AngloAmerican

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SUBMISSION TO THE

QUEENSLAND COMPETITION AUTHORITY

RESPONSE TO THE QCA DRAFT DECISION ON AURIZON NETWORK'S MAXIMUM ALLOWABLE REVENUE

DECEMBER 2014

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1. Executive summary

Anglo American Metallurgical Coal Pty Ltd (**Anglo American**) welcomes this opportunity to make a submission to the Queensland Competition Authority (**QCA**) in respect of its Draft Decision on Aurizon Network Ltd's (**Aurizon Network**)Maximum Allowable Revenue (**MAR**) for the 2014 Access Undertaking period (**UT4**) (the **Draft Decision**).

Anglo American agrees with the Draft Decision to refuse to approve the 2014 Draft Access Undertaking (**DAU**) insofar as it relates to Aurizon Network's submitted MAR. Anglo American broadly supports the findings made by the QCA.

In a number of instances throughout the Draft Decision, the QCA has stated that:

> …the price for access to the declared service should generate expected revenue for the service that is at least enough to meet the efficient cost of providing access to the service and including a return on investment commensurate with regulatory and commercial risks involved.[1]

Anglo American supports this principle. Anglo American believes that it is extremely important in a regulated environment to ensure that the regulated entity, in this case Aurizon Network, is fully and properly recompensed for the risks that it accepts in the regulated environment as well as the reasonable and prudent cost of providing the service altogether. Most importantly, however, Anglo American believes that this involves a balancing of facts: specifically, a balancing of the risks that the regulated entity accepts against the risks that the regulation passes through to customers of the regulated entity. In this instance, therefore, Anglo American believes that a strong focus of the QCA should be on identifying and valuing the commercial risks that Aurizon Network, in reality, bears as opposed to the various commercial risks that Aurizon Network requires users of the Central Queensland Coal Network (**CQCN**) to bear.

Importantly, Aurizon Network's revenue cap remains under UT3 and is proposed to remain under UT4. Further, as UT1 agreements expire, users will transition to UT3 or UT4 agreements and any of Aurizon Network's remaining volume/revenue risk, if any, will be removed as a result.

In summary, Anglo American submits that:

[1] This particular quote is from Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 154.

(a) it agrees with the QCA that Aurizon Network's submitted MAR of $4.67 billion is excessive, and does not appropriately reflect an efficient return on, and return of, capital based on the relevant parameters;

(b) the Weighted Average Cost of Capital (**WACC**) proposed by the QCA is inappropriate and, therefore, still too high. In particular, it does not adequately reflect the very limited risk borne by Aurizon Network;

(c) it agrees with the QCA that Aurizon Network's operating costs are excessive and, therefore, too high. They are more than two times greater than the costs of the Hunter Valley Coal Network's operations.[2] Anglo American supports the QRC's submission on this point: that while the QCA has noted the massive difference in cost per train path on these two networks, the Draft Decision only reduces those operating costs by approximately 16%. Anglo American believes that Aurizon Network should be incentivised to lower its costs significantly further than it has, including reducing its operating costs by more than the 16% currently proposed by the QCA. Anglo American also disagrees with the QCA's suggestion that CPI - X is not appropriate. Whilst it acknowledges the difficulties in picking the appropriate value for X, Anglo American refers to the unsuccessful attempt to introduce a performance regime (see the proposed Draft Incentive Mechanism). In the current economic climate it is critical that Aurizon Network has an incentive to reduce its costs. Anglo American would accept the initial value of X being relatively small to enable all stakeholders to gather information for future determinations of X; and

(d) while the approach to insurance is still not entirely clear, Anglo American believes that the QCA should ensure that there is no double dipping. For example, if a single force majeure event occurred during the 2014-2015 year which resulted in $15 million worth of damaged rail infrastructure, it is not appropriate that all costs above $1 million are passed through to customers, when those customers have already paid $5.65 million in self-insurance costs. Either $5.65 million should be deducted from the $15 million before cost pass-through applies or self-insurance costs should be removed from the MAR and all force majeure events should be dealt with on a cost pass-through basis.

2. Market risk premium

Anglo American notes that in its Draft Decision, the QCA stated that it has attempted to "provide Aurizon Network with sufficient revenue to meet the efficient costs of providing

[2] Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 92.

access to the declared service, including a return on investment commensurate with the commercial and regulatory risks involved".[3] Anglo American agrees that this is the appropriate test to apply under the *Queensland Competition Authority Act 1997* (Qld) (**Act**), however, does not agree that the figure arrived at by the QCA appropriately represents the commercial and regulatory risks borne by Aurizon Network in relation to the CQCN.

Anglo American refers to the findings of Castalia Strategic Advisers (**Castalia**) as commissioned by the QRC. In particular, Anglo American notes the finding that the inherent regulatory risks in Aurizon Network's business are no greater than the regulatory risks facing any other regulated business in Australia.[4] Anglo American notes that the QCA itself has acknowledged this view, in stating that it does "not consider Aurizon Network necessarily faces greater non-systematic risk, including regulatory risk, than other regulated Australian businesses in comparable circumstances.[5]

The QCA itself noted that "the regulatory regime also provides a number of measures that act to reduce the regulatory and commercial risks faced by Aurizon Network."[6]

Importantly, Anglo American notes that Aurizon Network is protected from risk in a number of key ways:

(a) first, Anglo American does not believe that there is a significant variance between the UT3 and UT4 regulatory periods that should be compensated with a 14% overall increase in Aurizon Network's Maximum Allowable Revenue. While there are a number of existing UT1 and UT2 contracts that will require renegotiation during the UT4 period, it can only be assumed that with the mine life left for the vast majority of Aurizon Network's customers, these contracts will be renewed, and that they will be renewed on, or at the very least not less favourably for Aurizon Network than, the terms of the approved Standard Form Access Agreements. As such, these contracts will retain their Take-or-Pay provisions, ensuring that Aurizon Network continues to have considerable cashflow and almost 100% revenue security throughout the UT4 period, precisely as it did under UT3;

(b) second, Aurizon Network's revenue cap form of regulation is proposed to remain in place during UT4, as well as the "overs and unders account" which transfers almost

[3] Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 29.
[4] This was noted by Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 190.
[5] Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 191.
[6] Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 190.

all demand and volume risk to customers. This means that Aurizon Network's revenue stream is guaranteed to be at the level approved by the QCA, barring any major catastrophes, including the impact of any force majeure event which will nevertheless be borne by users rather than Aurizon Network. This minimal volume risk was openly acknowledged by Aurizon Network's previous form, QR Network, in its Share Offer Document to potential shareholders where it stated that "[t]o the extent that actual revenue earned for coal carrying train services differ from the levels used in setting the relevant Reference Tariff, an adjustment is made in the second year subsequent to ensure that QR Network earns the allowable revenue for the relevant coal system. As such, QR Network bears limited volume risk";[7]

(c) third, there are a number of operational "ancillary mechanisms" which further reduce the risk that Aurizon Network faces. Anglo American notes that these ancillary mechanisms include:

(i) as noted above, 100% Take-or-Pay on a number of elements of the Reference Tariffs;

(ii) annual volume forecast resets to reduce the impact on Aurizon Network's revenue stream if costs must be incurred or reimbursed at a later date, ensuring consistency of return;

(iii) various processes which allow Aurizon Network to seek customer pre-approval, user funding or execution of enforceable Take-or-Pay contracts prior to capital expenditure, meaning that the costs of construction and asset stranding risk are significantly reduced;

(iv) Aurizon Network's ability (unlike the users) to seek amendments to the Access Undertaking by lodging Draft Amending Access Undertakings when risk profiles change so that it does not bear any of the volatility of those risk changes;

(v) annual adjustment mechanisms via "unders and overs" accounts to ensure that the forecast Maintenance Cost Index aligns with Aurizon Network's claimed maintenance costs;

(vi) accelerated depreciation over rolling 20 year asset lives for new capex;

[7] QR National, *QR National Share Offer Document* (2010) 74.

