TCI Fund Management Limited

The Queensland Competition Authority
145 Ann St
Brisbane
Queensland
Australia

8 March 2018

Dear Sirs,

TCI is a global investor in infrastructure and has been an equity investor in Aurizon since the Initial Public Offering of QR National shares upon the privatization of the company by the Queensland Government.

Our observations on the QCA's Draft Decision focus on the need for the regulatory process to provide an appropriate risk-adjusted rate of return for equity holders.

In our view, the Draft Proposal of a 5.41% WACC (which equates to a 6.99% equity return) is:

- Too low in absolute terms to justify sensible levels of investment in the CQCN
- Significantly below the WACC settled for the Hunter Valley Coal Network (HVCN), the Central Queensland Coal Network's (CQCN) closest rail network peer.

Equity investors simply cannot support investment where returns are not commercial. This is logical and fair. This low return, together with the reduction in operating and maintenance cost allowances to maintain the network (despite asset base growth of approximately 20%), force Aurizon Network to slash overall cash spend. In a normal regulatory process, a regulatory decision would be reached before the start of the regulatory period, giving time for all to adjust to the new regime. Given the UT5 period starts on 1 July 2017, Aurizon Network has rightly moved quickly to reduce operating and maintenance costs to the levels set in the allowances.

This much lower cost regime cannot be a good commercial outcome for CQCN system reliability, export volumes, employment and associated Government royalties over the medium term. The saving for miners arising from the difference between the Aurizon Network submission and QCA Draft decision) is easily outweighed by the profit margins lost on lower volume (or the risk of lower volume) transported through the rail system.

The ultimate customers of Australian coal exporters are rightly concerned (as evidenced in recent media coverage) and appear to be taking steps to diversify their sources of supply. US exports increased by 60% in 2017 in response to supply issues in Australia (which in turn raised prices that incentivised such supply). Broker forecasts for 2018 predict further significant increases in supply from US and Canada, in part given continuing concerns about the resilience of Australian coal networks. This Draft Decision will only add to the global concerns as to the ability of the CQCN to meet global coal demand in the long term.

Rate of return is too low in absolute terms

Given the inherent long-term risks of a coal related network, the equity return should be at least 8-9% (which is in line with the settlement for the HVCN, as discussed below).

Aurizon Network commissioned Deloitte's who surveyed five leading global investment banks involved in large infrastructure transactions over the last two years. Deloitte's findings suggest that the post-tax return on equity for Aurizon Network should lie between 8.0% and 9.5%. Deloitte concluded that the unique risks faced by Aurizon Network over the long term would place upward pressure on the post-tax equity return required by infrastructure investors. We wholly endorse this view as it clearly aligns with the commercial views of equity and debt markets.

The QCA uses a highly mechanistic process and only considers 4-year periods when making assessments of risk adjusted returns. Equity investors always take into consideration the risk to cash flows over a much longer period than this, no matter what the asset class. Most regulators agree, given the vast majority (including the ACCC) use the 10-year risk free rate (RFR) as a key input to estimating the equity return for a long asset life business.

All Sovereign RFRs have been influenced significantly by quantitative easing (QE), nearer term measures the more so. For example, the 4-year RFR used by the QCA in the Draft Decision is 1.9% (being the average RFR from the 20 business days leading up to the end of June 2017, the end of the UT4 period). This "point in time" measurement ignores the medium term trend and it was also at a low point just as global bond yields started to rise. The 4-year RFR is already around 2.3%, some 40 basis points higher. The equivalent 10-year rates were 2.44%for the June 2017 averaging period and 2.76% for the January 2018 averaging period, significantly higher than the Draft Decision. Consensus economic forecasts expect bond yields to continue rising as QE reverses and given the strength of the global economy.

In the UK, Ofgem has recently recognised the problem of high inflation and low, QE influenced, interest rates with a proposal to (1) consider indexing the RFR and (2) using CPI inflation (which is lower than RPI) as a way of bringing forward cash flows to aid financeability.

Notwithstanding our view that the 10-year RFR is the appropriate measure and by far the most commonly used by regulators globally, at the very least there needs to be an assessment of the likely level of RFR over the 4-year period of UT5, using current data points and evidence, and possibly using creative tools to properly address the highly unusual and negative effect QE has on returns. This is both reasonable and commercial.

There are other inputs to the bottom up calculation of WACC that have been reduced, such as the asset beta to 0.42 v 0.45 in UT4 and DBCT. Save to say, it would be easy to be drawn into a point-by-point debate about each input, but the bottom line is that the academic process that has led to a c.7% equity return is deeply flawed from a market and commercial point of view. This alone will discourage investment by Aurizon Network in (and maintenance of) the CQCN and this cannot be the right answer for customers and employees in a market where mining companies are earning very high margins on each tonne of product railed.

<u>Comparative WACC and the HVCN settlement</u>

The QCA and consultants from both sides have argued over which companies represent the most appropriate comparators for Aurizon Network, thereby providing supporting evidence to the bottom up process. This included Australian and international regulated companies spanning rail, electricity, gas and water. For Australian utilities, the QCA *"considers that Aurizon Network's exposure to volume, counterparty and asset stranding risk is similar to that faced by regulated energy and water businesses"*.

