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| QRC Submission:RSM BiRd cAMERON REVIEW OF ut4 OPERaTING EXPENDITURE7 March 2014 |

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# Introduction

QRC has reviewed the report prepared by RSM Bird Cameron (“RSMBC”). While we support a number of the conclusions of the report, we consider that:

* the report does not indicate that a thorough review of Aurizon Network’s claimed corporate and operating costs has been completed;
* the cost reductions recommended in the report are insufficient;
* the resulting costs will exceed efficient costs.

We have not sought to assess the extent to which shortfalls in the report may relate to any limitations of the Terms of Reference. Rather, we provide comments on the content and conclusions of the report, and how these compare to what we would expect to see from a thorough review of Aurizon Network’s claimed costs.

Our key concern is that, while RSMBC recommends a number of reductions to Aurizon Network’s claim, the efficiency of the adjusted costs has not been determined. We take little comfort from the recommended reductions, given that we did not consider Aurizon Network’s claim to be credible.

RSMBC sought to review the efficiency of the proposed cost allowances using three methods. In our view, none of these have been adequately completed:

* Benchmarking: This has been undertaken at a high level, with insufficient analysis of the differences between the benchmarked entities and Aurizon Network. For corporate costs, the RSMBC report concludes that the benchmarking undertaken by Aurizon Network’s consultants will overstate Aurizon Network’s costs. Alternative benchmarking (including the ‘shadow’ approach) is undertaken by RSMBC, which indicates that corporate costs should be substantially lower, yet recommendations to reduce the allowance are focussed on allocation issues, with limited adjustments to the baseline costs. For other operating costs, high level benchmarking against ARTC, which ignores the benefits of Aurizon Network’s scale, is relied upon to conclude that costs are appropriate, despite alternative benchmarks indicating that costs are excessive.
* Detailed analysis of actual costs: Actual costs of a prior period may be a relevant basis for establishing cost allowances if (i) the efficiency of those costs is examined and verified and (ii) adjustments are made to reflect changes which will occur between the past and future periods. We do not consider that such an exercise has been adequately undertaken.
* ‘Indicative shadow’ approach: This is a ‘ground up’ analysis which does not require reference to past costs or benchmarks. RSMBC has undertaken such an analysis in regard to Aurizon Network’s overhead costs and operating costs. The analysis indicates that both the overhead costs and operating costs of Aurizon Network are too high, even after adjustment for matters identified by RSMBC. RSMBC appears to have been reluctant to rely upon the indicative shadow assessments, due to the ‘desktop’ nature of this analysis.

For corporate costs, the indicative shadow is 8% below the costs which would result from acceptance of all of RSMBC’s recommended reductions (including adoption of the direct cost methodology in place of the blended rate). This is, the revised costs remain 8% too high when compared to the indicative shadow cost.

For operating costs, the analysis indicates that Aurizon Network’s costs for 2013/14 are nearly $5m (9%) too high. Despite this, RSMBC concludes that the operating costs are ‘not unreasonable’.

**Recommendations**

QRC considers that:

* The recommendations of RSMBC for cost reductions should be accepted.
* Further reductions in Aurizon Network’s claimed costs should be required by the QCA, based on the information presented by RSMBC. This includes:
	+ adopting the direct cost basis of allocation for corporate costs which have no clear causal driver
	+ the exclusion of electricity pass-through costs (energy and transmission charges) from all relevant allocators (direct costs and revenue).
* Additional analysis should be undertaken in order to assess the extent to which further reductions in the claim (additional to those noted above) are required to reduce final approved costs to an efficient level. This includes:
	+ Assessment of the complexity of Aurizon Network relative to the remainder of Aurizon, and how this impacts corporate costs.
	+ More detailed analysis of Aurizon Holdings’ FY12 Plan to ensure that the costs contained in the plan are efficient and will be required in future years. This should include adjusting the costs for planned efficiency improvements (such as the announced $100m of savings in shared services areas).
	+ More thorough review of benchmarks. For example:
		- RSMBC states that ARTC’s overheads are $16.7m (page 124). Given that some overhead items are at least partly fixed with volume, this would suggest that an overhead allowance for Aurizon Network of $31m (i.e. the ARTC cost scaled on gtks) would overstate efficient overheads.
		- Further work is require to ensure that the costs included in benchmark data are comparable (in terms of inclusions/exclusions) with the Aurizon Network costs and are efficient, and to assess the impacts of operational differences between entities, including the benefits which Aurizon Network should derive from its scale. If this cannot be achieved with reasonable accuracy, we recommend a more thorough ‘shadow’ approach to deriving Aurizon Network’s efficient costs.
* Additional analysis should be undertaking to ensure that no double counting exists, particularly for maintenance overheads.
* Aurizon Network’s proposed to accelerate depreciation and bring forward cashflows should be rejected.
* Aurizon Network’s proposal to charge for the use of certain maintenance assets by reference to Gross Replacement Value should be rejected.
* A reasonable x-factor should be developed, and should be applied to baseline cost allowances which are efficient.

# Overview

## Corporate overheads:

RSMBC recommends a number of amendments to Aurizon Network’s claimed corporate costs, which QRC supports. Depending on the allocation methodology chosen for costs which have no clear causal driver, the amendments reduce corporate costs from $66m to either $54m (Aurizon Network method), $49m (revised blend) or $43m (direct costs). RSMBC’s analysis clearly indicates that direct costs are the most appropriate allocator for costs which have no clear causal driver, yet the report lacks a clear recommendation to adopt this method. RSMBC’s reluctance to adopt this method seems to be based on a concern that pass-through electricity costs (included in direct costs) would not tend to be correlated with corporate costs. QRC agrees with this concern. The appropriate response is to exclude electricity pass-through costs from direct costs, which will further reduce Aurizon Network’s corporate cost allocation. In addition, the claimed corporate costs remain inflated due to reliance on Aurizon Holdings’ FY2013 Plan as a base, and the lack of any adjustment to reflect the complexity of the operations of the remainder of Aurizon’s operations compared to the operations of Aurizon Network. We consider that the benchmarking work, including the ‘shadow’ approach and the comparison with ARTC, supports the view that corporate costs of $43m substantially exceed an efficient cost.

## Maintenance overheads:

QRC is unclear as to whether the allocation methodology for corporate overhead addresses potential double-counting issues, in the context of the charging of a separate maintenance overhead. The concern is that, while the allocators exclude maintenance-related items, the base overhead (which is allocated) may not.

## Acceleration of depreciation:

QRC does not agree that there is a need to further accelerate Aurizon Network’s return of capital. In the absence of a demonstrated need to further accelerate Aurizon Network’s cashflows (following the UT3 acceleration), we consider that some stability in approach is preferable.

