1 Industry Supported Principles

Aurizon Network's UT4 operating expenditure submission should be reviewed on the basis of the established regulatory principles of:

(a) **Efficient Costs** - Industry strongly supports the principle that Aurizon's operating expenditure should be assessed on an efficient cost base that will effectively deliver required access services. Use of benchmarking is considered an appropriate means of identifying efficient costs provided that the benchmark organisation is an appropriate and demonstrably efficient comparison.

(b) **Standalone Cost Basis** - Aurizon Network's Central Queensland Coal Network (CQCN) is a regulated, self contained, geographically concentrated and coal centric business, which can be contrasted with Aurizon's contestable, geographically diverse and multi-commodity, above rail business. In assessing the standalone costs of Aurizon Network, the relative simplicity of the CQCN business compared to the related above rail business, needs to be taken into account.

(c) **Appropriate Allocation of Overhead/Support Costs** - Aurizon is a vertically integrated above and below rail business, with its above rail business competing with third party rail operators on the CQCN. With a large portion of operating costs allocated to Aurizon Network from overhead/support functions there is a potential for costs not reasonably attributable to the provision of access services on the CQCN to flow to the below rail business. If these overhead/support costs are inappropriately allocated to the below rail business in favour of the above rail business, this could materially discriminate against third party rail operators and would hinder effective competition.

(d) **Transparency** - Industry is seeking a much greater degree of transparency and consultation with UT4 operating arrangements and expenditure compared with previous Undertakings. This includes consultation on electrical transmission connection agreements which will be renegotiated during UT4 and transparency with insurance and risk arrangements.

2 Proposed UT4 Operating Expenditure has Risen Significantly

Aurizon Network's operating expenditure proposal for UT4 includes System Wide and Regional Costs, Transmission and Electricity Energy Costs and Risk and Insurance.

<u>System Wide and Regional Costs</u>

Aurizon Network's proposed UT4 System Wide and Regional Cost allowance is $123.6M in FY14, which is a 103% increase over the average UT3 annual allowance of $60.1M. As shown in Figure 1, this represents yet another step increase in previously approved

System Wide and Regional Cost allowances. The UT3 System Wide and Regional allowance was, on average a 130% increase in the average annual UT2 allowance.

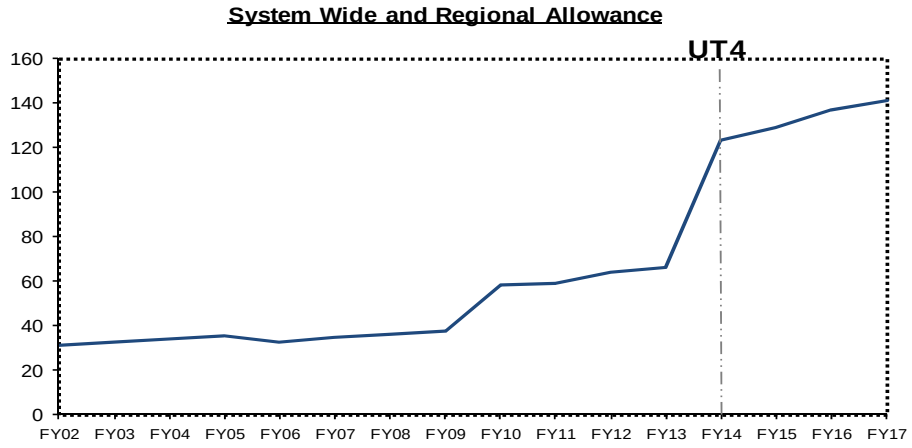

Figure 1 - System Wide and Regional Costs UT1 – UT4 (nominal $'s)

Total forecast volumes in UT4 (i.e. from FY14 to FY18) are 910Mt, which is only an 8% increase in UT3 forecast volumes (i.e. FY10 to FY13) of 841Mt. The proposed cost increases appear disproportional to the increase in tonnages, notwithstanding that much of System Wide and Regional Cost structures are relatively fixed.

