

Decision

Aurizon Network's review event: 2016 flood claim

May 2017

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THE ROLE OF THE QCA—TASK AND CONTACTS

The Queensland Competition Authority (QCA) is an independent statutory authority which promotes competition as the basis for enhancing efficiency and growth in the Queensland economy.

The QCA's primary role is to ensure that monopoly businesses operating in Queensland, particularly in the provision of key infrastructure, do not abuse their market power through unfair pricing or restrictive access arrangements.

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1 BACKGROUND

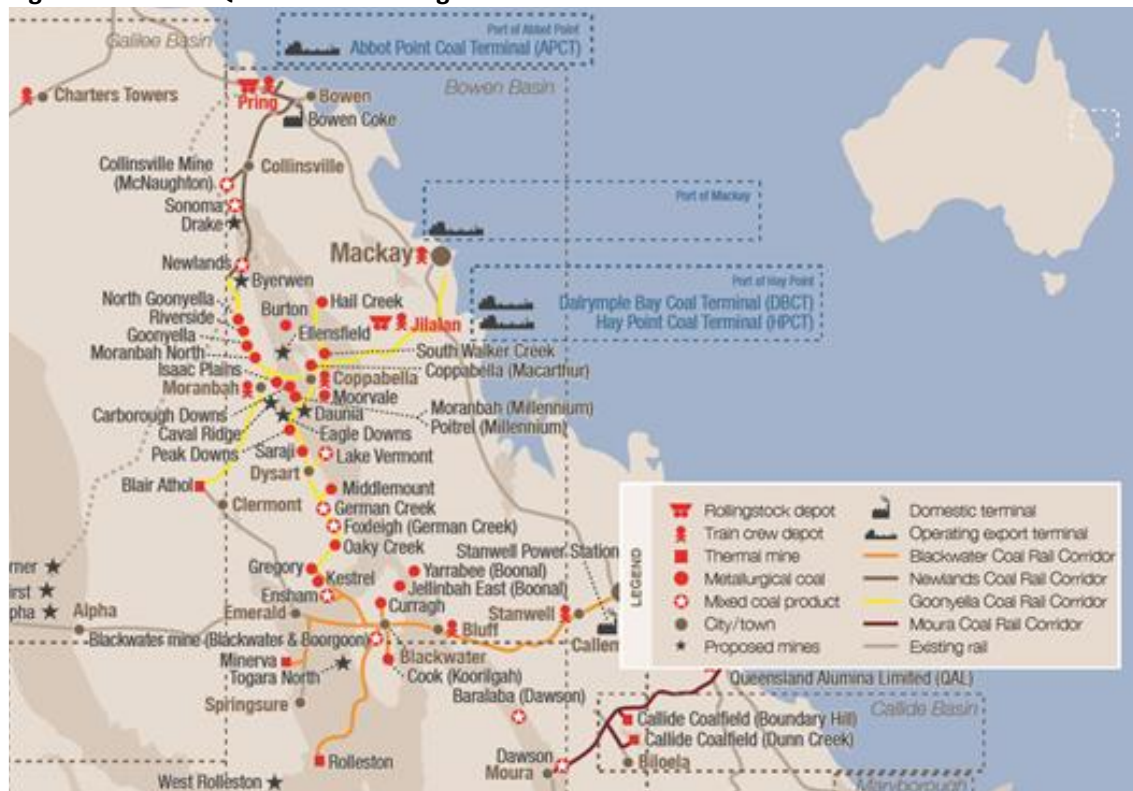
1.1 Flood event

A severe rainfall event in the Central Queensland coal region (CQCR) in February 2016 damaged Aurizon Network's rail infrastructure in the Goonyella and Newlands systems (see Figure 1). The Broadlea to Coppabella line, in the Goonyella system, was the most heavily damaged location (see Figure 2).

