision, however, for the final decision, we request more transparency regarding the calculations. For example, it is our understanding that the MAR numbers, and the indicative tariffs, do not reflect:

- The approved revenue cap adjustments for FY12 and FY13, and the proposed adjustments for FY14.
- Approved flood recovery costs.
- The recovery of the variance between actual and approved revenue for FY14, which is proposed to be smoothed over the final three years of UT4.
- Any other smoothing adjustments.

In addition, Blackwater tariffs are very sensitive to:

- the question of whether forecast tonnages for WICET are set at 90% of contract, or at an expected throughput level.
- The proportion of consists using electrical infrastructure.

Information regarding these matters would be appreciated.

2.3 Comparison of MAR and indicative tariffs

Our comments on each of the elements of the MAR will be provided in the relevant sections. In regard to the graphs presented in Section 2.3 of the draft decision, we request information regarding the Newlands MAR. The amount shown as ‘Aurizon Network MAR’ on page 34 for Newlands is significantly higher than the Newlands MAR’s proposed by Aurizon (page 22 of



volume 3 of the explanatory material for the 2013 DAU).

2.4 Transitional matters relating to the UT4 MAR

We support QCA's draft decision (2.2) to accept Aurizon Network's proposal to smooth the difference between 2013-14 allowable and actual revenues over the remaining three years of the UT4 period, on the basis that:

- The delays in finalising UT4 have caused substantial difficulties for customers in terms of planning and budgeting. Having an adjustment charge arise in regard to FY14 a year or more after the end of that period causes further difficulties.
- Producers have now planned and budgeted based on an understanding that this adjustment will be smoothed over FY15,16 and 17. Producers made this assumption based on the fact that:
 - a majority of customers prefer this approach.
 - Aurizon Network supported and proposed this approach (April 2014 DAAU Explanatory Memorandum)
 - The QCA's preliminary view (May 2014 decision on the Extension DAAU) was to support this approach.
 - The QCA's September 2014 Draft Decision continues to support this approach.

Given these consistent indications, QRC considers that the smoothed approach should be confirmed in the final decision.

In regard to the final adjustment for FY15 (difference between transitional allowable revenue and final approach MAR), it has been the expectation of customers that an Adjustment Charge would apply upon approval of UT4. Producers have sought to budget on this basis. Therefore QRC is comfortable with the FY15 true up being settled by way of an Adjustment Charge.

3. VOLUME FORECASTS

QRC supports the draft decision to amend volume forecasts based on the latest available information, including the actual results for FY14. QRC members have raised concerns that the Energy Economics forecasts do not reflect the latest available information. Producers involved in WICET consider that the forecasts for WICET are overly conservative.. We encourage the QCA to review the forecasts, taking into account input from producers and terminal operators, and seek comments closer to the time of the final decision.

When updating the forecasts, consideration will need to be given to how these forecasts are applied. We suggest that:

- The revised forecasts should be used to assess any element of MAR (such as maintenance costs) which varies with volumes.



- The revised forecasts should be used to establish triggers for take or pay, but not in regard FY14, as it is our understanding that volumes for this purpose were previously settled, and that take or pay was finalised on that basis.
- The revised forecasts should generally be adopted for tariff calculation purposes, subject to the QCA making a decision on the treatment of WIRP for this purpose. We note that Aurizon Network proposed a WIRP forecast based on 90% of contract for the purposes of tariff calculations and take or pay triggers. We understand that the QCA's views on this matter will be provided in the draft decision relating to the remaining elements of UT4.
- The QCA provides information on the gtk's forecast to be carried in electric and non-electric trains.

For the longer term, we note that some stakeholders have suggested an approach in which forecast volumes are used only for calculating the MAR, while contracted volumes are used to set tariffs. This proposal would need to be considered in the context of its impact on take or pay arrangements and the broader regulatory framework. QRC would welcome engagement with Aurizon Network, the QCA and other stakeholders to determine if and when this transition should occur.

4. OPERATING COSTS

4.1 Overview

QRC generally supports the approach to assessing efficient costs, subject to our concerns regarding the use of 'reasonable' costs as a proxy for efficient costs, which were discussed in Section 2.1.

4.2 System-wide and regional costs (excluding corporate overheads)

Escalation: QRC supports the QCA proposed approach to cost escalation for direct system-wide and operations costs.

Productivity factor: Our understanding is that the QCA proposes not to apply a productivity factor due to the absence of a robust benchmarking and productivity analysis. The lack of clear productivity improvements and cost reductions during the UT4 period is disappointing given the environment facing the industry and the substantial improvements being achieved by coal producers. Some of these savings are available due to more competitive conditions in the market for services provided to mining companies. For example, coal producers have benefited from substantial rate reductions in labour hire across all trades, and substantial reductions in rates for earth moving services. We would expect that Aurizon Network would also benefit from the more competitive conditions in the market for services such as these.

Also, Aurizon Network is likely to be able to reduce costs in areas such as 'commercial development' given that its customers have transitioned from a strong growth phase, to a 'survival' stage. Coal producers have achieved substantial savings by discontinuing or scaling down spending on project development. The very limited growth expected during the UT4 period should provide Aurizon Network with substantial opportunities to reduce commercial development costs, which we do not see reflected in the UT4 opex claim.



We do not consider that the costs which the QCA proposes to approve reflect significant efficiency improvements or cost reductions, and we consider that there is scope for improvement given current market conditions. A CPI-x factor, which will still result in increasing nominal costs, should be introduced at a minimum. We would expect that this will substantially understate the cost reductions which can be achieved.

For UT5, we strongly support the QCA's view that "*we need to evolve the regulatory framework to place greater emphasis on transparent, achievable and measurable productivity targets*". For this to be achieved, substantial work will need to be undertaken by all stakeholders well ahead of the expiry date of UT4.