System Wide and Regional Costs expenditure are costs directly related to running the business, such as train control, and other costs, such as Corporate Overheads, which are determined based on a calculated allocation basis.

As shown in Figure 2, the increase in System Wide and Regional Costs has occurred in all major categories, especially for Corporate Costs (Overhead allocation).

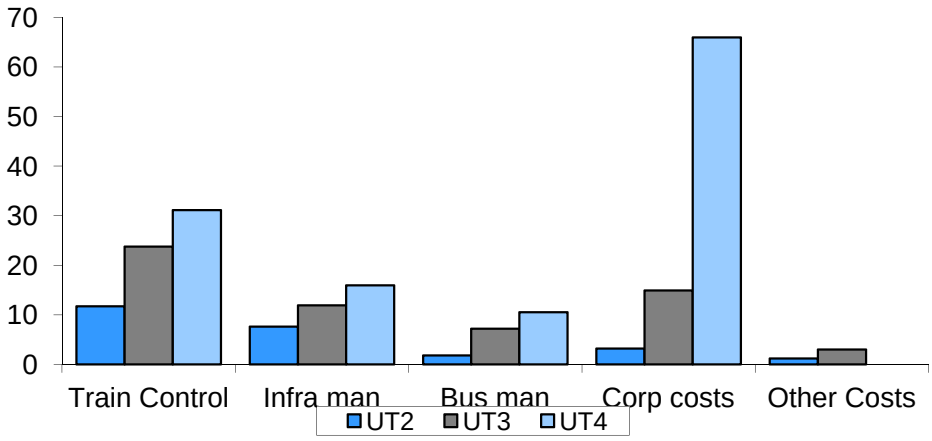

Figure 2 – Breakdown of System Wide and Regional Costs UT2 – UT4 (nominal $'s)

Aurizon Network[1] state that one of the main reasons for the increase in System Wide and Regional costs has been the loss of economies of scale brought about by structural changes and the separation of the Queensland Rail (QR) Network from the Aurizon Network. Aurizon Network contends "that they are now responsible for a smaller network while having to incur similar operating costs".

Industry believes that Aurizon's structural changes over the past three years are irrelevant to the principle of efficient, stand alone costs. Aurizon[2] argued in its UT3 submission that it had already evolved to a less integrated, stand alone business with separate identifiable cost centres. Therefore to the extent that Aurizon's Network costs have increased in real terms since UT3, it is a measure of inefficiencies it has introduced into the business since UT3 or costs relating to the management of the QR Network, which were not removed at separation. Either way, these inefficient costs should not be passed through to Industry. Industry is at a loss to understand why Aurizon would make structural changes which results in inefficiencies and cost increases to its customers.

With respect to the issue of Aurizon's Network alleged loss of scale arising from the separation of the QR Network, industry notes that Aurizon Network's business is now a much simpler business than before:

(i) Single commodity versus multiple commodities;

(ii) Non timetabled freight services only versus timetabled freight and passengers;

(iii) Reduced geographic scope with a 2713km network in Central Queensland versus 10,000km network Queensland wide.

It is also noted that the even with the separation of the QR Network, the Aurizon Network business is still 3 times the size of ARTC's Hunter Valley coal business in terms of traffic task and revenue.

At an investor briefing[3], Aurizon reported a targeted $100M reduction in centralised support costs and $130M in above rail productivity improvements by FY15. It is unclear, if the savings in centralised support costs have been factored into Aurizon Network's UT4 System Wide and Regional Cost claim. However, the targeted reduction in centralised support costs and above rail productivity improvements is at complete odds with its UT4 System Wide and Regional cost claim. Industry contends that productivity improvements which are occurring in non regulated businesses in Aurizon Group are equally applicable to Aurizon Network. We believe that the Authority should consider reintroducing a productivity factor, such as CPI – X, to apply to Aurizon Network operating expenditure through the UT4 period, as occurred prior to UT3.

