

Submission to the Queensland Competition Authority

**Submission in response to
Aurizon Network's 2013 flood claim final costing & recovery**

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April 2014

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1 Executive summary

Anglo American Metallurgical Coal Pty Ltd (**Anglo American**) welcomes this opportunity to make a submission to the Queensland Competition Authority (**QCA**) on Aurizon Network Pty Ltd's (**Aurizon Network**) 2013 flood claim final costing and recovery.

As well as not addressing a number of existing concerns raised by stakeholders in respect of the initial flood claim and the Sinclair Knight Merz (**SKM**) report commissioned by the QCA, Anglo American notes that Aurizon Network has raised new issues with its final costing and recovery submission.

As such, Anglo American reiterates the majority of the submissions made in the Anglo American Submission on Aurizon Network's 2013 Review Event dated September 2013 (**Anglo American First Submission**).

Anglo American also takes this further opportunity to make new submissions, specifically that:

- (a) Aurizon Network should clearly explain (and provide supporting documentation for) the significant 34% increase in costs from September 2013 (when it was estimated that there was \$4,251,000 of future costs) to March 2014 (where the actual further cost incurred was \$5,698,187). Aurizon Network has only added this increase to its final costing and recovery without any detailed explanation of the rise;
- (b) Aurizon Network should not be entitled to escalation of costs based on the Weighted Average Cost of Capital (**WACC**) (currently 9.96%, which Anglo American has consistently maintained is not representative of the true risk borne by Aurizon Network). As a Review Event is truly a cost pass-through of actual costs prudently incurred, Aurizon Network is not entitled to earn a return on the expenditure and use of the WACC in this instance would be essentially rewarding Aurizon Network for opportunity risk which it is not bearing. Aurizon Network should only be entitled to escalation at a rate equivalent to its cost of holding the amount payable (**Holding Cost**), reflecting the delay in repayment as opposed to rewarding Aurizon Network for a risk it is not taking. This Holding Cost is considered to be circa 5% p.a.. Should the QCA approve a methodology to use a WACC instead, then this should be the WACC endorsed as part of the current 2013 Draft Access Undertaking (**UT4**) process;
- (c) Aurizon Network should recover any approved 2013 Review Event costs through appropriately applied adjustment charges under the 2010 Access Undertaking (**UT3**), rather than increasing the System Allowable Revenue as it has suggested in its final costing and recovery. Aurizon Network has sought to utilise the recovery mechanism that it has submitted in its UT4, a document which is yet to be properly considered and is far from being finalised. The 2013 Review Event claim was made under the provisions of UT3 and the recovery should be made using those same provisions; and
- (d) Anglo American particularly wishes to stress that, to the extent works undertaken as a result of the Review Event which would have otherwise been undertaken by Aurizon Network as part of planned activities during the course of the UT3 or UT4 regulatory period (be it either capital renewals/upgrades or maintenance), Aurizon Network has already been compensated under the regulatory regime and should not be allowed to 'double-dip' by recovering these costs from the Review Event. Aurizon Network should be required to clearly demonstrate that this is not the case. Items which are identified by the QCA as being in either a future capital replacement/upgrade program or maintenance program, but just time accelerated from the flood repair works, should be excluded from the cost claim and treated as normal in the ongoing tariffs.

Please note that any capitalised terms which are not defined in this submission take their meaning from UT3.

2 Outstanding concerns

Anglo American specifically notes the following issues that it raised in the Anglo American First Submission:

- (a) the quantum of costs for the repair of the Moura System seems high and in light of the findings of SKM in respect of the anomalies surrounding a claim for \$1,453,716, Anglo American is concerned that the costs may not be for 'incremental costs' as required by UT3. Please see section 2 of the Anglo American First Submission for further details;
- (b) before making a decision on the 2013 Review Event, the QCA should be entirely satisfied that Aurizon Network has thoroughly exhausted all avenues of insurance claims. Further, Aurizon Network has previously indicated that flood risk is largely 'self-insured'. Anglo American believes that before approving any of the claimed costs, the QCA should seek assurances that effective premium costs are not being included in Aurizon Network's cost base and resulting in subsequent double-recovery. Please see section 3 of the Anglo American First Submission for further information;
- (c) Anglo American agrees with the report by SKM that the amount of \$2,301,270 should be excluded from the claim as it relates to ordinary labour which should be covered by the UT3 maintenance allowance. Anglo American notes that Aurizon Network attempted to address this issue in its response to the SKM report by stating that costs associated with Review Events were always intended to be recovered through that Review Event submission. At the same time, however, Aurizon Network has 'absorbed' some costs, which has led to an increase to the Maintenance Cost Allowance. Anglo American believes that if Aurizon Network feels that the labour costs for the Review Event should be covered by the 2013 Review Event submission, its submission should contain *all* labour costs so that the QCA and stakeholders can clearly determine whether these costs have been appropriately incurred rather than the current complete lack of transparency, where some costs are claimed and yet others are supposedly reflected by exceeding the Maintenance Cost Allowance. Please see section 4 of the Anglo American First Submission for more information;
- (d) although previously accepted by the QCA, Anglo American does not believe that Aurizon Network should obtain a margin of 5.75% on labour costs as costs recovered for a Review Event should be on a cost pass-through basis. Please see section 4 of the Anglo American First Submission for more information; and
- (e) Anglo American has serious concerns with the significant proportion of the Moura System costs that have been attributed to overtime labour costs as compared to that on the Blackwater System. Where only approximately 4% of the Blackwater System costs are attributed to overtime labour, almost 20% of the Moura System costs are this component and Anglo American notes that Aurizon Network is still yet to produce any evidence of why this is so. Please see section 5 of the Anglo American First Submission for more information.

All of these issues remain outstanding and Anglo American notes that Aurizon Network has not addressed any of those concerns (or the concerns of the BHP Billiton Mitsubishi Alliance or the Queensland Resources Council).

3 Significant increase in outstanding costs

Anglo American notes between September 2013 and March 2014, Aurizon Network's total claim amount has risen from \$17,157,174 to \$18,604,361 (an increase of \$1,447,187). Aurizon Network gave a fairly limited explanation of the outstanding costs during its initial Review Event submission, however, in the few months since that date those outstanding costs grew from \$4,251,000 to \$5,698,187 (an unexpected 34% increase).

In its final costing and recovery submission, Aurizon Network has not provided any details regarding this significant increase in outstanding costs, nor what they have been applied to, rather it has simply stated that the costs have risen to that level. Assumedly, in its previous application Aurizon Network had completed extensive planning for the outstanding work and had, at that stage, factored in escalation of costs, meaning that the 34% increase in outstanding costs is purely related to materials and labour that Aurizon Network did not foresee at the time.

As such, Anglo American does not believe that the QCA should approve Aurizon Network's submission without clear evidence being provided to outline the fact that this significant increase in costs was prudently and reasonably incurred. At this point in time, the QCA and stakeholders have absolutely no information to support this significant increase to Aurizon Network's costs.

4 Application of the Weighted Average Cost of Capital

Anglo American notes that in its final costing and recovery submission, Aurizon Network plans to apply the current WACC of 9.96% (a WACC that Anglo American already believes to be significantly higher than the actual risk borne by Aurizon Network) to escalate the Review Event costs until 30 June 2014. Anglo American believes that this is inappropriate and that the only cost escalation applied in that period should be directly in line with the cost of holding the amount to be paid at a suitable borrowing rate, currently circa 5.0% p.a.. Escalation may then occur at CPI over the course of the regulatory period under which the relevant Review Event costs are being recovered (in this regard, it is Anglo American's preference that the Review Event costs are spread evenly over the UT4 regulatory period, due to the significance of the increase in tariffs if only applied to one year of the UT4 regulatory period). Escalation in this manner reflects the cost to Aurizon Network for the outstanding money, however, does not reward Aurizon Network for opportunity risk (which it does not bear on the repaired infrastructure which is almost entirely risk-free).

Works undertaken to repair the damage caused by the 2013 flooding does not represent an investment in the CQCN to which the WACC should be applied. A WACC reflects the investment risk and sunk investment cost that an operator has put into infrastructure: the 2013 Review Event does not fall into either category. It is merely a pass-through of the costs expended by Aurizon Network in order to return the CQCN to its previous operating state and should not attract a WACC, nor be included in the Regulated Asset Base. Escalation of costs should only be applied to ensure that Aurizon Network receives the costs incurred for the repair of the network (ie, a direct cost pass-through to users), rather than allowing Aurizon Network to earn a return on the Review Event.

