

# FINANCIAL REVIEW

## Aurizon owners Investors Mutual, TCI Funds slam unworldly regulator

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by [Matthew Stevens](#)

Senior global and local infrastructure investors have described the Queensland Competition Authority's wildly disputed draft decision on what Aurizon can charge customers of its rail network as excessively academic, uncommercial and a threat to not just future investment but also Australia's place in the seaborne coal market.

The big UK-based infrastructure player, TCI Funds Management, and Australian-based funds manager Investors Mutual have both taken aim at the underlying commercial [logic used by the QCA to generate a decision](#) they both separately condemn as flawed and confidence-sapping.

Both funds are long investors in Aurizon (TCI has been there since privatisation in 2010) and their aligned views on the commercial fragility of the QCA's finding were delivered in separate formal responses to the draft recommendations.

If the QCA draft becomes final (and as we keep noting, it normally does) then Aurizon will be left with a four-year pricing regime that leaves it \$1 billion shy of where it wanted to be and a further \$100 million shy on its expectations for recovering what it spends on maintaining the network.

On Monday [Aurizon requested a judicial review of the draft](#), which is unusual in itself because it has gone to the Queensland Supreme Court at least six months before the QCA is due to make its final deliberation. That Aurizon is seeking a review on the grounds of apprehended bias caused by the QCA's chairman's conflict of interests transforms this from rare to unprecedented.

Certainly, the move aimed at taking the whole regulatory process back to square one accurately indicates the level of anxiety that has been triggered at the executive and board levels of Aurizon by what remains a draft set of recommendations.

The submissions offered by TCI and Investors Mutual announce resoundingly that this level of concern is shared by Aurizon's long owners.

The TCI response, which was signed off by the fund's deeply respected principal, Phil Green, identifies the draft as "deeply flawed from a market and commercial point of view" and carries a warning that the decision risks amplifying "continuing concerns" in seaborne markets "about the resilience of Australian coal networks".

## **Brutal assessment**

Anton Tagliaferro at Investors Mutual was, if anything, rather more brutal in his assessment.

"As shareholders in Aurizon on behalf of clients, we are of the strong opinion that the Aurizon Network UT5 Draft Decision, while grounded in theory, is ultimately inconsistent with the commercial realities of operating a complex coal network," the Investors Mutual submission opened.

"Confidence in regulatory outcomes is a pre-requisite for long term investors such as ourselves – and the UT5 Draft Decision not only damages investor confidence, but in the long term it will also damage the economic interests of the State of Queensland by discouraging investors to invest in infrastructure assets there."

Now, given that these guys are long shareholders and that Aurizon has lost about \$2 billion in market capitalisation since the QCA's draft determination was delivered just before Christmas, it would be all too easy to put these submissions in the "well, they would say that, wouldn't they" drawer.

But there is a whole lot more than that tasty rhetoric in this pair of submissions and both offer clear lenses on the way big and bigger funds allocate their very large pools of capital.

As we have identified often, the two pivotal points of dispute here are the regulator's assessment of Aurizon's weighted average cost of capital (WACC), a number that effectively sets the cap on what the operator can charge for access to its railway over the four-year term of the undertakings. And the other is the cap on recovering the cost of maintenance.

Now, this time around the QCA settled on a WACC of 5.4 per cent. Aurizon was asking for 7.03 per cent.

The only Australian operation that gets anywhere near matching Aurizon's kit is the Hunter Valley network run by the Commonwealth's rail operator, ARTC. The Australian Competition and Consumer Commission regulates the price of access to the Hunter network. Last year it settled on a WACC of 6.3 per cent.

## **Ignoring trends**

According to TCI's Green, the net effect of the ACCC decision is that the operator can earn an equity return of circa 9 per cent from its network while investors in Aurizon will earn only 6.99 per cent.

Green assesses that the QCA has failed to anticipate an end to an era of low interest rates that is already underway and it has value to price risk.

The way Green sees his investment world, all sovereign risk-free rates (RFRs) "have been influenced significantly by quantitative easing (QE), the nearer term measures the more so".

He notes that the four-year RFR used in the QCA modelling is 1.9 per cent, which is apparently drawn from the average over the 20 business days leading up to the end of June 2017, which was the putative end of the most recent undertakings (UT4).

"This 'point in time' measurement ignores the medium-term trend and it was also at a low point just as global bond yields started to rise," Green continued. He noted at the time of writing (mid-March) that the four-year RFR had jumped 40 basis points to 2.3 per cent.

"The equivalent 10-year rates were 2.44 per cent for the June 2017 averaging period and 2.76 per cent for the January 2018 averaging period, significantly higher than the Draft Decision," Green continued.

"Consensus economic forecasts expect bond yields to continue rising as QE reverses and given the strength of the global economy," Green said before noting that the UK energy markets regulator had recently responded to the problem of high inflation and low interest rates by indexing RFR and using CPI inflation to guide pricing outcomes as a means of "bringing forward cash flows to aid financeability".

"Save to say, it would be easy to be drawn into a point-by-point debate about each input, but the bottom line is that the academic process that has led to a c.7 per cent equity return is deeply flawed from a market and commercial point of view. This

alone will discourage investment by Aurizon Network in (and maintenance of) the CQCN and this cannot be the right answer for customers and employees in a market where mining companies are earning very high margins on each tonne of product railed," Green advised.

## **Unreasonable**

The Investors Mutual submission, signed off by Tagliaferro, described the QCA's proposed WACC of 5.4 per cent as "far lower than that required by any real world reasonable investor".

"It makes no sense to us at all that Aurizon Network should earn a lower return than recent water utility decisions."

The Investors Mutual submission suggested that the gap between the QCA view and any commercial reality "appears to be the extremely low risk-free rate and beta assumptions used – which we urge you to reconsider".

"It seems to have been forgotten that coal mining is an inherently risky business activity," the submission continued. "The QCA seems to have forgotten that it was only a few years ago when the coal industry was on its knees and many mines were being closed."

Interestingly enough, this view of the risk burden carried by the network operator is aggressively disputed by some of Aurizon's customers and their lobby, the Queensland Resources Council.

The QRC is strongly supportive of the regulator's draft and the metrics that produced it. Indeed, the latest submission from the QRC notes that the regulator has arguably been excessively generous, most particularly in its maintenance allowances. That submission argues, pretty persuasively, it must be said, that the regulatory framework serves to significantly reduce cyclical risk for Aurizon.

The QRC said that coal's recent recession had "provided an excellent test of the extent to which Aurizon is exposed to volatility in the market in which its customers operate".

The Council's submission noted that while coal mines closed and miners ran on negative cash flow, rail network volumes actually rose. It was noted too that even had those volumes had fallen, the impact on Aurizon would have been mitigated by take-or-pay contracts and by a regulatory environment that allows for the "socialisation of revenue recoveries".

"Far from demonstrating any additional or increased risk faced by Aurizon Network, as claimed, the QRC submits that the experience over recent years during a period of volatility in the global coal price provides clear evidence of the high degree to which Aurizon Network is insulated from such risks by the regulatory framework," the QRC concluded.