Aurizon Network's System Wide and Regional Cost UT4 proposal has risen substantially from the UT3 allowance. The Authority should assess the System Wide and Regional costs on an efficient, standalone basis consistent with previous undertakings, with particular scrutiny placed on the allocation of corporate costs. The Authority should also consider reintroducing a Productivity Factor to apply to operating expenditure over the course of UT4

[1] Aurizon, *2013 Draft Access Undertaking, Volume 3 , Maximum Allowable Revenue and Reference Tariffs*, Pg 190

[2] QR Network, *Access Undertaking (2009) Submission to QCA – Volume 2*, pp 124 - 128

[3] Aurizon, *Aurizon Analyst and Investor Presentation*, 18 July 2013

Transmission and Electric Energy Costs

Aurizon Network's UT4 submission includes $68.3M for FY14 (and increasing forecasts in subsequent years) for traction electricity transmission connection costs. These costs are included in the AT5 tariff.

The transmission connection costs of $68.3M for the first year of UT4 are a 107% increase from the $33M cost for the first year of UT3. This cost increase is a concerning trend for Industry, which may ultimately impact on the relative economics of diesel versus electric traction options in the Blackwater and Goonyella rail systems.

It is not clear in Aurizon's UT4 submission whether electricity transmission connection costs are a straight pass through from PowerLink or if any Aurizon Network costs have been added. It is noted that connection services currently provided to Aurizon Network are a combination of prescribed transmission services and negotiated transmission services and that by the end of UT4, all connections will become negotiated services. Industry would like transparency and consultation on terms and conditions on new connection agreements, which will be negotiated transmission services.

It is noted that Aurizon has voluntarily committed in its UT4 submission to continue to supply electricity at cost to access seekers for the duration of UT4. Industry welcomes the continuation of this arrangement. It is noted that Aurizon Network currently procures its electricity through a fixed nodal supply agreement, which expires in FY14 and that other electricity procurement models are being investigated. A number of coal producers in Queensland are currently involved in managed electricity procurement models with indirect market participation through a retailer. Industry welcomes electricity procurement initiatives which will result in more cost efficient electricity supply within acceptable risk parameters, but requires greater transparency and consultation of arrangements being considered. This is particularly important given that the pass through nature of the arrangement creates little incentive for Aurizon to deliver the lowest cost outcome.

Aurizon Network electricity supply costs includes a pass through of environmental charges including the Queensland Gas Scheme and the Enhanced Renewal Energy Target Scheme. The forecast UT4 environmental charges increase from $4.6M in FY14 to $6.6M in FY17. Rather than add these costs to the EC component of tariffs, Aurizon Network argues that these costs are a "defacto" tax and should be included as an overhead cost and paid by both electric and diesel traction users. Whilst it only represents a couple of cents per tonne, Industry is of the view that these costs should be quarantined to electric traction users and be part of the EC charge so as to not distort the traction choice argument by making arbitrary adjustments. The fact is that environmental charges have not been levied on diesel fuel and so should not be paid by diesel traction users in the CQCN.

Industry welcomes the move to allow regenerative braking on electric AC traction locomotives in the Goonyella and Blackwater rail systems and the cost savings that this will generate. This is an example of an initiative which will legitimately favour electric locomotives over diesel locomotives, with the latter dissipating the dynamic braking energy by wasteful heating of grids on the locomotives. Industry supports Aurizon Network's plan to require all AC electric locomotives to be fitted with a power meter by 1 July 2016 to be able to participate in the Regen Credit Pool distribution. This will allow those users of regeneration braking capable locomotives to receive the benefits rather than it going users of all electric locomotives.

Electricity transmission connection and supply costs have risen substantially since UT3. The Authority should assess that these costs are being passed through at cost. Industry would like Aurizon to pursue more cost efficient supply options and would like greater transparency and consultation on supply and connection arrangements being contemplated.

Industry does not support Aurizon's view that electricity environmental charges should be included general overhead costs but rather it should be part of the EC tariff component.

Industry supports Aurizon's Regenerative Braking Proposal.

Risk and Insurance Costs

Aurizon Network's UT4 submission proposes a combination of external insurance, self insurance and regulatory pass through provisions to manage risks to network infrastructure.