There are academic arguments both ways on this, but the evidence from the "real world" is clear: coal related networks are harder to finance, carry more risk (which is supported by investment banks and credit rating agency actions and views) and should necessarily be expected to have a higher cost of capital than "high quality regulated assets and infrastructure assets supported by firm, long-term contracts" (as evidenced by the Deloitte survey noted above).

The QCA has rejected this evidence, but has failed to engage with real providers of finance in an open forum. Open engagement between regulators and providers of finance (workshops/seminars) is common globally. In the UK, this iterative approach was introduced over 15 years ago. I understand the QCA declined two requests by Aurizon Network to have a workshop on cost of capital as part of the UT5 process where there would have been ample opportunity to test the rigour of its academic hypothesis with real providers of finance.

Despite all of the global comparative analysis, the most appropriate comparator has to be the HVCN. However, in its Draft Proposal the QCA effectively dismissed it, preferring to rely on its bottom up approach *"than simply undertaking a benchmarking exercise that references other regulatory decisions"*.

In our view, there is no more relevant regulated network business than the HVCN. The debate around the relative risks of each network is also highly informative and relevant.

To recap on the HVCN proposals:

- The majority of members of the QRC are also users of the HVCN and are members of the Hunter Rail Access Task Force (HRATF). In February 2017, the HRATF responded to the Australian Rail Track Corporation (ARTC) 2017 Draft Access Undertaking (DAU) for HVCN.
- HRATF (and the ACCC) considered a WACC of 6.3% as appropriate (implied equity return of nearly 8%) while the QRC, made up of similar members, recommended a WACC of 5.1% for CQCN. HRATF also made it very clear that it considered the CQCN to be higher risk yet suggested a materially lower WACC.

HRATF stated in its submission:

"Our view is that a careful analysis of risks faced by ARTC compared to other regulated rail service providers on the east coast of Australia strongly supports our position that ARTC's asset beta (i.e. risk) should be materially lower than the level observed for Aurizon."

The reasons cited include:

- *"...Aurizon operates several different coal systems with limited cross system traffic, with each individual coal system having lower volumes and less diversification of users than the Hunter Valley;*
- *ARTC has rolling 10 year agreements, meaning that ARTC has volumes contracted for the next 10 years. Aurizon access agreements have a term of 10 years with a right to renew, meaning that for an individual user the total future volume contracted to Aurizon will decline each year until renewal;*
- *Aurizon faces the risk that the QCA may remove from its regulated asset base the value of infrastructure which is deemed no longer to be required. This is not a risk faced by ARTC ..."*

In the final decision (June 2017), the WACC for HVCN was increased to 6.95% from the initial 6.3%, creating an even larger spread to the QCA Draft Proposal for CQCN of 1.54%. The implied nominal equity return for HVCN is 9.2% or 2.21% above QCA Draft Proposal of 6.99%.

<u>Financeability</u>

As noted above, an open dialogue with providers of finance would also include rating agencies, particularly the two most important to company ratings, Moody's and S&P. While they have slightly different approaches to the ratings process, it is important to take full account of the opinions of both in setting a financeable package for investment grade at Baa1/BBB+. This is normal in regulatory processes

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internationally given the regulated entity needs an investment grade rating from both in order to access debt markets on an efficient basis.

From the Draft Decision, it is evident that Moody's has set Aurizon Network's tolerance level at a materially higher threshold than equivalently rated regulated energy network utilities, in recognition of the increased likelihood of cash flow volatility. This is understandable and drives higher required credit metrics than S&P for FFO/debt and FFO/interest cover over the UT5 period. The QCA's consultant, Incenta, considered that S&P's approach *"is appropriate"* in assessing Aurizon Network's benchmark credit metrics. It is not clear to us why this is the case. However, from the Draft Decision it is evident that under the Moody's higher threshold level for investment grade at Baa1 (S&P BBB+) credit metrics, the economic package proposed by the QCA would fail. The QCA must take full account of the opinions of both rating agencies and their tolerance levels for the economic package to be financeable at Baa1/BBB+.

In summary, while there are numerous areas of debate in the QCA Draft Decision, we have focused our comments and concerns on (1) the low risk-adjusted rate of return for equity holders (2) the impact of much reduced cost allowances and (3) the clear risk that the overall economic package is not financeable at investment grade metrics of both major rating agencies.

In our view, the evidence supporting a significantly higher return is compelling and is necessary for Aurizon shareholders to support investment in the CQCN. Evidence from HVCN cannot be ignored given its relevance. There is clearly room for discussion and improvement in cost allowances in order to ensure system performance and resilience. To do otherwise would send the wrong signal to Australia's coal customers and may lead to further, but understandable, diversification of supply.

Finally, it is noteworthy that upon his appointment as Chairman of Port of Newcastle, Professor Roy Green highlighted the opportunities in the Hunter Valley, but also stated that, *"Clearly the long term outlook for coal is a threat to the Port and Hunter region"*. He also stated that while the Hunter Valley economy will continue to be central to the prosperity of the region and Port of Newcastle for some time to come, *"there is also an urgent need to diversify the Hunter economy and the Port's business"*. We agree, and this is why investors consider the long term prospects and risks to such infrastructure. The CQCN is no different.

Yours faithfully

Philip Green

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