



10 July 2018

Professor Flavio Menezes
Chair
Queensland Competition Authority
Level 27, 145 Ann Street
Brisbane, Queensland 4000

Via QCA website: <http://www.qca.org.au/submissions>

Dear Professor Menezes,

RE: Request for comments – Proposal to change the averaging period – Aurizon Network's 2017 draft access undertaking (Stakeholder Notice)

Communication without prejudice to judicial review proceedings

This communication is without prejudice to the judicial review proceedings filed by Aurizon Network on 30 April 2018 and is provided to the Queensland Competition Authority's (QCA) against the possibility that the QCA does not restart the decision-making process for the 2017 Draft Access Undertaking (UT5) under a new Chair or a Court does not make the orders sought in the application. This letter should therefore be read in the context of the proceedings and Aurizon Network's letter to the QCA in connection with the judicial review proceedings dated 1 May 2018.

Purpose of this letter

This letter constitutes Aurizon Network's submission to the QCA's stakeholder notice of 26 June 2018 (**Stakeholder Notice**) requesting comments in relation to Aurizon Network's proposal to revise the averaging period from that initially proposed for UT5.

Aurizon Network contends:

- The QCA's Stakeholder Notice perpetuates a fragmented and piecemeal approach to consultation on critical matters in relation to UT5;
- Its proposal to revise the averaging period was made sufficiently in advance of the period occurring and is consistent with its previously stated intentions and the indicative timelines for a Final Decision for UT5; and
- Setting an averaging period closer to the Final Decision is consistent with regulatory best practice and is supported by regulatory precedent.

These points are further expanded upon in subsequent sections below.

Stakeholder notice

Aurizon Network is concerned the QCA's Stakeholder Notice further perpetuates a fragmented and piecemeal approach to consultation on critical matters in relation to UT5. By addressing individual issues independently, the QCA limits stakeholders' ability to effectively assess the overall reasonableness of the QCA's decisions. Aurizon Network maintains that those critical matters arising in response to the QCA's UT5 Draft Decision (**Draft Decision**) should have been collated and consulted upon in aggregate shortly after the receipt of stakeholder submissions by the QCA. Instead the process administered by the QCA for UT5 resembles that of a sub-optimal regulatory regime – one that does not allow for effective consultation and thereby decision making by the regulator.¹

In Section 5.5.6 of Aurizon Network's response to the Draft Decision, it was made clear that it would propose an averaging period closer to the date of the Final Decision.² The response stated at pages 99–100 that:

- *“it was reasonably anticipated by Aurizon Network at the time of nominating the averaging period that the Final Decision would be finalised reasonably close to the commencement date of the UT5 regulatory period”*; and
- *“Aurizon Network will propose an averaging period closer to the Final Decision”*.

Aurizon Network's letter of 8 May 2018 to the QCA (**May Letter**) is therefore consistent with our stated intention as outlined in our response to the Draft Decision. Aurizon Network contends the QCA's proposed consultation is therefore not in respect of the May Letter but instead is in relation to Aurizon Network's submission on the Draft Decision – which stakeholders have already had an opportunity to review and if necessary would have been able to comment on.

While section 168B(3) of the *Queensland Competition Authority Act 1997* (Qld) (**QCA Act**) provides that the QCA may make a decision as to a draft access undertaking without taking into account late information where it is reasonable to do so, this section does not in any way operate to prevent stakeholders from making a submission to the QCA on any aspect of the UT5 DAU (proposal or otherwise) at any time. Presumably, if changes to the averaging period were a significant issue, stakeholders could make a submission to the QCA for its consideration. If a submission was made after the period for providing responses to the Draft Decision, the QCA would then need to give consideration as to whether it is reasonable to make the decision without taking the late submission into account.

Aurizon Network notes that comments in response to the Stakeholder Notice will be received more than four months after Aurizon Network made clear its intention to revise the averaging period as set out in the response to the Draft Decision. Aurizon Network contends the release of a Stakeholder Notice this late in the process to be inconsistent with the QCA's stated intent regarding the timeliness of assessment and decisions and the predictability of regulatory outcomes as outlined in its July 2016 Statement of Regulatory Intent.

Finally, it is Aurizon Network's understanding that negotiation and finalisation of an averaging period occurs confidentially between the regulated entity and regulator and is therefore not subject to broader consultation with stakeholders due to its commercial sensitivity. This is consistent with regulatory best practice as adopted by other Australian regulators including for

¹ Aurizon Network explored these flaws in its response to the QCA's Consultation Paper – Request for comments: Aurizon Network's 2017 Draft Access Undertaking: maintenance allowance and practices.

