



## QRC submission

QCA request for comment on Aurizon Network's proposal to change the averaging period

July 2018

## Introduction

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The Queensland Resources Council (QRC) appreciates the opportunity to comment on the proposal from Aurizon Network to change the averaging period for use in calculating time-variant parameters in the weighted average cost of capital (WACC) for the 2017 Draft Access Undertaking (UT5).

## Summary

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Aurizon Network has raised an entirely new and novel argument at a late stage of the process. There is no reasonable basis for abandoning the agreed averaging period at this late stage. A change to the agreed averaging period could be highly material, in terms of its impact on the WACC, maximum allowable revenue and access charges. Equally importantly, approval of the proposed change would:

- Set a dangerous regulatory precedent.
- Encouraging 'gaming' of the process.
- Establish a process by which regulated entities can achieve an upward bias in rate of return outcomes.
- Impact on regulatory certainty, given the inconsistency of this approach with processes adopted for previous undertakings.

## Cause of UT5 delays

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Delays to the UT5 process are predominantly of Aurizon Network's making, and are a direct consequence of Aurizon Network's actions throughout the UT4 and UT5 processes.

The first version of UT4 was submitted three and a half months prior to the scheduled expiry of UT3. This document was submitted without consultation with customers, reflected ambit revenue claims, and shifted the commercial balance of the undertaking significantly in Aurizon Network's favour. The draft undertaking was later withdrawn. The process of developing an acceptable undertaking from this base consumed most of the UT4 period. As a result, the draft UT5 was submitted only seven months ahead of the expiry of UT4. Aurizon Network failed to substantiate its UT5 claims, and provided numerous late submissions, causing substantial delays to the finalisation of the draft decision. Aurizon Network then provided further significant information in response to the draft decision, which the QCA has taken into account in preparing the consultation paper of May 2018. Aurizon Network now seeks to disrupt the UT5 process through a judicial review process.

Aurizon Network's disruption of regulatory processes has been long-running and is on-going.

Aurizon Network now claims, without providing evidence of the claim, that it has been adversely affected by the averaging period occurring prior to the release of the draft decision. To the extent that these claimed impacts exist, QRC considers that it is entirely inappropriate to address those impacts by allowing unusual and unexpected changes to be made to the regulatory process, particularly given that the change proposed by Aurizon Network would deliver a substantial uplift in Aurizon Network's revenue above the level which would have been achieved in the absence of the delays caused by Aurizon Network's actions.

## Aurizon Network's new argument for changing the averaging period

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Aurizon Network argues that the averaging period should be changed because the QCA's draft decision was published later than Aurizon Network had originally expected. Aurizon Network says that its original proposal for the averaging period to take place in June 2017 was on the premise that a "decision" for the UT5 regulatory period would be made prior to the commencement of that period. We assume that Aurizon Network's reference to a "decision" is intended to be a reference to a draft

decision, as it must have been apparent to Aurizon Network at the time the period was proposed in February 2017 that a final decision could not be made by early June 2017. Aurizon Network argues that, because the QCA's draft decision did not arrive prior to the originally agreed averaging period, that averaging period is no longer appropriate and should be changed.

This is an entirely new argument. It has not featured in any of Aurizon Network's submissions so far in the UT5 process. It also did not feature in any of Aurizon Network's submissions during the UT4 process, despite the fact that exactly the same issue arose during UT4 – the UT4 draft decision was made well after the agreed averaging period had passed.

The QRC notes that, in a submission dated September 2017, Aurizon raised a different objection to use of the averaging period that it had proposed and agreed with the QCA. At that time, Aurizon Network claimed that the outcome in this agreed averaging period was "anomalous". The QRC's submission in response to the QCA's draft decision demonstrated that the outcome in the agreed averaging period was clearly not anomalous. Moreover, to the extent that yields were somewhat lower in June 2017 than in the months before and after, Aurizon would have benefited from this through a lower cost associated with debt raised in that period (Aurizon issued \$425 million in debt in June 2017). Aurizon Network now appears to have abandoned its claim that the outcome in the agreed averaging period was "anomalous", in favour of a new argument regarding the timing of the draft decision.

It is surprising that Aurizon Network has only raised this now, six months after the QCA's draft decision and almost a year after the agreed averaging period. If Aurizon held a genuine concern regarding the timing of its averaging period relative to the draft decision timing, it should have raised this at a much earlier point in the process – either as soon as its originally agreed averaging period had passed, and/or in its September 2017 submission and/or in response to the QCA's draft decision. The fact that Aurizon Network has not raised this issue until now suggests that it is a somewhat contrived argument directed only at achieving a more favourable rate of return outcome.

