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

22 September 2017

Dear Professor Green and Mr Millsted,

I refer to our meeting on 10 August 2017 and my subsequent letter dated 15 August 2017, in relation to Aurizon Network's Draft Access Undertaking (**UT5**) and other regulatory matters.

At this meeting and in my letter, I outlined that 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.

In the QCA's Statement of Regulatory Intent published in July 2016 and your letter dated 25 August 2017, you have outlined the QCA's process for assessing any information that it receives relating to the investigation of UT5, including any information which is considered by the QCA to be 'late information'.

While Aurizon Network acknowledges that compliance with deadlines in relation to the provision of information to the QCA is important, we also believe, that where new information has become available as a consequence of regulatory or market developments which is relevant to the decision the QCA is to make, that this new information should be considered by the QCA as part of its draft decision on UT5. 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.

Consequently, Aurizon Network believes that the enclosed information, 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.

The new information is in the form of additional reports which accompany this letter. Specifically these reports are:

- 'Estimating Gamma in the Regulatory Context', prepared by Frontier Economics (**Gamma Report**);
- 'Best Estimates of Inflation for regulatory purposes' prepared by the Competition Economists Group (**Inflation Report**);
- 'Appropriateness of External Credit Rating' prepared by Ernst & Young (**Credit Rating Report**); and
- 'Risk Comparison between Aurizon Network and Energy and Water Networks' prepared by Synergies Economic Consulting (**Risk Comparison Report**).

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 QCA's draft decision on UT5, 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:

Gamma Report

1. New Information

Since Aurizon Network's UT5 Submission:

- in May 2017, the Full Court of the Federal Court published its decision on the judicial review application brought by the Australian Energy Regulator that raised grounds for review in connection with a decision of the Australian Competition Tribunal concerning the value of gamma in the regulatory frameworks applying in gas and electricity; and
- additional court and Tribunal proceedings have commenced, including the Victorian Electricity Distribution businesses' hearing before the Australian Competition Tribunal which raised grounds for review relating to gamma, and a judicial review hearing before the Full Court of the Federal Court of a decision of the Australian Competition Tribunal concerning the value of gamma in the regulatory framework applying to electricity. Further, the Australian Energy Regulator has published a number of decisions that respond to recent developments and issues raised as to the appropriate value of gamma to be adopted in the electricity and gas regulatory frameworks.

The key question in these processes has been how the value of imputation credits should be interpreted and estimated.

2. Relevance

The Gamma Report provides an update on Aurizon Network's UT5 submission which incorporates new information based on the processes referred to above.

This information is of critical importance and relevance to the QCA's draft decision on UT5 with respect to the value of imputation credits as a consequence of the similar role of gamma in the regulatory framework that is presently applied to Aurizon Network.

Inflation Report

1. New Information

Since Aurizon Network's UT5 Submission:

- nominal and indexed Australian Government Securities trading data, new actual inflation data and more recent RBA short-term inflation forecasts have become available; and
- the Dalrymple Bay Coal Terminal 2015 DAU process was finalised. The QCA issued a final approval in February 2017 (**DBCT Decision**) in which the QCA approved the use of the inflation forecast methodology involving the use of RBA short-term inflation forecast and long-term inflation target (**RBA method**).

2. **Relevance**

Aurizon Network considers that this new and updated information is important in determining the best estimate of inflation to apply in the regulatory regime as implemented by the QCA under the QCA Act. This report analyses the new and updated information and how it is reflected in the different methodologies, in particular:

- how the breakeven inflation forecast, the RBA method and other market based measures such as inflation swaps have changed with respect to market movements; and
- the Inflation Report evaluates the most appropriate inflation forecast with reference to more recent data, the regulatory framework and the DBCT Decision.

As a result, the information contained in the Inflation Report is relevant to the QCA's draft decision on UT5.

Credit Rating Report

1. **New Information**

Since Aurizon Network's UT5 Submission:

- credit rating agencies have re-reviewed their assessments of Aurizon Network's credit rating. By way of example, Moody's has revised the negative outlook on the Baa1 credit rating to stable in February 2017, and both Moody's and Standard and Poor's have reaffirmed the credit ratings as Baa1(stable) and BBB+(stable) respectively in August 2017;
- in June 2017, Aurizon Network completed a debt refinancing by issuing \$425 million of Australian medium term notes, supported by the current BBB+/Baa1 credit ratings; and
- in August 2017, Aurizon Network publicly reaffirmed its commitment to maintaining the BBB+/Baa1 rating, as part of the FY17 results release to the Australian Stock Exchange.

2. **Relevance**

The Credit Rating Report incorporates these latest developments and concludes that, based on a comparison with peers in the market place and an analysis of the key considerations of an appropriate credit rating, the appropriate credit rating for Aurizon Network is BBB+/Baa1.

The Credit Rating Report also notes that:

- Aurizon Network's credit rating has remained unchanged since inception; and

- given that Aurizon Network's debt portfolio of >\$3bn has been borrowed based on its existing credit ratings, there are significant commercial implications arising from any substantive change in Aurizon Network's credit metrics and any subsequent downgrade to those credit ratings.

Credit rating is a key input into the WACC determination, given its inter-relationship with capital structure and direct impact on debt risk premium. Consequently, the new information contained in the Credit Rating Report is relevant to the QCA's draft decision on UT5.

Risk Comparison Report

1. *New Information*

Since Aurizon Network's UT5 Submission:

- the QCA issued its DBCT Decision in February 2017, which reaffirmed its approach to use energy and water networks as the comparable firms for the purpose of calculating beta;
- metallurgical and thermal coal prices have continued to be highly volatile which increases the propensity for coal producers to adjust operating and contractual arrangements to allow for greater production variability;
- two independent miners, Caledon Coal and Baralaba Coal, entered into voluntary administration in 2017, reinforcing Aurizon Network's concern over counterparty credit risk;
- Wood Mackenzie's latest 2017 seaborne coal market cost curve identifies that a higher proportion of central Queensland coal mines now reside in the highest cost quartile; and
- Adani has committed to the development of its Carmichael mine, which increases the risk of bypass for parts of the Central Queensland Coal Network.

2. *Relevance*

The Risk Comparison Report provides a comprehensive assessment of Aurizon Network's risk profile, incorporating the recent developments referred to above. It also provides a detailed comparison between Aurizon Network and energy and water networks, in order to clearly illustrate the differences in the underlying risks. This information is of critical importance and relevance to the QCA's draft decision on UT5 with respect to asset/equity beta, as it affects the selection of comparable firms for the beta calculation.

Conclusion

Although the formal collaborative consultation period on UT5 ended on 17 March 2017, Aurizon Network 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, which has been a time and resource intensive process.

Although Aurizon Network supports the principle of timely decisions, it should be noted that less than 2 months of the 6-month statutory timeframe has passed as at the date of this letter. 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.

As previously highlighted, adopting the approach of fully considering all information prior to a draft decision will narrow issues that require resolution for a final decision and avoid the potential to have further consultation papers that may fracture the decision process as seen during the UT4 process.

Further request to adjust regulatory timetable

Aurizon Network will make additional submissions with further reports relating to further new information that we have become aware of since Aurizon Network's UT5 Submission up until the end of September.

In this regard, once the QCA has had the opportunity to consider the material submitted, Aurizon Network would request that 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 draft decision on UT5 being issued by the QCA.

Yours sincerely



Michael Riches
Group Executive Network