Train control, safe workings and operations: The QCA notes that the CQCN is not operating in a capacity constrained environment. This was made clear by Aurizon Network in its 2013 DAU submission (Volume 3, page 10). In regard to FY2014 tariffs, Aurizon Network stated "*a major driver of the current tariffs is the under-utilisation of the network relative to contract*".

QCA also notes that it is not "*efficient, or necessary, for Aurizon Network to be managing its train control functions in a manner where it has the capacity to deliver contracted tonnages in UT4, particularly given there is no realistic expectation this level of demand will occur over this period*". This is a more difficult issue. Customers expect that Aurizon Network will be able to meet its contractual commitments when required, however there is also an expectation that Aurizon Network should be able to adjust its resourcing and costs based on actual demand. In this context, it would not make sense for UT4 to reflect operating costs based on contracted demand, while forecast volumes are substantially lower.

QRC considers that the QCA's proposed approach to assessing train control, safe workings and operations costs will result in an overestimation of efficient costs. QCA states that "*we do not consider there is a strong reason why the CQCN costs should be over double the cost per train path of the HVCN*". Despite this, the adjustments proposed by QCA reduce costs by only around 16% of Aurizon Network's claim.

We support the exclusion of Aurizon Network's proposed step changes, and the QCA's approach to allocating costs to non-coal traffic. The remaining issue is that the efficiency of the base (2012/13) cost has not been demonstrated, and that this cost appears inefficient when compared to the HVCN benchmark.

Infrastructure management: QRC accepts the draft decision.

Business management: QRC supports the proposed reduction to cost allowances associated with the preparation of UT5 (from \$4.5m to \$3.0m). However, it is our understanding that the cost of permanent Aurizon staff who are involved in the preparation of undertakings is additional to this allowance. If this is the case, then the additional allowance need only relate to the cost of consultants and experts engaged specifically for the UT5 process. We remain concerned that a budget of this magnitude (which is additional to the 'internal' budget) will continue to encourage the inefficient approach and excessive use of expert reports which characterised the early stages of the UT4 process.

4.3 Corporate Overheads

QRC's concerns with Aurizon Network's UT4 corporate overhead claim included:

- The claim was for a substantial increase and was a significant contributor to tariff increases.



- The claim was primarily based on an allocation of actual corporate overheads. There was little evidence to suggest that those overheads were efficient, while cost reductions achieved in recent years did not seem to be adequately reflected in the claim.
- The allocation methodology was inappropriate and resulted in an allocation to the network business which would exceed the efficient costs of a stand-alone network business.
- The methodology resulted in instances of double-counting.
- The benchmarking exercise which was used to support the claim could not be relied upon due to the failure of Aurizon Network to demonstrate that the data used and the nature of the benchmarked entities (which were not identified) were comparable.

The report prepared for the QCA by RSM Bird Cameron supported QRC's views in a number of these areas, however, QRC was concerned that the review:

- Reached conclusions, in a number of areas, which were not supported by the analysis.
- Defaulted to a 'not unreasonable' conclusion in cases where a range of benchmarks indicated conflicting conclusions, rather than seeking more information.
- Accepted Aurizon Network's explanations/claims as to why its costs should exceed benchmark costs, without verifying the claims or their financial impact.
- Placed too much reliance on Aurizon's past costs, with limited consideration for the efficiency of those costs or the relevance of those costs to future periods.

The QCA's draft decision goes some way towards addressing these concerns. The QRC supports:

- The use of direct costs as the most appropriate basis for the allocation of costs which do not have a clear causal driver.

The direct cost method was identified by RSMBC as being the most appropriate allocator for such costs. The use of revenue and assets in a blended allocator involves double-counting, and we do not agree that these items are causative of overhead costs to the same extent as are direct costs. For example, Aurizon will not incur more/less overhead costs as the value of Aurizon Network's depreciation claims varies over time.

- The exclusion of electricity pass-through costs from the direct costs used as an allocator.

We agree with Aurizon Network's view that energy costs have no strong causal relationship with overhead costs. Given that these costs are a pass-through expense, we consider that negligible overhead costs would be associated with this activity.

- The inclusion of maintenance overheads within the overhead allowance, using a consistent allocation methodology. Aurizon Network's proposal was inconsistent, as it adopted a 'bottom up' approach for maintenance overheads, and an allocation methodology for other overheads. The use of different approaches introduces a range of risks including double counting.
- Adjustments for overhead costs which would not be required, or would not be required to the same extent, for a stand-alone below rail business of a similar size. This includes



adjustments relating to investor relations and corporate branding, and company secretary.

- Adjustment of costs relating to CEO and board, legal services and finance costs, stakeholder relations and national policy, business re-engineering and corporate restructuring. Due to confidentiality claims of Aurizon Network and the resulting limited information provided in the draft decision regarding these adjustments, we are unable to comment on the magnitude of these adjustments.

QRC supports the adjustments made to Aurizon Network's claimed overheads. QRC viewed Aurizon Network's initial costs as an ambit claim. The draft decision to reduce the claim by more than 40% supports this view. Unfortunately, we are unable to conclude that the reduced cost is efficient, or even that it is 'not unreasonable'. We note that the QCA "*have not had the benefit of a rigorous bottom-up assessment of the corporate overhead costs of an optimally configured 'stand-alone' business*" and that the QCA estimates that the reduced overhead allowance is still more than 20% higher than the HVCN in terms of cost per gtk. Based on this measure, we would have to conclude that the reduced overhead allowance proposed in the draft decision exceeds the efficient costs of the below rail network, because:

- The reduced allowance exceeds the benchmark by more than 20%, or \$9 million per annum.
- Overhead costs should not be expected to increase on a straight line basis with volume, therefore we would expect Aurizon Network's efficient overheads to be significantly lower on a 'per gtk' basis than those of the HVCN.
- The HVCN costs may also contain inefficient allowances, due to the problem of regulated entities demonstrating efficiency by benchmarking against each other.