## Operating costs:

Aurizon Network’s claimed operating costs have not been shown by RSMBC to be efficient. Claimed costs exceed the ARTC, Brookfield Rail and ‘Shadow’ benchmarks on a ‘per forecast gtk’ basis, despite Aurizon Network’s significantly larger scale. This is rationalised in the report:

* by repeating Aurizon Network’s untested claims of complexity, without consideration of the complexities faced in the benchmarked systems;
* by repeating Aurizon Network’s suggestion that it must incur all of the costs required to perform 100% of contract, despite forecasts being significantly below contract for the duration of the undertaking.

QRC considers that significant additional analysis is required to determine efficient baseline operating costs.

## Efficiency improvements:

RSMBC recommends a relatively small ‘x factor’, based on a range of productivity improvements which Aurizon Network claims are built in to its claimed costs. Much of this claimed productivity improvement comes from volume increases which spread fixed costs, while the evidence of the improvements themselves actually reducing costs is lacking. Initiatives such as Project Pluto are cited as evidence of improved efficiency, yet Aurizon Network claims that it must full a number of train control positions which have been vacant for some time.

A small x-factor is appropriate only in the case where baseline costs have been shown to be efficient, which is not the case here. As an example, Aurizon Holding’s is planning to implement $100m of savings within its shared services area. Rather than reflecting a reasonable share of this saving in the base efficient cost, RSMBC takes this into account when proposing the x-factor. Based on a corporate overhead allowance in the order of $43m (direct cost method), the saving from the x-factor in year 1 would be $0.3-0.4m. This is clearly an inadequate share of $100m of imminent savings.

## Gross Replacement Value:

RSMBC supports Aurizon Network’s proposal to charge for the use of certain assets based on Gross Replacement Value. In reaching this conclusion, RSMBC refers to ‘commercial risks’ and a ‘competitive environment’, neither of which we consider currently exist in regard to the relevant services. The proposal creates a substantial windfall gain for Aurizon Network. This is not appropriate where services are being provided to ‘captive’ customers, in a non-competitive environment, where the services are necessarily required in order for Aurizon Network to provide access.

# Key Concerns with RSMBC review

## Conclusions not supported by analysis

In a number of areas, the report reaches conclusions which are not supported by the consultant’s analysis. For example, while Aurizon Network’s operating costs are found to be significantly higher than some benchmarks, a “not unreasonable” conclusion is drawn based (in our view) on a single indicative benchmark and on the inherent difficulty of applying benchmarks. We do not consider that lack of reliable information should lead to a conclusion that costs are “not unreasonable”. Rather, if information is not considered reliable or sufficient, no conclusion should be reached until additional analysis (which RSMBC has recommended) is completed.

## Excessive reliance on Aurizon Network information and explanations

The report quotes the explanations provided by Aurizon Network extensively, particular in regard to why Aurizon Network’s costs have increased or exceed benchmarks, yet there is limited analysis of whether these explanations are valid, nor of the extent to which the issues raised by Aurizon Network would impact costs. There is also limited attempt made to identify factors which would influence costs in the opposite direction (that is, factors which would tend to raise certain costs of the benchmarked entities, relative to Aurizon Network’s reasonable costs).

## Insufficiently developed benchmarking

QRC considers that the benchmarking exercises undertaken by RSMB are too high level, whether due to a lack of available information or other causes. In particular, differences between the benchmarked entities are insufficiently considered, and the comparability of data (i.e. do the costs include the same functions) is not clear.

## Reliance on Aurizon’s actual costs as a base

The report relies heavily on the past costs of Aurizon Holdings or Aurizon Network as a base, with insufficient analysis of the extent to which costs incurred in the past were efficient, or will be required in future years. For example, the analysis of corporate costs focuses primarily on the allocation of the costs reflected in Aurizon Holdings’ corporate plan for FY2013, updated to reflect 4 months of actual data and 8 months of forecast (the “FY2013 Plan”). While some adjustments have been recommended based on changes between the FY13 and FY14 plans or on the reasonableness of specific base costs, we do not consider that this process is adequate to ensure that the remaining costs are efficient.

# Detailed Comments

## Review of Corporate Overhead Costs

**(Section 3, pages 43 to 61: RSMBC Task 3.2.1)**

The analysis undertaken by RSMBC seeks to determine:

* Whether the benchmarks quoted by Aurizon Network can be relied upon as a demonstration of the efficiency of Aurizon Network’s claimed corporate overhead costs. Our understanding of RSMBC’s conclusion is that the benchmarks cannot be relied upon for this purpose.
* Whether Aurizon Holdings’ corporate costs, as shown in the FY2013 Plan, are appropriately allocated. RSMBC makes a number of recommendations in this regard.

As only a very limited assessment of the efficiency of the costs contained in the FY2013 Plan has been undertaken, and the benchmarking was found to be unreliable (and overstated), we have no basis on which to conclude that Aurizon Network’s claimed corporate overheads, (even after the adjustments recommended by RSMBC), are efficient.

4.1.1 FY2013 Plan as a base

Aurizon Network based its proposed overhead costs on an allocation of FY2013 Plan costs, plus escalation.

FY2013 was a year of substantial reform within the Aurizon group. Implementation of this reform involves costs which may not be required in future years, and should deliver benefits which are not (or are only partly) reflected in the FY2013 Plan.

The following information, from Aurizon Holdings’ FY2013 Results Presentation of 19 August 2013, and from the Aurizon Holdings’ Investor briefing of 16 December 2013, provides examples of why reliance on FY2013 costs may not provide a reasonable indication of future efficient costs:

| **Information** | **Concern** |
| --- | --- |
| * 960 Voluntary redundancies were implemented during FY2013 at a cost of $96m.
* A further 248 VRs occurred in the following six month period.
* Aurizon Holdings’ total headcount has reduced by 2074 since the IPO (to 16 December 2013)
 | * To what extent do the FY2013 corporate costs include costs of implementing this program, which may not be incurred in future years?
* How have the ongoing cost savings from the reduced headcount ($85m per annum from the FY2013 VRs alone) been reflected in Aurizon Network’s claimed corporate, operating or maintenance costs?
* Is it right to assume that these efficiency improvements will cease from 2013 or should further improvements be reflected in Aurizon Network’s claimed costs?
 |
| Of the 248 VRs to occur in the second half of 2013, one person was from Network. | * Is Aurizon seeking efficiency improvements within Network with the same urgency as elsewhere in the business?
* Should the undertaking provide appropriate incentives to drive cost reductions?
 |
| Of the 248 VRs to occur in the second half of the 2013 calendar year, 118 were in support roles (Commercial & Marketing, Strategy & Business Development, HR, Finance, Enterprise Services). | Has the benefit of this reduction in corporate costs been reflected in Aurizon Network’s claim, given that the claim is based on an allocation of costs from the FY2013 Plan (that is, a plan which ended prior to these redundancies). |
| Aurizon Holdings incurred $29m of ‘transformational costs’ in FY2013, including implementation of the ‘functional business model’. | * To what extent is this cost reflected in FY2013 Plan overhead costs and will such a cost be incurred in each future year?
* Are the benefits of these ‘transformational’ projects fully reflected in Aurizon Network’s claimed overhead, operating or maintenance costs?
 |
| Aurizon Holdings is targeting “$230m+” of cost and productivity improvements by FY2015. | How has the benefit of this planned reduction in costs and increase in productivity been reflected in Aurizon Network’s claimed corporate, operating and maintenance costs? |
| Aurizon Holdings completed a $3.6b debt raising in June 2013. | To what extent were corporate overhead costs included in the FY2013 Plan which related to this debt raising (including internal staff costs)? Are these costs excluded from the debt raising costs which are provided for in the WACC? Are costs at the level reflected in the FY2013 corporate costs likely to be required in all future years? |

The above table provides some examples of why FY2013 Plan costs are likely to be an unreliable indicator of future efficient costs. QRC is concerned that the RSMBC report focusses more strongly on the allocation of these costs, than on the question of whether the resulting costs are efficient. We acknowledge that RSBMC undertakes some review of FY13 Plan costs under task 3.2.5. This is primarily a review against the FY14 plan, and therefore will only capture cost reductions which are planned to be implemented (in full) by FY14, and not any remaining inefficiencies.