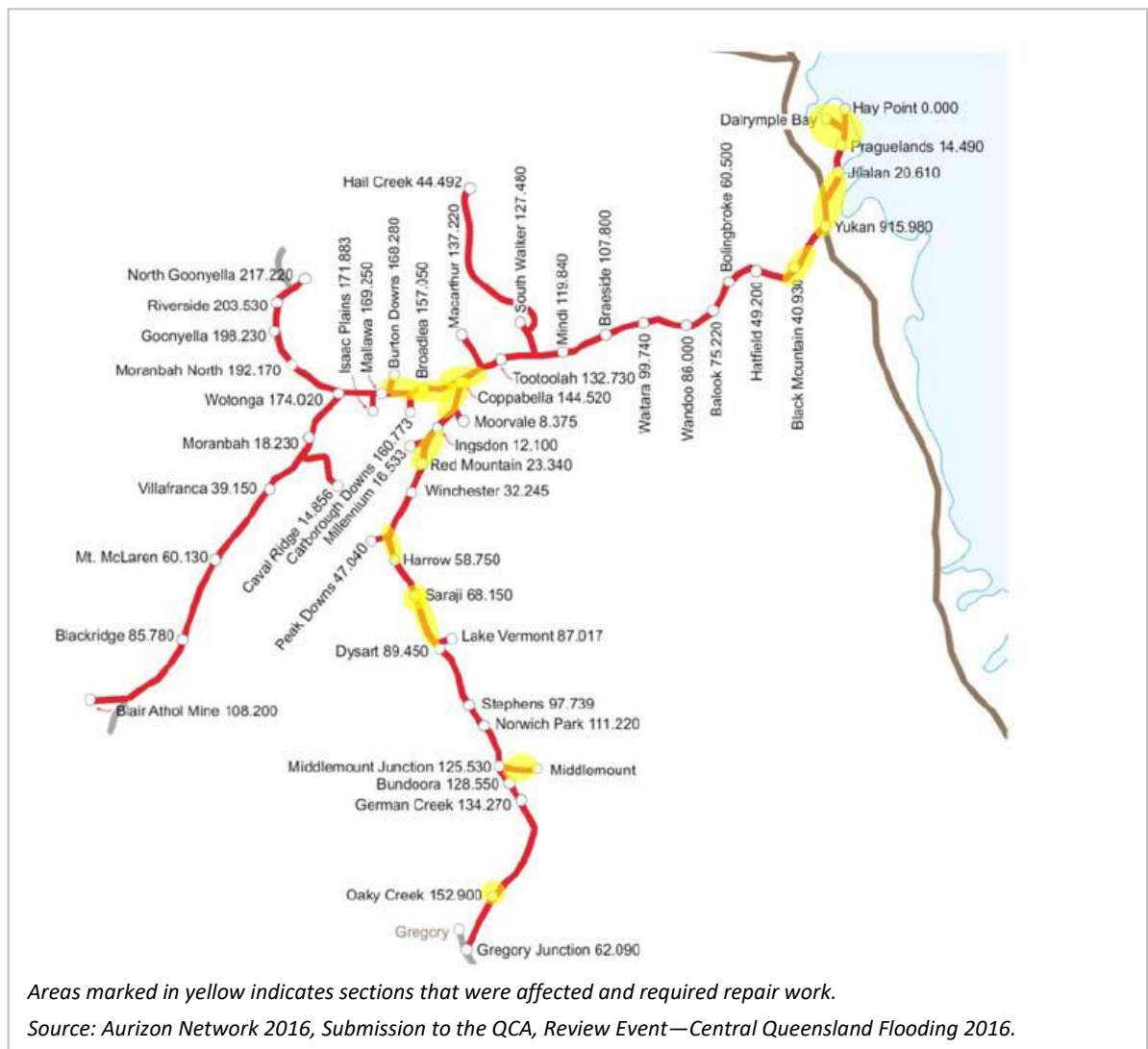
Aurizon Network declared force majeure for both systems on 5 February 2016. While the Goonyella system was reopened on 10 February 2016, traffic was restricted to a 25 km/h speed limit.

Aurizon Network's flood claim relates to the Goonyella system only. Aurizon Network noted that the flood damage in the Newlands system was minor and has not been included in this claim. It will not be the subject of a separate claim either.¹

Figure 1 Central Queensland coal region



¹ Aurizon Network 2016, Submission to the QCA, *Review Event—Central Queensland Flooding 2016*, 31 October, p. 3.

