Resourcing Queensland's future

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Queensland Competition Authority
145 Ann Street
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(Submitted via QCA Online Submission Form)

RE: Aurizon Network: Reset Schedule F Preliminary Values

The Queensland Resources Council (**QRC**), on behalf of the QRC's Rail Working Group, welcomes the opportunity to comment on Aurizon Network's Reset Schedule F Preliminary Values.

1. Introduction

The extension of Schedule F values under part 6A of Aurizon Network's Access Undertaking is required because the approved Undertaking does not contain Reference Tariffs, Allowable Revenues or Gtk Forecasts for the final four years of the term of the Undertaking, known as the Reset Period (FY23, 24, 25 and 26).

The intention of part 6A was to provide clear processes by which the Reset Schedule F Preliminary Values would be calculated, with these processes being consistent with the basis on which the corresponding values were calculated for the earlier period of UT5. We have reviewed and commented on Aurizon Network's approach to the extent possible based on the information provided. However, our ability to comment is limited by:

- Lack of access to Aurizon Network's models and confidential information.
- Difficulty in determining, in some areas, whether the methodologies applied by Aurizon Network are entirely consistent with the methodologies employed by the QCA in the development of the initial Schedule F values. This includes the development of the Debt Risk Premium and the Risk-Free Rate.

We rely upon the QCA to conduct a thorough review which is not limited to issues raised in submissions.

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2. Preliminary System Forecasts

We support Aurizon Network's proposal to adopt Preliminary System Forecasts which are consistent with the forecasts most recently approved by the QCA. We note however that the QCA approved forecasts did not consider the Independent Expert's Initial Capacity Assessment Report (ICAR) or 2022 Annual Capacity Assessment Report (ACAR) which identified Existing Capacity Deficits (ECD) in some rail systems. The QRC's support for the Preliminary System Forecasts is based on Aurizon Network's commitment to engage with Customers late in 2022 to develop updated preliminary system forecasts for submission to the QCA by 28 February 2023.

3. Expected variations to preliminary Allowable Revenues

We support an update of Reset Schedule F Preliminary Values in February 2023, to reflect regulatory determinations made prior to that date and updated information such as the approved values under the FY23 Maintenance and Renewals Strategy and Budget.

4. Capex and Direct Maintenance forecasts

We note that Aurizon Network has sourced forecasts of capital expenditure and direct maintenance costs from the FY23 MRSB, which Aurizon Network states were "approved" by the RIG and QCA. We have no objection to the use of these values for the purposes of developing the Reset Schedule F Preliminary Values, however we do not consider that the RIG has "approved" these values. The focus of RIG consultation is on the coming year (FY23 in the case of the FY23 MRSB). Information provided by Aurizon Network in regard to subsequent years is provided only at a high level, to put the current year costs into a longer-term context.

We would support an update of the maintenance and renewals forecasts, based primarily on the FY24 MRSB, ahead of FY24. This should include consideration of the appropriateness of including Transitional Arrangements within the forecast, to the extent that these are settled ahead of FY24.

5. Electric Energy Charge

Aurizon Network has adopted the current approved EC Charge, but has indicated that it "*proposes to amend the preliminary EC Tariff for the Reset Period to reflect the QCA's decision on the EC DAAU*" (page 8). The EC DAAU seeks to adjust EC to reflect forecast electricity costs for FY23, a year of extraordinarily high expected prices which we hope will not continue into FY24. We support an update of EC for the Reset Period, based on a reasonable forecast of costs for the Reset Period as at February 2023, rather than on the values contained in the EC DAAU.

6. Base WACC

We agree that the Report Date has occurred, and that a base WACC of 6.3% is appropriate for the current purpose. However, we note that:

- A review of whether the Rebate Objectives have been met may occur under Clause 7A.6(f) and may result in a reduced base WACC which would then need to be reflected in the Reset WACC from the Reset Date.

[redacted]

7. Reset Risk Free Rate

We rely on the QCA to consider whether Aurizon Network's methodology for determining the Reset Risk Free Rate is aligned with the requirements of the Undertaking, which include the use of "*methodologies consistent with those applied by the QCA in the development of the rate of 1.9% as set out in Appendix F of the QCA's Final Decision*" (UT5 definition of Risk-Free Rate). We note Aurizon Network's comment (Section 4.1.2) that "*as the bonds are semi-annual coupon paying, the 4-year YTM is annualised*". The footnote to this comment references the QCA's 2021 Rate of Return Review. The methodology applied to developing the Reset Risk Free Rate must be consistent with the methodology applied by the QCA when developing the UT5 value of 1.9% and, if the Rate of Return review recommends any change or refinement to those practices, those recommended changes must not be applied in the current process. It is not clear to us whether Aurizon Network's Reset Risk Free Rate does, or does not, reflect the UT5 approach.

