

Queensland Competition Authority

Final decision

Aurizon Network's review event: 2015 flood claim

December 2016

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THE ROLE OF THE QCA – TASK AND CONTACTS

The Queensland Competition Authority (QCA) is an independent statutory authority which promotes competition as the basis for enhancing efficiency and growth in the Queensland economy.

The QCA's primary role is to ensure that monopoly businesses operating in Queensland, particularly in the provision of key infrastructure, do not abuse their market power through unfair pricing or restrictive access arrangements.

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1 BACKGROUND

1.1 The flood event

Cyclone Marcia brought widespread flooding to the Central Queensland coal region in February 2015, damaging Aurizon Network's rail infrastructure in the Blackwater and Moura rail systems, with the Moura system being the hardest hit. Aurizon Network declared a force majeure on 19 February 2015 after the rail line damage occurred.

1.2 Aurizon Network's claim

Aurizon Network made a submission under the 2010 undertaking proposing to recover about \$4.05 million (pre-escalation), which it considered was incremental maintenance costs related to flood repair works on the Moura system.

Aurizon Network considered the February 2015 flood event satisfied the definition of a review event, as it was beyond its reasonable control, the amount exceeded the \$1 million materiality threshold, and the additional incremental costs had not previously resulted in a variation of the relevant reference tariff.

1.3 QCA's draft decision

In October 2016, we made a draft decision not to approve Aurizon Network's 2015 flood claim of \$4.05 million (pre-escalation).

We assessed a range of issues raised by stakeholders and considered that further information was required on Aurizon Network's costs, to determine, in particular, that there was no double-counting of maintenance costs, capital costs or self-insurance costs.

We also said that the approach to escalating flood costs should be adjusted for consistency with the mid-year approach used in our final decision on the 2014 DAU.

1.4 Stakeholder comments on draft decision

Following consultation on our draft decision, we received submissions from Anglo American and Aurizon Network. Anglo American reiterated concerns about the treatment of costs, including whether the underlying works were incremental maintenance or capital in nature. Aurizon Network's submission provided further information in support of its claim.

Issues raised in these submissions are considered in this final decision.

2 QCA ANALYSIS AND FINAL DECISION

We have considered Aurizon Network's 2015 flood claim and reviewed our October 2016 draft decision in light of comments and information provided by Aurizon Network and other stakeholders. Based on the considerations set out in this chapter, we have decided to approve Aurizon Network's proposed 2015 flood review event claim for the costs associated with the repair work on the Moura system. Our decision is for Aurizon Network to recover those costs in the remaining six months of 2016-17.

2.1 Approval criteria

We have assessed Aurizon Network's 2015 flood claim under the 2016 undertaking, in accordance with the transitional provision in the 2016 undertaking, which states that:

All acts, applications, approvals, approval processes ... any other process or thing whatsoever (Matter) done ... received, undertaken, commenced or established (Done) ... under the 2010 Undertaking are deemed to be Done and, as applicable, continue under this Undertaking as though the Matter was Done under this Undertaking to the extent that this Undertaking provides for equivalent Matters to be Done (cl 12.4(a), 2016 undertaking).¹

We are satisfied the 2016 undertaking provides for the variation of reference tariffs due to a review event, including a force majeure event, and that the approval criteria in the 2016 undertaking are equivalent to those in the 2010 undertaking—that is, the QCA must be satisfied that:

- (1) a review event has occurred which includes an assessment of whether:
 - (a) a force majeure event has occurred
 - (b) Aurizon Network incurred additional incremental costs exceeding \$1 million
 - (c) the incurred costs had previously resulted in a tariff variation
- (2) the variation of the reference tariff is consistent with the change in the costs resulting from the review event
- (3) the tariff variation reflects the impact of the review event on the financial position of Aurizon Network (including the impact of incremental maintenance and incremental capital costs)
- (4) the variation of the reference tariff is calculated as if all other tariffs were also being recalculated.

Appendix A provides the relevant clauses in the 2016 undertaking.

We therefore consider the analysis and the issues identified in our October 2016 draft decision are relevant to this final decision.

In making this final decision, we have considered the issues raised by stakeholders in submissions, which are discussed in the following sections.

Jacobs, as our consultant for this flood event review, has advised us in assessing Aurizon Network's 2015 flood claim.

¹ Aurizon Network 2016 Undertaking, Part 12: Definitions and interpretation, p. 300.

