

26 March 2021

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Level 27, 145 Ann Street
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(submitted via QCA Online Submission Form)

RE: Aurizon Network FY2022 maintenance strategy and budget: Newlands system

Thank-you for the opportunity to provide this submission on behalf of the Rail Industry Group (RIG).

1. Executive summary:

The RIG considers that Aurizon Network has:

- Failed to take actions which a prudent below-rail owner/operator should take when its associated entities are dealing with assets which are critical to the below-rail business. This includes failing to bring the rail grinding assets into Aurizon Network when similar critical assets were moved into Aurizon Network [REDACTED]
- Assisted Aurizon Operations to dispose of critical assets by entering into a contract featuring material rate increases.

[REDACTED]

- Moved to a sub-optimal procurement methodology which exposes customers to inefficient costs.

This has been done without consultation with customers and in a non-transparent manner, creating the perception of decision-making driven by the interests of the Aurizon group rather than the interests of Aurizon Network and the Central Queensland Coal Network.

2. Participation of RIG:

This submission to the Queensland Competition Authority (QCA) was developed by members of the RIG.. A draft of the submission was provided to RIG members and was reviewed and discussed at a meeting of the RIG held on 25th March 2021. The submission was unanimously supported by the RIG members in attendance at the meeting. Note that RIG members which are part of the Aurizon group agreed (at our suggestion) not to participate in the development of this submission.

3. Relevance to all systems:

During consultation on Aurizon Network's FY22 Maintenance and Renewals Strategy and Budget (MRSB), RIG members in all systems shared concerns about the increase in unit rates for rail grinding services. These concerns resulted in the Maintenance Strategy and Budget (MSB) for Newlands system not being approved. Votes were cast against approving the MSBs due to concerns about rail grinding costs in most other systems. Also, RIG members who voted to approve the MSBs indicated that they had strong concerns about rail grinding costs, expected consultation on the issue to continue post-approval and would not be minded to approve the MSBs for subsequent years unless this consultation addressed their concerns.

The RIG understands that the QCA's role in the current process is limited to a review of the Newlands MSB. However, the issue is not specific to Newlands, nor does it have any special impact on Newlands compared to other systems. RIG members in all systems look to the current QCA approval process to inform their consideration of future draft MSBs.

4. Confidential information:

This submission is based on public information in addition to confidential information made available to members of the RIG by Aurizon Network as part of the UT5 maintenance and renewal obligations under 7A.11.3 of UT5. Aurizon Network provided additional information under a confidentiality agreement to the Chair of the RIG and to the RIG's expert advisor, which was not able to be shared with the RIG. That information was not used in the development of this submission. The Chair and expert advisor have participated in the development of this submission, and do not consider that any of the statements or conclusions of the submission would vary if the RIG had access to this confidential information.

5. RIG position:

The RIG considers that an assessment of the efficiency of Aurizon Network's rail grinding costs requires the QCA to first assess whether external procurement or internal procurement is the most efficient procurement methodology. Benchmarking of costs (with appropriate adjustments for differences such as scale) is appropriate only where external procurement is found to be most efficient. Where internal ownership of the assets is more efficient, which we believe to be the case for the rail grinding activity, allowances should reflect the cost of capital and internal costs. This was the basis for all rail grinding costs assessed by the QCA at least as far back as UT3.

We believe that Aurizon Network held itself out as being the owner of the rail grinding assets prior to its UT5 submission. Aurizon Network has now informed the RIG that this was never the case. Given that Aurizon Network treated these assets as its own under successive undertakings, and facilitated the sale to Loram by signing a new contract featuring higher rates, we consider that it is not appropriate for Aurizon Network to now hide behind the ownership structure and treat the decision to sell the assets as a decision of an independent third party. On this basis, it is open to the QCA to develop an efficient cost allowance which reflects internal ownership of these assets by Aurizon Network.

6. Rail Grinding costs:

Aurizon Network's proposed mainline rail grinding unit costs for FY22 are increasing (compared to the FY21 MRSB rates) by [REDACTED] across all systems.