Recommendation: A more thorough review of the corporate costs of Aurizon Holdings is required in order to establish an efficient base for allocation.

4.1.2 Allocation issues

We understand that Aurizon Network has allocated corporate overhead costs in five ways (the resulting FY14 costs are shown):

* FTEs excluding maintenance ($2.4m)
* Revenue (less maintenance revenue) ($2.3m)
* Direct costs, excluding maintenance, labour and depreciation but including capex and electricity pass-through costs ($3.2m)
* Blended allocator ($43.2m):
* FTE excluding maintenance ($14.4m)
* Revenue excluding maintenance ($14.4m)
* Asset values ($14.4m)
* 100% Aurizon Network ($14.8m)

Key concerns with the allocation methodology are:

1. Use of the blended allocator for costs with no causal cost driver

QRC agrees with RSMBC’s analysis, which suggests that direct costs are a more appropriate allocator for these costs than Aurizon Network’s blended allocation. We support RSMBC’s finding that:

* “there is generally a stronger correlation between an entity’s direct costs and its corporate overhead costs than the value of the entity’s assets and its corporate overhead costs” (Page 7 of RSMBC report).
* “Ernst & Young’s Summary of Precedents indicates that the most commonly used cost allocation methodology is the direct cost methodology” (Page 6).
* “A large proportion of Aurizon Network’s revenue relates to the return on and the return of capital in relation to the value of the RAB. The utilisation of revenue would therefore appear to include reference to the value of Aurizon Network’s assets twice” (Page 7).
* The Energex precedent on which Aurizon Network relies relates to a small part of Energex’s business. For the vast majority of its corporate costs, Energex uses a direct cost methodology for allocation and has stated “*Energex has determined that overheads will be allocated to services based on total direct spend as this reflects a strong correlation with the consumption of indirect overhead*”.

Unfortunately, despite the above findings, RSMBC does not clearly recommend the use of the direct cost method, instead recommending only that it “*be considered*”. RSMBC’s caution seems to be based on the fact that “*circa 59% of Aurizon Network’s direct costs relate to energy costs which may reduce the appropriateness of the direct cost methodology*”. The concern being expressed here is that the direct cost method may overstate Aurizon Network’s share of overhead allocation, because of the inclusion of pass-through energy costs. We share RSMBC’s concerns regarding the inclusion of pass-through energy costs (see the discussion at item (b) below). However, the consequence of responding to this concern by moving to a blended allocation is to overstate Aurizon Network’s overhead allocation by a further $10m in FY14, and by more than $10m in each subsequent year (see table on Page 9 of the RSMBC report compared to the first of the tables on Page 10).

RSMBC’s analysis clearly shows that direct costs are the most appropriate allocator for costs where there is no clear causal driver. RSBMC is right to raise the concern that the inclusion of energy pass-through costs within the direct costs may result in this method overstating the appropriate overhead allocation. The appropriate response to this concern is not to move to an alternative method which overstates costs by an additional $10m per annum. Rather, the appropriate response is to adjust the direct costs to exclude the pass-through energy costs and then apply the remaining (genuine below-rail) direct costs as an allocator.

1. The impact of electricity pass-through

QRC considers that electrical energy is an above-rail cost. Aurizon Network provides a service in procuring transmission access and electricity, and recovers the cost from Access Holders. These costs are significant. RSMBC notes that 59% of Aurizon Network’s direct costs relate to energy costs. Our understanding is that this is the total of transmission and electric energy costs, as a percentage of total direct costs (excluding maintenance and overheads). This pass-through activity increases Aurizon Network’s share of the corporate cost allocation (under Aurizon Network’s method) through:

* The allocator based on revenue (we estimate that transmission and energy pass-through is ~15% of revenue).
* The allocator based on direct costs (59% of direct costs).
* The revenue component of the blended allocator.

We do not consider it credible to suggest that the contracting and pass-through of these services would drive overhead costs in the same way as Aurizon Network’s other business functions. We consider that these costs should be excluded from the allocators, particularly the direct costs allocator (including the direct cost component adopted in place of the blended allocator, if the RSMBC suggestion is accepted).

We note that in UT3, the costing manual required that certain corporate costs were allocated to Network using allocators which excluded fuel and electric energy. There is no indication in the RSMBC report as to whether the allocation method adopted in UT3 was considered as part of the current review. This would have provided a useful benchmark.

1. Adjustment of base corporate costs prior to allocation

*(QRC note: the following recommended approach may well have been implemented, however, we are unable to find any clear reference to this in Aurizon Network’s original submission or in RSMBC’s report)*

Deductions are made from certain allocators (such as direct costs, revenue, FTE’s) to exclude maintenance functions of Aurizon Network. This is because the maintenance overhead is separately estimated (without reference to Aurizon Network’s actual overheads) and allowed for in Aurizon Network’s maintenance costs. However, it is not clear that the values within various Aurizon Holdings cost centres, which are then allocated, have been reduced by the $12m which is recovered through the maintenance overhead allowance. Our concern is that, if $12m of corporate overhead is genuinely incurred by Aurizon Holdings, which would not have been incurred in the absence of the Network maintenance function, and it is not deducted from the corporate costs prior to allocation, then this cost is double counted. Alternatively, the $12m should be considered part of the “100% allocation” category, such that it is not included in the cost base for any other allocator. Note that the exclusion of maintenance costs from the allocators does not address this issue, as this simply reduces Aurizon Network’s share of the double count.

1. Other recommendations of RSMBC:

We generally support RSMBC’s remaining recommendations in regard to corporate cost allocation, in particular:

* That workers compensation insurance should be allocated by reference to FTE’s rather than through a blended rate.
* That, where direct costs are used as an allocator, the direct costs of the below rail business should exclude capital expenditure, as an overhead for this item is capitalised through a corporate service charge. We assume that total direct costs (the divisor) would continue to include the capital expenditure of other parts of the business, to the extent that corporate overhead is not capitalised.
* Train simulator costs and property disposal costs (as identified on Page 5) should not be allocated to, or shared with, Network.
* That further consolidation of cost centres will reduce transparency and further increase the requirement for subjective allocation of costs.