Given the available information and the constraints introduced by Aurizon Network's confidentiality claims, it is difficult for QRC to identify the cause of any excess or the areas requiring further adjustment. We remain concerned that the following matters may not have been adequately considered or addressed:

- The relative complexity of the remainder of Aurizon's business compared to the network business, and how this should impact on the reasonable allocation of overheads.
- The potential (much of which has now been announced or even implemented) for Aurizon to reduce its overhead costs, compared to the costs included in the FY2012 Plan (which we understand was the basis for the UT4 submission).

We understand that the QCA must soon make a decision based on the information available to it at that time, rather than allowing further delay to the finalisation of UT4. We consider that the following steps should be undertaken to limit the extent to which overhead costs are over-estimated for UT4:

- Maintain, at a minimum, the reductions proposed in the draft decision.
- Review all recent Aurizon announcements and ensure that cost reductions are adequately reflected in the base values prior to allocation.
- Given the extent of cost reductions announced by Aurizon in recent years, apply a CPI-x factor to escalation of overhead costs. We do not consider it credible that efficiency



improvements have now been implemented to the maximum extent possible, particularly given the level of costs relative to benchmarks.

We also suggest that:

- The final decision should clearly document the limitations faced by the QCA, in terms of the lack of bottom-up costing and reliable benchmarking, so that the UT4 costs are not taken to represent a baseline for UT5 allowances.
- The QCA, Aurizon Network and stakeholders should develop a rigorous process to address these information shortfalls and implement the process well ahead of the preparation and submission of a proposed UT5.

4.4 Risk and Insurance

Self-insurance

We share the QCA's concerns regarding the robustness of data used to estimate self-insurance claims and regarding the lack of transparency in this area. The QCA has, as it did in UT3, recommended additional reporting to address these concerns.

We note the QCA's comments (page 82) that:

“the major increase in self-insurance related costs in UT4 is driven by an increased allowance for weather-related events, with an increase of over 100% in real terms. This was a result of the UT3 period including a number of flood and cyclone events which caused a higher level of damage to the network than had occurred in previous periods”.

QRC understands that the history of prior losses is relevant to assessing future risks and therefore premiums, however, we do not accept that a period of exceptional losses should result in resetting a premium on the basis that those losses will be repeated in future periods. Aurizon Network's risks and premium should be informed by past losses, but not determined by the magnitude of a small sample period which included an unusual number of large scale events.

Self-insurance: Cost pass-through

We note the QCA's comments in regard to the pass-through mechanism and the very material impact that this has had on customers in the Moura system. A number of options are available which may limit the severity of impacts on individual customers when such events occur, including greater coverage by commercial insurance. QRC would welcome a discussion with QCA, Aurizon Network and other stakeholders. A key requirement will be to ensure that any arrangement does not involve cross subsidies between systems or mines.

Insurance premium costs

We support the QCA draft decision that premium costs should escalate at CPI rather than at a rate above CPI. We support the recovery of insurance premiums relating to feeder stations through AT5.

We do not support the increase in self-insurance costs, which the QCA states is over 100% in real terms. It appears that the UT4 costs have been based entirely on the loss experience of the UT3 period, which we consider was an unusual period in terms of flood and cyclone events. Premiums should be based on expected losses in future periods, with all available



data relating to past losses (rather than just the UT3 period) being taken into account in valuing this risk.

4.5 Audit and condition-based assessment

We accept the QCA's draft decisions in regard to the costs of audits and condition based assessment. We note that the QCA did not support the QRC's suggestion that such costs be recovered via the QCA levy. The QCA stated that "*the QCA levy can only be used to recover costs we incur, not those incurred by Aurizon Network*". Given that our suggestion was that the QCA engage the auditors directory, these would be costs incurred by the QCA, not by Aurizon. The driver for this suggestion is not related to the cost recovery mechanism (to which we are largely indifferent). Rather, we are seeking to:

- Ensure that the audit is independent and address conflicts/perceived conflicts.
- Ensure that the auditor owes a duty of care to the QCA.
- Simplify the undertaking: with QCA engaging auditors, there will be no need to assess and approve forecast costs or variances, and no need for additional cost adjustment mechanisms.

4.6 Environmental charges

We support the recovery of environmental charges relating to the supply of electricity through the EC component.

4.7 Operating costs – electric assets

We support the QCA's proposal to conduct a review of transmission connection costs. Connection agreements involve substantial long term commitments, and, in the case of a prepayment, a large upfront investment which is comparable in nature to capital expenditure. Customers have had no transparency in regard to these arrangements. We suggest that:

- The prudence of past decisions should be reviewed, to the extent that decisions have not previously been reviewed by the QCA.
- If prepayments of prudent costs have been made, then, given the lack of prior consultation or agreement, Aurizon Network's return for this arrangement (which we consider to be equivalent to capital expenditure) should be the regulated WACC.
- Aurizon Network should be able to obtain pre-approval for very material contracts such as these, and consultation should occur to the extent possible.



5. MAINTENANCE COSTS

5.1 Overview

QRC generally supports the QCA's assessment process for Aurizon Network's proposed maintenance costs, subject to our concerns regarding the use of 'reasonable costs' as a proxy for efficient costs (see Section 2.1 of this submission).

5.2 Direct maintenance costs (excluding ballast undercutting).

[note to QCA: table 45 contains an error in the general track maintenance total for 2015-16].