Increases for turnout grinding are less significant.

Aurizon Network has advised that the increases are mainly the result of a step-up in rates under the services contract with Loram. We understand that this contract was also in place for FY21, but that Aurizon Network negotiated a rate for that year [REDACTED]. Our understanding is that the QCA has not previously reviewed the contract or considered the efficiency of the costs. The RIG was not consulted before Aurizon Network entered into the contract. Clearly, in this situation, there is potential to offer higher prices under a services agreement in order to inflate the sale price for the benefit of the related entity.

The RIG believes that statements made in the FY21 MRSB (page 45) now appear somewhat misleading, with the forecast increase for FY22 and beyond described as a "slightly higher unit rate" and the contract signed with Loram being described as a "renewal". The RIG was not provided with the relevant scope of rail grinding so as to enable the actual unit rates to be calculated for FY22 and beyond at the time. The actual increases in unit rates have proven to be significant. The FY21 MRSB (page 45) sought to justify the rate increases on the basis of a trade-off for reduced take or pay commitments, which Aurizon Network said was important because of expectations of reduced grinding volumes in the future, however the long-term forecasts in the FY22 MRSB suggest continuing increases in grinding volumes. This not only contradicts the justification for rate increases which Aurizon Network previously offered, but also exacerbates the effect of the inefficient cost increases.

7. Sale to Loram

The sale of the rail grinding business to Loram was announced on 12th August 2019 (Loram website) and completed on 31 October 2019 (Aurizon Annual Report, FY20). The Loram announcement stated that, subject to completion, Loram would perform "all mainline and turnout rail grinding for Aurizon Network Pty Ltd".

Aurizon's FY20 Interim Financial Report of 15 February 2021 shows that:

- The Rail Grinding business was sold to Loram for \$164.5 million dollars (page 6).
- The profit on the sale was \$105.4.

Based on this information, it appears that the book value of the business was \$59.1m. The \$105.4m profit captured by the Aurizon group most likely reflects, at least in part, the difference between the book and market value of the rail grinding assets (which is increased by the new Aurizon Network contract): effectively capturing, for the benefit of the Aurizon group as a whole, the revaluation benefit which Aurizon Network [REDACTED], and the QCA rejected, under UT4 (see Section 7 and 8).

We consider that the QCA was correct when it stated in the September 2014 Draft Decision on the Maximum Allowable Revenue element of the 2014 DAU 2014 that *"it is unlikely to be efficient for Aurizon Network to sell these assets and outsource the maintenance activity"*.

8. History of rail grinding issue through successive undertakings:

Note: References to Aurizon Network's UT4 submission below are generally references to Aurizon Network's "UT4 Maintenance Submission" of 30 April 2013. This submission can be found on the QCA website under Rail, Aurizon Network, Previous Access Undertakings, 2013 Draft Access Undertaking. The 2013 Draft Access Undertaking was the first version of UT4. While it was ultimately withdrawn and replaced by the 2014 Draft Access Undertaking, the proposed approaches discussed below did not change (and Aurizon advised that the Maintenance submission for the 2013 Draft Undertaking was to be considered as part of the submission on the 2014 Draft Undertaking).

We have been advised by Aurizon Network that Aurizon Network has never owned the rail grinding assets and that these, prior to the sale to Loram, were always held by Aurizon Operations Limited (Aurizon Operations) and its predecessors. This is surprising given that the regulatory allowance for this activity under UT3 and UT4 was clearly based on a return on assets plus depreciation approach. These allowances were based on the book value of the assets. In Aurizon Network's UT4 submission, there is no explicit mention of the ownership of rail grinding assets (nor of similar assets such as the ballast cleaning machine), however:

- The Evans and Peck report provided by Aurizon Network as Schedule N of Aurizon Network's submission states on Page 4 that *"Due to QR Network maintaining some of their key maintenance activities in-house, the CQCN have maintained reasonably competitive per kilometre rates for rail grinding, ballast cleaning and mechanised resurfacing"*.
- The discussion in Section 5.8.1 of Aurizon Network's submission, regarding the return on maintenance assets and depreciation of those assets, clearly includes rail grinding assets (along with other assets such as ballast cleaning machines), which is not consistent with ownership of these assets by a third party. The Coal Link Alliance governance structure described in Section 3.3.6, and the organisational structure shown in Figure 2 clearly demonstrates that Aurizon Network was responsible for the "Specialised Track Services" team that managed the rail grinding activity and other specialised maintenance tasks.