(vii) claimed cost "pass-through" provisions for operating expenditure and maintenance costs, as well as in a number of instances where Aurizon Network's direct costs vary by a certain percentage;[8]

(viii) claimed cost "pass-through" provisions for Review Events in force majeure circumstances and where maintenance costs claimed exceed allowances by more than 2.5%;

(ix) standard form agreements which give a clear understanding of the minimum requirements of agreements that Aurizon Network might enter during the course of the Access Undertaking, ensuring certainty and understanding around the risk profile that Aurizon Network is most likely to be required to accept; and

(x) removal of regulatory lag due to Aurizon Network's ability to shift risk and costs during the course of the Access Undertaking, sometimes quite contemporaneously to an event, by virtue of the above mechanisms.

Anglo American notes that these factors, among others, mean that Aurizon Network is sheltered from almost all commercial and regulatory risks involved in the expansion and operation of its own rail track business. Anglo American does not believe that this is inappropriate, especially given the requirement to ensure the protection of the infrastructure owner's legitimate business interests, however, it does believe that this almost complete risk mitigation should be clearly reflected in the Maximum Allowable Revenue that Aurizon Network is entitled to under the Access Undertaking.

In spite of this, Aurizon Network has still submitted that its Market Risk Premium should be 7.00%. The QCA has allowed 6.5% but Anglo American believes that 6.0% is appropriate in the circumstances, particularly based on Dr Lally's independent views.

3. Aurizon Network's return on investment

3.1 Overview

Anglo American notes that the QCA has addressed Aurizon Network's allowed return on investment in section 10 of the Draft Decision. Anglo American broadly agrees with the QCA's comments in relation to Aurizon Network's return on investment, including:

(a) Aurizon Network has over-estimated the majority of figures used for the building block methodology to determine the appropriate WACC for the UT4 period; and

[8] A UT3 example is the provision regarding "pass-through" where electric or connection costs vary by more than 2.5%: *Aurizon Network's 2010 Access Undertaking*, Schedule F, Part A, clause 2.2.

(b) the public interest test in section 138(2)(d) of the Act should be interpreted in context with the current adverse economic climate in the Queensland mining industry, including a desire to minimise costs and increase efficiency in all aspects of the supply chain.[9]

Anglo American does not, however, agree with a number of elements of the Draft Decision in relation to Aurizon Network's return on investment, or otherwise wishes to make further submissions on these points. Anglo American has outlined these points below.

Anglo American is particularly concerned with Aurizon Network's argument that a central consideration when determining WACC should be the investor's perspective. Anglo American understands, and supports the fact, that the legitimate business interests of Aurizon Network are to be considered as part of the QCA's determination. In saying that, Anglo American notes that Aurizon Network is, has been, and should remain, a regulated natural monopoly asset. Investors in regulated monopoly assets come to their investment decision with the full knowledge that the asset earns a stable and predictable rate of return based on a number of transparent estimated factors with limited risk. While this return may be lower than can be expected in the competitive market place, the benefit is that the return is more likely to continue. This has been especially so for Aurizon Network which, through the period of the Global Financial Crisis and the downturn of mining investments in Queensland, has been partially sheltered by the long-term take or pay contracts and fixed revenue cap. It has certainly had the benefit of returns better than those of its customers.

Investors in the Aurizon business were well informed of the regulation and regulatory risks involved in the business and invested in it knowing that regulation was an inherent feature of what would be a large proportion of the public company's business. The QR National Share Offer document itself noted that:

(a) "QR National's network is subject to extensive regulation that significantly affects its business, and there is a risk of regulatory outcomes that are adverse to QR National";[10]

(b) "Any significant reduction in the regulated tariffs of QR National's network business is entitled to levy could adversely affect QR National's financial performance";[11]

[9] Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 186.
[10] QR National, *QR National Share Offer Document* (2010) 21.
[11] QR National, *QR National Share Offer Document* (2010) 21.

(c) "QR National is exposed to the risk that the costs of network operations or capital expenditure programs may exceed the amounts allowed in the determination of QR National's regulated revenues;"[12]

(d) "QR Network's current Access Undertaking (UT3) was approved by the QCA in October 2010 and applies to 30 June 2013;"[13]

(e) "To the extent that actual revenues earned for coal carrying train services differ from the levels used in setting the relevant Reference Tariff, an adjustment is made in the second year subsequent to ensure that QR Network earns the allowable revenue for the relevant coal system. As such, QR Network bears limited volume risk";[14]

(f) "QRN Network Services revenue is subject to a cap mechanism that serves to ensure the network recovers its full regulated revenue over the regulatory period, with the majority of under or over recovery in access tariffs (net of take-or-pay charges) during a financial year being charged or refunded in the second financial year following";[15] and

(g) "Changes in government policy and regulation may have a material adverse effect on QR National's business, operational performance and financial results";[16]

As such, while Anglo American agrees that investors should not in any way be disadvantaged by the QCA's decision in relation to UT4, it should certainly not be entitled to increased returns simply to protect investors from an investment risk that they were well aware of and that is central to Aurizon Network's existence as a regulated entity.

3.2 Risk free rate

Anglo American agrees with the QCA's draft determination regarding the term for the risk free rate, specifically the fact that the risk free rate should be equal to the term of the regulatory period (five years). Anglo American notes that the 10 year Commonwealth bond rate takes into account some level of risk for the fact that funds will be unusable for a longer period of time and therefore has a traditionally higher rate. In contrast, Anglo American notes that Aurizon Network is entitled to a full review of its regulatory terms and conditions every five years (or, as is the case currently, in an even shorter timeframe where the decision-making process for the current undertaking extends past the regulatory reset date). As such,

[12] QR National, *QR National Share Offer Document* (2010) 21.
[13] QR National, *QR National Share Offer Document* (2010) 73.
[14] QR National, *QR National Share Offer Document* (2010) 74.
[15] QR National, *QR National Share Offer Document* (2010) 97.
[16] QR National, *QR National Share Offer Document* (2010) 122.

the relevant risk free rate applied should reflect the regulatory reset approach applied to the overall regulation of Aurizon Network.

Therefore, Anglo American agrees with the QCA's suggestion to follow the regulatory precedent from the New Zealand competition authorities and apply the five year Commonwealth bond rate where that is the regulatory period proposed.