QCA's draft decision proposes only two adjustments to Aurizon Network's direct maintenance costs:

- Capitalisation of re-railing costs: This adjustment will be NPV neutral for Aurizon Network, but is important as it ensures that the users of a system in the year in which re-railing costs are incurred are not bearing the full cost of an asset upgrade which will benefit all users over a longer timeframe.
- Adjustment for lower forecast volumes.

Beyond these adjustments, the QCA proposes to accept Aurizon Network's claimed direct maintenance costs (excluding ballast undertaking). The shortcomings of the SKM benchmarking analysis were detailed in the QRC's submission of March 2014 and included:

- Lack of comparability of data and
- Conclusions which were not supported by the analysis.

Given these limitations, we assume that the QCA's acceptance of Aurizon Network's claim is primarily based on taking comfort from the decline in costs per gtk compared to UT3. This would be a reasonable conclusion if:

- Aurizon Network's UT3 costs were shown to be efficient and
- The decline in costs was shown to be reasonable, taking into account efficiency improvements available over time, and the benefits of increasing scale.

We do not consider that either of these requirements have been met.

Performance during UT3

QRC's strongest concern in regard to direct maintenance costs is that the draft decision lacks any proposed remedy for the failure of Aurizon Network to deliver the planned scope during the term of UT3. QCA notes that "*SKM also observed for the most part, Aurizon Network did not meet its scope targets for UT3 (eg. rail grinding and resurfacing)*"¹.

¹ Draft Decision, page 103



SKM “supported adjustments to annual allowable revenue in the event that Aurizon Network fails to achieve the proposed maintenance scope”². The QCA’s comments in this issue included: *“We note Aurizon Network’s under-delivery of maintenance scope in UT3 as found by SKM. We consider this outcome inefficient given the fact that the actual maintenance spend in UT3 was close to the approved allowance. In our view, this issue is best dealt with in an ex post review of Aurizon Network’s maintenance performance”*.

QRC considers that the ‘ex post review’ as suggested by QCA has been completed by SKM and the QCA. The conclusion is that scope was under-delivered, resulting in an inefficient cost which was borne by Aurizon Network’s customers. What is lacking is any proposed response to this situation, other than a suggestion that processes be introduced into UT4 to prevent this from happening again. This will do nothing to address the under-delivery of UT3 scope. Customers will be required to pay again for scope which should have been delivered during the UT3 period (or, viewed another way, Customers have paid for inefficient delivery of the reduced UT3 scope).

To the extent that scope was not delivered during UT3, then the condition of the relevant assets must now be at a standard which is below the expected standard had the work been done. It is therefore appropriate to either reduce asset values to reflect a deterioration in standards or to require Aurizon Network to complete the scope for which it has previously been paid, without further compensation.

In regard to future processes for setting maintenance budgets, monitoring performance and adjusting allowances, we have had some discussions with Aurizon Network and intend to continue consultation with a view to developing improved processes for implementation under UT5 or, subject to QCA approval, possibly during the latter years of UT4. QRC will provide further comments on this in our response to the draft decision on the balance of UT4.

5.3 Indirect maintenance costs

QRC supports the QCA’s draft decision to:

- Calculate a return on assets using the historical cost approach.

QRC considers that the GRV approach would provide Aurizon Network with a substantial windfall gain. The justifications for the approach, which focus on the opportunity cost of the assets and the pricing which would apply in a competitive environment, ignore the reality that these assets are not provided in a competitive environment and that Aurizon Network does not face the risks which it would face in such an environment. In addition, the GRV approach would require adjustments to asset values to reflect their condition, or reductions in operating cost allowances to reflect costs which would be incurred and scope that would be delivered using a machine in new condition. Given that the historical cost approach provides Aurizon Network with adequate returns on its investments, we do not consider that there is a need to add this level of complexity.

- Remove cost allowances for return on inventory and working capital.

² Draft Decision, page 105.



- Assess overheads for Aurizon Network as a whole, rather than applying different methodologies to a separate assessment of maintenance overheads and other overheads.

Allocation of overheads between the various parts of Aurizon is a difficult and subjective exercise. Creating a notional separation within Aurizon Network in order to allow for different methodologies to be applied to overhead estimation creates a need for further subjective judgements and allocations. We see no benefit in this additional complexity.

5.4 Maintenance Cost Index (MCI)

QRC supports the QCA's draft decisions regarding the MCI. Based on the analysis of SKM and the QCA as set out in the draft decision, we consider that the revised MCI more closely aligns with the market related factors which will drive escalation of Aurizon Network's direct maintenance costs.

In regard to escalating the return on and return of maintenance assets at CPI, we note the QCA's comment that "this will yield the same outcome as if these assets were part of the RAB".³ We support the principle that Aurizon Network's returns on these assets should be the same as the returns that would apply if the assets had been added to the RAB, and we support the QCA's suggestion that the assets should be added to the RAB. In regard to the current proposed approach, we seek clarification as to whether the proposed treatment does in fact yield the same outcome as for RAB assets. Where the value of RAB assets is escalated at CPI, the revaluation increment is deducted from Aurizon Network's MAR (as it is effectively a source of revenue for Aurizon Network). We question whether a corresponding adjustment is required when the return on and of maintenance assets is escalated.

6. BALLAST UNDERCUTTING COSTS

6.1/6.2 Overview and UT4 ballast undercutting costs

Ballast fouling and ballast cleaning in the CQCN has been a difficult issue since UT1. Despite Aurizon Network's assurances that the network is not deteriorating and the claimed benefits of the Coal Loss Management Project and Coal Dust Management Plan, Aurizon Network's forecast ballast undercutting costs for the 2014 DAU are almost 90% higher, in real terms, than the actual UT3 costs⁴.