We do not doubt Aurizon Network's claim that the assets were owned by Aurizon Operations (of which Aurizon Network was a wholly owned subsidiary). What the examples demonstrate is:

- a lack of regard for the distinction between the entities; and
- an approach in which the procurement of the service from Aurizon Operations or internally by Aurizon Network is considered entirely fungible.

In UT4, Aurizon Network proposed a new approach for valuing and calculating allowances for mechanised plant including rail grinding assets, which would have increased the allowances (discussed in Section 8). No distinction was made, in terms of ownership, between rail grinding assets and the assets owned by Aurizon Network. It

now appears that, in regard to the rail grinding assets, any benefits of an uplift in allowances was to be passed to Aurizon Operations. If Aurizon Operations was providing services to Aurizon Network under a services agreement at the time, then the terms of that agreement were not consistent with those expected under contract negotiated on an arms-length basis.

9. Aurizon Network's UT4 revaluation proposal and QCA response:

For UT4, Aurizon Network proposed a new approach to calculating depreciation and return on assets for mechanised plant, including rail grinders. Section 5.8.1 of Aurizon Network's submission discusses the proposed changes. The changes sought to align the allowances with costs which Aurizon Network considered would prevail in a competitive market, rather than being based on Aurizon Network's actual or historical costs. The proposed approach involved:

- [REDACTED].
- Applying the rate of return, and calculating depreciation allowances, to a replacement cost of the assets, rather than to book values. This was to be achieved via a Gross Replacement Value (GRV) annuity approach (where the annuity reflected both a return on capital and a depreciation allowance). Aurizon Network also proposed that the Gross Replacement Value would reflect the cost of the "Modern Equivalent Asset", reduced only to the extent that the actual assets had a lower service potential.

In support of the proposed change in approach, Aurizon argued that *"if prices for maintenance activities did not reflect market value it would be more profitable for the regulated firm to either sell the plant to realise market value or redeploy the capital to a profitable purpose and outsource the activity with pass through reflecting an efficient competitive market price"*. We note that the reference to "selling" the assets is inconsistent with the rail grinding assets being owned by Aurizon Operations. That is, it would not have been possible for Aurizon Network to sell an asset which it did not own in order to redeploy capital. We assume that the statement was made on a 'whole of Aurizon Holdings' basis. The Aurizon Group has now implemented the strategy which Aurizon Network was warning of in this statement.

The QCA considered Aurizon's proposal to move to a GRV approach and rejected it in the September 2014 Draft Decision on the Maximum Allowable Revenue element of the 2014 DAU (a position which was confirmed in the April 2016 Final Decision). In Section 5.3.4 of the Draft Decision, the QCA said:

"We acknowledge some of these activities could potentially be outsourced to external parties. However, Aurizon Network has invested a significant amount of capital in its maintenance assets—the undepreciated value of these assets in 2013–14 is \$52.88 million. Given these assets are highly customised for use in the CQCN, it is unlikely to be efficient for Aurizon Network to sell these assets and outsource the maintenance activity as of now. For this reason, we view the main priority should be to ensure that:

- *the maintenance task is cost reflective; and*
- *Aurizon Network should be allowed to recover appropriate return for its initial investment in these maintenance assets, as it would be the case for any other assets included in the RAB."*

These comments regarding the potential for Aurizon Network to “sell these assets” are consistent with the QCA being unaware that ownership of the relevant assets sat with a third party. The reference to “any other assets included in the RAB” also suggests that these assets were in the RAB, although we suspect that it may have been an error in wording.

