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SUBMISSION TO THE QUEENSLAND COMPETITION AUTHORITY

COST ALLOCATION MANUAL

OCTOBER 2015

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1. Executive summary

Anglo American Coal Australia (**Anglo American**) welcomes this opportunity to provide a submission to the Queensland Competition Authority (**QCA**) in respect of the amendments to the Cost Allocation Manual (**Manual**) lodged by Aurizon Network.

In summary, Anglo American is of the view that:

(a) The purpose and use of the Manual is not clear and the principles in the Manual should be consistent with the principles used to establish the MAR and Reference Tariffs;

(b) The Manual should more clearly set out organisational structure and arrangements of the Aurizon Group; and

(c) The establishment of costs on a "stand-alone" basis is inconsistent with the principle that Aurizon Network should only be allowed to receive efficient costs. In UT4 Aurizon Network argued that the baseline for costs in UT4 should be based on "actual costs". This resulted in a significant increase in operational and maintenance costs. Anglo American understood that by "actual" costs they meant costs incurred. To the extent that the costs used in UT4 are not based on costs incurred then the QCA should not accept them as a baseline.

2. Purpose and use of the Manual

Part 1 of the Manual sets out the purpose of the Manual. Section 1.1(e) of the Manual seems to say that the QCA has requested Aurizon Network to prepare and submit the Manual *'to satisfy the accounting responsibilities under the Act and financial reporting obligations contained in the Undertaking'*. The Manual is then written on the presumption that its use is solely for the determining costs to be allocated solely for financial reporting purposes. Although it is not entirely clear, the Manual seems to suggest that it is not to be used for determining, amongst other things:

(a) whether capital costs should be allocated to Below Rail Services for the purposes of being included in the Regulated Asset Base (**RAB**) and therefore recovered from the users; or

(b) whether operational expenditure should be allocated to Below Rail Services for the purposes of determining operational and maintenance expenditure for the Maximum Allowable Revenue (**MAR**).

Anglo American has not seen the request and is unable to comment on whether the request is limited to using the Manual for the purposes of constructing the Financial Statements. In any event, Anglo American believes that the Manual should be used for the additional purposes listed above.

As the QCA is aware, the customers have almost no visibility on the cost build-up nor on its approach to allocating costs for the purposes of establishing the MAR and Reference Tariffs. For the remainder of this submission Anglo American has made comments based on the assumption that the principles contained in the Manual for the purposes of allocation of costs are the same principles applied in establishing the MAR and Reference Tariffs.

3. Review of costing manual and inconsistency

Section 2.3 of the Manual provides that Aurizon Network may seek amendments to the Manual at any time and sets out a process whereby the QCA may approve or not approve that amendment.

Section 159 of the QCA Act provides that the QCA may revise the manual from time to time. It is important that the QCA has the ability to seek amendments to the Manual. Sections 167 and 168 of the QCA Act set out a clear order of priority in terms of inconsistency between fundamental documents. That order is the QCA Act, the access agreement and then the access undertaking. However, this order of priority does not specify where in the order the Manual sits.

Anglo American believes that it is clear that the terms of the Manual are subject to the QCA Act. However, to avoid any doubt about whether section 2.3 of the Manual is attempting to specify that the process for all amendments to the Manual, it would be preferable for section 2.3 to specify that the QCA may require amendments to the Manual, or draft its own amendments to the Manual as long as it complies with section 159(3) of the QCA Act.

4. Organisational Structure

Section 3.1 of the Manual deals with the organisational structure and states that Schedule B illustrates the Aurizon Structure. The section also states that the organisational structure is intended to facilitate the separation of the management of Below Rail Services.

It seems to Anglo American that there are business areas which sit outside of Aurizon Network Pty Ltd but which provide corporate overhead services to Aurizon Network. The business areas set out in Schedule B are:

(a) Finance;

(b) Strategy;

(c) Business development;

(d) Business sustainability;

(e) Enterprise services; and

(f) Human resources.

Section 4.3.3.8(a) of the Manual refers to business support costs being provided to Aurizon Network as including the EVP, Finance, Regulation and Commercial Development. However, section 4.3.7(d) of the Manual seems to say that there are costs to be allocated in respect of Enterprise Services, Human Resources, Strategy, Safety and Board and CEO.