2.2 Our assessment

Aspects of the approval criteria are similar and related, therefore we have structured our assessment to consider:

- the occurrence of a force majeure event
- the amount and the nature of cost resulting from that event, in particular whether it is an incremental cost that would not otherwise be incurred
- whether the tariff variation calculation reflects those costs.

A force majeure event

A force majeure event is defined as any cause, events or circumstances beyond Aurizon Network's reasonable control and includes flood events.

Stakeholders had no comments on this matter.

We therefore retain our draft decision that the February 2015 flood event meets the definition of a force majeure event.

Costs resulting from the review event

Incremental costs

In assessing the amount and nature of the costs associated with the flood claim, we considered whether these costs were incremental, whether these were directly the result of the flooding event, and whether the costs exceeded the \$1 million threshold.

To determine this, we engaged Jacobs to assist us in assessing whether:

- the flooding event triggered the claimed works on the network
- the activities were incremental to business as usual operations, particularly whether future maintenance works would be avoided
- the costs were required to provide access for the operation of train services
- the costs were reasonably incurred.

In its response to our draft decision, Aurizon Network supplied additional information to show its approach to the cost pass-through application was based on flood-related incremental maintenance costs only. Aurizon Network provided work-specific data for sampled projects MSL-1 (signalling cabinets) and MSL-66 (ballasts washout) and said that the claimed costs were purely incremental in nature, as the activities undertaken were refurbishment works that were necessary due to the flood.²

Anglo American remained of the opinion that works set out in the 2015 review event are not incremental maintenance activities and can be considered capital in nature. Anglo American said its view was 'heighted by the vagueness in Aurizon Network's approach to classifying capital works'.³

² Aurizon Network 2016, Flood Review Event 2015 draft decision, submission, p. 7.

³ Anglo American 2016, Flood Review Event 2015 draft decision, submission p. 2.

Jacobs assessment and our review

Jacobs sampled 28 per cent, or \$1.15 million⁴, of the \$4.05 million (pre-escalation) cost claim. The sampled items represented a cross-section of the type of works included in the flood rectification. Jacobs' draft report said that there was insufficient information provided by Aurizon Network to substantiate its claim in full.

We commissioned Jacobs to assess the additional data provided by Aurizon Network and further review the sampled projects against our assessment criteria.

Jacobs found the following:

- Water and debris caused damage on sites and caused earthworks to be washed out. Jacobs found that the flood triggered the need for Aurizon Network to reinstate earthworks and signalling cabinets⁵ and that repairs were needed to return the track to its former condition.⁶
- Aurizon Network had not avoided its planned maintenance activities as a result of the floods.⁷ For example, maintenance inspections that did not occur on the scheduled date were deferred, not cancelled, and those activities associated with the flooding were recorded as overtime and were contract-specific. Jacobs concluded that the flood works were incremental and did not overlap with planned maintenance that would have otherwise occurred.⁸
- The activities Aurizon Network had undertaken were required to provide access to train services to operate the network safely and effectively.⁹ For instance, Jacobs said that damage to signalling cabinets could result in signals failing, thus compromising network safety. Similarly, without ballast and formation repairs, rail collapse could ensue.
- Following receipt of further data from Aurizon Network, Jacobs revised its conclusion from its draft report related to the hours spent on repair activities¹⁰ and the intensive nature of the track works.¹¹ Jacobs concluded that Aurizon Network's allocation of hours was reasonable, unit rates comparable to industry benchmarks and costs were efficient.¹²

Jacobs concluded overall that the projects sampled were assessed to be flood-related; incremental to business-as-usual operations; were required to provide access to train services; and on balance, costs were reasonable. Jacobs considered it reasonable to extend its recommendation to Aurizon Network's total flood costs claim of \$4.05 million (pre-escalation).¹³

On the basis of Jacobs' advice, we consider that Aurizon Network's costs were incremental and a direct result of the flooding event, and exceeded the \$1 million threshold.

⁴ Sampled projects consisted of: signalling cabinet reinstatement (MSL-1), embankment and track washout (MSL-61), ballast scour and track washout (MSL-66), and track washout, Earlsfield–Dakenba (MS-69)

⁵ Jacobs 2016, Moura Floods Supplementary Report, pp. 4, 9.

⁶ Jacobs 2016, Moura Floods Supplementary Report, p. 9.

⁷ Jacobs 2016, Moura Floods Supplementary Report, p. 6.

⁸ Jacobs 2016, Moura Floods Supplementary Report, pp. 6, 10.