Figure 2 Flood-affected locations in the Goonyella system

1.2 Regulatory process

Aurizon Network's 2016 access undertaking provides for Aurizon Network to seek approval from the QCA to vary reference tariffs in response to a review event, which is defined as a force majeure event caused by, amongst other things, a flood with an impact of greater than \$1 million.

Aurizon Network's 2016 access undertaking requires Aurizon Network to apply to the QCA to vary reference tariffs within 60 days of a review event (cl. 5.1 of Schedule F).

On 1 April 2016, Aurizon Network requested an extension to 31 October 2016, which was granted by the QCA.

On 31 October 2016, Aurizon Network lodged a review event submission for the 2016 flooding in the Goonyella system. The amount of incremental maintenance costs Aurizon Network is seeking to recover, due to the flood damage rectification works, is \$1.98 million (pre-escalation). Aurizon Network proposed applying the tariff variation to the 2017–18 reference tariffs, commencing 1 July 2017.

The QCA released Aurizon Network's submission on 14 November 2016, with 22 December 2016 being the due date for stakeholders' comments. No submissions from stakeholders were received.

2 QCA ASSESSMENT

2.1 Approval criteria

We have assessed Aurizon Network's 2016 flood claim under the 2016 access undertaking, which sets out the criteria for approving reference tariff variation due to a review event (cl. 5.5(c) of Schedule F).

In accordance with the criteria, the QCA must be satisfied that:

- (1) a review event has occurred
- (2) the variation of the relevant reference tariff is consistent with the change in the cost resulting from the review event
- (3) the tariff variation reflects the impact of the review event on the financial position of Aurizon Network (including the impact of incremental maintenance and incremental capital costs)
- (4) the tariff variation has been calculated as if all other reference tariffs were also being recalculated due to the review event.

In particular, in considering the occurrence of a review event, the QCA must assess whether:

- a force majeure event (of the type set out in cl. 5.3 of Schedule F) has occurred
- Aurizon Network has incurred additional incremental costs exceeding \$1 million
- the incurred costs have not previously resulted in a variation of the relevant reference tariff.

The relevant clauses in the 2016 access undertaking appear in more detail in Appendix A.

We engaged B&H Strategic Services (B&H) to advise us on the technical matters in Aurizon Network's 2016 flood claim. B&H's report is available on the QCA website.

As aspects of the approval criteria are similar and related, we have structured our assessment to consider:

- the occurrence of a force majeure event (of the type set out in cl. 5.3 of Schedule F)
- the amount and the nature of the costs resulting from that event, in particular whether these were incremental costs that would not otherwise be incurred
- the proposed tariff variation and recovery approach.

2.2 A force majeure event

[Aurizon Network's submission](#)

Aurizon Network considered the February 2016 flood event to be a force majeure event, as it was beyond Aurizon Network's control, and it was not preventable.²

² Aurizon Network 2016, Submission to the QCA, *Review Event—Central Queensland Flooding 2016*, 31 October, p. 13.

Assessment

The 2016 access undertaking defines a force majeure event as any cause, event or circumstance which:

- is beyond Aurizon Network's reasonable control
- Aurizon Network was not reasonably able to prevent or overcome, by exercising due diligence.

Certain types of force majeure events are included in the definition of a review event, and this includes flood events (cl. 5.3 of Schedule F).

B&H considered that Aurizon Network could not have controlled the flood event and that reasonable due diligence could not have prevented or overcome the event. However, B&H noted that Aurizon Network 'could investigate similar circumstances and locations since it appears from their claim history and the weather records that similar events will be more common' and that 'future events may not be force majeure'.³

Decision

The QCA is satisfied that the February 2016 flood event meets the definition of a force majeure review event under the 2016 access undertaking. The QCA encourages Aurizon Network to consider B&H's observation regarding any future flood events.