There are three elements to Aurizon Network's new argument:

1. Aurizon Network says that, when it originally proposed the averaging period in February 2017, this proposal was on the premise that a decision for the UT5 regulatory period would be made prior to the commencement of that period. In other words, Aurizon Network expected a "decision" on UT5 (presumably a draft decision) within approximately three months of it notifying the QCA of its averaging period proposal.
2. Aurizon Network claims that it is "essential" that the averaging period occurs after the draft decision, because the draft decision signals the QCA's approach to key matters and therefore informs Aurizon Network's financial risk management strategies.
3. Aurizon Network says that a period closer to the making of the final decision should be used because such a period will contain better or more up-to-date information as to conditions expected to prevail over the regulatory period.

Each of these points is addressed below.

## The premise for Aurizon Network's original averaging period proposal

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Aurizon Network now states that its original averaging period proposal was premised on an expectation that a decision (presumably a draft decision) would be made prior to the start of the nominated period.

This premise was not stated in Aurizon Network's letter to the QCA dated 13 February 2017. If this was a premise for the proposal, and if Aurizon Network intended to revisit its choice of averaging period in the event that it was not realised, this should have been clearly stated.

As noted above, this issue was not raised in the UT4 process, despite exactly the same circumstances arising in that process. Therefore, this could not have been assumed by the QCA or stakeholders to have been an implicit premise of Aurizon Network's proposal.

In any event, the QRC considers that it would have been a very bold assumption on Aurizon Network's part, to assume that the QCA would publish a draft decision by June 2017 given the status of the process as at February 2017. Given the experience of all stakeholders in past processes

(including the recent experience of UT4), it seems implausible that Aurizon would have proceeded on the basis of this premise.

If this was truly the premise for their original proposal, Aurizon Network should have raised this issue regarding the timing of its averaging period relative to the draft decision timing at a much earlier time. Aurizon Network has had multiple opportunities to raise this issue before now, including in its response to the QCA's draft decision.

## Aurizon Network's claim that it is "essential" that the averaging period occur after the draft decision

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The QRC does not consider that it is "essential" that the averaging period occurs after the draft decision.

In fact, it is not uncommon for an averaging period to take place prior to a draft decision, including in circumstances where a draft decision is made later than expected. This happened in UT4, and Aurizon Network did not seek to revisit the averaging period at that time.

Aurizon Network has not explained how the content of a draft decision would practically impact its financial risk management strategies, and therefore why it needs to have the draft decision prior to raising finance in the averaging period. Aurizon Network notes that a draft decision will signal the QCA's intended approach to key inputs into the calculation of maximum allowed revenue. However, it is not explained how the draft decision on these input parameters would practically impact on financial risk management strategies.

It is also not clear how changing the averaging period now would lead to a change in Aurizon Network's financial risk management strategies. The agreed averaging period has now passed and Aurizon Network has raised finance in that averaging period. Aurizon Network cannot go back and change the way in which it raised finance in the June 2017 period, nor change its overall strategy so that it raises finance at a later time rather than in that period.

Regardless of the content of a draft decision, Aurizon should have an incentive to manage any financing arrangements in an efficient manner. Aurizon Network would have an incentive to minimise financing costs while effectively managing interest rate risk, refinancing risk and other relevant financial risks. The content of a draft decision should not alter these core incentives, which arise from the design of the incentive regulation framework.

In any event, Aurizon should have been aware of the QCA's likely approach to key matters relevant to the cost of capital from previous extensive consultation processes. For example, the QCA has recently consulted extensively on its approach to the cost of debt (a consultation which concluded in 2015), and the cost of equity (a consultation which concluded in 2014). The QCA has also explained its approach to a range of inputs in its recent (2016) UT4 final decision.

## Aurizon Network's argument that the averaging period should be as close as possible to the final decision

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Aurizon Network argues that the June averaging period will not provide a good indication of market conditions likely to prevail over the "regulatory period".

Underlying this argument is an important premise: that the relevant period for which market conditions are to be proxied is the period from which the QCA makes its final decision (a period yet to be determined).

The QRC disagrees with the fundamental premise of this argument. The QRC considers that the averaging period should broadly reflect market conditions expected (ex ante) to prevail over the period for which allowed revenues are to be determined. Therefore, the averaging period should be reasonably close to the beginning of the period for which allowable revenue is being determined.