Commenting on this issue is difficult for QRC given Aurizon Network's confidentiality claims, and conflicting information. A key issue is the extent of corrective maintenance required over the UT4 period. The draft decision states that:

³ Draft decision, page 123

⁴ Draft decision, page 131



- The condition based assessment conducted by Evans & Peck in 2013 did not conclusively suggest that significant remedial work was needed⁵.
- Aurizon Network made reference to ‘many locations where high levels of coal contamination are present’ in its 2013 DAU.⁶
- SKM considered that the ballast undercutting task is high due to the existing fouling that was not addressed in the UT3 period.⁷

SKM also stated that “*the scope of the ballast undercutting task is reasonable, although it is important to note that the increase in costs would not be reasonable without the presence of existing fouling*”.⁸

QRC is not in a position to form an opinion on the true position. We note that QCA has presented a draft decision that there is not sufficient evidence that significant remedial work is required. QCA has also indicated that it is willing to consider further evidence from Aurizon Network supporting the larger scope of work which Aurizon Network proposed.

Regardless of the outcome of the QCA’s further deliberations, we encourage QCA to ensure that the package of final decisions made on this issue reflects a consistent view of the condition of the network. For example:

- If the QCA accepts that the condition is such that significant remedial work is required, then Aurizon Network should be required to complete this work, but mechanisms should be put in place to ensure that customers do not pay twice for work which should have been completed in prior undertaking periods, and do not bear costs relating to poor management of the network in prior periods. Options include:
 - Continuation of the impairment charge.
 - Write down of assets followed by capitalisation of the costs incurred to restore the assets to a satisfactory condition.
 - Exclusion of the cost of remedial work from the maintenance budget (while ensuring that Aurizon Network is required to undertake the work).
- Alternatively, if the QCA accepts that significant remedial work is not required, then:
 - the UT4 budget for ballast undercutting should be based on the scope of work which is required for a network in good condition.
 - The RAB impairment charge can be discontinued.

The draft decision reflects the latter approach. We accept the discontinuation of the ballast impairment charge within this draft decision, as this is consistent with a conclusion that the network does not require significant remedial work.

⁵ Draft decision, page 135

⁶ Draft decisions, page 133

⁷ Draft decision, page 135

⁸ Section 2.2.4 of SKM report to QCA



6.3 Treatment of the UT3 impairment – ballast undercutting

Section 6.3 of the draft decision discusses a range of matters in regard to Aurizon Network's proposal to reverse of UT3 impairment charge, including:

- Was/is Aurizon Network's approach to the management of ballast fouling and cleaning efficient?
- If not, should Aurizon Network bear responsibility for this inefficient management?

The questions arise in regard to the proposal reversal of the UT3 impairment charge but are equally relevant, in the event that the QCA concludes that remedial work is required in the UT4 period, to the consideration of:

- Whether the impairment charge in UT4 should be discontinued.
- Whether Aurizon Network should be able to recover its full costs, including the cost of remedial work, from customers during the UT4 period.

In the QCA's final decision on UT3, the authority said that it would consider reversing the ballast impairment decision if Aurizon Network could demonstrate:

- It had adopted an efficient approach to maintaining a sound ballast (whether through ballast cleaning and/or fouling prevention), and
- Its past approaches to ballast fouling had been cost effective.

Unfortunately, despite ballast fouling being a contentious issue since the time of UT1, Aurizon Network has still not undertaken the analysis required to demonstrate these matters.. This is confirmed in Aurizon Network's 2013 DAU, which states "*until a full analysis has been undertaken and an appropriate regime designed for managing fouling that appropriately imposes costs on the parties causing spillage, Aurizon Network's proposal is that the impairment charge imposed in UT3 be reversed through an adjustment*".⁹

We would have thought that the UT3 impairment charge, and the level of contention surrounding this issue since the time of UT1, would have provided Aurizon Network with sufficient reason to undertake a full cost benefit analysis of this issue and establish either that current practices are efficient, or that current practices must change. QCA noted in its June 2010 draft decision that "*as the owner of the infrastructure, QR Network has a responsibility to ensure that its ballast is not excessively fouled by users*".¹⁰ Determining whether the ballast is being "excessively" fouled requires the full analysis which Aurizon Network is yet to undertake.

Aurizon Network is best placed to undertake this study as the below rail aspects of the study are the most complex (in terms of ballast cleaning costs and below rail capacity impacts under various scenarios). Above rail and port information required for the study could readily be obtained from operators, or these aspects could be completed by consulting organisations. We find it difficult to understand why Aurizon Network takes responsibility for

⁹ Aurizon Network 2013 DAU, sub. No.3: 45

¹⁰ QCA draft decision, June 2010: p171



the determination of all other matters relating to the requirements which trains must meet in order to access its infrastructure, yet seems to consider this aspect outside of its control. We would accept that the matter was beyond Aurizon Network's control if, for example:

- The cost of the study required was substantial and the QCA refused under UT1, 2 and 3, to approve a mechanism proposed by Aurizon Network through which the cost could be recovered.
- Aurizon Network sought to impose requirements for mitigation through conditions in Standard Access Agreements in UT1, 2 or 3, or in the undertakings, and the QCA rejected the inclusion of such conditions.

As far as we are aware, Aurizon Network has not initiated any attempts to study the efficient approach to ballast fouling, or to change existing practices, which have been frustrated by the QCA, Access Holders or customers.

Therefore QRC considers that Aurizon Network:

- has not demonstrated that its approach to management of ballast fouling and ballast cleaning in UT1, 2 and 3 was efficient.
- has still not undertaken a study of the most efficient approach to management of ballast fouling.
- has not demonstrated that the issue was outside of its control. In fact, when Aurizon Network proposed a range of mitigation strategies in the Coal Loss Management Project, supply chain participants cooperated in the implementation of those initiatives.

