

SUBMISSION TO THE QUEENSLAND COMPETITION AUTHORITY

FLOOD EVENT 2015

DECEMBER 2015

1. Executive summary

Anglo American Coal Australia (**Anglo American**) welcomes the opportunity to make submission to the Queensland Competition Authority (**QCA**) in relation to Flood Event 2015.

Aurizon Network is seeking approval from the QCA for a variation to the Moura System reference tariffs to recover its incremental maintenance costs resulting from this event. The claim is for \$4,237,120 expressed in FY2016 dollars proposed to be recovered over an 18 month period commencing 1 January 2016. Although Anglo American is still in negotiations with Aurizon Network in respect of any payment mechanism that may be appropriate (whilst reserving its rights to make a submission in future on that should it be required), it would like to make this submission to the QCA in respect of the separate issue as to whether the amount claimed is prudent and efficient.

In summary, Anglo American's view is that:

- (a) there is insufficient information, granularity or transparency contained in Aurizon Network's Flood Review Event Submission 2015 for Anglo American or the QCA to determine whether the costs said to have been incurred were prudent and efficient;
- (b) the QCA should engage an appropriately qualified expert, such as an engineering company, to peer review Aurizon Network's claim;
- (c) Anglo American is concerned as to the high cost and proportions of both external labour costs and plant/equipment hire costs. In particular, Anglo American is concerned that this may be an indication that maintenance activities which would ordinarily be undertaken by Aurizon Network, as part of its operation and maintenance of, in this case, the Moura System have been outsourced or transferred to Aurizon Operations which is clearly inefficient. Further, that there is little (or no) oversight as to the terms and conditions upon which Aurizon Operations contracts with Aurizon Network in respect of the maintenance of the below rail infrastructure is of particular concern. For example, it is not clear whether profit is being made by Aurizon Operations in carrying out such activities which are properly categorised as being access related maintenance;
- (d) the escalation calculation is inappropriate and acts to escalate payments already made, creating windfall revenue for Aurizon Network;
- (e) given total costs claimed on the Moura System are said to exceed \$8,000,000 and that the works are all asset reinstatement or future flood immunity related, it is submitted that capitalising all of these costs into the RAB is appropriate.

2. Prudency of costs associated with Flood Event 2015

The application by Aurizon Network for a variation to the Moura System reference tariffs does not contain sufficiently detailed information for Anglo American to determine whether the amount of \$4,237,120 is prudent and efficient as required by the provisions of UT3. It is also noted that the claim only represents a portion of total costs to be claimed by Aurizon Network in relation to the Flood Event 2015, with the incremental capital claim still to be made. Therefore, Anglo American respectfully requests the QCA to:

1. only consider the Flood Review 2015 claim once it has received the incremental capital claim, so that it has the complete picture and detail behind all works and costs claimed; and
2. engage an appropriately qualified expert such as an engineering company, with no supplier relationship to Aurizon Network, to peer review the technical, cost and cost allocation aspects around the claims.

3. Capitalisation into RAB

Anglo American believes that the works set out in the Flood Event 2015 claim can be considered capital in nature. The Flood Event 2015 is significantly different from the two previous flood events, in the following aspects:

- The damage to the Moura System was more extensive, requiring replacement of assets or improvements to assets;
- The rectification works were clearly in the nature of capital replacement as opposed to simple maintenance;
- Approximately half of the total Flood Event 2015 costs are already recognised as being of a capital nature;
- Works included in the Review Event claim are fundamental to other works undertaken as part of the incremental capital claim and should not be segmented from those activities, e.g. slewing of track works associated with rebuilding of the track embankment;
- The total quantum of costs for the Flood Event 2015 is unprecedented.

Anglo American submits that all rectification costs are more appropriately rolled into the RAB and recovered by Aurizon Network through the regulatory regime over the life of the asset. This is because the works undertaken as a result of the Flood Event 2015 would have otherwise been undertaken by Aurizon Network during some future regulatory period through capital renewals, upgrades or future planned maintenance works. Items which are identified by the QCA as being in either a future capital replacement, upgrade or maintenance task (although accelerated by the flood repair works), should be excluded from the cost claim and recovered through the existing regulatory regime eg – ballast replacement.

If the QCA is of a mind to consider the claim as incremental maintenance, Aurizon Network will need to satisfy the QCA that it is truly incremental in nature and none of it has already been included in the 2014 Draft Amending Access Undertaking claimed maintenance costs, including ballast replacement, consumables and inventory allowances, or in the reference tariffs for FY 2016 MAR as stated by Aurizon Network or reference tariffs for FY2017. The items of work determined by Aurizon Network as capital expenditure said to be excluded from the current claim, but to be claimed later as an ‘ex post’ capex claim, should also be examined to ensure that any of the costs being claimed here were not properly part of those works such that those costs should also properly be capitalised.

It is difficult to understand why track re-slewing is also considered to be maintenance and not considered a capital related item.

Aurizon Network should also have to provide proof that it made a claim under its insurance and that some or all of the costs cannot be recovered accordingly.

4. External Labour and Plant/Equipment

Two issues of particular concern to Anglo American are the use of external labour and plant/equipment.

In Table 1, Anglo American has set out analysis (to the extent that it is possible from the information provided) of labour costs in Flood Event 2013 and Flood Event 2015.