4.1.3 Review of corporate cost benchmarking

RSMBC notes the following concerns with the benchmarking of corporate costs undertaken for Aurizon Network by Ernst & Young:

* Ernst & Young applies revenue as the sole normalisation factor to account for differences in the size and nature of the comparable companies, both of which have lower revenues than Aurizon Network. RSMBC notes that “as companies increase in size, it is not uncommon for corporate overheads as a percentage of revenue to decrease”.
* Ernst & Young has benchmarked Aurizon Network as a ‘stand-alone’ entity. No allowance has been made for the synergistic benefits of the integrated group. The integrated group creates serious concerns for Aurizon Network’s customers and above-rail operators (other than the related operator). The sole benefit is potential cost savings, therefore it is important that these are reflected in Aurizon Network’s claims.
* Company 1 in the study includes operations which are more expansive than Aurizon Network and include the complexities of operating a passenger network.
* Ernst & Young uses other benchmarks, the relevancy of which cannot be ascertained.
* Anomalous costs within benchmark entities are not examined (and are therefore extrapolated to larger values, based on volumes, to develop the Aurizon Network estimate). These should be excluded if the nature of the costs and their applicability to Aurizon Network is not understood.
* $4.1m of costs that are proposed to be allocated are not benchmarked.

We concur with each of these concerns, and note:

* the use of revenue as a normalisation factor suggests that corporate costs are fully variable with revenue. Aurizon Network’s own corporate cost allocation methodology confirms that this is not believed to be the case. In addition, Aurizon Network’s UT4 submission states that the loss of economies of scale has had implications for operating costs: “Aurizon Network is now responsible for a smaller network while still having to incur similar operating expenses that were previously spread across the Queensland Rail network”. Clearly this statement is completely inconsistent with a world in which overhead costs are totally variable with revenue.
* The lack of consideration of differences between Aurizon Network and the benchmark entities means that no conclusions can be reliably drawn from this analysis. Clearly we would expect a passenger service to generate overheads per unit of revenue that are many times greater than the overheads required to generate Aurizon Network’s revenue, much of which comes from the fact of having assets in the RAB.
* A significant portion of Aurizon Network’s revenue comes from passing through electricity costs. By normalising based solely on revenue, the benchmarking assumes that this activity requires the same overhead, per dollar of revenue, as the activities of the benchmark entities. Clearly generating revenue by providing passenger train services will generate very different overheads to the passing on of electricity costs.

RMSBC concludes that the benchmark costs are likely to be overstated. We concur with this view. Given the nature of the problems with the benchmarking, it is not possible to adjust it to derive a meaningful estimate of Aurizon Network’s efficient corporate costs. We note that RSBMC has sought to estimate efficient corporate costs by undertaking its own benchmarking, and by developing an ‘indicative shadow’ cost, in Section 9 of the report.

4.1.4 Consideration of stakeholder submissions

Pages 58-59 of RSMBC’s report set out a number of stakeholder comments regarding Aurizon Network’s overheads, and provide certain responses which generally confirm that RSMBC’s conclusions are consistent with these submissions. As is set out on Page 58 of the report:

“B*MA and BMC raised the issue that Aurizon Network's regulatory business is self-contained as well as geographically contained and coal centric, which is in contrast with the geographically diverse and multi-commodity, above rail business. Therefore in assessing the standalone costs of Aurizon Network, BMA/BMC submit that the relative simplicity of the CQCN business compared to the related above rail business, needs to be taken into account*.”

RSMBC appears to accept this comment in principle, stating “*Any allocation methodology adopted for allocation of corporate overheads should reflect the utilisation of those corporate overheads. In the case of Aurizon Network, the utilisation of these functions would, in part, be influenced by the complexity and size of the respective operating businesses within Aurizon Network Holdings*”.

It is not clear to us how the acceptance of this issue has been reflected in RSMBC’s analysis or recommendations. The allocation methodology (including as amended) makes no distinction between a dollar of network revenue and a dollar of coal haulage or general freight revenue. The same is true of asset values, FTEs and direct costs. The most striking example of this is the inclusion of electricity pass-through costs in direct costs, which suggests that this activity is as complex (in terms of overheads incurred per dollar of revenue) as, for example, moving general freight between remote towns throughout Queensland.

It is also important to consider the complexity of the Aurizon Network business in the context of the treatment of maintenance overheads and the charging of overheads to capital expenditure projects. RSMBC has correctly identified that maintenance costs and capex costs should be excluded from certain allocators, because overheads for these activities are separately calculated and charged. The overhead being assessed for Aurizon Network should therefore be the overhead appropriate to a below rail business which (for this purpose) does not maintain its assets or undertake capital investment projects. This is clearly an artificial construct, but assessing on this basis is a necessary consequence of Aurizon Network’s approach. This is relevant in:

* The consideration of benchmarks, including the ‘shadow’ benchmark. Unless an overhead has been allocated by the benchmark entities to maintenance and capex, and has then been deducted from the overhead numbers being used for comparison with Aurizon Network, the overheads of the benchmarks should be compared to the Aurizon Network overhead after adding back the $12m per annum of overhead which is allocated to maintenance, and any amounts expected to be recovered against capex.
* The consideration of the complexity of the business, as it relates to the level of reasonable overheads. Aurizon Network, exclusive of maintenance and capex activities, is clearly a relatively simple business compared to the remainder of the Aurizon operations (the activities of which should be considered to include maintenance and capex functions for this purpose). Aurizon Holdings’ operations include (and are not limited to) intermodal freight (40 depots in 5 states), dangerous goods transport, bulk freight for resources, manufacturing and primary industries, rolling-stock maintenance services (30 facilities across Queensland, NSW and WA) and design services (civil, track, signalling, telecommunications, over-head traction). It is clearly not credible to suggest that a dollar earned by holding assets in a RAB, or by passing on electricity costs, causes a similar level of overheads to revenue earned through activities such as these. Allocating too much overhead to the below rail business will provide the non-regulated elements of Aurizon’s business with an advantage which competitors cannot replicate.

QRC considers that the point raised by BMA and BMC has been accepted by RSMBC but not addressed, and that the allocation of overheads should be adjusted to reflect the relative complexity of the regulated and non-regulated operations.

4.1.5 Conclusion to Section 3 of RSMBC report

We note that the conclusion (Section 3.103) refers to revised corporate overheads of $48m in FY14. Later sections of the report identify a range of further adjustments which are not reflected in this number, and provide a revised value using the direct cost methodology of $43.4m (see page 32). This compares to $16.7m for ARTC’s Hunter Valley operations. It is not clear whether ARTC’s $16.7m is inclusive or exclusive of overheads related to maintenance functions, which add a further $10-12m to Aurizon Network’s claim.