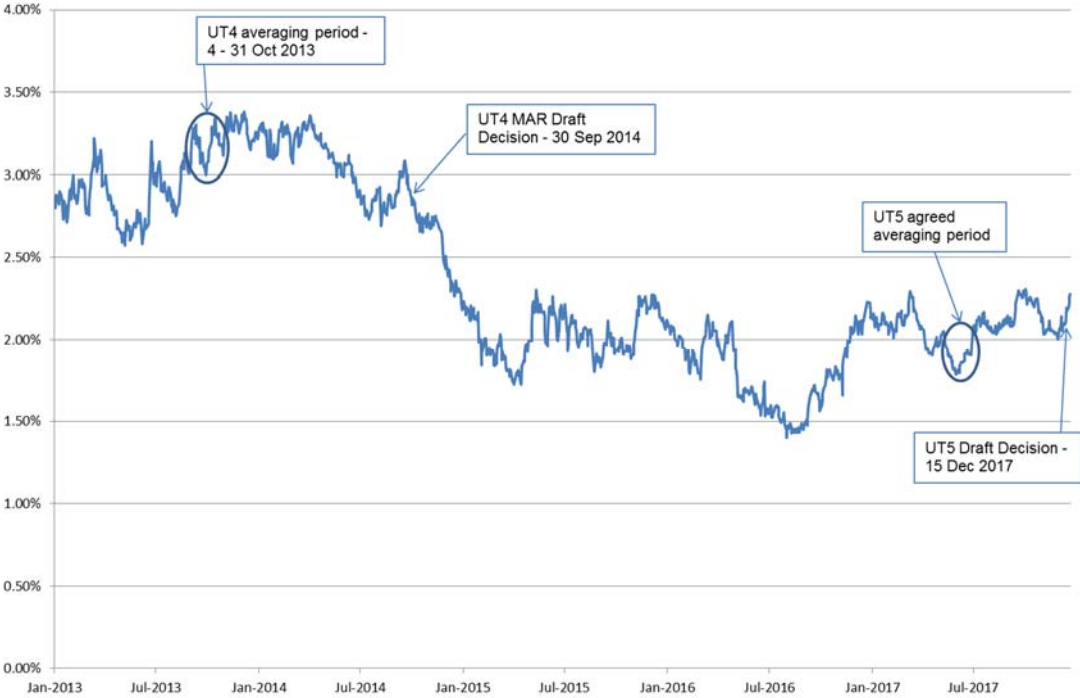
In this case, for reasons previously explained by the QRC and QCA, the relevant revenue period commenced on 1 July 2017. Therefore, an averaging period in June 2017 is entirely appropriate and consistent with the statutory objects and pricing principles.

# Potential for bias if service providers were allowed to revisit their choice of averaging period

If Aurizon Network was allowed to change its averaging period now, this would set a dangerous regulatory precedent. It would create an option for service providers to revisit their averaging period proposal whenever there is some delay in a regulatory process (as occurs often). Clearly, such an option would only be exercised where it is likely to benefit the service provider, and so would give rise to biased outcomes.

The potential for bias can be seen by simply comparing the position of Aurizon Network now with its position in UT4. As noted above, exactly the same circumstances arose in UT4 – the UT4 draft decision was made well after the agreed averaging period had passed. However, Aurizon Network did not seek to revisit its choice of averaging period in that case. As can be seen from Figure 1 below, the agreed averaging period for UT4 turned out to be a period of relatively high Government bond yields, while the period following the UT4 draft decision was a period of declining yields. If Aurizon Network was allowed to revise its averaging period for UT5 now, it would potentially result in a higher rate of return. However, there was no corresponding reduction in the rate of return for UT4, as would have occurred if the same type of revision to the averaging period had occurred in that process.

**Figure 1: Yield on 4-year Commonwealth Government Securities**



Creating scope for upwardly biased rate of return outcomes would be inconsistent with the pricing principles and objects of Part 5. In particular, this would not promote efficient investment in, or efficient operation and use of, infrastructure, and would not be in the interests of access seekers nor in the public interest.

## Conclusion

Aurizon’s request to revise its averaging period proposal should be rejected. There is no reasonable basis for changing the averaging period at this late stage. If the QCA were to accept Aurizon Network’s proposal, this would set a dangerous regulatory precedent and create the potential for bias in rate of return outcomes – a result that would be inconsistent with the statutory objects and pricing principles.