3.3 The cost of debt

Anglo American continues to support the QRC's previous comments in relation to Aurizon Network's cost of debt. Anglo American reiterates its own previous submission on this point. Anglo American notes that its previous position differs slightly from the final recommendations of the QCA.

In particular, Anglo American does not support the QCA's decision to set a regulatory precedent that it will use the "simple portfolio econometric approach". While Anglo American agrees that this can, in some circumstances, provide a more accurate estimation of the cost of debt, Anglo American does not believe that the QCA should so readily disregard the quality of the data presented by Bloomberg as a reputable worldwide financial institution. While the extrapolated Bloomberg approach is no longer being produced, Anglo American notes that it is being replaced by the BVAL data series and although this has not yet been applied in a regulatory context, the QCA should not shy away from being the first regulator to do so.

Anglo American notes that the QCA has already suggested that it will adopt that approach in the future, specifically that it "will continue to use the Bloomberg or similar approaches (e.g. the new BVAL data series in future) as a 'cross-check' to the econometric approach".[17] Anglo American believes that if the QCA is intending to use this method in the future, it should begin applying it now with the still current information from the extrapolated Bloomberg approach. Anglo American recommends analysing both approaches to determine which is the more accurate, or potentially weighting the approaches to ensure that the most accurate average is produced.

Anglo American notes that if the current data presented to the QCA is averaged, the debt risk premium results in a figure of 2.615%, extremely similar to the 2.6% proposed by the QRC. While the QCA noted that its recommended 2.72% is only a relatively small amount higher than the QRC's suggestion, Anglo American does not believe that the QCA should be applying a "near enough" approach, particularly given the relative value of the Regulated Asset Base to which it is applied. Rather, Anglo American believes that the QCA should be

[17] Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 220.

considering all of the reliable data that is presented to it and focusing on what is likely to be the most accurate result. Here, Anglo American believes that the most accurate result is likely to be that which takes into account the best and broadest range of information available to the QCA, which Anglo American submits is an average of the two methods.

As such, Anglo American submits that the QCA should revise its cost of debt estimate to 2.62% in light of the average calculation of the two reputable methods that the QCA's advisors have used to determine the appropriate cost of debt figure.

3.4 Market risk premium

Anglo American has, both previously and elsewhere in this submission, commented on the number of risk reducing measures that Aurizon Network already has within the Access Undertaking. Further, through its submissions on UT4 and UT4.2 Aurizon Network has sought to increase its regulatory protection from any of the risks that the industry currently faces.

In contrast to this risk averse approach to its regulation, Aurizon Network has nevertheless sought an overall increase in its market risk premium. Anglo American does not believe that this is appropriate. To do so also presumes that the UT3 market risk premium is an acceptable starting point which is a flawed assumption.

Anglo American has previously made extensive submissions in relation to setting the market risk premium for Aurizon Network.[18] Anglo American continues to support the arguments that it raised in that submission, and asks the QCA to revisit Anglo American's detailed comments.

In relation to the Draft Decision, Anglo American specifically notes that while the QCA has previously noted that the data in three of the four alternative market risk premium estimation methods that it relies upon is "biased upward", the QCA has continued to rely on that information. Further, even though the QCA noted that the Cornell method is "unequivocally biased upward", the QCA has continued to rely on this method to determine the market risk premium of 6.5% that it has suggested in the Draft Decision.[19] Anglo American urges the QCA to take greater account of the bias in these estimation methods. As Anglo American has already noted, rather than the QCA's suggested average of 6.5%, Anglo American believes that once the bias is removed the market risk premium average is closer to 5.8%.

[18] Anglo American, *Submission to the Queensland Competition Authority: Anglo American submission in relation to the WACC consultation papers and WACC forum* (January 2014) 5.
[19] Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 237.

With the application of data from foreign markets that Anglo American outlined in its previous submission, Anglo American continues to submit to the QCA that Aurizon Network's market risk premium should not be increased to 6.5%, but rather that a more accurate estimation of the market risk premium figure lies somewhere between 5.0% and 6.0%. Considering the data available to Anglo American, and to the QCA from its own reports on this point, Anglo American believes that an appropriate market risk premium figure sits around 5.8% - 5.9%. Again, a material impact given the value of the Regulated Asset Base.

3.5 Calculation of the asset beta

Anglo American does not agree with the approach and therefore the findings of Incenta, nor therefore the findings of the QCA, in relation to the asset beta figures applied to Aurizon Network.[20] Anglo American reiterates its concerns that Incenta's approach incorrectly simplified the categorisation of benchmarks and, therefore, that the QCA's question in relation to risk reduction mechanisms was not appropriately answered.

Further, Anglo American disagrees with the QCA's decision to set the asset beta at 0.45, toward the higher end of the spectrum identified by Incenta. In particular, Anglo American notes that while the QCA has acknowledged which benchmarks set those upper and lower bounds (specifically, toll-roads at 0.49 and DBCT at 0.35), it has not appropriately compared Aurizon Network's profile. Aurizon Network's very business nature, specifically as a revenue-assured with little to no volume risk and full Take-or-Pay contracted tonnage, is significantly closer to the profile of DBCT than it is to the volatile profile accepted by toll-road owners and operators. Further, where toll-road owners and operators face some level of competition within their respective markets (including some level of substitutability from public roads), Aurizon Network has a completely monopolistic captured market. There is a major difference in the profiles of these businesses and Anglo American submits that the consideration of Australian toll-roads in Incenta's analysis is inappropriate and has created an upward bias in the data, leading to an incorrect upper bound of 0.49.

As such, Anglo American questions why the QCA has made the decision to set Aurizon Network's asset beta at the higher end of the spectrum near benchmarked entities that bear extremely limited similarities with Aurizon Network's business model, rather than at the lower end where the benchmark entity has an almost identical (if somewhat still higher) risk profile than Aurizon Network.

[20] In particular, those considered in Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 251-253.

Once again, Anglo American supports the statements made by both the QRC's economic expert, Castalia, and Anglo American's previously consulted economic expert, Economic Insights. This leads Anglo American to submit that the appropriate asset beta for Aurizon Network is much lower than the Draft Decision, closer to a range of 0.2 - 0.3.

3.6 Estimating gamma

Anglo American broadly supports the QCA's finding that the gamma distribution rate should equal 0.84.[21] This almost mirrors the earlier findings of the QCA's economic expert, Dr Lally, on this point. Anglo American believes that the gamma should, in truth, be set at the 0.85 rate proposed by Dr Lally. In particular, Anglo American notes that Aurizon Network's consultant, SFG Consulting, took issue with the factor that Dr Lally's original research only considered large companies to determine the distribution rate, however, Anglo American notes that Aurizon Network (and the broader Aurizon Holdings Group which can make use of imputation credits) is itself a large Australian company, with interests in many states of Australia as well as offshore. Anglo American sees no reason to reassess the data for smaller companies when that would not, in any way, replicate Aurizon Network's ability to use imputation credits. As such, Anglo American believes that the QCA should raise the distribution rate back to 0.85.