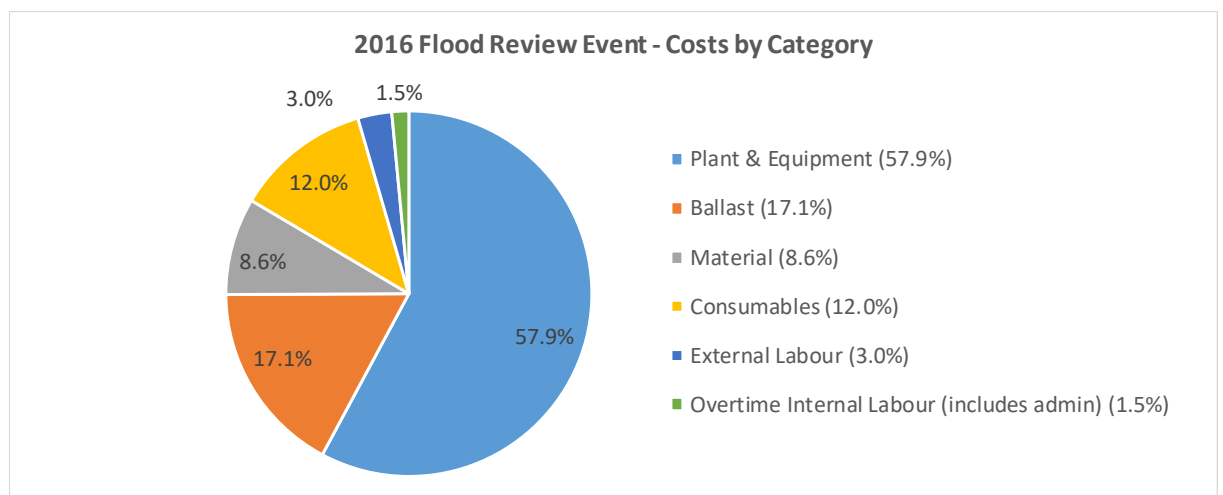
2.3 Costs resulting from the review event

2.3.1 Incremental costs

Aurizon Network's submission

Aurizon Network calculated the incremental maintenance costs related to its flood response to be \$1.98 million excluding escalation (incurred in the 2015–16 financial year). The hiring of plant and equipment (58 per cent) formed the majority of the claim, with ballast being the other sizable portion (17 per cent) (see Figure 3).

Figure 3 Aurizon Network's flood cost breakdown



Note: Rounded to one decimal place.

Source: QCA analysis

³ B&H 2017, *Review of the 2016 Flood Event Claim*, April, p. i.

Aurizon Network said that the costs that forms this flood claim:

- can be specifically attributed to Aurizon Network's response to the flood event
- relate only to incremental costs such as overtime and not ordinary labour.

Aurizon Network also submitted that the flood-related costs were captured at the work order level. Each affected site was treated as a job with a work order attached, and each work order was assigned a revision code, to ensure all work orders could be separately identified in the finance system.⁴

Assessment

In assessing the amount and nature of the costs associated with the flood claim, we considered whether these costs were directly the result of the flooding event, whether these costs were incremental, and whether the costs exceeded the \$1 million threshold.

To determine this, we engaged B&H to assist us in assessing whether:

- the flooding event triggered the claimed works on the network
- the works were required to provide access for the operation of train services
- the costs were incremental
- the costs were reasonably incurred.

Having reviewed Aurizon Network's submission, and the subsequent information provided by Aurizon Network, B&H found the following:

- The scope of works consisted of establishing access to flood affected areas, removal of debris including earthworks on and alongside the track, temporarily rebuilding washed out formation, clearing drains, and applying ballast and realigning the track (vertically and horizontally). B&H was satisfied that the flooding triggered these claimed works on the network, and that these works were required to provide access for the safe passage of train services.⁵
- Double counting of UT4 maintenance work has not occurred. B&H was satisfied that Aurizon Network has been carrying out drainage maintenance, in accordance with the UT4 maintenance allowance, prior to the flood event, and that these costs were not included in this flood claim.⁶
- The majority of the claimed costs (around 94 per cent^{7,8}) were externally incurred, and were associated with the unplanned activities resulting from the flood event⁹; therefore, they were incremental¹⁰. In particular:

⁴ Aurizon Network 2016, Submission to the QCA, *Review Event—Central Queensland Flooding 2016*, 31 October, p. 14.

⁵ B&H 2017, *Review of the 2016 Flood Event Claim*, April, p. i.

⁶ B&H 2017, *Review of the 2016 Flood Event Claim*, April, p. i.

⁷ Based on Aurizon Network's internal cost being 5.6 per cent of its total claim.