We consider that the revised numbers continue to substantially overstate Aurizon Network’s efficient overhead, due to:

* the inclusion of electricity pass through costs in allocators.
* the lack of any adjustment to reflect the relative simplicity of Aurizon Network’s business (when compared to the remainder of Aurizon Holdings’ operations).
* inadequate assessment of the efficiency of the corporate costs of Aurizon Holdings (including due to adopting FY13 as a base), which are then allocated.

## Review of Corporate Overhead Costs in the UT4 Maintenance Submission

**(Section 4: RSMBC Task 3.2.1b)**

QRC notes RSMBC’s comments (page 68) regarding double-counting, however we are unclear as to whether RSMBC has considered the need to deduct the maintenance overhead allowance from the total overheads of Aurizon Network Limited prior to commencing allocations.

We also note the table presented in Section 4.43 (page 67), which is reproduced from the Deloitte report. The table indicates that overheads, in recent regulatory decisions, have averaged 7% of costs. ARTC is the outlier at 12% of operating costs. We are confused as to how this data compares to:

* RSMBC’s table at page 32, which indicates that ARTC’s overheads are 36% of total costs.
* Aurizon Network’s claim for non-maintenance overheads, which are more than 53% of total costs.

## Benchmarking of insurance costs

**(Section 5: RSMBC Task 3.2.2)**

RSMBC has carried out benchmarking exercises and has concluded that the corporate insurance costs proposed by Aurizon Network do not appear unreasonable. Based on the limited information made available, QRC is unable to comment on this review, other than to question:

* whether it is reasonable to forecast that insurance premiums will continue to increase at a rate which is well in excess of CPI on a sustained basis.
* what is the relevance of ‘movements in rolling stock values’ to a below rail business?

## Review of change to depreciation methodology

**(Section 6: RSMBC Task 3.2.2)**

RSMBC has reviewed Aurizon Network’s proposal to accelerate depreciation such that all assets are depreciated over a maximum 25 year life. RSMBC concludes that such a proposal “*is not an unreasonable position for Aurizon Network to adopt*”. QRC does not agree that this proposal should be accepted.

4.4.1 Regulatory certainty

Depreciation methods were amended, based on an Aurizon Network proposal, under UT3. While RSMBC may considers Aurizon Network’s new proposal to be “not unreasonable”, there are no doubt many other approaches, including the UT3 approach, which may also be “not unreasonable”. We do not consider that Aurizon Network has demonstrated any real need for the latest change; the QRC considers the assumptions used by Aurizon Network in seeking to demonstrate the need for change are unrealistic. Aurizon Network asserts that the financial impact of the change is minimal (a claim which we are unable to verify) which further raises the question as to why the change is required.

4.4.2 Unrealistic assumptions

Limiting depreciation to the average life of existing mines is based on a number of unrealistic assumptions, including:

* That a new mine will never replace a mine which exhausts its reserves. Clearly this is not the case, as there are numerous examples of mine closures in Central Queensland over the past decade, yet the system remains fully contracted.
* That existing mines will never increase their marketable reserves. Marketable reserves are a subset of the mine’s resources. Converting resources to reserves is a costly process involving (among other things) additional exploration and economic assessment. Miners seek to do this a reasonable time ahead of production requirements in order to facilitate mine planning and approvals, but it is not uncommon to convert additional resources to reserves during the life of a mine.
* That mine lives should be determined based on production rates which are 90% of contract – an assumption which is inconsistent with Aurizon Network’s UT4 volume forecasts.

Given Aurizon Network’s assertion that the proposed change in methodology has only a small impact, consideration of any of the above factors would presumably lead to a conclusion that there is no need to change the existing practice.

4.4.3 Queensland’s coal reserves

The Queensland Exploration Council’s 2013 report (“Queensland Exploration Scorecard”) assesses Queensland’s reserves of various commodities, without applying the above unrealistic assumptions. The 2013 report concludes:

* Queensland has 64 years of proved and probable coal reserves at current production rates.
* Proved and probable coal reserves were 12,565mt at the end of FY2013, yet were only 9,361mt at the end of FY2012. This demonstrates how exploration expenditure results in additional reserves being “created” (out of resources) over time.

4.4.4 ‘Intergenerational’ considerations

Aurizon Network has sought to present a scenario in which, if depreciation is not accelerated and railings decline in the future as the coal industry exhausts its reserves (around 25 years from now according to Aurizon’s approach), the remaining mines may become uneconomic due to a high remaining asset base (i.e. high ongoing depreciation charges and return on capital). This is despite Aurizon Network’s claim that the proposed acceleration has minimal financial impact and that Access Charges represent only a small proportion of a mine’s operating costs.

While we are not in a position to predict conditions which may apply 25 years into the future (or 64 years into the future based on the Queensland Exploration Council numbers), we would expect that in the scenario described by Aurizon Network there would be a number of factors which would actually be causing costs to reduce. For example, asset renewal expenditure would significantly reduce and the value of the RAB would be approaching very low levels (with or without Aurizon Network’s new acceleration proposal) such that the return on capital requirement would be substantially reduced.

In fact, QRC’s concern is the reverse of the concern raised by Aurizon Network: which is that accelerated depreciation may ultimately result in a RAB which is so low that Aurizon Network is being asked to run a significant business (in terms of operations) while earning very little return through the return of and on capital.

4.4.5 Conclusion

Based on the above considerations, QRC suggests that:

* the acceleration of depreciation which was approved under UT3 should be retained.
* no further acceleration is justified by genuine asset stranding concerns, which are substantially mitigated through a range of existing mechanisms within the undertaking.
* any further acceleration only serves to ‘front-end’ Aurizon Network’s revenues, with possible adverse long term consequences.

We note that RSMBC has repeated Aurizon Network’s assertion that taking into account potential new mines or proven resources would “*require Aurizon Network to take on exploration and development risk*”. The remote risk referred to is that new mines will not develop, existing mines will cease to extend their reserves, and Aurizon Network will be unable to recover a return on its investment as the number of operating mines declines. The probability of any one of these occurring is low, yet Aurizon Network’s proposal is based on a scenario in which all three must occur. Aurizon Network seems to understand this when the issue is considered in the context of tax depreciation. RSMBC states (page 84) that:

“*Aurizon Network advised that it considers that the UT4 weighted average life of the mine of 25 years is not acceptable to use as a reasonable estimate of the effective life of railway assets. This is on the basis that the assets (i.e. being the railway lines forming part of the CQCN) will be able to be used by Aurizon Network for a period beyond 25 years as longer life mines continue to operate and additional mines come online*.”

That is, it appears that Aurizon Network understands that the ATO would reject a proposal for accelerated depreciation, for the same reasons as QRC challenges the proposal in the regulatory context. We understand that tax outcomes and regulatory outcomes need not be the same, however, in the current case, the issues to be considered are similar.

Aurizon Network has been very successful in identifying and eliminating remote risks over successive undertakings. Should the risk discussed above eventuate, (evidence of which is not apparent at this time), it can be addressed adequately through undertakings approved over the coming 20 year period.