⁹ Jacobs 2016, Moura Floods Supplementary Report, pp. 8, 10.

¹⁰ Jacobs 2016, Moura Floods Supplementary Report, p. 7.

¹¹ Jacobs 2016, Moura Floods Supplementary Report, p. 10.

¹² Jacobs 2016, Moura Floods Supplementary Report, p. 11.

¹³ Jacobs 2016, Moura Floods Supplementary Report, p. 13

Capitalisation

On determining whether or not the variation in reference tariffs proposed by Aurizon Network reflects the impact of the review event on its financial position, our broader consideration is to assess whether the costs claimed are appropriately categorised as capital or maintenance, and are not double-counted.

Aurizon Network said that the jobs identified as capital required creation of new assets. They said that works that are classified as capital in nature, have been included in Aurizon Network's ex post capital expenditure claim, which is currently under QCA consideration. Aurizon Network said these were separate from the incremental flood repair works, which were maintenance in nature.¹⁴

Anglo American believed that due to the scale of expenditure associated with the flood rectification works and the arbitrary decision of whether these costs are claimed as incremental maintenance or capital, any prudent expenditure claimed should be rolled into the regulatory asset base (RAB) and then recovered by Aurizon Network through the regulatory regime over the life of the asset.¹⁵

Jacobs assessment and our review

In its supplementary report, Jacobs accepted that there was a lack of clarity on the definition of capital costs in the undertaking¹⁶.

Jacobs applied its own professional judgement to establish whether an activity is capital or maintenance, and considered enhancements, expansions, augmentations, replacements, renewals, and duplications to be capital. Jacobs noted this position was consistent with the definition of 'extension' under Schedule 2 of the *Queensland Competition Authority Act 1997*.¹⁷ Jacobs considered maintenance to include maintaining and refurbishing an asset in a way that did not increase capacity or reflect technological improvements.¹⁸

Jacobs reviewed whether the sampled items (and activities therein) were capital or maintenance in nature. Jacobs concluded that neither the consolidation of the signalling cabinets or ballasts washout had the effect of enhancing overall system capacity or allowed Aurizon Network to increase the number of train paths on the Moura system.¹⁹ Jacobs said that maintenance and refurbishments are different from replacements or renewals, in that, under the former category, the existing asset is still retained.²⁰ Jacobs therefore concluded that the sampled activities were maintenance in nature,²¹ and considered it reasonable to extend that position to Aurizon Network's overall flood costs claim.

We note Anglo American's suggestion that treatment of flood damage costs should be capitalised rather than included as maintenance. We consider that an alternative mechanism for treating flood rectification works is outside the scope of this review. The need for an alternative mechanism could be considered in other regulatory processes.

¹⁴ Aurizon Network 2016, Flood Review Event 2015 draft decision, submission, p. 7.

¹⁵ Anglo American 2016, Flood Review Event 2015 draft decision, submission, p. 2.

¹⁶ Jacobs 2016, Moura Floods Supplementary Report, pp. 2, 6

¹⁷ Jacobs 2016, Moura Floods Supplementary Report, p. 2.

¹⁸ Jacobs 2016, Moura Floods Supplementary Report, p. 2.

¹⁹ Jacobs 2016, Moura Floods Supplementary Report, p. 6.

²⁰ Jacobs 2016, Moura Floods Supplementary Report, p. 2.

²¹ Jacobs 2016, Moura Floods Supplementary Report, p. 10.

The 2016 undertaking allows review event costs to be recovered as incremental maintenance. On the basis of Jacobs' review, we accept that the costs in the 2015 flood claim are maintenance-related and should not be capitalised. We will review Aurizon Network's 2015–16 capital expenditure claim for consistency with the 2015 flood maintenance claim.

Self-insurance

We have considered whether Aurizon Network's flood costs claim were covered by insurance or self-insurance arrangements.

Anglo American said it supported the QCA's draft decision that Aurizon Network should provide further information to demonstrate that the claimed flood costs are not covered in the self-insurance allowance in the QCA's final decision on the 2014 DAU.²²

Aurizon Network said that its UT4 self-insurance costs assessment adopted Finity's analysis, which assumed major weather events resulting in below-rail costs to the network of more than \$1 million will continue to be subject to pass-through via the undertaking.²³

We note that in our 2014 DAU final decision we accepted Aurizon Network's methodology for self-insurance provision and accepted that costs associated with major weather events or force majeure events exceeding \$1 million would be subject to a pass-through provision in the undertaking. On this basis, we accept the 2016 undertaking allows Aurizon Network to claim weather-related pass-throughs, which means Aurizon Network claims for flood damage exceeding \$1 million is reasonable, as it is not part of the UT4 self-insurance allowance.