Aurizon Network has proposed a total UT4 risk and insurance allowance of $39.0M, which is a 46% increase over the $26.7M allowance in UT3. The self insurance component of the UT4 submission is $23.8M or 61% of the total claim.

It is noted that in earlier Undertakings the Authority had rejected Aurizon's claims for self-insurance on the basis that the claims were excessive and that Aurizon had not established a properly constituted self insurance scheme. However, in UT3, the Authority accepted Aurizon's claims for self insurance and also accepted a reduction in the pass through threshold from $8M to $1.0M[4].

Industry has not been provided with the Finity report on quantification of risks that Aurizon is self-insured for and losses relating to below-deductible losses on insured risks. We are therefore unable to assess the appropriateness of Aurizon Network's insurance program.

Industry does have several concerns with the risk and insurance submission including:

(i) There is still significant uncertainty regarding the coverage and nature of Aurizon's self insurance program. For example, does it reflect an efficient and prudent level when the forecast maintenance, capital expenditure and historical incident rates are taken into account?

(ii) An apparent failure to be able to claim on an insured risk relating to repairs to a declared bridge damaged in the 2013 Central Queensland flood event;

(iii) Aurizon's position of conflict, which enables it to "bundle" losses and to determine the repair scope, so that the $1M threshold can be exceeded;

(iv) The "blurring" of costs between self insurance claims and maintenance cost allowances and opportunities for "double recovery".

Industry notes from the Willis Report[5], that the largest asset class covered in the Industrial Special Risk policy is Feeder Stations, which are valued at $560M. Industry requests that consideration be given to including the share of the Industrial Special Risk premium for Feeder Station insurance be included in the AT5 component of access tariffs.

Risk and Insurance costs have risen substantially in UT4. The Authority should assess the appropriateness and efficiency of Aurizon's self-insurance and external insurance program and its relationship to forecast maintenance and capital programs.

[4] Queensland Competition Authority, *Draft Decision, QR Network's 2010 DAU – Tariffs and Schedule F*, June 2010, pg 67

[5] Willis, *Expert Opinion on the Cost of Insurance Premiums for the Purposes of the Aurizon Network Access Undertaking 2013*, pg 4.

3 Efficient Costs and Benchmarking

Aurizon Network's total operating expenditure claims for UT4 (excluding electrical connection costs) is $593M of which $280M or 47% are allocated corporate costs. Therefore it is critical that any benchmark comparisons are appropriate and efficient.

Aurizon Network[6] contends that its UT4 cost estimates for corporate overheads place it within an externally benchmarked range expected on a standalone business of similar industry.

Industry has serious reservations about Aurizon's benchmarking of corporate overheads claims and the study undertaken by Ernst & Young[7]. These reservations include:

(i) Aurizon Network has a separate level of overhead costs within its business including Business Management and Infrastructure Management functions. These functions, which are outside Aurizon Group's corporate costs do not seem to be present in other similar companies, such as Australian Rail Track Corporation (ARTC);

(ii) Aurizon Network appear to bring in corporate costs into their overall cost base at various levels. For example, in addition to the $66M proposed FY14 corporate cost allocation, $12M of corporate cost is also brought into Aurizon Network's cost base through maintenance charges. The issue may even be deeper, with corporate costs also potentially being allocated to other functions in Aurizon Group which provide maintenance services such as hook and pull services for work trains and track equipment. The scattering of the allocation of corporate costs therefore makes benchmarking very dubious unless all these influences are properly accounted for;

(iii) The two government-owned railway operators provided data to Ernst & Young on a "no names" basis. It is therefore impossible to gauge the appropriateness of these companies for benchmarking against Aurizon Network and if they are any structural differences between the companies;

(iv) The choice of benchmarking parameters (e.g. track kilometres versus gross tonne kilometres) and benchmarking partners can support completely different conclusions on the efficiency of Aurizon Network.

Aurizon Network does not appear to benchmark corporate overhead costs against ARTC (unless ARTC is one of the undisclosed government owned Asia-Pacific rail companies in Ernst & Young's report). This is surprising because ARTC is a very similar business to Aurizon Network and there is a lot of cost information on ARTC publically available through regulatory processes.