## Review of forecast compliance audit costs

**(Section 7: RSMBC Task 3.2.4)**

QRC considers that the practice of Aurizon Network engaging and paying auditors to undertake compliance audits creates:

* potential independence issues for the auditors (and/or perceptions of such conflicts).
* Unnecessary assessment process in the undertaking approval process (to determine the reasonableness of the forecast costs).
* Unnecessary complexity in the undertaking, in the form of the proposed pass-through arrangement.

QRC suggests that the QCA engage auditors directly to undertake the compliance audits, and pass the cost to industry through the QCA levy. This will address each of the above issues.

QRC considers that the scope of audits should be determined by the QCA, and should not be limited to audits of Aurizon Network. These issues are currently being discussed between the QRC and Aurizon Network as part of the ‘ring-fencing’ discussions.

## Benchmarking of Aurizon Network’s operating expenditure (excluding overheads)

**(Section 8 Pages 90 to 97: RSMBC Task 3.2.5 (part 1))**

RSMBC has benchmarked Aurizon Network’s claimed operating costs against ARTC’s Hunter Valley Network, the Brookfield Rail Network in WA, and against a “shadow” benchmark developed by RSMBC. RSMBC notes that:

* differences between the characteristics of these businesses mean that any benchmarking exercise can only provide an indicative comparison.
* Aurizon Network operates a larger sized network than the ARTC Hunter Valley coal network.
* “the variables applying *to below rail access providers should not vary a great deal based on GTK, if the operations are of similar track length and complexity*”.

4.6.1 Reliance on Aurizon Network’s claims for increased costs:

RSMBC quotes a number of factors which Aurizon Network claims may increase its costs relative to benchmarks. We are not aware of the extent to which RSMBC has assessed the relevance of these claims, or attempted to quantify the impacts of the claimed differences on costs. Perhaps more importantly, we do not know the extent to which RSMBC took these claims into account when reaching its conclusion. QRC has a number of concerns about these claimed ‘special factors’, including:

* Most of the differences would result in administrative challenges, not necessarily in material additional costs.
* Aurizon Network’s intention to facilitate short term transfers in the future is not a driver for higher costs than ARTC, which already provides such services.
* It is not accurate to say (see page 91) that “*the Dalrymple Bay Coal Terminal has a cargo assembly model which places significantly more strain and operational complexity onto the rail and mine components of the supply chain compared with the Hunter Valley*”. It is true that DBCT has a cargo assembly model. Other systems in Central Queensland do not. In contrast, the Hunter Valley is predominantly a cargo assembly system, with the added complexity of one coal terminal (located in the same port precinct) operating in an even railings mode. To the extent that cargo assembly adds “significantly more strain and operational complexity”, this is a reason to expect Aurizon Network’s costs to be below those of ARTC as only one of four port precincts in Queensland operates in cargo assembly mode.
* We do not understand why RSMBC would raise the possibility that “*UT4 forecast growth resulting in longer trains could, without corresponding changes in infrastructure, such as increased length of sidings and passing loops, make the operations more complex*”. We are not aware of any intention of Aurizon Network to accommodate UT4 growth by running longer trains without corresponding changes in infrastructure.

4.6.2 Lack of consideration of special complexities of benchmark entities

The RSMBC report quotes Aurizon Network’s claimed ‘special complexities’ which may justify higher costs, yet there is no evidence of consideration being given to whether there are also factors which may increase the complexity or costs of the benchmark entities. These factors, in the case of ARTC, may include:

* The convergence of all of ARTC’s network at one location may result in operational challenges which are lessened by Aurizon Network’s more diversified system.
* ARTC must deal with cargo assembly operations at PWCS (which includes two unloading points), while NCIG operations are closer to an ‘even railings’ arrangement. These different terminal operating modes must be accommodated in the same rail system, which is true only of the Goonyella system in Central Queensland.
* The Carrington Coal Terminal utilises rail facilities over which steel products, grain and general freight are also railed.
* ARTC’s system must deal with significant volumes of railings to domestic power stations, which is true of only the Blackwater and Moura systems in Central Queensland.
* Different train types run within the system due to axle load limits at the upstream ends of certain hauls. This is not the case in all systems in Central Queensland.
* The Hunter Valley features a number of significant lines off the main line (including Ulan and Gunnedah), each with a number of load-points, in addition to many single mine spurs linking to the main line.
* There are currently four above-rail operators providing coal haulage services in NSW (three in Queensland).
* ARTC holds Access Holder Agreements with every individual miner, plus Operator Sub-Agreements with each operator in respect of each haul. Aurizon Network holds relatively few agreements.

QRC has not undertaken an assessment of the extent to which the above factors are material, but we raise these issues to point out the dangers of relying on Aurizon Network’s claims of complexity, without consideration of the merits of these claims or of special challenges faced by the benchmark entities.

4.6.3 ‘Shadow benchmark’

The task of determining that the benchmark entities are comparable in terms of operations, and ensuring that the cost data of the benchmark entities covers similar operating functions, is difficult. Given this challenge, RSMBC concludes that the analysis can only provide an indicative comparison. For this reason, we support RSMBC’s development of the ‘shadow benchmark’.

Based on the description of the shadow benchmark provided in the report, we are unable to determine whether the it was prepared appropriately. The report states that the shadow costing was developed with the assistance of rail industry experts based on labour costs required to perform the functions of a below rail infrastructure manager and associated running costs. Unless the experts were instructed otherwise, these costs would include maintenance costs and corporate overheads. Given the scope of operating costs being assessed, the shadow benchmark must exclude these items. Similarly, when the results were tested against information available to the experts from comparable railways, the costs of those entities would need to exclude maintenance and overheads.

The shadow benchmark indicates that Aurizon Network’s costs may be overstated by around $5m, or 9%. This is despite RSMBC making some adjustments to reflect Aurizon Network’s “*current operational structure*”. Our reading of this is that RSMBC has developed a shadow benchmark based on efficient operations, then adjusted it for some current practices which may not be efficient. To some extent, this seems to defeat the purpose of the exercise, as reflecting current practices in the shadow benchmark will result in any inefficiencies inherent in these practices being built into the benchmark costs.

Despite developing a shadow benchmark, RSMBC fails to rely on it when reaching its final conclusion, based in part on the ‘desktop’ nature of the review. We support RSMBC’s suggestion that a more detailed review, including site visits, be undertaken in order to verify costs and assumptions.

4.6.4 Data used in benchmarking

We are unable to verify the source of much of the benchmark data, and therefore cannot comment on its comparability with the Aurizon Network data. For comparability, the costs used must exclude maintenance, maintenance overheads, insurance costs, and each of the overhead items allocated to Aurizon Network (some of which could well be treated as operating costs in other entities).

4.6.5 RSMBC conclusions

RSMBC concludes that “*the proposed Operational Costs do not appear unreasonable*”. We are unable to reach that conclusion based on the information presented in the report.