8. Reset Debt Risk Premium

It is clear from Section 4.1.3 of Aurizon Network's submission that Aurizon Network's calculation has required a large number of decisions to be made regarding matters such as sampling criteria, and the inclusion or exclusion of particular bonds. In some cases, Aurizon Network states that its approach is consistent with the UT5 approach. In other areas, such as the inclusion of callable bonds, Aurizon Network adopts a method which is inconsistent with the 2018 Decision on the basis that the 2018 decision provides for their inclusion where justified. Aurizon Network's primary justification for the adoption of an approach inconsistent with the QCA's 2018 Decision is the increased prevalence of callable bonds in the bond market and its assessment of the value of the callable bond options. There is clearly a risk of "cherry-picking" if Aurizon Network is able to exercise judgement calls which at times strictly follow the QCA's 2018 approach, and at other times represent a departure from that approach while claiming to remain consistent with the QCA's underlying methodology.

The calculation of the debt risk premium by both the QCA in 2018 and by Aurizon Network in the current process requires significant exercise of judgement and is not a 'mechanical' process. The QCA process was clearly an independent exercise uninfluenced by commercial interests, however it is unrealistic to assume the same of the Aurizon Network exercise.

The QRC acknowledges that one of the QCA's primary bases for the determination of the Debt Risk Premium, the PWC report, is now almost ten years old, and there may have been changes in the bond market during this time. However, the reset process as set out in the undertaking is intended to be a mechanical process in which values are updated using the same process as was previously adopted by the QCA. We encourage the QCA to assess whether Aurizon Network's proposed changes are consistent with the approach previously adopted. It is not appropriate, in the current process, to depart from the approach required by the undertaking based on arguments such as changes in circumstances or markets.

Given these issues, we do not consider that the QCA's initial focus should be on reviewing each particular step and judgement made by Aurizon Network to consider whether each can be justified as consistent with the QCA's 2018 methodology. Such an approach may validate an approach which is upwardly biased. Instead, we suggest that the QCA should itself (with support of consultants if required) estimate the Debt Risk Premium, consistent with the 2018 approach, and then compare the outcome with the Aurizon Network estimate. Any differences can then be considered to ensure that a balanced approach has been taken to each judgement call.

9. Preliminary Reset Inflation Rate

The calculation of Preliminary Reset Inflation Rate appears consistent with the UT5 definition. However, we note that the RBA provides forecasts which are rounded in different ways in various parts of its reports. Section 5.1 of the RBA's May 2022 Statement on Monetary Policy rounds to the nearest quarter of a percent, while the Appendix to the report rounds to one decimal place. As a result, the June 2023 inflation forecast is either 4¼ %(4.25%) per Section 5.1 or 4.3%, per the Appendix (and adopted by Aurizon). We are comfortable with the use of the Appendix data (one decimal point) provided that this selection is consistent with the selection adopted by the QCA for the initial UT5 approval.

10. RAB Values

We rely upon the QCA to verify the calculation of RAB values as shown in Section 4.3 of Aurizon Network's submission. However, we note that the inflation increment for most systems appears to be based on 3.05% of the sum of the opening asset value plus capex, while the inflation adjustments for Newlands and GAPE are a higher percentage. We queried this difference with Aurizon Network and understand that the difference is due to certain assets in these systems being deferred and therefore escalated at the WACC rather than at the inflation rate. It would improve transparency and understanding if these groups of assets (CPI-escalated and WACC-escalated) could be separately presented in Aurizon Network's submissions.

11. Other aspects of the Reset Schedule F Preliminary Values

We have commented in this submission on specific matters where the public information provided by Aurizon Network is sufficient for us to provide a comment. The calculations of revenue allowances and tariffs relies upon information which in most cases is not available in the public documents, such as Aurizon Network's model. We rely upon the QCA to conduct a thorough review of all calculations of revenue allowances and tariffs to ensure that calculations are correct and that methodologies are consistent with those adopted in the development of tariffs for the initial years of UT5.

Thank you for the opportunity to provide this submission.

Yours sincerely

Andrew Barger