

27 September 2013

Mr Mark Gray
Chief Executive Officer
Queensland Competition Authority

Email: rail@qca.org.au

Dear Mr Gray

Review Event Submission – Central Queensland Flood January 2013

The Queensland Resources Council (QRC) appreciates the opportunity to provide this feedback on Aurizon Network's Review Event Submission.

The QRC's key concerns are to ensure that:

- The claim does not pass through costs which are not truly incremental.
- The claim only includes costs actually incurred.
- The claim does not pass through costs which should be recovered under insurance arrangements.
- The costs claimed are efficient and prudent.
- The costs are appropriately allocated between coal and non-coal traffic.
- The recovery of the costs is undertaken in a reasonable manner.

Based on the information provided by the Authority, the QRC is not confident that each of these matters has been appropriately dealt with in Aurizon's submission. For each of these matters, we rely on the Authority to conduct a thorough assessment. In the sections below we outline the reasons for QRC's concerns and the matters which we consider require further consideration.

1. Are the claimed costs truly incremental?

a. Ordinary labour costs:

The Authority engaged SKM to conduct a review of Aurizon's review event claim. SKM's report includes the following conclusion:

"SKM finds that Aurizon Network has included ordinary labour costs of \$2,301,270 (excluding

estimated costs not yet incurred) in its claim. SKM finds that ordinary labour should be covered by the UT3 maintenance allowance and notes that only overtime labour costs should be considered as a necessary additional expense”.

QRC shares SKM’s concerns in that it appears that much of the labour applied to the flood recovery task involved existing employees or contractors of Aurizon, who were reallocated from other tasks. We accept that this may still involve an incremental cost, provided that the tasks which would otherwise have been completed using these resources were subsequently completed during overtime, or using additional resources. To the extent that the work which was deferred in favour of the flood recovery work:

- Was subsequently able to be completed in ordinary time or
- Was deferred, such that it will find its way into UT4 cost allowances

then the ordinary time labour costs are not incremental.

b. Margins

We question why the 5.75% margin is added to direct labour costs to cover ‘corporate overhead allocations’. Corporate overheads, by their nature, are largely fixed costs in the short term. Aurizon states, for example, that Senior Management were involved in the flood recovery task and that this involved “*additional incremental business and overhead costs*”. Given that Senior Management is unlikely to claim overtime, we assume that this is a reallocation of overheads from other parts of the business, to reflect the increased proportion of effort being applied to the flood recover. Our concerns with this approach include:

- The parts of the business which would benefit from a reallocation of overheads to the flood recovery task should include the remainder of Aurizon Network, yet no offsetting saving is included in the claim.
- We doubt that a similar approach would apply during a period in which the attention of Senior Management is directed towards the above rail business, or a business development opportunity. That is, there would not be a reallocation of overheads to those areas with a resulting tariff reduction in the below rail business.

c. Maintenance savings

To the extent that any track was restored to a better condition than its pre-flood condition, then there will be future maintenance cost savings. To the extent that these savings relate to the UT3 period, they should be deducted from the incremental cost. Given the extent of damage and the extent of repair work, costing a total of \$17.1m, Aurizon’s claim that they have been unable to identify any future saving arising from this work is surprising.

2. Is the claim limited to actual costs incurred?

SKM notes that:

“Aurizon Network has included \$4,251,000 expenditure that is forecast to be spent in 2013/2014. Because these costs have not been incurred yet, SKM has not been able to review the actual expenditure and therefore is not in a position to recommend that the Authority approves these costs as reasonable until they have been incurred”.

QRC notes Aurizon’s response, stating that the remaining costs will be incurred during 2013 and are expected to be consistent with the estimate. If the rejection of these costs would result in a subsequent claim early in 2014, then QRC would prefer the decision on the current claim to be deferred, such that SKM can complete the review of the final costs, and a single adjustment be made to reference tariffs.

We note that Aurizon's claim includes a full year of CPI escalation, and, according to SKM's report, a half year of WACC escalation applied to costs incurred up to 30 June. We question whether this is appropriate, noting that UT3 does not provide for this adjustment (as it refers to actual costs incurred), that some of the costs are still to be incurred yet are being escalated, and that the WACC adjustment suggests that all of the costs incurred in the 2012/13 year were incurred on January 1.

3. Does the claim recover insured costs?

QRC's April 2011 submission regarding the review event application for the 2010/11 floods raised a number of issues in regard to insurance. Those issues remain unresolved. Coal producers fund certain insurance coverage through reference tariffs, yet have no visibility of the coverage obtained.

- Aurizon states that the Neercol Creek Bridge was a declared bridge within the Industrial Special Risk Policy, but that the claim in regard to this loss was rejected. We ask that the Authority satisfies itself that Aurizon's decision to accept this response from the insurer was reasonable.
- Self insurance. Aurizon claims that self-insurance is not relevant because "*the amount included in the UT3 operating costs for self-insurance has been materially exceeded by weather-related infrastructure repairs (not related to this flood event) over the course of UT3*". We struggle to understand the relevance of this statement. It is the nature of insurance (and, from the perspective of the insured party, the purpose of insurance) that claims sometimes exceed total premiums. If the self-insurance premiums paid within operating costs are intended to cover losses limited to the value of the premiums, then the payments serve no purpose, other than to provide Aurizon with a risk-free windfall in incident-free years.

In the Authority's October 2012 decision regarding the review event for the 2010/11 floods, the Authority noted that "*the level of certainty that could have been provided around the self-insurance arrangements has been, and continues to be, lacking*". The Authority "*strongly encouraged*" Aurizon to provide greater certainty by following a series of recommended steps "*as soon as possible*". It appears that this has not occurred.

4. Are the costs efficient and prudent?

QRC relies on the review of SKM and the Authority in regard to the prudence and efficiency of the costs incurred.

5. Allocation to non-coal traffic.

Aurizon has proposed to recover the entire flood recovery cost from coal traffic. This issue was raised in the QRC's April 2011 submission regarding the 2010/11 flood recovery costs within the Blackwater system. The decision of the Authority (October 2012) was that "*a pro-rata allocation of the flood recovery costs to these customers [non-coal] is a non-material value*". The QRC requests that the Authority again considers this matter, taking into account:

- That the Authority's previous decision related to a significantly lower-value claim;
- That the previous claim was limited to the Blackwater system;
- That the current claim includes a material cost(\$2.5m) incurred on the North Coast line, where non-coal traffic is significant;
- That an allocation based on revenue (which was the basis of the Authority's previous assessment) may not be appropriate, particularly in regard to the North Coast line. For example, a path usage basis or gtk basis, would lead to a material allocation to non-coal traffic.

6. Recovery mechanism

Aurizon proposes to recover the approved cost over the 2013/14 period, including by retrospective adjustment of past Access Charges. Given that the finalisation of the flood recovery work is not expected until December

2013, the retrospective adjustment will be a material amount for each of the affected parties. QRC understands that this approach is consistent with the provisions of UT3, however we would encourage Aurizon and the QCA to consider an alternative approach, in which the flood recovery cost is included in the UT4 cost allowances and recovered over the term of UT4.

This letter does not contain confidential information and the QRC is happy for this letter to be made public.

Please do not hesitate to contact me to discuss this submission further (davidr@qrc.org.au), (07) 3316 2522.

Yours sincerely



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Queensland Resources Council