Aurizon Network[8] states in its UT4 maintenance submission that its maintenance costs compare favourably with ARTC, though this comparison is on a track kilometre basis. Industry contends that a more relevant benchmark for comparison is cost per gross tonne kilometre (gtk) or net tonne kilometre (ntk), as this is a true measure of activity and the basis on which rail infrastructure companies are reimbursed. To emphasise this inconsistency Aurizon Network uses a net tonne kilometre parameter in its UT4 submissions when comparing various costs from year to year over the UT4 duration.

[6] Aurizon, *2013 Draft Access Undertaking, Volume 3 , Maximum Allowable Revenue and Reference Tariffs*, 30 April 2013, pg 233

[7] Ernst & Young, *Benchmarking of Corporate Overhead Costs for QR Network Pty*, July 2012

[8] Aurizon, *2013 Draft Access Undertaking, UT4 Maintenance Submission, 30 April 20123, pg 13*

To highlight the problems with benchmarking and to present a different view on the efficiency of Aurizon Network, Industry has constructed a comparison of Aurizon Network's and ARTC's operating and maintenance costs shown using publically available information, as shown in Table 1. Costs have been kept at a high level, including bundling of operating and maintenance expenditure to avoid cost category/allocation issues. Costs are also in nominal dollars of the year.

	Aurizon UT3 - FY09 (2007-08$)	**Aurizon UT3 - FY09 (2013-14$)**	**Aurizon UT4-FY14 (2013-14$)**	**ARTC[9] (2010-11$)**	**ARTC (2013-14$)**
Maintenance	142	190	232.7	49.5	57
less electric traction maintenance[10]	-12.0	-16	-9.6		
Train Control	23.8	28	31.1	6.3	7
Infrastructure Management	11.9	14	15.9		
Business Management	7.2	8	10.5		
Other Costs[11]	16	19	13.6		
Corporate Overheads	14.9	17	66	11.1	12
Electricity Transmission & Connection					
Total	**203.8**	**259.8**	**360.2**	**66.9**	**75.7**
Gtk's (Billion)	71.1	71.1	80.5	27.0	27[12]
Benchmark Cost - $'s per 000 gtk		**$3.65**	**$4.47**		**$2.81**

Note: 2007-08$ maintenance cost estimates inflated by assuming the MCI increase to 2010/11 (5.1%) per annum to 2011-12 and 4.6% thereafter. The 2007-08$ operating costs inflated using actual CPI data.

Table 1 – Operating and Maintenance Cost Comparisons

This analysis shows, that even taking account of differences in inflation between the Aurizon UT3, Aurizon UT4 and ARTC cost comparisons, the real outlier is Aurizon's UT4 operating and maintenance costs, which brings into question UT4 cost efficiency.

[9] *Data from Australian Rail Track Corporation Ltd1 July to December 31 2011 Submission to ACCC in respect of Hunter Valley Access Undertaking, Roll Forward Asset Base Ceiling Test Unders and Overs Account, May 2012*

Revised 2010 Hunter Valley Access Undertaking – Revised Interim Indicative Access Charges, April 2011

[10] Electric traction maintenance and transmission and connection costs removed from Aurizon's cost base

[11] $8.5M expenses project costs removed from ARTC cost base

[12] Data from *Australian Rail Track Corporation Ltd Revised 2010 Hunter Valley Access Undertaking – Revised Interim Indicative Access Charges*, April 2011

It should be noted that when comparing operating & maintenance cost benchmarks, Aurizon Network, even after separation from QR Network, is still approximately three times the size of ARTC. Therefore, Aurizon Network's claim that significant cost increases in UT4 arise as a consequence of its loss of scale with the separation of QR Network is highly questionable. Industry contends that Aurizon Network's UT3 Operating Expenditure was approved by the Authority through the regulatory process and is still an appropriate consideration for determining Aurizon's UT4 allowances.

The Authority should make an independent assessment of the efficiency of Aurizon's UT4 Operating Expenditure claims. Care should be taken when determining appropriate benchmarking parameters, partners and cost categories to compare.