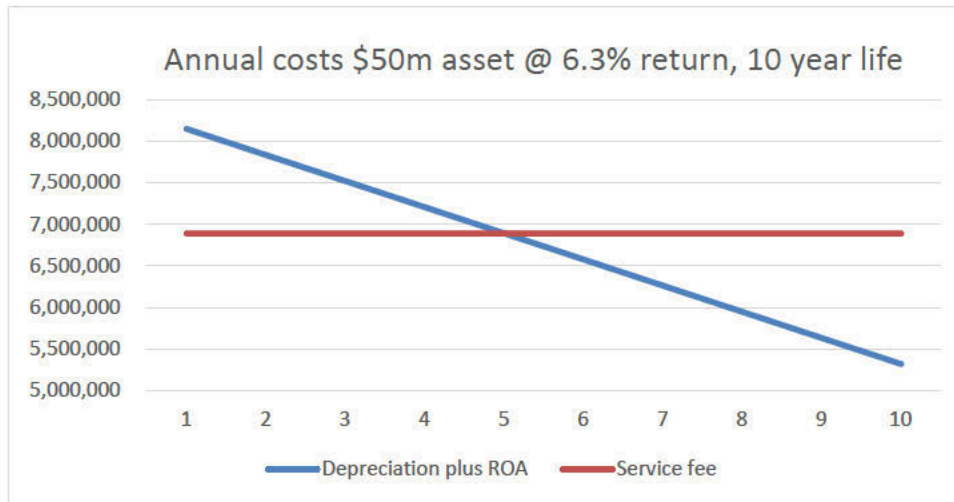
We consider that the QCA was correct when it stated that “*it is unlikely to be efficient for Aurizon Network to sell these assets and outsource the maintenance activity*”. The Aurizon Group has now implemented this inefficient arrangement, which Aurizon Network participated in by executing a new contract with the purchaser of the assets ahead of the sale, without consultation with customers and, to the best of our knowledge, without seeking offers from alternative service providers. Despite consistently treating these assets as its own when seeking allowances under successive undertakings (noting that UT5 continued to be priced based on historical asset values), Aurizon Network now expects customers and the QCA to respect the separation of Aurizon Operations and Aurizon Network and to accept that the decision of Aurizon Operations to sell the assets is an action of an independent third party. This inconsistency of approach is unreasonable and will lead to inefficient costs.

10. Change in approaches can result in overcharging:

Aurizon Network has changed from an approach in which services were priced based on a return on, and of, the historical cost of the asset, to a price which it claims represents a market price. This has achieved, for the Aurizon Group, the revaluation and windfall which Aurizon Network sought (apparently for the benefit of Aurizon Operations) under UT4, and which the QCA rejected.

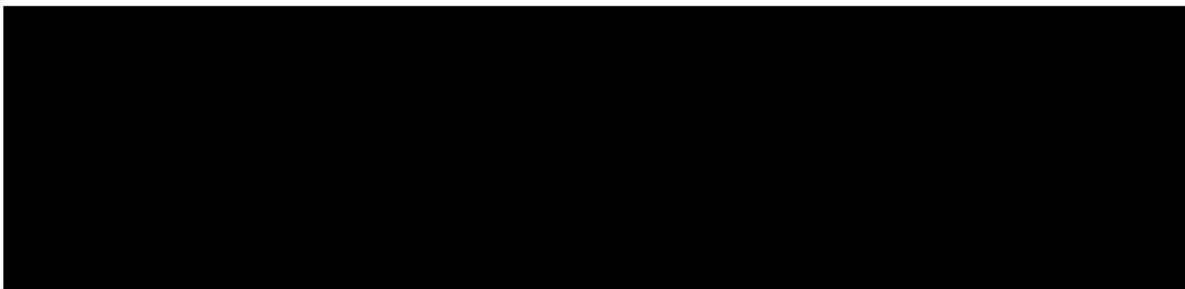
Changing approaches during the life of the asset can result in double-charging. Section 5.8.1 of Aurizon Network's UT4 submission explains (page 115) that, “*efficient prices in a service agreement would not be expected to be high early in the service agreement and low late in the service agreement*”. This is true because a similar service can be provided regardless of whether the asset is new (with a high written-down value) or older (with a low or zero written down value). For example, freight charges for above-rail services do not generally vary with the age of the train: services provided by a significantly depreciated asset can attract the same charge as can services provided by a new train.