It is not clear precisely what areas provide corporate overhead services to Aurizon Network and, if so, to what extent they do so. Aurizon Network should be required to provide a more detailed explanation of the services provided and the extent of the services provided.

Also, it is not clear precisely where the Aurizon Group's interests in other aspects of the supply chain are held. For example, it is not clear where the 15% interest in Aquila Resources Pty Ltd is held. Schedule B would benefit from a traditional company structure diagram showing interests held in other companies.

Anglo American submits that the QCA should request Aurizon Network to set out in more detail the corporate structure of the Aurizon Group in Schedule B.

5. Establishment of costs on a 'stand-alone' basis

Anglo American has never queried the foundational principle that costs should be built up on the basis of a stand-alone business. This concept has been historically included in the Access Undertaking and relied on as a fundamental element of Aurizon Network cost build up; specifically, that the MAR is developed by relying on the calculation of efficient costs incurred for the Stand Alone provision of Access for Train Services.[1]

Anglo American notes, however, that establishing the MAR for a vertically integrated business (such as the Aurizon Group) on the basis of stand-alone business model ignores a number of practical realities for the operation of that business. For example:

(a) **insurance costs:** while the Aurizon Group has group corporate insurance (and, assumedly, some level of discounts relating to the scope of that insurance policy), the insurance costs relied on to calculate the MAR are those that Aurizon Network would be required to pay if it received insurance on a stand alone basis. There is undoubtedly a difference in the cost of these two insurance premiums, and yet the component charged to users is the hypothetical cost of Aurizon Network operating alone; and

(b) **building / rent costs:** while a number of Aurizon Network's buildings and facilities are utilised by both above and below rail companies (as well as other parts of the Aurizon Group), where a building contains any Aurizon Network presence it is Anglo American's understanding that the entire cost of that building is allocated to below rail on the basis that this would have been the associated cost if Aurizon Network did operate on a stand-alone basis.

Anglo American notes that these are only two examples of situations where Aurizon Network's actual incurred costs do not meet those of the hypothetical stand-alone service provider, and yet users are required to pay a premium for services when Aurizon Network does not outlay the cost. Anglo American believes that in the current economic circumstances to continue to allow a vertically integrate (or to remain integrated) to undertake a cost build

[1] See the *2010 Access Undertaking*, cl 6.2.2(b).

up based on costs that it will never incur (because it is a vertically integrated business) is inconsistent with the fundamental pricing principles in the QCA Act.

Essentially, Aurizon Network (and the broader Aurizon Group) receive efficiency benefits of vertical integration and yet users do not obtain these benefits but are forced to accept the negative elements of vertical integration (eg, breaches of ringfencing protocols or increased supplier power), in fact to the contrary, the MAR build-up specifically *prevents* users from receiving any benefits of efficiencies.

Anglo American believes that the continued reliance on using a hypothetical stand-alone business to calculate the MAR is inappropriate. It ignores the practical reality that the Aurizon Group is actually vertically integrated, rewards Aurizon Network for expenses that it does not incur, disincentivises Aurizon Network to operate efficiently (as it will receive a premium whether or not it is efficient), and passes no benefits on to users. Rather than relying on the stand-alone business model, Anglo American submits that the Manual should focus on the practical realities of Aurizon Network's business structure, and that all cost build-up should be done in relation to either actual or estimated costs, with a reconciliation at a set period to align the MAR with the costs to the Aurizon Network business.

It should also be noted that in its UT4 submission Aurizon Network sought to justify its significant increase in costs and asked the QCA to establish costs for the UT4 period based upon "actual" costs. It seems that those costs were not "actual" costs but costs of a hypothetical stand-alone business. Anglo American believes that the QCA should not accept the hypothetical costs but establish costs for UT4 based on the "actual" costs incurred.

6. Allocation process

Anglo American does not purport to have any understanding as to how the allocation of expenses occurs, and the Manual does not much enlighten readers who have no access to the black box.

The table on page 16 (of the tracked version of the Manual) refers to an allocation between coal and non-coal only for Train Operations Management. Anglo American assumes that the QCA does not allow costs for all of the other items in that table in relation to non-coal trains to be part of the cost build-up for coal Reference Tariffs.

There is also no clarity around the treatment of port costs. It is assumed that these costs are incurred by a different legal entity but the lack of detail on the corporate structure does not make this clear.