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Aurizon Network– Draft Access Undertaking - UT5 – Provision of Updated Information

29 September 2017

Dear Professor Green and Mr Millsted,

I refer to our meeting on 10 August 2017 and my letter dated 22 September 2017, in relation to Aurizon Network's Draft Access Undertaking (**UT5**) and other regulatory matters.

As outlined in both that meeting and in my letter, in the period since the submission of UT5 and supporting materials in November 2016, new and updated information has become available that is relevant to the QCA's assessment of UT5. This information relates in particular to key components of the Weighted Average Cost of Capital (**WACC**) contained within UT5.

Aurizon Network believes that the information enclosed with this letter and the information which was submitted on 22 September 2017, all of which is being submitted in support of our UT5 submission made in November 2016 (**Aurizon Network's UT5 Submission**), should be considered by the QCA as part of its Draft Decision on UT5 (**UT5 Draft Decision**). This will enable the QCA to provide a temporally relevant and fully considered draft decision which is based upon the most recent relevant and applicable information. We acknowledge that this is of critical importance to each of the QCA, Aurizon Network and all stakeholders.

The new information enclosed with this letter is in the form of additional reports relating to key components of WACC. Specifically these reports are:

- 'The term of the risk-free rate', prepared by Frontier Economics (**Risk-Free Rate Report**);
- 'An updated estimate of the market risk premium' prepared by Frontier Economics (**MRP Report**); and
- 'Required Returns for infrastructure Assets – Market Based Evidence' prepared by Deloitte (**Survey Report**).

As with the previous information submitted with my letter dated 22 September 2017, these new reports are provided to outline the latest market data available, recent court proceedings and recent regulatory decisions which have direct implications for the UT5 Draft Decision, in particular in relation to WACC.

Listed below are the details of the relevant reports that are being submitted with this letter, including an outline of the new information contained within each:

Risk-Free Rate Report

1. *New Information*

Since Aurizon Network's UT5 Submission:

- The Australian Competition Tribunal and Federal Court have issued decisions outlining that the appropriate allowed rate of return must be gauged by the disciplines of a workably competitive market;
- The Independent Pricing and Regulatory Tribunal's current WACC review issue paper has been published which reaffirms that the appropriate benchmark for a risk-free rate is to replicate the outcomes of a workably competitive market;
- Additional information has been identified that confirms that market practice is to use a 10 year risk-free term when valuing regulated assets, which is particularly relevant to equity holders when analysing and valuing firms that own and operate regulated assets and estimating the required return in order to proceed to invest; and
- More recent risk-free rate data has become available.

2. *Relevance*

The risk-free rate is an important input into the WACC calculation as it affects both the cost of equity and cost of debt. One of the key elements of risk-free rate determination is the term of the risk-free rate.

This Risk-Free Rate Report discusses the key implications from recent Tribunal and Federal Court decisions on the term of the risk-free rate and concludes that the 10-year term is the most appropriate term to use, which further supports Aurizon Network's UT5 Submission. As a result, this report is relevant to the UT5 Draft Decision.

The updated information in this report continues to adopt the risk-free rate based on the June 2017 averaging period. We however note that this period produced a risk-free rate, based on the 10 year term, which is significantly lower than the rates before and after the June 2017 period. The 10 year risk-free rate average for the last 20 business days in April, May, July and August 2017 was 2.60%, 2.56%, 2.68% and 2.64% respectively. The differential in the risk-free rate from that calculated using the June 2017 averaging period (2.44%) being between 12bps to 24bps for a 10 year term. The significantly lower rate during the June 2017 averaging period would appear to be due to anomalous market factors and would not appear to reflect the likely rate that will apply during the regulatory period – this matter should be taken into account in determining the overall WACC.

MRP Report

1. *New Information*

Since Aurizon Network's UT5 Submission:

- The latest Market Risk Premium (**MRP**) survey results, which form part of the current QCA MRP methodology, were released by Professor Fernandez in April 2017;
- More recent market data relevant to the MRP calculations has become available; and
- Using current data and aligning it with the approach outlined within Aurizon Network's UT5 Submission, would result in a current estimate of 7.5%.

2. *Relevance*

The QCA has expressed its support for a timely MRP estimate within its Market Parameters Decision. The MRP Report attached to this letter updates Aurizon Network's submitted UT5 MRP estimate to incorporate the more recent data that has become available.

It is important for the MRP to reflect the prevailing market conditions as the current regulatory practice sets risk-free rate at the prevailing rate.

Updating for more recent data, the MRP Report continues to support an MRP estimate above 7.5% using Frontier Economics' preferred methodology. More importantly, it shows that even if the QCA's current estimation methodology is retained (i.e. including the Siegel approach and excluding quantification of market indicators), the updated MRP is now 7.5%, when the framework laid out in the November 2016 Frontier Economics report is applied. Aurizon Network therefore proposes to revise its UT5 MRP from 7.0% to 7.5%, based upon the evidence supplied.

Survey Report

1. *New Information*

Since Aurizon Network's UT5 Submission:

- A survey of 5 global investment banks reveals that investors in Infrastructure assets are seeking post-tax equity returns of between 7% and 13%. This range is broken down into three categories being:
 - 7.0% - 9.5% for regulated infrastructure assets supported by long-term contracts;
 - 8% - 11% for high quality transport assets; and
 - 10% - 13% for assets with more operating and commodity risk.
- The survey indicates the post-tax equity return required by investors in Aurizon Network would likely sit at the high end of the range for regulated assets or the lower end of the range for high quality transport assets due to its commodity exposure, environmental exposure and the lack of predictability in the regulatory regime; and
- Investors are not heavily influenced in their investment decisions by changes in the yields of government bonds, resulting in the overall return not moving in parallel to the risk-free rate.

2. Relevance

The consideration of investor expectations relating to the overall equity returns is an important factor that should be considered when determining the WACC.

Having information that confirms the actual expectations that equity investors have allows the QCA to assess if its calculations prior to issuing the UT5 Draft Decision are in-line with those required by investors.

The information also confirms that Aurizon Network should not be considered in the same category as utilities, given the different risks that it is exposed to.

Conclusion

Aurizon Network has continued to progressively provide information to the QCA in relation to its Requests for Information on Aurizon Network's maintenance and operating expenditure up until August 2017. Due to this, it should be noted that less than 2 months of the 6 month statutory timeframe has passed as at the date of this letter.

We would re-iterate that the QCA therefore still has a considerable amount of time to fully understand and properly consider this new information within its statutory timeframes and allow for a comprehensive draft decision on UT5.

Further request to adjust regulatory timetable

Aurizon Network repeats the request made in its letter dated 22 September 2017 that, once the QCA has had the opportunity to fully consider all the material submitted to it by Aurizon Network, the QCA reconsider an extension of the regulatory period for submissions on the UT5 DAU until 22 December 2017. This will allow the QCA and other stakeholders sufficient time to consider and respond to those submissions.

We believe this will then allow for a fulsome and robust UT5 Draft Decision being issued by the QCA.

Yours sincerely



Michael Riches
Group Executive Network