In contrast, pricing based on historical asset value will be high in early years, and low in later years (and nil when the asset is fully depreciated). This is demonstrated in the following graph (illustrative example: not based on particular assets). Note that the two revenue streams shown below have the same NPV. Aurizon Network provided a similar graph in Section 5.8.1 of the UT4 submission.



By switching between approaches, Aurizon Network may capture the high charges which apply early in the life of a regulated asset, then move to the flat service fee approach which will result in total charges over the life of the asset exceeding the cost expected under the consistent application of either approach. Note that:

- Where the actual asset life exceeds the period over which assets are depreciated, charges under the historical asset value approach will become zero, while costs under the service fee approach will continue at the rate shown. To the extent that this is likely to occur for this class of assets, it is a further indication that the decision to divest is not prudent from a regulatory perspective.
- We acknowledge that the NPV of the total charges would not increase (above the level which applies under each of the approaches alone) in the scenario where, upon switching to the service fee approach, the fee is set by reference to the written down book value of the assets at the point of transfer. That is clearly not the case here, as a gain of \$105.4m was realised on the sale of the assets.
- We acknowledge that a new rail grinding machine was purchased around the time of the transaction. This may limit the effect described above in regard to that particular asset.
- We acknowledge that the regulatory approach of escalating the written down value at CPI each year would narrow the pricing gap between the two approaches to some extent. It is not clear to us whether this methodology applied to rail grinding assets.



[REDACTED]

12. Potential for future gaming

We have serious concerns about the precedent which would be set by allowing this type of restructuring and repricing to occur. The opportunity would be created for regulated entities to immediately capture any difference between the market value of assets and the written down book value: effectively achieving a revaluation windfall on the assets. No reciprocal adjustment is likely to apply where the market value of assets is below the written down value as Aurizon Network would expect to continue to recover depreciation and a return on capital based on book values.

Customers will suffer higher charges because of the effective resetting of the asset values and will also lose any efficiency benefits achieved through in-house performance of the services. The revaluation effect provides the regulated entity with an incentive to move to an inefficient service delivery model, as has occurred in this case.

13. Conclusion

It is the role of the QCA to determine if the activities and costs in the Newlands MSB as submitted by Aurizon Network for FY22 are prudent and efficient.

We dismiss the proposition Aurizon Network had no part in or influence over the sale of the rail grinding assets due to the assets being owned by Aurizon Operations. As noted above, in all prior undertakings (including UT5), the treatment of rail grinding was consistent with that of the other network maintenance activities for which Aurizon Network was apparently the owner.

“Prudent” can be defined as “acting with or showing care and thought for the future”. We believe that Aurizon Network was not prudent in either its procurement process, or in their decision to sign a contract with Loram for rail grinding services. The decision to “outsource” this service [REDACTED], while benefitting a related party, has decreased the competitiveness of the Queensland coal industry. Aurizon Network facilitated the sale to Loram [REDACTED], with significant price increases, with no evidence of alternative sourcing options having been considered.

As evidenced by both Evans and Peck and the QCA's own statements during the UT4 approval process, the provision of rail grinding “in-house” was in fact an efficient maintenance delivery method. The deviation from this method has clearly resulted in increased costs. The resulting increased costs must therefore be considered inefficient.

¹ “Australian Mining”: <https://www.australianmining.com.au/news/rail-maintenance-contract-win/>

We have serious concerns about the impact of allowing such restructuring / repricing behaviour and the precedent it may set for other regulated entities.

Thank you for the opportunity to provide this submission.

Yours sincerely

Gary Costello
Chair, Rail Industry Group