There does not appear to have been sufficient analysis of ARTC and Brookfield in terms of operational differences or costs (i.e. do the costs include/excluded similar items to Aurizon Network’s operating costs) to ensure that the comparisons are valid. The Brookfield benchmark numbers are significantly lower than Aurizon Network’s, but seem to be ignored in reaching the conclusion. The conclusion is also inconsistent with the shadow benchmark analysis, even after this analysis was adjusted from an efficient assessment to a “*current operational structure*”.

The conclusion appears to be based primarily on the ‘per gtk’ comparison with ARTC. This is a valid basis for the conclusion **only if**:

* The cost data is comparable in terms of inclusions/exclusions.
* There is a straight line relationship between operating costs and gtks – that is:
* there are no economies of scale
* a train path with a longer haul involves the same cost per km as shorter hauls; and
* a train with a larger payload drives more costs to be incurred in the areas of train control, infrastructure management, safe-working and business development than a train with a lesser payload .

As RSMBC notes: “*the variables applying to below rail access providers should not vary a great deal based on GTK, if the operations are of similar track length and complexity*”. We accept that the ‘per track km’ comparison may address some of these concerns, however, we are unable to assess whether track kms for Aurizon Network and ARTC have been measured on a comparable basis.

* ARTC is assumed to be efficient. This has not been established though this review. We have serious concerns with the costs of a single entity being the basis for a conclusion that Aurizon Network’s costs are ‘not unreasonable’. A similar approach, if applied by the ACCC, would allow ARTC to use Aurizon Network’s costs to demonstrate its efficiency, creating a circular proof in which the costs of neither entity are tested for efficiency. Our concerns about reliance on one benchmark entity are heightened by the fact that RSMBC established two other benchmarks (Brookfield and the shadow), each of which indicated that Aurizon Network’s costs were too high.

The doubts surrounding the relevance of the benchmark data are so strong that we consider the indicative shadow to be the most reliable indicator of Aurizon Network’s efficient costs. We support more analysis being undertaken on the indicative shadow, or on the benchmarking, in order to improve the assessment of this element of Aurizon Network’s claims, but consider that:

* reliance should be placed on benchmarks only if efficiency of the benchmark entity’s costs are established, differences between operations are understood, and the comparability of cost data is established.
* further development of the shadow benchmark should be based on a genuine independent assessment, in which any explanations provided by Aurizon Network for its higher costs are tested for efficiency. Clearly a process in which the shadow benchmark is further adjusted to reflect Aurizon Network’s current practices will result in the shadow being transformed from an assessment of efficient costs, into a justification of current costs.

## Comparison of forecast and historical corporate costs

**(Section 8 Pages 98 to 108: RSMBC Task 3.2.5 (part 2))**

RSBMC has undertaken a comparison of Aurizon Network’s claimed corporate costs against historical costs, and against FY14 budget costs. While the reductions recommended by RSMBC are welcomed (page 23), we are unable to comment on this section of the report due to redacted information.

We note that the explanation for many of the cost increases are that activities became centralised, a change which would be expected to reduce costs. We can only conclude that these increases are actually a reallocation of costs.

We also note that the recommended reductions arise primarily from a review against the FY14 plan, and therefore will only capture cost reductions which are planned to be implemented (in full) by FY14, and not any remaining inefficiencies.

There are a number of specific cost elements with which QRC has concerns, which are discussed below.

4.7.2 Corporate branding

The extent of the adjustment for ‘corporate branding’ is not shown. This is an activity which a regulated monopoly would be expected to incur little expenditure on.

4.7.3 Legal costs within Commercial Development

These costs are allocated 100% to regulated activities (see page 208 of Volume 3 of Aurizon Network submission). A number of Aurizon Network activities are directed at earning unregulated revenue. This is reflected in the cost allocation of most Aurizon Network functional units, and we do not understand why legal is an exception.

4.7.4 UT5 and other regulation and policy expenditure

The reasonableness of the budget for ‘regulation and policy’, which is more than $12m over the UT4 period, should be reviewed. RSMBC’s review seems to be limited to consideration of the relativity of the UT5 cost ($4.5m within the overall $12m) against UT4 costs. Our comments are:

* The efficiency of the UT4 cost has not been established, and we would suggest that UT4 has been an extremely inefficient process.
* UT4 was a complete re-write of the undertaking. QRC would hope that, with UT4 likely to be finalised at around the same time as early drafts of UT5 will need to be prepared, another re-write should not be necessary.
* The true UT5 budget is not limited to $4.5m, as we would expect that a significant portion of the resources of the regulation and policy team would be applied to this task (for example, if UT5 represents 50% of the internal regulation and policy budget, the true UT5 budget is $8-9m).
* A budget of this magnitude risks encouraging the excessive use of consultant reports and the creation (as per UT4) of volumes of material which must be considered by stakeholders and the QCA.
* An excessive budget encourages ambit positions to be taken, while a more modest budget would encourage a timely and efficient resolution of the undertaking.
* Resourcing Aurizon Network to this extent increases the UT5 costs incurred by QCA and stakeholders, each of which is forced to consider and respond to Aurizon Network’s material. Taking into account Aurizon Network’s costs and the costs incurred by the QCA and stakeholders, it is not difficult to foresee total costs in excess of $15m flowing to industry.
* The costs proposed by Aurizon Network are consistent with UT4. The shortfalls of the UT4 process have been acknowledged by all participants. QRC sees dangers in providing a budget which would allow for a repeat of this experience.

## Comparison of forecast and historical operating expenditure

**(Section 8 Pages 109 to 121: RSMBC Task 3.2.5 (part 3))**

This is a review of forecast operating costs against historical operating costs and therefore does not assess efficiency. QRC takes little comfort from a reducing cost in $/train path, as system wide direct costs should not be expected to be entirely variable (and we note that costs per train path will actually increase if the growth in volumes is less than that assumed by Aurizon Network).

## Total cost benchmarking

**(Section 9: RSMBC Task 3.2.6)**

This section is largely a consolidation of the overhead and operating cost analysis undertaken in previous sections, on which we have commented above.

We note that Aurizon Network’s costs are substantially higher than those of ARTC, Brookfield, and the Indicative Shadow on a per track km basis and on a ‘per forecast gtk basis’. Aurizon Network’s costs are also more than 7% higher than each benchmark on a ‘per contracted gtk’ basis, a comparison which (given that ARTC’s forecast and contract gtks are said to be the same) assumes that Aurizon Network can perform the full contracted gtk’s without incurring any additional operating costs. Put another way, the assumption is that Aurizon Network must resource to meet 100% of contract, and cannot mitigate any costs whatsoever when forecast volumes are 33% below contract (and are expected to remain substantially below contract for the entire undertaking period). The extent of inflexibility implied in this assumption is totally unrealistic, yet it appears that RBMBC has placed significant reliance on the ‘per contracted gtk’ comparisons.

We note that, based on the table, Aurizon Network’s overhead claim is four times the overhead of ARTC. Aurizon Network’s scale could account for its overhead costs, if assumed to be totally variable with gtks (which is not the nature of overhead costs), being only double that of ARTC. This difference is worthy of further investigation as the adjustments recommended elsewhere in the report would still leave Aurizon Network with an overhead allowance which is well beyond that which would appear reasonable based on a comparison with ARTC.