General conclusion

From the above analysis and based on Jacobs' findings, we accept Aurizon Network's cost claim of \$4.05 million (pre-escalation):

- was triggered by the February 2015 flooding event and exceeded the \$1 million threshold
- the activities were incremental to business as usual operations and were maintenance costs
- the costs were required to provide access for the operation of train services
- the costs were reasonably incurred.

Variation in the reference tariffs

Escalation

Aurizon Network agrees with the mid-year approach and has escalated the 2016–17 costs to mid-year instead of end-of-year dollars.

Anglo American supports the midpoint approach to determining the appropriate escalation, noting this removes the double-counting and windfall concerns that arose from Aurizon Network's initial escalation calculations.

We consider Aurizon Network's escalation approach to be consistent with the mid-year approach used in the 2016 AU.

²² Anglo American 2016, Flood Review Event 2015 draft decision, submission, p. 3.

²³ Aurizon Network 2016, Flood Review Event 2015 draft decision, submission, pp. 7–8.

Methodology

We accept that the flood claim costs have been appropriately modelled and that the variation of reference tariffs reflects these costs. In particular, we accept that:

- costs claimed were not already considered in a previous tariff variation (per the above assessment on additional incremental costs)
- the tariff variation is due to these attributed costs
- the tariff variation has been calculated correctly to reflect the change in these costs
- the tariff variation has been calculated as if all other tariffs were being recalculated—that is, existing approved tariffs were taken into account when considering this variation.

In our draft decision we noted Aurizon Network's proposed recovery of flood costs was through a variation to the AT3 and AT4 reference tariffs. Stakeholders had no additional comments on this.

We consider that AT3 and AT4 reference tariffs are the appropriate tariffs to vary, as all customers who use the affected system should contribute to the repair costs resulting from the floods. We consider this approach is consistent with the general approach to calculating reference tariffs.

We have also examined the details of the methodology, data and assumptions used to vary the reference tariffs proposed by Aurizon Network, and are satisfied that the proposed variation is consistent with the principles set out in our previous decisions and our draft decision.

Recovery period

We noted in our draft decision that, given some time has elapsed since the initial claim was lodged, stakeholders may now prefer an alternative timing of the recovery period.

Anglo American said that, should recovery of any amounts not be capitalised into the RAB, then its preference was for a recovery period over 2016–17 and 2017–18, in order to reduce price shocks.²⁴

While noting that the draft decision enabled the recovery of costs over the second half of 2016–17, Aurizon Network proposed a six-month recovery effective from 1 January 2017 outlined in Table 1.

Table 1 Proposed recovery option—flood cost recovery, 1 January–30 June 2017

<i>Cost recovery</i>	<i>2016–17</i>
Amount to be recovered (mid-year) (\$ millions)	4.48
Net tonnes — 6 months (millions)	6.26
\$ per net tonne	0.72
<i>Tariff increase</i>	<i>2016–17</i>
AT3 (\$/000 ntk)	2.25
AT4 (\$/nt)	0.36

²⁴ Anglo American 2016, Flood Event 2015 draft decision, submission, p. 3.

Aurizon Network also said it was discussing with stakeholders and would advise the QCA if agreement was reached on an alternative recovery period.²⁵

Aurizon Network subsequently advised it was comfortable recovering the flood costs over a period of 18 months commencing 1 January 2017, subject to concluding its negotiations for an access agreement.²⁶