⁸ B&H 2017, *Review of the 2016 Flood Event Claim*, April, pp. i–ii.

⁹ B&H 2017, *Review of the 2016 Flood Event Claim*, pp. ii–iii.

¹⁰ B&H 2017, *Review of the 2016 Flood Event Claim*, April, p. 7.

- The invoices, related to the hiring of plant and equipment from contractors and the use of contractors to supplement Aurizon Network's internal work force, were provided to B&H's satisfaction.¹¹
- The cost of ballast included the supply and transportation of ballast by Aurizon above rail (an external party). B&H said that ballast was used to restore the tracks to a workable condition, including as 'fill' in locations where formation was washed away.¹²
- Aurizon Network's claimed costs were reasonably incurred. B&H noted that the use of plant and equipment that were already performing work in the area was an expeditious strategy.¹³
- B&H has concerns that Aurizon Network's internal overtime labour and plant costs were not based on incremental rates, but consider any possible inaccuracies to be immaterial.¹⁴

B&H concluded that Aurizon Network's claim was justifiable against the criteria in the 2016 access undertaking, because the majority of costs (around 94 per cent) resulted from unplanned work performed by external contractors, which means any possible inaccuracies or miscalculations of Aurizon Network's internal costs are immaterial.

In its report, B&H made a number of recommendations for Aurizon Network to improve the transparency and calculation of its internally incurred costs. For example, B&H said that the fixed cost components of labour and plant should not be used to calculate the incremental rates. B&H also recommended Aurizon Network adopt a template that explains the underlying logic and transparency for claiming future force majeure review events (B&H provided a possible template in its report).¹⁵

Decision

On the basis of B&H's advice and assessment, we are satisfied that Aurizon Network's flood claimed costs reasonably reflects incremental costs, were a direct result of the flooding event, and exceeded the \$1 million threshold.

While Aurizon Network's internal costs were immaterial in this assessment, we note that B&H has identified a lack of transparency in those costs. For this reason, Aurizon Network is encouraged to consider B&H's recommendations to enhance the transparency of its internal costs, for the quantum could be different in future review events that might be submitted under the 2016 access undertaking.

2.3.2 Cost categorisation

Aurizon Network's proposal

Aurizon Network stated that it analysed each rectification job by the size of the work involved and the volume of materials required, to assess if it was incremental capital or incremental maintenance in nature. The jobs requiring upgrades and rebuilding of the assets were categorised

¹¹ B&H 2017, *Review of the 2016 Flood Event Claim*, April, p. 6.

¹² B&H 2017, *Review of the 2016 Flood Event Claim*, April, pp. ii, 4.

¹³ B&H 2017, *Review of the 2016 Flood Event Claim*, April, p. 6–7.

¹⁴ B&H 2017, *Review of the 2016 Flood Event Claim*, April, p. 7.

¹⁵ B&H 2017, *Review of the 2016 Flood Event Claim*, April, pp. ii–iii.

as capital and excluded from this claim. Aurizon Network's capital cost will be submitted separately as part of an ex post capital expenditure claim process.¹⁶

Aurizon Network noted that this claim includes all ballast costs, consistent with the 2016 access undertaking treatment of ballast as a maintenance activity.¹⁷

Assessment

In determining whether or not the variation in reference tariffs proposed by Aurizon Network reflects the impact of the review event on its financial position, our broader consideration has been to assess whether the costs claimed are appropriately categorised as capital or maintenance, and not double-counted.

B&H considered Aurizon Network's claimed costs to be maintenance in nature based on current business-as-usual conventions.¹⁸

However, B&H noted that, as this claim was for maintenance only (i.e. no capex works), the full extent of the work scope was unclear.¹⁹ B&H recommended that future maintenance and capex claims be submitted at the same time.²⁰

Decision

We agree with B&H that the claimed costs are maintenance in nature.

We also agree with B&H that future maintenance and capex claims, triggered by the review event provision, under the 2016 access undertaking could be submitted at the same time. This would more readily enable an assessment of the full extent of the work scope; a review for consistency between claims; and a check for double counting issues.

However, in the present circumstance, the QCA will review Aurizon Network's capital expenditure claim when it is submitted, for consistency with this flood maintenance claim.