We suggest that the question of the variability of costs with volumes requires further consideration. We struggle with the challenge of simultaneously accepting Aurizon Network’s claims that (i) costs have risen due to the loss of economies of scale (separation of Queensland Rail), and (ii) at the same time, costs have risen due to higher coal volumes. Similarly, the approach of normalising on contracted tonnes suggests that Aurizon Network has no costs which are variable upon a 30% change in volumes. This is not consistent with benchmarking Aurizon Network’s costs against ARTC on a per gtk basis (which suggests that ARTC’s costs are entirely variable). RSMBC acknowledges that unit cost benchmarks will tend to overstate the required cost of Aurizon Network as a larger entity, but there is no indication of this being considered in developing the conclusions.

## Review of operating costs for double counting and review of cost categories against benchmarks

**(Section 10: RSMBC Task 3.2.7)**

4.10.1 Review of cost items

QRC supports the proposed adjustments regarding the duplication of depreciation charges (resulting in an overstatement of overheads) and the allocation of a share of Mackay train control centre costs to non-coal traffic (pages 131-132). We also suggest that QCA assess the need for this facility (and we would welcome a discussion with Aurizon Network on this point).

4.10.2 Benchmarking of amended costs

This section is largely a consolidation of previous information and again repeats Aurizon Network’s claims regarding the special factors which make the CQCN complex, without testing these claims or considering the special factors which make other rail systems complex.

We note the conclusion that the direct cost method of allocation provides costs which are most closely aligned with benchmark costs and that, as part of a larger group, Aurizon Network’s corporate services costs should reflect benefits which are not available to the benchmark entities.

4.10.3 Productivity improvement

RSMBC has repeated a number of claimed future efficiency improvements provided by Aurizon Network. These seem to be useful initiatives which may improve the performance of the network, however, no evidence is provided to indicate that the planned projects have been reflected in the operating cost claimed by Aurizon Network in UT4, such that costs reduce, other than unit cost reductions in some areas due to volume increases.

We do not consider that capturing natural economies of scale demonstrates sufficient focus on efficiency improvement. In fact, if, as suggested by Aurizon Network, resources must be in place such that 100% of contract can be delivered without incurring additional costs, then operating costs are fixed and the ‘productivity improvement’ that comes from volume increases is simply the spreading of these fixed costs. Taking up this slack may produce a unit cost reduction, but it indicates nothing about any genuine productivity improvement. Similarly, the cost per gtk of depreciation and return on capital will also reduce as volumes increase toward contract, however, the cause is customers more fully utilising what they have paid for, and is not a basis for Aurizon Network ‘ticking the box’ on productivity improvement.

**4.10.3 CPI –x adjustment to overheads**

In regard to a CPI-x factor being applied to overhead costs, RSMBC notes that Aurizon Network is planning to implement $100m of savings within shared services areas and that RSMBC does not consider it unreasonable to expect that a proportion of cost savings relate to below-rail activities. RSMBC takes this into account and recommends a CPI-x factor of 0.625% to 1%. Based on RSMBC’s suggested corporate overhead allowance of $43.4, this represents a real cost saving of $270,000-$430,000 in the first year. Clearly, applying a CPI-x factor is a completely inadequate response to an imminent cost reduction of $100m – a reduction which indicates very substantial existing inefficiencies. CPI-x factors of the magnitude quoted by RSMBC are only suitable for application to cost bases which are already efficient, such that the x factor need only reflect future improvements from an efficient base.

QRC considers that an appropriate approach is:

* Establish an efficient baseline overhead allowance, based on a shadow benchmark approach or on an allocation method after ensuring that each element is efficient prior to allocation.
* Apply a CPI-x to the resulting allowance, reflecting further efficiency improvements which can be captured over time.

## Interest During Construction

**(Section 11: RSMBC Task 3.3.1)**

We rely on QCA to assess this section in conjunction with Aurizon Network’s proposed modelling approaches.

## Review of capital cost build up

**(Section 12: RSMBC Task 3.3.2)**

QRC has no comments.

## RSMBC review of return on assets used in maintenance

**(Section 13)**

4.13.1 Gross Replacement Value

Aurizon Network proposes to charge for the use of certain fixed assets on the basis of Gross Replacement Value (“GRV”) rather than book values. RSMBC considers that this approach is reasonable on the basis that:

* The approach compensates Aurizon Network for the commercial risks involved in providing the maintenance service.
* In a competitive environment, service providers can be expected to price their services having regard for the opportunity costs of utilising the assets to provide the maintenance services.
* The use of replacement costs takes into account the opportunity costs of utilising the assets to provide the maintenance services.

Each of these points would be valid in a world in which maintenance services were regularly tendered in a genuine competitive environment in which Aurizon Network may, or may not, win the work. Such an environment would create the commercial risks to which RSMBC refers, and pricing would be constrained by the competitive environment. Aurizon Network does not provide these assets in such an environment. Rather, the assets are effectively underwritten by the CQCN and Aurizon Network’s customers are generally exposed to varying utilisation of the assets (that is, the same ‘rent’ will be paid regardless of the volume of work which the assets are required to perform).

The additional cost arising from the change in approach is estimated at $13m over the UT4 period, less any allowance for major periodic maintenance which is excluded from Aurizon Network’s claims which would be included under a book value approach (note that RSMBC has been unable to confirm that this is the case). This is a substantial cost.

For Aurizon Network, the change appears to create a substantial windfall gain. For example, if we understand Section 13.13 correctly, the ballast cleaner with a historical cost of $7.3m will now be valued at $33m. The total value given to revalued assets is $133m (historical cost is not disclosed).

QRC’s concerns include:

* It is not appropriate for Aurizon Network to capture windfall gains by providing services to ‘captive’ customers, in a non-competitive environment, where those services are necessarily required in order for Aurizon Network to provide access.
* It is not appropriate to pay an untested ‘market’ price if there is not a competitive market. Competition will drive efficiencies and transfer risks in a way which is not currently replicated by the regulatory arrangements. Paying a market price for a service which is not exposed to competitive pressures represents the worst of both worlds.
* In the absence of a competitive market or genuine risk borne by Aurizon Network, an approach to these assets which is similar to Aurizon Network’s regulated assets is appropriate. That is, Aurizon Network’s charges should reflect a regulated return on the written down asset value.

## RSMBC review of return on inventory and working capital within maintenance

**Section 14**

QRC understands that, under Aurizon Network’s proposed new modelling framework, working capital allowances are not required in regard to operating expenses. We have reviewed the RSMBC report but do not understand why maintenance costs are an exception. Maintenance costs are incurred throughout the year, as are other operating costs, and are recovered as part of Access Charges. To the extent that the new modelling framework deals appropriately with operating expenditure and Access Charge timing issues, we do not understand why a different treatment is required for maintenance costs.