² Aurizon Network. 2017 Draft Access Undertaking Response to the Queensland Competition Authority's Draft Decision. 12 March 2018.

example the Australian Energy Regulator (AER). Aurizon Network notes the QCA has followed a similar approach for other regulated entities. For example, in its Final Decision in relation to the DBCT Management's 2015 draft access undertaking, the QCA note:

“This averaging period of the 20 business days ending on 31 May 2016 was confidentially agreed between DBCTM and the QCA in March 2016 and published on the QCA's website in June 2016.”³

Revising the averaging period

Aurizon Network reaffirms its position in relation to the proposed amendments to the averaging period for UT5 as detailed in our May Letter. As previously stated⁴, Aurizon Network considers:

- the initially proposed averaging period is no longer appropriate given:
 - it occurred before the Draft Decision was published; and
 - the length of time that will pass between the initially proposed period and the date of the Final Decision on UT5, being in excess of 12 months; and
- its proposed revision to the averaging period is:
 - consistent with the expected statutory timeframes for the making of a Final Decision on UT5; and
 - was made sufficiently in advance of the averaging period to expose Aurizon Network to both favourable and unfavourable movements in market parameters – and in this regard, should not give rise to concerns as to bias.

As previously stated in our May Letter, in the absence of a Draft Decision (or Final Decision) by the QCA prior to the nominated averaging period, Aurizon Network considers that the initially proposed averaging period is no longer appropriate. This is for two main reasons as set out below.

First, in order for Aurizon Network to properly consider what steps it may be prudent to take to manage potential risks (for example, by way of hedge contracts or other risk management instruments), it is essential that the averaging period (being the period in which risk management strategies would be put in place), occurs after the Draft Decision (and as close to the Final Decision as reasonably possible). This is because it is the Draft Decision document that signals the QCA's intended approach to significant matters including inflation and the return on debt. That is, the content of the Draft Decision informs Aurizon Network's assessment of what, if any, financial risk management strategies would be prudent to implement during the averaging period in light of the approach the Draft Decision indicates will be adopted to revenue-critical parameters.

In the time between 10 March 2017 where the QCA indicated that it was:

³ Queensland Competition Authority. Final Decision. DBCT Management's 2015 draft access undertaking. November 2016.

⁴ Aurizon Network. Letter to QCA Re: 201 Draft Access Undertaking – Revision to the Proposed Averaging Period. 8 May 2018

“favourably disposed towards the 20 business days ending 30 June 2017 to be used as the averaging period for determining the time sensitive parameters for Aurizon Network’s 2017 DAU.”⁵

and the release of the Draft Decision on 15 December 2017 (a period of almost nine months), Aurizon Network received no communication from the QCA that a final decision to accept or otherwise had been made in relation to the averaging period. To be clear, the notion the QCA is “favourably disposed” to a particular averaging period is not acceptance of Aurizon Network’s proposal and therefore cannot be relied upon. Aurizon Network maintains it would be imprudent to execute its financial risk management strategies for the whole of the UT5 regulatory period in the absence of a Draft or Final Decision from the QCA.

Second, a period closer to the making of the Final Decision should be used because such a period will, all else being equal, contain better or more up-to-date information as to the conditions expected to prevail over the regulatory period. In this regard, the June 2017 averaging period does not provide a good indication of the market conditions likely to be experienced over the regulatory period. As per our May Letter this was evident in:

- a reduction in BBB spreads over the 10-year CGS as evident in Table F3 of the Reserve Bank published statistics;
- an increase in the nominal risk-free rate with a corresponding increase in the break-even inflation rates; and
- an increase in the nominal yield from 2.51% in June 2017 to 2.83% in February 2018 in relation to the period from 28 February 2018 to 30 June 2027.⁶

Measuring parameters during a period that is likely to be more reflective of the market conditions that will be experienced over the regulatory period:

- promotes the object of the QCA Act as set out in section 69E (in particular economically efficient investment in infrastructure);
- is appropriate having regard to the factors set out in section 138 of the QCA Act, including:
 - the legitimate interests of Aurizon Network and access seekers; and
 - the pricing principles in section 168A, most relevantly, that the price of access should generate expected revenue for the service that is at least enough to meet the efficient costs of providing access and include a return on investment commensurate with the regulatory and commercial risks involved.