Table 1: Analysis of external labour costs

Flood Event	Internal - Ordinary	Internal - Overtime	External	External Percentage
2013	3,089,770	184,639	563,995 ¹	17% ²

¹ SKM Report.

² Based on all systems.

2015	[Not disclosed]	200,243	1,048,150	Significant
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In 2013 Aurizon Network stated that "it used internal labour costs to undertake a significant portion of the flood repair works".³ In 2015, Aurizon Network sub-contracted the major rectification work to Aurizon Program Delivery Team, who used external contractors for the "majority" of the works.⁴

It is not clear to Anglo American that it was necessary for Aurizon Program Delivery Team to "manage" external contractors. It is also not clear to Anglo American why in 2013 the majority of work is done by internal labour and in 2015 there is such a significant increase in work undertaken/costs billed by external contractors or why this was appropriate.

In 2013 the QCA found that ordinary labour costs were not recoverable on the basis that those costs are not incremental. It would be a matter of great concern if the shift in usage by Aurizon Network of internal labour towards external labour was governed by the fact that only external labour is recoverable. Anglo American asks the QCA and any consultant it may choose to appoint, to consider whether the quantum of usage of external labour was efficient and a decision that is prudent and therefore justifiable.

Aurizon Network has also claimed approximately \$2,300,000 of external Plant/equipment costs, some 54% of the total amount claimed, which is said to exclude costs associated with the pending incremental capital claim. Anglo American has concerns in relation to these external Plant/equipment costs, particularly given that some activities which would usually have been undertaken within Aurizon Network (i.e ballast undercutting in particular) appear to have been outsourced as hire costs possibly, it is assumed, to Aurizon Operations or third party suppliers.

Anglo American believes that under the current methodology being used to outsource labour and Plant/equipment, Aurizon Network is not incentivised to manage or minimise the costs of the Review Event.

5. Escalation

Anglo American is concerned about Aurizon Network's method of calculating escalation. Aurizon Network appears to have applied escalation to the Moura flood recovery costs to the end of the financial year in which the amounts are actually being recovered in, thereby ignoring the benefit of cashflows. An example of Aurizon Network's proposed methodology

³ SKM Report, 13.

⁴ Aurizon Network, Review Event Submission - Central Queensland Flooding 2015 (30 November 2015), 24.

is that the Review Event money to be paid by Moura System users for the month of July 2016, will actually have a 30 June 2017 dollar term.

Anglo American understands that the additional revenue gained from this methodology under the Option 2 proposal is in excess of \$100,000. This represents an inappropriate windfall gain for Aurizon Network and is not consistent with general industry best practice. It is also noted in the Consolidated Draft Decision by the QCA of 21 December 2015 (vol 4 p274) that the QCA does not consider that Aurizon Network should adopt such a modelling assumption which provides a material revenue bias in favour of the service provider.

Anglo American does not understand how money, once effectively paid to Aurizon Network, can then be used for future escalating purposes. Anglo American suggests, as it has done previously, that the more appropriate method would be to escalate the repayment stream to the mid-point of the recovery period (e.g. 31 December of a FY), not the end of a recovery period. Anglo American requests the QCA to review the cost recovery accordingly.

Further, as Aurizon Network has predominantly applied the WACC as the escalation factor, this is consistent with it capitalising such costs for insertion into the RAB where it is entitled to earn the WACC return on such capital. If the incremental costs are not capital in nature, then these should be escalated/de-escalated at a more appropriate escalator and consistent with that used in calculations for maintenance opex amounts, e.g. MCI or CPI.

6. Payment Mechanism

As noted, Anglo is in discussions with Aurizon Network as to an appropriate payment mechanism should any incremental tariff be required and again reserves its rights to make a further submission on that if this cannot be resolved.

It should be noted however that the current proposed mechanism, albeit for 18 months, overlaps with the 2013 Flood recovery period allowed by the QCA due to a 1 January 2016 commencement date proposed by Aurizon Network. The proposed approach is clearly at odds with a preferred approach of seeking to 'minimise the immediate financial impact of any tariff adjustment'.

The incremental tariff needs to be revised to take into account WIRP volume assumptions.

Aurizon Network considers splitting the recovery of the claim evenly between AT3 and AT4 as the most efficient means of recovering the costs but does not indicate why. If the QCA accepts that AT3 and AT4 are the appropriate tariffs for the incremental tariff, then the increment should only be charged on actual tonnes railed and not become 'Take or Pay'

aligning revenue with the incremental tariff given cash flow impacts and export coal market conditions.

In any event, for the reason stated in the 2013 flood recovery submissions, no retrospective adjustment should be allowed as such approvals mean Aurizon Network is not incentivised to adhere to regulatory processes and users may not have accrued for such costs.

Further, it is submitted that Aurizon Network has not discharged the onus, as applicant, seeking approval from the QCA that clause 2.3, schedule F, Part A of the 2010AU (as extended) entitles it to impose an Adjustment Charge, including interest, on the difference between the reference tariffs paid and any revised reference tariffs that may be payable if the QCA hands down a subsequent decision simply because Aurizon Network interprets the section that way and seeks recovery from an arbitrary point in time or at all.