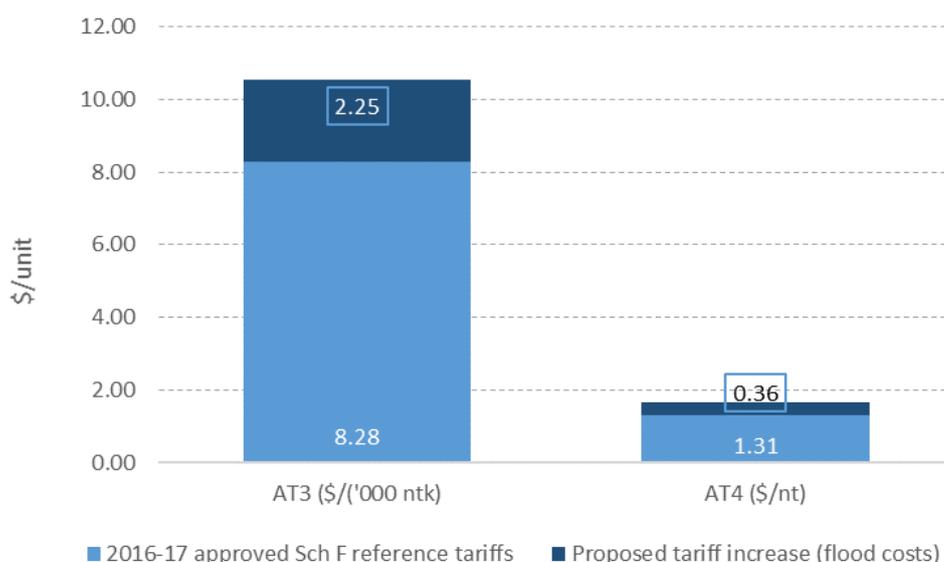
Our view

We have made this final decision on the basis of the information available to us.

In the absence of any further information from Aurizon Network and stakeholders, we consider it is appropriate to approve a recovery period of six months commencing 1 January 2017. In doing so, we have taken into account the current expiry date of the 2016 AU of 30 June 2017 and the need to ensure costs are recovered within a reasonable period of time (particularly given the risk of further flood events). The effect of the consequent tariff variation is outlined in Figure 1.

We consider negotiating access agreements are Aurizon Network's commercial matter and we do not consider it appropriate for our decision to influence in any way the outcome of those negotiations.

Figure 1 Aurizon Network's proposed reference tariffs variation (effective from 1 January 2017)



2.3 Final decision

For the reasons outlined in this decision document, we have made a final decision to approve Aurizon Network's 2015 flood claim of \$4.05 million (pre-escalation).

The AT3 and AT4 reference tariff variation (including escalation of total flood amount to \$4.48 million) is effective from 1 January 2017.

²⁵ Aurizon Network 2016, Flood Review Event 2015 draft decision, submission, p. 9.

²⁶ Aurizon Network 2016, email from D Bowman of 25 November 2016.

APPENDIX A: EXCERPTS FROM THE 2016 UNDERTAKING

Review event approval criteria

Schedule F, clause 5.1(a)(ii) of the 2016 AU states that Aurizon Network will submit a variation of reference tariff to the QCA if a review event occurs.

A variation of a reference tariff as a result of a review event must be submitted in accordance with Schedule F clause 5.4, whereby Aurizon Network must:

- (1) nominate the reference tariff to be varied
- (2) include details of the methodology, data and assumptions used to vary the reference tariff; and
- (3) include evidence the review event has occurred or will occur

Under Schedule F clause 5.5(c)(ii), the QCA may approve the proposed variation if it is satisfied that:

- (1) the review event has occurred or will occur; and
- (2) the variation of the relevant reference tariff:
 - (a) is consistent with the change in the cost resulting from or that will result from the review event
 - (b) reflects the impact of the relevant review event on the financial position of Aurizon Network (including the impact of incremental maintenance and incremental capital costs), and
 - (c) has been calculated as if all other reference tariffs were also being recalculated due to the occurrence causing or that will cause the review event.

Force majeure review event

In Schedule F clause 5.3 of 2016 undertaking, a review event includes the occurrence of a force majeure event affecting Aurizon Network, to the extent that Aurizon Network:

- (1) has incurred or will incur additional incremental costs greater than \$1 million
- (2) have not previously resulted in a variation of the relevant reference tariffs
- (3) has given written notice to the QCA of Aurizon Network's intention to propose a variation to that reference tariff

A force majeure event is defined as any cause, event or circumstance or combination of causes, events or circumstances which:

- (a) is beyond the reasonable control of the affected party; and
- (b) by the exercise of due diligence, the affected party was not reasonably able to prevent or is not reasonably able to overcome

The force majeure review event definition includes acts of God, fires, floods, earthquakes, washaways, landslides, explosions or other catastrophes, epidemics and quarantine restrictions.

Incremental costs are defined as those costs of providing access, including capital (renewal and expansion) costs, that would not be incurred (including the cost of bringing expenditure forward in time) if the particular train services did not operate. Those costs are assessed as the efficient costs and based on the assets reasonably required for the provision of access.