In relation to the utilisation rate, Anglo American does not support the QCA's disregard of the findings outlined by its own economic expert on this point, Dr Lally. Anglo American has previously analysed Dr Lally's findings in relation to the utilisation rate and reiterates its support for his methodology.[22] Anglo American believes that Dr Lally's consideration is the only one that appropriately aligns with the definition of utilisation. Anglo American reiterates its argument that the counter analysis proposed by SFG Consulting seeks the benefit of "cherry picking" parameters that actually fail and are deficient when applied to the approved model, as they simply seek an artificial lowering of the gamma.

As such, Anglo American believes that the QCA's finding of a utilisation rate of 0.56 is incorrect and that a figure closer to Dr Lally's recommendation of 1.0 is more appropriate. Anglo American submits that this appropriate analysis should lead to a final gamma closer to 0.85, significantly higher than the 0.47 proposed in the Draft Decision.

[21] Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 261.
[22] See Anglo American, *Submission to the Queensland Competition Authority: Anglo American submission in relation to the WACC consultation papers and WACC forum* (January 2014) 10-11.

3.7 Factors "slightly higher" than average

Anglo American notes that the QCA has accepted a number of elements of the WACC building blocks based purely on the fact that those elements are only "slightly higher" than estimates or QRC expert reports. Anglo American does not agree with this approach, but rather submits that the QCA should be making its decisions based on the best and most accurate figures available to it at that point in time. While these figures might only be extremely small aspects of the WACC, magnified over the millions of tonnes of coal haulage and significant Regulated Asset Base that will be affected by the final Maximum Allowable Revenue decision these slight variations can be equal to millions of dollars of excess charges that coal companies (who are already investing in major cost saving measures) will be forced to pay over the next five years.

By way of example, Anglo American notes that:

(a) the proposed debt risk premium of 2.72% was seen as only a "relatively small amount higher than the QRC's proposal of 2.6%",[23] even though 2.6% was closer to the average of all reliable data available;

(b) a conservative upwards rounding of the applicable asset and equity betas of Aurizon Network, even though "future consideration of the betas for Aurizon Network may well lead to further reductions";[24] and

(c) the QCA has accepted an artificially lessened gamma distribution rate of 0.84 by taking account of small firms that should not have been included in the QCA's analysis. Anglo American believes that this rate should be returned to 0.85 to reflect Aurizon Network's true size and structure.

3.8 Final calculation of the WACC

Because of all the factors considered above, Anglo American submits that the 7.17% WACC proposed by the QCA in the Draft Decision remains too high.

As it has previously submitted, Anglo American continues to support the calculations of the QRC as the upper bound of appropriate WACC figures (ie, the QRC's submission of a WACC of 5.65%). Anglo American believes that, when properly considering the numerous measures that protect Aurizon Network from any kind of risk, the lower bound of the appropriate WACC figures could be as low as 5.00%.

[23] Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 220.
[24] Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 253.

As such, Anglo American believes that the QCA should reconsider a number of the building blocks used to calculate the Aurizon Network WACC for UT4.2.

4. Decision regarding operating costs

4.1 The operating cost allowance

Anglo American notes that the QCA has made a significant reduction in relation to the operating cost allowance proposed for UT4. While Anglo American acknowledges that the Draft Decision reflects the more appropriate utilisation of costs by Aurizon Network, unfortunately, however, Anglo American believes that the operating costs proposed under UT4, including the proposed recovery mechanisms and allocations, lack the transparency that is required for an appropriate cost pass through mechanism.

Ensuring that only appropriate operating costs are passed through to users is a major issue for the economic regulation of natural monopolies. Importantly, while monopoly pricing is the most well known and protected behaviour caused by a natural monopoly, internal inefficiency can have a much more silent and yet damaging effect.[25] This is because:

(a) it is far less likely that users will have transparent oversight of the internal cost allocation and management processes, unlike monopoly pricing which can usually be benchmarked or compared to similar firms; and

(b) while monopoly pricing is detrimental, it does not necessarily involve waste or mismanagement. Internal inefficiency on the other hand directly diverts funds from productive activities of the firms which benefit society as a whole, and only generates wastage.[26]

This impact of internal inefficiency is also magnified where the natural monopoly is vertically integrated, as the natural monopolist then has interests other than profit maximisation for its own business, and could be acting to effect an impact on other markets which is otherwise beneficial for the group as a whole.

While Anglo American believes that there are specific areas already less efficient than should be that are rewarded under a direct cost pass through mechanism to users, it also believes that there are significant operating cost areas where users and train operators have extremely limited oversight regarding the costs claimed by Aurizon Network resulting in an inability to determine whether the CQCN is operating as efficiently as befits Queensland's major export industry.

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[25] Richard A Posner, *Natural Monopoly and its Regulation* (Cato Institute, 1999) 35-36.
[26] See the comments on the detrimental impacts of internal inefficiency considered in depth in Richard A Posner, *Natural Monopoly and its Regulation* (Cato Institute, 1999) 36.

Anglo American has previously made extensive submissions regarding the Cost Allocation Manual. Anglo American continues to be of the opinion that a cost allocation manual is required under UT4; indeed, a cost allocation manual is more essential as Aurizon Network continues its drive towards vertical integration. It is an accepted concept that vertically integrated natural monopolies are incentivised to shift costs from related entities to the natural monopoly which is able to recoup those losses through either monopolistic pricing, or in a regulated industry through cost pass through mechanisms like the operating cost mechanism under UT4. While this is natural behaviour for a natural monopoly, the outcome of that cost shifting is only to undermine the effect of regulation in the first place, as it has the indirect effect of reducing competition in upstream and downstream markets where those related entities bear far fewer costs than their non vertically integrated counterparts.

Anglo American also notes that the QCA Draft Decision focusses significantly on an increase in corporate overheads. While not all services are shared (for obvious reasons) between the Aurizon Group entities, Anglo American is significantly concerned that corporate overheads are an area where inappropriate cost allocation has the potential to occur. This is because a number of entities can all use very similar support, back office and technology services: costs which are otherwise born by the entity receiving services, which occurs for competitors in upstream and downstream markets. While Anglo American does not believe that the Aurizon Group should lose the benefit of the economies of scale caused by its vertically integrated (but regulated separate) structure, it does believe that users should not be required to subsidise the broader costs of the Aurizon Group, specifically where other Aurizon Group entities are direct competitors with users and train operators.

4.2 Insurance and self-insurance

Anglo American understands that Aurizon Network maintains premium insurance on key strategic assets throughout the CQCN, however, operates using self-insurance and cost-pass through to users for a number of force majeure events. Anglo American does not believe that self-insurance and cost pass through are both appropriate mechanisms, at least not in the manner that has currently been proposed by Aurizon Network.

As currently structured, Anglo American understands that Aurizon Network's proposal is for users to pay between $5 million and $7 million a year over the course of UT4. Anglo American notes that there is no information on whether this money will be returned to customers if it is not utilised by Aurizon Network, or whether unutilised money is put towards Aurizon Network's self-insurance costs for the next year (and so the self-insurance figure would decrease for that year). Further, Anglo American notes that there is no mechanism in place for users or the QCA to hold Aurizon Network to account for how these "self insurance" funds are held or invested, including whether Aurizon Network makes profit of those funds.