2.3.3 Insurance and self-insurance

Aurizon Network's proposal

Aurizon Network said that none of the claimed flood costs were recoverable under its insurance policy, or covered by its self-insurance arrangements.

Aurizon Network stated that, of its below-rail assets, only selected bridges, tunnels and feeder stations are covered under the Industrial and Special Risks policy, and since they did not sustain any damage, no costs were recoverable. Aurizon Network also claimed that rail track infrastructure is not insured by this policy.²¹

Aurizon Network stated that its self-insurance policy, as estimated by Finity Consulting for the 2014 draft access undertaking (DAU), only insures key below-rail risks such as derailments, dewirements, weather events and below-deductible liability losses. The analysis by Finity

¹⁶ Aurizon Network 2016, Submission to the QCA, *Review Event—Central Queensland Flooding 2016*, 31 October, p. 14.

¹⁷ Aurizon Network 2016, Submission to the QCA, *Review Event—Central Queensland Flooding 2016*, 31 October, p. 14.

¹⁸ B&H 2017, *Review of the 2016 Flood Event Claim*, April, p. ii.

¹⁹ B&H 2017, *Review of the 2016 Flood Event Claim*, April, p. ii.

²⁰ B&H 2017, *Review of the 2016 Flood Event Claim*, April, p. 7.

²¹ Aurizon Network 2016, Submission to the QCA, *Review Event—Central Queensland Flooding 2016*, 31 October, pp. 14–15.

Consulting concluded that the cost pass-through option is an 'efficient way of dealing with extreme events, which occur infrequently, are extremely difficult to model and are beyond the normal control of businesses'.²²

Assessment and decision

In our final decision on the 2014 DAU, we accepted Aurizon Network's methodology for self-insurance provision and accepted that costs associated with major weather events or force majeure events exceeding \$1 million would be subject to a pass-through provision in the access undertaking.^{23,24} On this basis, we accept the 2016 access undertaking allows Aurizon Network to claim weather-related pass-throughs. Therefore, Aurizon Network's claim amount for flood damage exceeding \$1 million is reasonable, as it is not part of the UT4 self-insurance allowance.

2.3.4 General conclusion

From the above analysis and based on B&H's findings, we accept the following regarding Aurizon Network's claimed cost of \$1.98 million (pre-escalation):

- The costs were triggered by the February 2016 flooding event and exceeded the \$1 million threshold.
- The works were required to provide access for the operation of train services.
- The costs were incremental and were maintenance in nature.
- The costs were reasonably incurred.

2.4 Escalation

Aurizon Network's proposal

Aurizon Network's modelling showed that the incremental maintenance cost was \$1.98 million (pre-escalation).

In order to escalate this cost to reflect a deferred cost recovery, Aurizon Network applied a weighted average cost of capital (WACC) of 7.17 per cent and a Consumer Price Index (CPI) of 2.5 per cent. Aurizon Network said that these estimates are consistent with the 2016 access undertaking.²⁵ As a result, \$1.98 million pre-escalation has been escalated to \$2.19 million as at the middle of 2017–18 (see Table 1).

Table 1 Cost escalation

<i>Type</i>	<i>Description</i>
Pre-escalation	<ul style="list-style-type: none"> • \$1.98 million comprised of \$1.65 million incurred in February 2016 and \$0.32 million incurred in April 2016.
As at the end of 2015–16	<ul style="list-style-type: none"> • The cost incurred in February 2016 was escalated at WACC by 4 months to arrive at \$1.69 million as at the end of 2015–16. • The cost incurred in April 2016 was escalated at WACC by 2 months to arrive at \$0.33 million as at the end of 2015–16.

²² Aurizon Network 2016, Submission to the QCA, *Review Event—Central Queensland Flooding 2016*, 31 October, p. 15.

²³ QCA 2016, *Aurizon Network's 2014 DAU*, Final Decision, Volume IV—MAR, p. 83.

²⁴ Cl. 5.3 of Schedule F of the 2016 access undertaking.

²⁵ Aurizon Network 2016, Submission to the QCA, *Review Event—Central Queensland Flooding 2016*, 31 October, p. 18.