Therefore we agree with the QCA's draft decision that the impairment charge for UT3 should not be reversed.

We also suggest that the QCA should require Aurizon Network to conduct a full cost benefit analysis of options in regard to the management of ballast fouling in order to ensure that future practices are efficient. This analysis would need to take into account:

- The direct costs of alternative mitigation strategies.
- If an option has an impact on payloads or above rail efficiency, the additional above rail operating costs and the additional capital costs required to increase train numbers (above rail, below rail and at the unloading facility).
- The cost of ballast undercutting over time, based on various levels of fouling which reflect a range of fouling mitigation strategies.
- The cost of ballast fouling in terms of lost capacity (including due to ballast cleaning activities and speed restrictions) under each option. This assessment would reflect the full loss of system (mine to port) capacity.

6.4 Is ballast undercutting renewals or maintenance expenditure?

We share the QCA's view that the costs of ballast undercutting have many of the features which would be considered to be renewals expenditure. SKM suggested certain 'cut-off' points for establishing whether specific ballast undercutting work is treated as maintenance



or renewals. Despite these comments, the QCA's draft decision has "*taken the view ballast undercutting costs should continue to be included as part of the maintenance expenditure allowance*"¹¹ and to 'keep the issue open' for consideration under UT5. We do not consider that the facts of the issue will be different under UT5 compared to UT4. Therefore, if the QCA considers that the issue should be assessed as part of UT5, then we see no reason why the issue should not be considered for UT4. The discussion in the draft decision shows that the QCA has given some consideration to this matter, however, that discussion supports a decision to capitalise some or all of the ballast undercutting costs, not to treat all of the costs as maintenance. We encourage further consideration of this matter and, if the draft decision is confirmed, an explanation of the reasons for the decision.

7. OPENING ASSET VALUE

7.1 Opening asset base (RAB roll-forward)

We rely on the QCA's assessment of these calculations.

7.2 Equity raising costs

We support the QCA's draft decision to refuse to approve equity raising costs relating to the UT3 period.

Each undertaking is based on a specific risk allocation in regard to MAR. For a range of elements of MAR, adjustment mechanisms exist. In some cases, these adjustment mechanisms are designed to restore Aurizon Network's result to exactly the expected NPV result over time (such as the revenue cap arrangements in regard to volume variances), while in other cases, the adjustment only approximates the impacts on Aurizon Network (such as the application of escalation indices). In limited cases, Aurizon Network retains the risk of variations. Aurizon Network's UT4 submission seeks a range of adjustments for items which varied from expectations during UT3 in a direction which was adverse for Aurizon Network, and for which the undertaking did not include an adjustment mechanism. Clearly an approach in which retrospective adjustments are allowed where risks allocated to Aurizon Network vary in an adverse direction is not symmetrical given that there is no mechanism in place to ensure that variations in the other direction are passed back to Access Holders. We therefore support the draft decision to refuse to approve an adjustment for this particular variation.

8. REGULATORY ASSET BASE (INCLUDING CAPITAL EXPENDITURE)

QRC relies on the QCA to assess the capital indicator, interest during construction, asset renewals, and the capex carry-over account. We support the draft decision to capitalise re-railing costs.

¹¹ Draft decision, page 151



9. RETURN OF CAPITAL (NET DEPRECIATION)

Acceleration of depreciation

QRC supports the draft decision to refuse to approve the acceleration of depreciation under UT4. The issue of asset stranding risk was considered under UT3 and changes were made to depreciation arrangements to reduce Aurizon Network's stranding risks at that time. We see no need for further change at this time.

We note that Aurizon Network has concerns about the global competitiveness of Queensland coal mines and perversely proposes, based on those concerns, to increase charges by accelerating depreciation. QCA notes that "*Aurizon Network can influence, to some extent, the global competitiveness of Queensland's mining sector in the CQCN*". We prefer that this influence be exercised in the opposite direction.

Aurizon Network also based its claim for accelerating depreciation on the risks which strong growth in the industry posed in terms of the significant investments required and the amount of capacity being added (which may later be stranded if the industry contracts). Clearly this risk has abated, and is unlikely to return during the term of UT4. In any case, we consider that this risk is relevant to the consideration of expansion projects as they are planned and committed, and would no doubt be considered by Aurizon Network when developing its Access Conditions proposals.

Commencement of depreciation

Aurizon Network proposed that depreciation would commence in the year after it is commissioned. QCA has rejected this approach and proposes that depreciation commences in the year of commissioning. QRC prefers the deferred approach, primarily on the basis that it is more likely to align the costs and benefits of the use of the new assets, particularly in the case of significant expansions. This is because (i) the asset may be in service for only part of the year in which it is commissioned and (ii) the use of the asset by expanding mines is likely to follow a ramp-up profile, rather than stepping up to full utilisation immediately. Applying depreciation in the year of commissioning, when expansion tonnage is unlikely to be at full volumes, increases the risk that the project will cause tariffs to increase, and therefore increases the likelihood that an Expansion Tariff will be required (based on the proposed UT4 pricing principles). While we understand the cashflow benefit to Aurizon Network of the earlier commencement of depreciation, the deferred cashflow will simply need to be taken into account in Aurizon Network's planning and financing arrangements.

In the event that the QCA prefers to retain the existing approach, we suggest that the issue should be considered separately in regard to each major project as these occur. These will generally require a DAAU to vary reference tariffs, unless dealt with through the capital indicator. In either case, we consider that the QCA should assess, for major projects, the extent to which commencing depreciation in the year of commissioning will result in a mismatch between charges and the benefits received from the use of the asset, and should consider a deferred start date for depreciation where the mismatch is significant.