One possibility that Anglo American has taken from Aurizon Network's self-insurance structure is that it is designed to operate as a form of sinking fund. If this structure is intended to operate as a sinking fund, Anglo American does not necessarily dispute that concept, however, that is not how Aurizon Network has presented it. A sinking fund would allow Aurizon Network to have easy access to usable capital in the eventuality of a force majeure event, however, would need to be applied as a discount to any Review Event claim that Aurizon Network made on the CQCN. Further, Anglo American notes that any cost escalation that Aurizon Network usually applies to costs (such as the currently disputed WACC escalation of the 2013 Review Event costs, or as Anglo American believes is more appropriate a holding rate or CPI escalation) would be inappropriate as:

(a) Aurizon Network would bear no risk on the maintenance activities as the money would already be available to it through the self-insurance mechanism; and

(b) Aurizon Network would be able to complete maintenance activities out of the users' money, without needing to outlay any of its own funds.

If this is not the purpose of the self-insurance payment, then Anglo American does not understand what it is for, nor does it believe that it is appropriate.

In light of the uncertainty that Aurizon Network's self-insurance provisions create, Anglo American believes that the self-insurance component should be removed from UT4 altogether. The structure of the Access Undertaking already self-insures Aurizon Network through the Review Event process. Aurizon Network is entitled to reclaim the entire reasonable and prudent costs of repairing the CQCN after any force majeure and bears no risk on this aspect of its network. While the regulatory process allows for recovery two years later, Anglo American acknowledges that it is appropriate for Aurizon Network to escalate its costs at the appropriate holding rate in order to recover the full value of its expenses. If Aurizon Network has this mechanism to protect its interests, Anglo American does not understand why Aurizon Network should also be entitled to self-insurance costs which are likely to simply become a double-recovery mechanism.

Anglo American believes that not only is the form of self-insurance proposed by Aurizon Network inappropriate, it is also likely to lead to Aurizon Network double recovering the costs of force majeure events, while users will have no ability to challenge that double recovery. Anglo American disagrees with the QCA's decision to approve Aurizon Network's proposed insurance and self-insurance costs as they currently stand.

4.3 Subsidy of other arms of the Aurizon Group

Aurizon Network remains well sheltered from the major impacts on the coal market by both its revenue cap and the existing long-term Take-or-Pay contracts that are in place. Therefore, while ensuring adequate return on capital for the purpose of returning investments to shareholders is an important consideration, it should bear little weight in relation to Aurizon Network as its revenue stream is secure, defined and continuing.

It is noted that the broader Aurizon Group, has pursued forays into other markets, including the mining investment and West Coast rail markets. Anglo American does not believe that these venture capitalist actions of the Aurizon Group should be unfairly subsidised by users of the CQCN.

While it is broadly understood that any firm will be exposed to profit pressure by its nominal owners (the shareholders) the effects of this pressure should be considered and studied in relation to a firm regulated due to its natural monopoly position.[27] Specifically, while a natural monopoly may suffer pressure from shareholders to maximise profits, it cannot resort to maximising those profits by exploiting its natural monopoly; nor would effective regulation allow this to occur.

Specifically in relation to Aurizon Network, and its interests in the CQCN, Anglo American acknowledges that ensuring that shareholders are able to receive an appropriate return on investment is an important concern, however, submits that the natural monopoly held in the CQCN is already an assured revenue stream and should not be used to inappropriately fund speculative investments by the Aurizon Group elsewhere in the country.

A key element of the QCA approving a Draft Access Undertaking is that it be in the public interest; importantly including the public interest in having competition in markets.[28] Allowing the cross-subsidy (through user reimbursement of back office costs and corporate overheads) of other entities within the Aurizon Group operates completely contrary to this principle, as it undermines the effective competition that already exists in markets upstream and downstream from Aurizon Network's natural monopoly. This is further supported by the pricing principles that the QCA must consider, specifically that the terms or conditions of access should not allow the incumbent to discriminate in favour of its downstream operations.[29] Anglo American submits that this should rightly exclude indirect discrimination that reduces the costs that downstream operators would otherwise be required to bear.

[27] Richard A Posner, *Natural Monopoly and its Regulation* (Cato Institute, 1999) 8.
[28] *Queensland Competition Authority Act 1997* (Qld) s 138(2)(d).
[29] *Queensland Competition Authority Act 1997* (Qld) s 168A(c).

Further, where possible any overheads should relate directly to the running of the Aurizon Network business.

Anglo American notes the QCA's comments regarding incentivising Aurizon Network to incur costs efficiently by not permitting it to recover more than its efficient costs and return on investment.[30] More importantly, however, Anglo American believes that the QCA should ensure that it imposes its further recommendations in relation to "preventing Aurizon Network from recovering, via the access price, costs that are not reasonably attributable to the provision of the service."[31] Anglo American believes that this includes ensuring that Aurizon Network, and the broader Aurizon Group, cannot shift costs between its various Related Bodies Corporate and recover costs that should otherwise be paid for by an entity in a competitive market via an Access Charge levied on CQCN users. Anglo American notes that this is again another strong reason for the implementation of a transparent and effective Cost Allocation Manual.

Anglo American strongly supports the sentiments expressed by the QCA in its Draft Decision that UT4 "must include provisions for preventing Aurizon Network from recovering, via the access price, costs that are not reasonably attributable to the provision of the service."[32] Anglo American does not believe, however, that the QCA's draft analysis is correct, particularly in relation to the major increase in Aurizon Network's corporate overhead costs, numerous of which are undoubtedly shared with other Aurizon Group entities.

4.4 Electric assets

Anglo American notes that Aurizon Network, and subsequently the QCA, has noted that the increase in the proposed transmission connection charges is due to the negotiation of higher connection charges with Powerlink. Anglo American does not understand why some connection charges have been claimed as regulated, while others have been claimed as commercially negotiated (including those charges that have caused an overall increase of the proposed transmission charges for the UT4 period, to a level over double that at the commencement of UT3). In any instance where Aurizon Network should be receiving regulated charges and it has accepted commercially negotiated connection charges which are higher than the regulated ones, Anglo American believes that the costs passed through to users should be capped at the regulated rates.

[30] Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 27.
[31] Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 27.
[32] Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 46.

4.5 The "stand-alone business" model

As stated above, Anglo American agrees with the QCA's consideration of the pricing principles and criteria contained in the Act. In saying that, Anglo American does not necessarily agree with the approach that the QCA has applied in order to determine Aurizon Network's efficient operating costs for the purposes of the pricing principles.

In particular, Anglo American is concerned with the application of the "stand-alone business" concept.[33] While it does create a useful benchmark, Anglo American does not believe that Aurizon Network's position within, and the benefits derived from, the broader Aurizon Group can be ignored, meaning that the application of the "stand-alone business" concept adds only small worth to the determination of Aurizon Network's actual operating expenditure. Importantly, Anglo American notes that the QCA has made a draft recommendation not to accept Aurizon Network's "stand-alone business" analysis in relation to its corporate overhead costs;[34] a draft recommendation that Anglo American strongly supports as no aspect of the Aurizon Holdings business can be considered as being truly "stand-alone". Anglo American believes that if it is inappropriate to consider Aurizon Network's stand-alone approach as legitimate in relation to corporate overheads, it is similarly inappropriate to benchmark Aurizon Network as a stand-alone business for the purposes of assessing operating costs.