Setting an averaging period closer to the Final Decision

Economic and financial literature supports the use of an averaging period occurring as close as practically possible to the commencement of the regulatory period – assuming a final decision or determination is made prior to the commencement period starting. This allows for estimates

⁵ Queensland Competition Authority. Letter to Aurizon Network Re: Averaging period for Aurizon Network’s 2017 Draft Access Undertaking. 10 March 2017

⁶ Aurizon Network analysis of term structure of indicative mid-rates of AGS, Table F16 in RBA Statistics

of the risk-free rate to be representative of those experienced by the regulated entity over the forthcoming regulatory period.

In selecting an averaging period, the AER in its Explanatory Statement Rate of Return Guideline of December 2013 (**Explanatory Statement**), note:

“The CAPM uses the most current information to derive the rate of return. In theory, it would use the risk-free rate on the day.”⁷

Similarly, in its Explanatory Statement the AER citing the Federal Court of Australia in *ActewAGL Distribution v The Australian Energy Regulator* [2011] FCA 639 acknowledged:

“There was no dispute between the experts that the CAPM theory suggests that, ideally, the nominal risk-free rate input will be calculated on the day of the final determination.”⁸

Aurizon Network notes one of these experts was Associate Professor Lally acting for the AER who has also advised the QCA on aspects of the cost of capital as prescribed in the Draft Decision.⁹

The AER¹⁰ has similarly noted the expert views of Partington and Satchell that:

- *“for the WACC used in NPV calculations, the current required returns on debt and equity should be used; and*
- *in order to maintain the zero NPV condition, regular updating of the WACC should be undertaken”.*

These arguments are consistent with the nature of a Final Decision being an ex-ante assessment of net present value (**NPV**) and the QCA's own findings in its Final Decision: Cost of Capital: market parameters report where it was noted:

“Achieving dynamic and allocative efficiency requires a current risk-free rate, which reflects all available and relevant market information.”¹¹

Regulatory best practice requires a Final Decision prior to the commencement of the regulatory period and for that Final Decision to reflect the most reliable and recent information relevant at that time of that decision. Aurizon Network contends that in the absence of a Final Decision (or Draft Decision in the case of the UT5 assessment) prior to the commencement of the regulatory period, best practice would require the averaging period set to reflect all relevant information available at the time when the Final Decision is made. This is consistent with the QCA's approach to assessment of other aspects of the UT5 proposal such as Aurizon Network's maintenance practices where the QCA has sought the most up to date and relevant information as part of this overall assessment.

⁷ Australian Energy Regulator. Explanatory Statement Rate of Return Guideline. December 2013

⁸ Ibid.

⁹ The other expert was Greg Houston of HoustonKemp acting on behalf of ActewAGL.

¹⁰ Australian Energy Regulator (2018) Discussion Paper: Market Risk Premium, risk free rate averaging period and automatic application of the rate of return.

¹¹ Queensland Competition Authority. Final Decision: Cost of Capital August 2014

Importantly, Aurizon Network has proposed an averaging period sufficiently in advance of it occurring. Selecting an averaging period after the period has occurred leads to inherent bias in the QCA's Final Decision given its knowledge of prevailing rates at any past point in time and does not provide the appropriate incentive for efficient investment. Instead an averaging period at a future point in time provides for an unbiased estimate of future rates and may be deemed commensurate with the efficient financing costs of a benchmark efficient entity.¹²

Regulatory Precedent

Aurizon Network notes that where, for whatever reason, a regulator has not made a final decision prior to the commencement of the relevant regulatory period, it is often the case that the averaging period is selected to be a period prior to the date of the final decision, as opposed to a period prior to the commencement of the regulatory period. This is done on the grounds that this is likely to result in an estimate representative of the risk-free rate experienced over the forthcoming regulatory period. This is evident in the following examples shown in Table 1 which highlights various determinations whereby Australian regulators have set the averaging period after the commencement of the regulatory period and closer to the date of the final decision.