10. RETURN ON INVESTMENT

QRC's comments on section 10 of the draft decision are summarised below:

- The QCA's overall framework for determining the rate of return is sound. In particular, the QRC agrees that the QCA should be seeking to determine the best estimate of each parameter, rather than 'erring on the high side'. This approach appropriately reflects the fact that the QCA is required to balance a number of considerations in determining the rate of return.
- The QCA's approach to determining the risk-free rate, based on the advice of Associate Professor Lally, is appropriate.
- The QCA's estimate of the market risk premium (**MRP**) appears high in light of the available market evidence. At best, the QCA's estimate is at the upper end of a reasonable range and is therefore highly conservative.
- The equity beta estimate is not supported by evidence and overstates Aurizon Network's exposure to systematic risk factors. The QRC has previously observed that the analysis by Incenta (the QCA's consultant) is likely to overestimate Aurizon's equity beta. That notwithstanding, the QCA has adopted an equity beta estimate which is significantly higher than that recommended by Incenta.
- The QCA's approach to determining the debt margin is reasonable. While the QRC continues to believe that the Bloomberg fair value curve would be an appropriate data source, we accept that Incenta's alternative methodology is also reasonable.
- As previously noted, the QCA should seek to ensure that only prudent debt transaction costs are allowed for in the rate of return and that there is no double counting of these costs.

Each of these points is discussed below.

Framework issues

The QRC has previously argued that there is no justification for Aurizon Network's approach to the rate of return calculation, which involves adopting the upper bound of its range of estimates for each parameter. This approach is not supported either by economic theory, or by the statutory scheme.¹²

In their expert report for the QRC, Professors McKenzie and Partington explained that there was no merit, from the perspective of economic and finance theory, in Aurizon Network's proposal to use upper bound values for WACC parameters. Their report notes that by definition, the use of high end parameters for the WACC will result in a WACC that is upwardly biased.¹³

¹² QRC WACC submission, October 2013.

¹³ Michael McKenzie and Graham Partington, *Review of Aurizon Network's Draft Access Undertaking*, 5 October 2013, p 5.



The QRC therefore welcomes the comments made by the QCA in relation to its overall approach to determining the rate of return. In particular, the QRC agrees that the QCA should be seeking to “apply the best estimate of each parameter, rather than err on the high side”.¹⁴

Risk free rate

The QRC continues to support the QCA’s approach of seeking to match the term of the risk free rate and debt margin to the length of the regulatory cycle (i.e. four years). This approach is consistent with previous QCA practice and with the expert advice of Associate Professor Lally.

Market risk premium

The QCA’s estimate of the MRP appears high in light of the available market evidence.

The QRC has previously noted that a reasonable range for the MRP is 5% to 6%, and that a balanced view of the evidence supports a point estimate of no more than 6%.¹⁵ A value of no more than 6% is consistent with the recommendation of Professors McKenzie and Partington. McKenzie and Partington state that, if anything, 6% is likely to be an over-estimate of the MRP, given the upward bias in some of the underlying measures.¹⁶

At best, the QCA’s estimate of 6.5% is at the upper end of a reasonable range and is therefore highly conservative – i.e. it is more likely to over-estimate, rather than under-estimate the true MRP.

Equity beta

The QRC is concerned that the QCA’s estimate of the equity beta significantly overstates the degree of systematic risk faced by Aurizon Network.

The value adopted by the QCA is significantly higher than that recommended by the QCA’s own consultant. It is also well above estimates of the equity beta for other regulated businesses, many of which are *more* exposed to systematic risk factors than Aurizon Network.

The QCA’s consultant, Incenta, has undertaken an analysis of Aurizon Network’s asset and equity beta at the QCA’s request. Based on its analysis, Incenta recommended an equity beta value of 0.73 for Aurizon Network.

The QRC has previously noted that Incenta’s analysis is likely to overstate the true beta for Aurizon Network.¹⁷ While we generally agree with Incenta’s analytical framework and the comparisons drawn with regulated energy and water businesses, the QRC has a number of material concerns with how the analytical framework was applied by Incenta to derive an estimate of Aurizon Network’s equity beta, including:

¹⁴ Draft Decision, p 192.

¹⁵ QRC WACC submission, October 2013.

¹⁶ Michael McKenzie and Graham Partington, *Review of Aurizon Network’s Draft Access Undertaking*, 5 October 2013, p 27.

¹⁷ QRC Further WACC Submission, January 2014.



- The inclusion of toll roads in the set of businesses used to derive a range for Aurizon Network's asset/equity beta. As noted by Incenta, toll roads are subject to significantly more volume (revenue) risk, compared to Aurizon Network.¹⁸ This is because toll roads are typically not subject to a form of regulation which protects them from either cost or revenue risk, and they invariably face competition from alternative (usually free) roads. Due to their much higher risk exposure, the QRC considers that toll roads are not an appropriate comparator for Aurizon Network. Their inclusion in Incenta's comparator set has the effect of artificially widening the range of estimates for Aurizon Network's beta, and biasing upwards the point estimate.
- Incenta's use of a 'simulated month' estimation methodology, rather than a conventional methodology. This departure from conventional methodology results in a very significant increase in Incenta's beta estimates for energy and water businesses, which it says are the best comparators for Aurizon Network – the effect of this methodology change is to increase the median asset beta value from 0.34 to 0.42, and the equity beta at 55% gearing from 0.57 to 0.73.
- The inclusion in Incenta's sample of international energy business, many of which are not subject to the same (or similar) form of regulation.