Anglo American notes that in its UT4 submissions Aurizon Network indicated a loss of economies of scale in a number of areas.[35] While Anglo American notes that the separation from Queensland Rail would have reduced the massive scale that the broader QR Group held, it would not have drastically reduced the economies of scale available to the Aurizon Group and, therefore, Aurizon Network. With around 2,670 kilometres of track in the CQCN alone, the reduction in economies of scale is a matter of perspective.

As such, Anglo American submits that any implications or benchmarking drawn from the application of a "stand-alone business" concept should be carefully utilised by the QCA in determining the appropriate operating costs of Aurizon Network because of its high level of corporate and business vertical integration.

4.6 Actual versus forecast efficient costs

Anglo American agrees with the QCA's draft determination regarding using properly considered forecast efficient costs as a baseline for determining UT4 costs. Relying on the

[33] Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 48-49.
[34] Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 73.
[35] This was also considered by the QCA in Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 49.

previous years of actual costs only results in entrenching previously inefficient behaviour and does not provide a reasonable standard for Aurizon Network to strive to achieve in the efficient operation of its business. Further, it is a standard concept of natural monopoly regulation that a business should become more efficient over time, meaning that forecast estimates should take into account the growing efficiencies within Aurizon Network, rather than simply relying on the previous actual costs which are more than likely to be superseded with both technological and process-driven improvements to the business.

4.7 Advertising and branding costs

Anglo American also notes that in UT4 Aurizon Network has requested almost $8 million of corporate overhead costs for expenses relating to "enterprise strategy and branding". Anglo American does not believe that Aurizon Network has provided adequate detail in its submission to establish what costs are actually covered by or included in the "enterprise strategy and branding" section and believes that more detail should be provided so that stakeholders are able to determine the appropriateness of these costs or establish a reasonable basis to claim costs for a monopoly business.

On a more detailed review, Anglo American notes that the $1.8 million in "enterprise strategy and branding" costs that Aurizon Network claimed for the 2013/14 period is even $700,000 more than the rail company that Aurizon Network benchmarked its costs against.[36] While Aurizon Network provided some further analysis of why its costs were greater or lesser than the benchmark used for a number of other categories of corporate overhead costs, it provided no analysis for the extra costing in this particular subcategory.

While Anglo American wishes to see further detailed information on what Aurizon Network has actually included in its assessment of "enterprise strategy and branding", Anglo American submits that any costs related to the advertising or branding of Aurizon Network should not be included as aspects of corporate overhead costs. Anglo American notes that regulatory precedent has changed over the years to determine that costs such as advertisements that are intended to promote company image and charitable contributions for the purpose of company goodwill are not in the ambit of allowable costs.[37] This has been an established concept for a number of decades, based on the reasoning that advertising is specifically for the benefits of the shareholders of the corporate entity (here, the shareholders of Aurizon Network) and does

[36] Aurizon Network, *2013 Draft Access Undertaking Explanatory Materials Volume 3: Maximum Allowable Revenue and Reference Tariffs* (30 April 2013) 234.
[37] Commonwealth Treasury, *Price Regulation of Utilities* (16 April 2012) 62, available at <http://archive.treasury.gov.au/documents/194/PDF/round5.pdf>.

not do anything to benefit the ratepaying users of the regulated asset.[38] Further, there are limited instances in which a natural monopoly is actually required to advertise as, by virtue of its monopolistic economic position, it will receive customers for its services.

As such, Anglo American believes that it is inappropriate for Aurizon Network to claim any kind of corporate advertising, branding or goodwill payments as part of its regulated allowable costs, and Anglo American questions whether any of these costs are included in the undefined scope of "enterprise strategy and branding".

4.8 The cost of preparing the Access Undertaking

Anglo American notes that the QCA has significantly reduced the costs that Aurizon Network has previously claimed in relation to the preparation of the next Access Undertaking. Anglo American supports this reduction in costs, as it believes that the initial submission by Aurizon Network ($4.5 million) was far higher than was actually necessary.

In saying that, Anglo American supports the QRC comments in relation to ensuring that Aurizon Network does not use the allowable costs for preparing the next Access Undertaking for:

(a) double-dipping, especially as Anglo American notes that a number of Aurizon Network internal staff (whose salaries would already be reimbursed to Aurizon Network under staffing costs in the MAR) would not also need to be included in the calculation of the corporate overheads for the preparation of the next Access Undertaking; or

(b) inefficient purposes, including commissioning lengthy expert reports which nevertheless reach stakeholders and the QCA in heavily redacted formats so that the benefit that users have already paid for is lost. Anglo American agrees with the QRC in relation to the numerous expert reports that Aurizon Network commissioned for the development of UT4: namely, that none could be considered as independent because of Aurizon Network's involvement, and that the majority of the data and information considered in those reports lost relevance for stakeholders (as well as for the QCA) because of the restriction on the information that actually reached stakeholders.

Anglo American would much rather see the diversion of these costs to the QCA for the commissioning of independent reports which would reflect an appropriate application of the

[38] Michael Meyer, "Advertising by Public Utilities as an Allowable Expense for Ratemaking: Assault on Management Prerogative" (1978) 13(1) *Valparaiso University Law Review* 87, 115, citing a number of decisions by United States regulators disallowing advertising and goodwill costs as part of the regulated allowable costs.

millions of dollars that users are otherwise forced to direct to Aurizon Network for the preparation of the Access Undertaking.

As such, Anglo American is of the opinion that there are still more costs which can be extracted from the $3 million of corporate overheads in the MAR directed toward the development of the next Access Undertaking to reflect the fact that Aurizon Network staff are already reimbursed elsewhere in the MAR, and to ensure that Aurizon Network does not engage on inappropriate commissioning of numerous expert reports with limited use to stakeholders.

4.9 CPI - X

Anglo American notes the submissions made by the QRC in relation to Aurizon Network's market context, specifically:

(a) Aurizon Network is not impacted by any claimed exposure to coal markets as it is protected by its revenue cap regulation; and

(b) Aurizon Network is not exposed to any "market discipline" that would encourage it to focus on efficient costs or efficient utilisation of assets.[39]

Further, Anglo American notes that even though Aurizon Network has none of the efficiency incentives that coal producers are suffering, and bearing, on behalf of Aurizon Network, there is no allowance for the efficiency objectives that Aurizon Network is certain to achieve over the course of UT4. While Anglo American believes these efficiency gains should be reflected in the MAR, it also believes that the operating and maintenance costs should be subject to a CPI-X efficiency escalation as suggested by the QRC.