<i>Type</i>	<i>Description</i>
	<ul style="list-style-type: none"> Therefore, the total cost is \$2.02 million as at the end of 2015–16.
As at the end of 2016–17	<ul style="list-style-type: none"> \$2.02 million was escalated at WACC by 12 months to arrive at \$2.16 million as at the end of 2016–17.
As at the middle of 2017–18	<ul style="list-style-type: none"> \$2.16 million was escalated at CPI by 6 months to arrive at \$2.19 million as at the middle of 2017–18.

Source: Aurizon Network tariff modelling

Assessment and decision

We consider Aurizon Network's approach to escalating flood-related costs to be consistent with the 2016 access undertaking.

Consistent with our previous flood decisions, we do not consider escalation provides double-recovery, or escalates payments already made. Escalation does not reflect a return on the repair costs, but rather compensation for the fact that recovery of the passed-through costs is delayed by virtue of the application and approval processes.

2.5 Variation of the reference tariff

In the context of tariff variation in this review, two issues are relevant:

- timing of recovery
- calculation of the variation.

Aurizon Network's proposal

Aurizon Network proposed to recover the incremental costs in one financial year (i.e. 2017–18) and to evenly split the costs between the Goonyella system AT3 and AT4 reference tariffs. It has also adopted the 2016–17 volumes from the 2016 access undertaking as the basis of its calculation.²⁶ Aurizon Network's proposed recovery has been outlined in Table 2.

Table 2 Aurizon Network's proposed recovery

<i>Cost recovery</i>	<i>2017–18</i>
Amount to be recovered (\$ millions)	2.19
Net tonnes ('000)	115,623
\$ per net tonne	0.019
<i>Tariff increase</i>	<i>2017–18</i>
AT3 (\$/'000 ntk)	0.05
AT4 (\$/nt)	0.01

Assessment and decision

We note that Aurizon Network's proposed recovery of flood costs as a variation to the AT3 and AT4 reference tariffs is consistent with the principles set out in our previous decisions, as all customers who use the system should contribute to the repair costs.

²⁶ Aurizon Network 2016, Submission to the QCA, *Review Event—Central Queensland Flooding 2016*, 31 October, p. 19.

We consider the approved pass-through amount should be recovered through a variation to the Goonyella system AT3 and AT4 reference tariffs in 2017–18, as proposed by Aurizon Network.

2.6 QCA decision

For the reasons outlined in this report, we have made a decision to approve Aurizon Network's 2016 flood claim of \$1.98 million (pre-escalation) to be recovered through a variation to the Goonyella system AT3 and AT4 reference tariffs over 2017–18, effective 1 July 2017.

APPENDIX A: EXCERPTS FROM THE 2016 ACCESS UNDERTAKING

Review event approval criteria

Clause 5.1 of Schedule F of the 2016 access undertaking states that Aurizon Network will submit a reference tariff variation to the QCA if a review event has occurred.

A reference tariff variation as a result of a review event must be submitted in accordance with clause 5.4 of Schedule F, whereby Aurizon Network must:

- nominate the reference tariff to be varied
- include details of the methodology, data and assumptions used to vary the reference tariff, and
- include evidence the review event has occurred or will occur.

The QCA may approve the proposed variation, with respect to a review event, if it is satisfied that:

- the review event has occurred or will occur and
- the variation of the relevant reference tariff:
 - is consistent with the change in the cost resulting from or that will result from the review event
 - reflects the impact of the relevant review event on the financial position of Aurizon Network (including the impact of incremental maintenance and incremental capital costs), and
 - has been calculated as if all other reference tariffs were also being recalculated due to the review event.

Force majeure review event

In the 2016 access undertaking, a review event is defined as:

- the occurrence of a force majeure event, of the type set out in paragraph (e), (l) or (m) of the definition of that term
- affecting Aurizon Network to the extent that it has incurred or will incur additional incremental costs of greater than \$1 million, and
- have not previously resulted in a variation of the relevant reference tariff.

This definition limits its application to three types of force majeure events, namely:

- act of God
- fire, flood, storm surge, cyclone, tornado, earthquake, washaway, landslide, explosion severe weather conditions or other catastrophe or natural calamity, and
- epidemic or quarantine restriction.