The QRC has noted that if Incenta's calculation were to be adjusted to apply a more conventional analysis of the beta for Australian energy networks and remove toll roads from the beta range, the result would be an asset beta estimate of approximately 0.35 for Aurizon Network, which translates to an equity beta of 0.59 at 55% gearing. Given Aurizon Network's lower exposure to risk compared energy and water businesses, this should be the upper bound for Aurizon Network's equity beta.¹⁹

Despite these issues with Incenta's estimation methodology, each of which is likely to upwardly bias their estimate, the QCA has adopted an equity beta for Aurizon Network that is even higher than that recommended by Incenta. The QCA has adopted an equity beta value of 0.8, instead of 0.73 as recommended by Incenta – this results in an uplift to the WACC of 0.21%.

The QRC understands that the QCA's reasons for adopting this higher value are:²⁰

- estimating beta with a high degree of precision is inherently difficult, suggesting that there should be caution in changing from previous position, and that there is a risk of being "over-precise";
- in the interests of regulatory certainty, changes to predetermined parameters should require "solid justification". The QCA also states that their intent is to "maintain an environment conducive to investment";

¹⁸ Incenta Equity Beta Report, p 4.

¹⁹ QRC Further WACC Submission, January 2014.

²⁰ Draft Decision, p 253.



- the QCA's chosen value is within the wide range of values produced by Incenta's analysis; and
- changes to regulatory arrangements, such as the introduction of a revenue cap, were previously considered as part of UT3.

In relation to the first two points, the QCA's reasoning suggests a tendency to "err on the side of caution" or "err on the upside" in relation to the equity beta. The QCA's reasoning suggests that it will favour regulatory certainty and the promotion of an environment conducive to new investment, over more accurate estimates of this parameter.

If there were simply a concern as to "false precision" the most appropriate course would be to round estimates, perhaps to the nearest 0.1 – in this case, this would mean rounding to 0.7, not 0.8. However the QCA's approach is to round up, which suggests a tendency to "err on the high side".

This appears contrary to the QCA's stated approach to estimation of the rate of return. As noted above, the QCA has said it will seek to "apply the best estimate of each parameter, rather than err on the high side". This should apply equally to all parameters, including where the evidence demonstrates that there needs to be a downward adjustment from previously determined values.

The QRC is also concerned that the QCA appears to have set a high threshold for departing from previously determined values for the equity beta – the QCA states that "changes to predetermined parameters require solid justification". The QRC has two concerns with this:

- first, there does not appear to be any basis for an "inertia" principle in determining rate of return parameters. As the QCA correctly observes elsewhere in the Draft Decision, it should be seeking to apply the best estimate of each parameter. The QCA should not be starting with previously determined values and only departing from those previously determined values where there is "solid justification" or "persuasive evidence" to do so. This is clearly not the approach taken by the QCA to other parameters such as the MRP, and there is no reason why it should be adopted for the equity beta.
- secondly, it is not clear what the QCA would require, in terms of "solid justification", to depart from a previously determined value, beyond the solid justification currently available to the QCA. In this case the QCA has commissioned expert advice on the equity beta, and the advice of the QCA's expert has been to adopt a lower value. It is unclear what more justification the QCA would need.

In relation to the QCA's point that its equity beta value is within Incenta's range of estimates, the QRC notes that Incenta made an explicit recommendation as to the point estimate for Aurizon Network's asset and equity beta. Incenta also observed that the top of its range was the estimated asset beta for toll roads, which in Incenta's view "*are subject to significantly more volume (revenue) risk*".²¹ Given this, is not appropriate for the QCA to adopt an equity

²¹ Incenta Equity Beta Report, p 4.



beta towards the upper end of Incenta's range, and disregard Incenta's recommendation as to the best point estimate.

Finally, the QRC has provided detailed analysis of the various risk protections for Aurizon Network which are embedded in the regulatory regime.²² The QRC maintains its view that, given the extent to which Aurizon Network is protected from systematic risk, an equity beta of 0.8 is too high. As demonstrated by Castalia, while Aurizon Network is assigned a higher equity beta than what is allowed for other regulated businesses – including energy, water and telecommunications businesses – its overall exposure to risk is in fact lower, largely due to the form of regulation which applies to it.²³

In light of the above, the QRC considers that the QCA's position on Aurizon Network's equity beta is not supported by the evidence. The QRC maintains its view that an equity beta of 0.8 is too high, given Aurizon Network's exposure to systematic risk.

Debt margin

The QRC has previously argued that, at least in the case of the UT4 process, there is no compelling reason not to use Bloomberg data to estimate the debt margin. While there are advantages to the econometric methodology, the QRC does not consider that these outweigh the advantages of using a third party data source at the current time.

However, as previously noted, if the simple portfolio approach is to be used in determining the cost of debt in the UT4 process, the QRC would prefer that it be used as part of an average, along with the Bloomberg fair value curve estimate. We consider that this would be a more prudent approach, given that the simple portfolio approach is a relatively new methodology, and in the present case it does not appear to be as accurate as Bloomberg. Taking an average of two methodologies is an approach that has been used in the past to estimate the cost of debt.²⁴

Debt raising costs

The QRC has previously argued that, to the extent that any allowance is to be made for debt raising costs, this should be based on careful analysis of the costs that would be incurred by a prudent and efficient business.

²² QRC WACC submission, October 2013.

²³ Castalia, *Aurizon Access Undertaking: Risk Allocation Analysis*, October 2013.

²⁴ For example, in *ActewAGL*, the Tribunal decided to take an average of the CBASpectrum and Bloomberg estimates, on the basis that there was no grounds to prefer one estimate over the other (*Application by ActewAGL Distribution* [2010] ACompT 4, [80]).