While Anglo American supports the concept that a regulated entity that improves its operating efficiency should be entitled to the benefit of those gains, it believes that this concept is dependant upon the form of regulation being applied. Anglo American believes that the efficiency principles and incentives should apply as follows:

(a) where an entity is subject to a price cap form of regulation, efficiency gains result in greater system throughput and therefore greater profit for the company. As such, there is a clear efficiency incentive for the regulated entity to ensure that it is improving its best practices for the benefit of users; however

(b) where an entity is subject to a revenue cap form of regulation, the system throughput does not directly relate to the return that the entity receives from its regulated asset:

[39] Queensland Resources Council, *Submission to the QCA: Aurizon Network 2014 Draft Access Undertaking Maximum Allowable Revenue* (December 2014).

where it improves the efficiency of the network its revenue neither increases nor decreases. As such, there is no efficiency incentive and that lack of incentive is felt by users, rather than the regulated entity itself. As such, an entity subject to revenue cap regulation should also be subject to a CPI-X form of escalation. This creates an artificial efficiency incentive and ensures that the regulated entity is economically focused on ensuring the efficiency of its network in order to take advantage of the CPI escalation.

As such, Anglo American believes that the QCA should apply a CPI-X approach to escalating Aurizon Network's operating and maintenance costs over the period of UT4 to ensure that Aurizon Network is appropriately incentivised to pursue efficiency gains that resource companies and the broader mining sector are desperately in need of.

5. Costs related to train control

Anglo American notes the comments made by the QCA and its expert, SKM, in the Draft Decision regarding the costs related to train control and related services on the CQCN.[40] Anglo American agrees it is a reasonable approach in the circumstances to benchmark, where appropriate, the operation of the CQCN against the Hunter Valley Coal Network as, although there are significant differences in scope and geographical characteristics of the two networks, it is, in the absence of any other, the closest option for benchmarking a major coal chain network within Australia and shares various similarities.

In relation to the cost of train control and related services, Anglo American notes the findings that the CQCN experiences significantly higher costs per train path (indeed, from SKM's figures almost double the cost per train path) than the Hunter Valley Coal Network. While Anglo American does not submit that Aurizon Network's train control costs should be as low as those on the Hunter Valley Coal Network because of the significant differences between the networks, it does submit that the costs of the two should be a lot closer than they currently are.

Anglo American believes that a significant portion of Aurizon Network's inflated costs can be directly linked to the scheduling of the CQCN, not purely in relation to rail operation but also for whole of supply chain co-ordination.

Anglo American has previously made a number of submissions regarding the possibility of centralised co-ordination for the Queensland coal chain.[41] Most recently in its submission to

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[40] In particular see Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 52.

[41] See Anglo American, *Submission to the Queensland Competition Authority: Aurizon Network's 2014 Draft Access Undertaking (UT4.2)* (3 October 2014) 60; Anglo American, *Submission to the QCA re: Queensland Competition Authority*

the QCA on UT4.2 Anglo American noted the benefits that a transparent and independent central co-ordinator can bring to a supply chain, specifically in reducing train path timing and increasing the overall efficiency of a network. In that submission, Anglo American specifically considered the Hunter Valley Coal Chain Co-ordinator (**HVCCC**) as an excellent example of how independent, transparent central co-ordination can significantly improve the functioning of a supply chain, the Hunter Valley Coal Chain has doubled export volumes in the last 7 years.

Anglo American notes that this issue has also been addressed by other major industry participants. Importantly, in its submission to the QCA regarding UT4.2 the Queensland Government Department of State Development, Infrastructure and Planning (**DSDIP**) made extensive comments on the virtues of centralised co-ordination.[42] Quoting the Queensland Government's *InfrastructureQ Directions Statement* from September 2014, DSDIP noted that:

> …[s]upply chains compete globally, not just individually as mines railways and ports. Better supply chain integration and coordination can uplift infrastructure utilisation, making Queensland more competitive globally, and more attractive to industry. This has the potential to bring major economic gains to Queensland.

Anglo American strongly supports the view of DSDIP that centralised co-ordination has the possibility to bring extensive gains to Queensland and Queenslanders, especially by ensuring that the supply chain is as efficient as possible and there is limited wastage which could otherwise go to Queensland companies and Queensland investments.

By promoting independent and transparent centralised co-ordination akin to the HVCCC, Anglo American believes that there could be significant improvements via improved throughput contributing to reduced cost per train path figures for Aurizon Network (remembering that at present these figures are double that paid by users on the Hunter Valley Coal Network competing with the CQCN). While Anglo American understands that the QCA is required to consider Aurizon Network's position regarding train control and related costs, Anglo American does not believe that the QCA should do this in a vacuum, removed from the other aspects of the Access Undertaking that could otherwise improve the throughput, efficiency and productivity of the Queensland coal network. Importantly, if independent and transparent centralised co-ordination has the ability to reduce the cost per train path on the

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Pricing Papers (July 2013) 10; Anglo American, *Submission to the Productivity Commission re: Review of the National Access Regime* (18 April 2013) 8; Anglo American, *Submission to the Productivity Commission re: Review of the National Access Regime in light of the Draft Report* (July 2013); Anglo American, *Submission to the QCA re: Aurizon Network's 2013 Draft Amending Access Undertaking (UT4)* (October 2014) 20; Anglo American, *Submission to the QCA re: Aurizon Network's Reply Submission on the 2013 Draft Access Undertaking (UT4)* (January 2014) 17; Anglo American, *Submission to the ACCC re: Application for Interim Authorisation of DBCT Coal Chain Coordinator* (March 2014).

[42] Queensland Government Department of State Development, Infrastructure and Planning, *Aurizon Network's draft 2014 Access Undertaking (UT4)* (13 October 2014) 2.

CQCN, Anglo American believes that this is a key factor that the QCA should be considering for the UT4.2 pricing principles, indeed as directed by section 168A(d) of the Act that "pricing principles in relation to the price of access to a service are that the price should… provide incentives to reduce costs or otherwise improve productivity."

As such, Anglo American believes that while Aurizon Network's train control and related costs should be assessed for efficiency within the current structure of the supply chain, the QCA should also consider further options for greatly improving the potential efficiency of the CQCN.

6. Corporate overhead costs

6.1 Duplication of costs

Anglo American shares the QCA's and RSMBC's concerns in relation to the duplication of corporate overhead costs. In particular, Anglo American supports the QCA's draft decision to reject Aurizon Network's proposed corporate overhead costs due to duplication in:

(a) the costs associated with the directors and Board of Aurizon Network (or triplication as it is in this instance);

(b) legal services attributed solely to the regulated aspects of Aurizon Network's operations, completely ignoring the unregulated services that Aurizon Network provides;

(c) finance and back-office services which are provided for in a number of instances, as well as being necessary to service the broader Aurizon Holdings Group (and potentially resulting in the subsidy of other arms of Aurizon Holdings);

(d) cross-over between regional, System-specific and Network-specific costs resulting in layers of inappropriately duplicated costs; and

(e) a large portion of the costs associated with Aurizon Network's position in the broader Aurizon Holdings group of companies.

Anglo American notes that part of its concern in relation to these costs is directly due to the lack of transparency surrounding Aurizon Network's submission on its relevant corporate overhead costs. Without providing industry and the QCA with further information regarding its corporate overhead cost allocation, potentially through amending and reissuing its Cost Allocation Manual, Anglo American does not believe that it will be properly satisfied that there is little to no duplication of costs and only the prudent expenditure of an efficient and cost-effective business.