Table 1. Recent regulatory decisions – averaging period

Regulator	Entity	Regulatory Period	Averaging Period (End Date)	Final Decision (Date)
Economic Regulation Authority	Western Power	1 Jul 2017 to 30 Jun 2022	29 Mar 2018	02 May 2018*
Economic Regulation Authority	Western Power	1 Jul 2009 to 30 Jun 2012	30 Oct 2009	19 Jan 2010
Australian Energy Regulator	Envestra (Albany) Energy	1 Jan 2013 to 31 Dec 2017	20 Feb 2013	15 Mar 2013
Australian Energy Regulator	Envestra (Victoria) Energy	1 Jan 2013 to 31 Dec 2017	20 Feb 2013	15 Mar 2013
Australian Energy Regulator	Ergon Energy	1 Jul 2015 to 30 Jun 2020	28 Jul 2015	29 Oct 2015
Australian Energy Regulator	Energex	1 Jul 2015 to 30 Jun 2020	28 Jul 2015	29 Oct 2015
Australian Energy Regulator	SA Power Networks	1 Jul 2015 to 30 Jun 2020	28 Jul 2015	29 Oct 2015
Australian Energy Regulator	CitiPower	1 Jan 2016 to 31 Dec 2020	26 Feb 2016	26 May 2016
Australian Energy Regulator	Powercor	1 Jan 2016 to 31 Dec 2020	26 Feb 2016	26 May 2016
Australian Energy Regulator	TransGrid	1 Jul 2014 to 30 Jun 2018**	6 Mar 2015	30 Apr 2015
Australian Energy Regulator	ActewAGL	1 Jul 2014 to 30 Jun 2019***	6 Mar 2015	30 Apr 2015

¹² Australian Energy Regulator. Final Decision. ActewAGL distribution determination 2015–16 to 2018–19. Attachment 3 – Rate of return. April 2015

Regulator	Entity	Regulatory Period	Averaging Period (End Date)	Final Decision (Date)
Australian Energy Regulator	Ausgrid	1 Jul 2014 to 30 Jun 2019***	6 Mar 2015	30 Apr 2015
Australian Energy Regulator	Endeavour Energy	1 Jul 2014 to 30 Jun 2019***	6 Mar 2015	30 Apr 2015
Australian Energy Regulator	Essential Energy	1 Jul 2014 to 30 Jun 2019***	6 Mar 2015	30 Apr 2015

* ERA Draft Decision published 02 May 2018.

** Referenced as part of the AER's final determination for the regulatory period 1 July 2015 to 30 June 2018, the averaging period was used to calculate notional revenue for the transitional year 1 July 2014 to 30 June 2015 as part of the AER's true up of revenues.

*** Referenced as part of the AER's final determination for the regulatory period 1 July 2014 to 30 June 2019, the averaging period was used to calculate notional revenue for the transitional year 1 July 2014 to 30 June 2015 as part of the AER's true up of revenues.

Finally, Aurizon Network notes that in previous determinations the QCA has been inclined to accept an averaging period at least after the publication of a Draft Decision, if not after the Final Decision. For example, in its assessment of the Dalrymple Bay Coal Terminal (**DBCT**) 2015 Draft Access Undertaking (**DBCT 2015 DAU**), Aurizon Network notes the following events:

- 6 October 2015: DBCT proposes an initial averaging period ending 21 August 2015 as a placeholder to be revised following the QCA's Draft Decision;
- 9 February 2016: DBCT proposes amending the averaging period ending to 31 May 2016 in further correspondence with the QCA;
- 24 March 2016: QCA agrees to DBCT's proposed amendment to the averaging period as per its request of 9 February 2016;
- 19 April 2016: QCA publishes its Draft Decision in relation to DBCT 2015 DAU with reference to its preferred indicative averaging period ending 30 October 2015.

In publishing the Draft Decision, the QCA noted:

"[the] averaging period has been agreed between DBCTM and the QCA and is confidential at this time, to enable DBCTM to implement its hedging arrangements".¹³

- 21 November 2016: QCA publishes its Final Decision in relation to DBCT 2015 DAU with reference to the agreed averaging period ending 31 May 2016.

Regardless of the QCA not setting an averaging period around the Final Decision date, Aurizon Network notes the QCA's willingness to at least provide DBCT with an averaging period after the Draft Decision thereby allowing DBCT time to implement appropriate risk management arrangements (such as the execution of its hedging strategy). Aurizon Network contends that, at a minimum, it has not been afforded the same opportunities as other regulated entities based on the timing of the UT5 Draft Decision relative to the correspondence it received in March 2017 from the QCA.

¹³ Queensland Competition Authority. Draft Decision. DBCT Management's 2015 draft access undertaking. April 2016

Aurizon Network maintains that there are strong economic arguments and regulatory precedents that would support the QCA amending the averaging period as per its proposal in the May Letter. Aurizon Network welcomes the opportunity to discuss further with the QCA and its customers any outstanding concerns in relation to its proposed revisions to the averaging period.

Should you have any queries in relation to this submission, please do not hesitate to contact Jon Windle on jon.windle@aurizon.com.au.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'D Collins', with a long horizontal flourish extending to the right.

David Collins
Acting Group Executive Network