It should also be noted that in accordance with previous practice, the initial costs of certain infrastructure which has been damaged will remain in the Regulated Asset Base attracting a WACC, despite the physical removal of those assets.

The current costs claimed by Aurizon Network were in order to rehabilitate the affected sections of the CQCN to the standard prior to the 2013 Review Event, namely the standard and capacity that Aurizon Network has contracted those sections of the CQCN for. Aurizon Network has not enhanced or augmented the CQCN, there is no additional capacity beyond what Aurizon Network

is contractually obliged to provide and Aurizon Network is not entitled to receive a return on the maintenance costs incurred returning the CQCN to the original safe operating standard.

Aurizon Network's expenses in relation to the 2013 Review Event were OPEX, not value-adding CAPEX, and should therefore not be passed through to users at WACC. Should the QCA actually decide to approve the use of a WACC in this instance, then it would be expected that the UT4 WACC would apply as the UT3 WACC is not relevant and inappropriate.

5 Recovery mechanism

In its final costing and recovery submission, Aurizon Network has suggested that it intends the 2013 Review Event costs to be recovered in addition to the System Allowable Revenue. As Aurizon Network has suggested, this would be in line with its UT4 submission. Anglo American does not support this reasoning.

The 2013 Review Event claim was made under the existing provisions of UT3, specifically Schedule F clauses 2.2 and 2.3. As UT4 is not approved, the claim cannot be (and was not) brought under the provisions of UT4.

Aurizon Network's UT4 submission has dramatically altered many aspects of the existing regulation, including those provisions relating to Review Events. Further, the UT4 approval process is only partially complete and Anglo American, along with many other stakeholders, has expressed serious concerns regarding all aspects of Aurizon Network's UT4 submission, including Schedule F.

In short, the approved UT4 may have elements of the current drafting, or it may be completely different to the current drafting. As such, Anglo American does not believe that it is appropriate to determine the recovery mechanism for the 2013 Review Event costs on the basis of a draft Access Undertaking which may or may not be in force when these charges are reclaimed. Rather, Anglo American submits that the QCA should only approve the 2013 Review Event costs (where appropriate) using the adjustment charges mechanism contained in the current and operational UT3.

6 Potential for 'double-dipping'

Anglo American notes that part of the standard reference tariff that Aurizon Network receives from users is for planned capital (i.e. renewals and some flood protection works) and maintenance activity. This covers all standard and expected works undertaken on the CQCN.

Anglo American notes that SKM has not specifically considered whether works that Aurizon Network has undertaken as part of the 2013 Review Event should have been covered as part of annual planned maintenance or the forward capital program. Anglo American supports SKM's suggestion to exclude ordinary labour costs from the claim. However, the QCA should also be satisfied that all works undertaken and claimed would not have occurred on the CQCN without the Review Event.

Further, Anglo American is concerned that works undertaken and claimed as part of the 2013 Review Event might negate the need for planned maintenance works in the FY13/14 period. Anglo American submits that to the extent Aurizon Network would have undertaken maintenance works in the next period if they were not completed as part of the 2013 Review Event, the cost of those works should be excluded from the Review Event costs or deducted from the maintenance budget in the tariff charged to users.

Another concern with costs attributable to the 2013 Review Event is the impact that these rectification works will have on Aurizon Network's renewals program. In instances where rail and track infrastructure was due to be renewed (or improved with flood protection measures) in the

near future but has been replaced by virtue of the current flood works, the QCA should ensure that Aurizon Network only receives those costs once. Whether that is managed by deducting costs which soon would have been incurred for track replacement from the Review Event, or reducing the renewal margin in the Reference Tariff, the QCA must prevent Aurizon Network from securing double-recovery for the replacement cost of infrastructure which it already receives from users.

If costs overlap, Aurizon Network is essentially 'double-dipping' as it is already been compensated under the regulatory regime for maintenance while double recovering by virtue of the 2013 Review Event.