7. Potential for developments to regulation post UT4

Anglo American notes that the QCA specifically stated that it is "considering scope for a more robust baseline and measurement system" post UT4.[43] Anglo American strongly supports this continuing consideration, especially where that consideration relates to the concepts that the QCA has already canvassed and addressed in its *Statement of Regulatory Pricing Principles*.[44]

Further to just the operating and maintenance costs of the Aurizon Network business, however, Anglo American believes that the QCA should be giving extensive consideration to the form of regulation used on the CQCN. Specifically, Anglo American believes that this should include a consideration of whether Aurizon Network is regulated under the existing revenue cap form of regulation, or whether it returns to the original price cap method.

Anglo American has previously made extensive submissions regarding the form of regulation applied to the CQCN. Most notably, Anglo American's comments regarding the QCA Pricing Papers made extensive suggestions in relation to this topic.

Anglo American believes that the major concern is whether Aurizon Network is appropriately incentivised to provide services under the existing access regulation, and further where Aurizon Network is incentivised whether that is appropriately directed. Anglo American believes that there should be a clear focus on delivering capacity when and where the Queensland coal market requires that capacity, as well as maximising the overall delivery of the contracted capacity of the CQCN.

8. Socialisation of pricing for Expansions

Anglo American has previously made extensive submissions in relation to socialisation of costs. Generally, Anglo American relies on those previous submissions to outline the appropriate instances where it believes socialisation of costs is acceptable.[45]

In particular, however, Anglo American wishes to comment on submissions made by a number of other miners in relation to the socialisation of Expansion costs for the Wiggins Island Rail Project (**WIRP**).[46] Anglo American notes the number of instances cited by Vale in particular which, if the socialisation of the WIRP assets is completed, subsequently act to

[43] Queensland Competition Authority, *Draft Decision: Aurizon Network 2014 Draft Access Undertaking - Maximum Allowable Revenue* (September 2014) 27.
[44] Queensland Competition Authority, *Statement of Regulatory Pricing Principles* (August 2013).
[45] See Anglo American, *Submission to the Queensland Competition Authority: Aurizon Network's 2014 Draft Access Undertaking (UT4.2)* (3 October 2014) 36-37.
[46] Including the submissions made by BMA, Vale and Glencore in relation to UT4.2 (Glencore notes that it intends to make further submissions on this point in its submissions on the QCA's Draft Decision in relation to Aurizon Network's Maximum Allowable Revenue).

significantly reduce Aurizon Network's exposure and accepted risk (but which have not been accounted for when determining the appropriate figure to be socialised), including:[47]

(a) reducing Aurizon Network's credit risk and exposure to junior miners' lack of market capital as that is now underwritten by the entire user base of the Blackwater and Moura Systems;

(b) removing Aurizon Network's optimisation risk as the cost will already be rolled into the RAB;

(c) removing Aurizon Network's asset stranding risk for the same reason (particularly in relation to all upgrades and developments on mainline track as these are already going to be utilised by existing users); and

(d) minimal, if any, construction or finance risk once these assets are rolled into the RAB due to the various mechanisms that protect Aurizon Network generally under the Access Undertaking.

Further, as it was not part of the initial negotiations regarding the WIRP risks and costs, Anglo American and a number of other users have no oversight of the additional risks that Aurizon Network was initially rewarded for or the prudency of the costs incurred by Aurizon Network in building WIRP, however, are now being asked to comment on whether Aurizon Network should be able to socialise those costs to recover them from all users. Anglo American does not believe that this is a transparent process allowing users to determine the efficiency or prudency of Aurizon Network's actions, which those users are nevertheless being asked to pay for.

This process also raises significant questions in relation to the determination of volume forecasts by Aurizon Network. In determining the return for users through socialising the WIRP costs, Aurizon Network has used a figure of 90% utilisation. Anglo American, along with other miners who have previously submitted on this issue, does not agree that 90% utilisation is a realistic figure.

Importantly, Aurizon Network's current approach to WIRP cannot become the norm for Expansions that do not reach completion, or which are subsequently socialised into the RAB. Where Aurizon Network has sought and received benefits or additions to the return that it would have received under the regulated environment, those additional benefits should not be permitted to be rolled back into the RAB where Aurizon Network bears significantly lower

[47] As considered by Vale in Vale, *Aurizon Network's 2014 Draft Access Undertaking (UT4)* (3 October 2014).

risk than on the Expansion alone and to be paid for by users that did not agree or accept the additional conditions imposed by Aurizon Network.

To the extent that the cost of any Expansion, in this instance WIRP, is rolled into the RAB and socialised amongst existing users (not Expansion users), Anglo American believes that it is essential to ensure that Aurizon Network is not subsequently rewarded for risks that it does not bear. This means that in any instance where Aurizon Network proposes to roll all or part of the costs of a specific Expansion into the RAB, the QCA (or the QCA's appointed expert) should be involved in determining the prudency of the costs, as well as whether socialisation of those costs will impact on the risk that Aurizon Network is being rewarded for. It is Anglo American's firm belief that socialisation of costs will almost always impact upon the risk accepted.

9. A general lack of information

Anglo American notes that a major concern that is consistently presented by individual stakeholders, rail operators, the QRC and, at times, even the QCA is the lack of information provided by Aurizon Network in almost all of its submissions to the QCA. This lack of information constantly renders stakeholders unable to present a detailed argument either for or against Aurizon Network's submissions, and generally leads to lengthier decision-making times as users refuse to support Aurizon Network findings because of the lack of relevant information provided. Anglo American believes that this not only undermines the regulatory consultation process, but it also increases the professional advisory costs that stakeholders are required to refund Aurizon Network for in relation to the regulatory submissions made. As such, Anglo American believes that providing limited or insufficient information actually leads to inefficient expenditure and increases the regulatory burden on Aurizon Network and the rest of the industry.

Anglo American submits that throughout the UT4 regulatory period there should be a strong focus on ensuring that Aurizon Network provides enough detail and information for stakeholders to make fully informed submissions and decisions relating to regulatory processes. This should be particularly focused on providing properly detailed information on Aurizon Network's capital investment, operating and maintenance costs, and ensuring that stakeholders truly understand where their Access Charges, Reference Tariffs, SUFA and study funding is really going.

In many instances, the complete lack of information or verifiable data provided by Aurizon Network means that stakeholders are left without any ability to determine whether the costs presented are accurate, let alone whether they are reasonable or efficient as should be required under the Access Undertaking, and is required under the Act. This leaves stakeholders completely unable to comment, often taking a contrary view because they are unable to verify the cost asked for, or taking seemingly unreasonable stances because the alternative is to blindly support completely unsupported data.

Anglo American understands that there is always a need for commercial confidentiality in any operating business. What Anglo American does not understand, however, is why a regulated natural monopoly business with no identified commercial competitors requires such a significant level of information protection. Rather than the secrecy that pervades Aurizon Network's current approach to the regulatory regime, Anglo American believes that there should be a true focus on transparency of costs and expenditure so that there is significantly less scope for users to fear that their funds are being inappropriately applied to gold plate the CQCN or the Aurizon Network business, or are otherwise subsidising the commercially competitive arms of the broader Aurizon business.