

FINANCIAL REVIEW

Companies and Markets

QCA decision pushes Cooper Investors to sell out of Aurizon

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1,215 words

7 May 2018

The Australian Financial Review

AFNR

First

15

English

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Due Diligence

Aurizon's anger at an allegedly "flawed" regulatory decision has deepened after one of its earliest shareholders, Cooper Investors, revealed it had sold all its stock in the Queensland rail group.

Cooper Investors, which participated in the company's successful \$4.6 billion initial public offering in 2010 and held more than \$100 million of Aurizon shares, got rid of its stock between January and March.

The investment group has told investors in its Australian equities fund that it decided to sell after the Queensland Competition Authority (QCA) - which governs how much money Aurizon can charge customers to use its rail tracks - released a draft ruling in late December. The QCA said it would allow Aurizon to earn \$3.9 billion from its networks business between July 2017 and June 2021 - nearly \$1 billion less than the rail company believes it should make.

Cooper Investors said the QCA had assumed "an aggressively low cost of capital" - the regulator allocated Aurizon a weighted average cost of capital (WACC) of 5.41 per cent - and that it was "difficult to accept" a return of less than 5.5 per cent on "a coal network asset that is not riskless". The WACC represents the rate of return Aurizon is allowed to earn from its track assets.

While commending Aurizon's management team for improving productivity and restructuring the rail group's intermodal and bulk businesses under new chief executive Andrew Harding, Cooper Investors said it did not believe the QCA would change its WACC allocation in its final decision, due at the end of the year.

"If the QCA final outcome is similar to the draft outcome, it will largely offset management's initiatives and the improving coal volume in the above rail business," Cooper Investors said.

The performance of Aurizon's coal haulage business has been steady, with earnings before interest and taxation rising 2 per cent to \$223 million in the six months to December and analysts expect earnings to keep increasing over the next two years.

The QCA, which sees its job as trying to provide Aurizon with what it believes is a reasonable rate of return while not disadvantaging users of the company's rail network by imposing high prices, uses a set formulas to calculate WACC.

Coopers Investors' sale of Aurizon's shares, which are trading almost \$1 lower than they were before the QCA's draft ruling, comes as the rail company tries to force the regulator to rethinking its initial decision.

Aurizon is waiting on hearing dates from the Queensland Supreme Court after asking for a review of the decision, claiming QCA chairman Roy Green was conflicted because he is also chairman of the Port of Newcastle in NSW.

Aurizon argues that miners will be more likely to export coal from mines in NSW's Hunter Valley through the Port of Newcastle than mines in Queensland if its ability to invest in its Queensland networks is constrained.

Miners operating in the Hunter Valley use rail tracks operated by the government-owned Australian Rail Track Corporation to export through the Port of Newcastle. Some of the same miners, including BHP, Peabody,

Glencore and Yancoal, also use Aurizon's Queensland rail networks to export coal through ports at Hay Point and Gladstone.

But even if Aurizon succeeds in its demands for the court to "set aside" the decision, sending the QCA back to the drawing board with a new chairman (Green is due to step down at the end of June), it could still end up with the same QCA ruling, because the regulator follows set processes when evaluating how much money companies can make.

The court has only been asked to examine the methods the QCA used to make its decision - not the merits of the decision.

Meanwhile, steam is puffing out of the ears of Aurizon's mining customers, who are still furious with the rail group for changing the way it maintains and repairs its rail tracks, with the miners claiming changes are slowing coal exports.

The miners have also been agitating for legal action, and have encouraged the QCA to investigate if Aurizon's changes have contravened the Queensland Competition Authority Act and whether the regulator could initiate its own proceedings in the Supreme Court.

The QCA has already asked Aurizon to explain why it believes changes to maintenance activities would reduce coal haulage tonnages by an estimated 20 million tonnes annually but the rail group's response has not been released publicly.

Queensland Resources Council chief executive Ian Macfarlane has claimed that the maintenance changes could reduce royalties paid to the state government from coal producers by \$500 million annually, and has called on Aurizon to resume its previous maintenance practices.

But Aurizon has been insistent that the QCA's draft decision is "commercially unacceptable" and has shown no inclination to negotiate.

Miners are pessimistic about the likely outcome of the dispute between Aurizon and the QCA, foreseeing long and expensive court battles.

The miners have also been considering their legal options, and to date have sent three strongly worded letters from Herbert Smith Freehills, claiming Aurizon has not been giving enough information to users of its rail tracks, making it hard to forecast when track paths will be available and making it "impossible" for them to mitigate losses.

One miner described relationships with Aurizon as "pretty grim" and said a negotiated outcome to the maintenance furore seemed unlikely in the near term.

Analysts have also been worried by the long-term impact of Aurizon's disputes, with UBS warning the maintenance changes could "drive instability" in the company's network business and potentially cause "collateral damage" to its rail haulage business.

In addition, Aurizon runs the risk that by taking the QCA to court and alleging Green failed to keep "an impartial mind," it appears to be using the QCA chairman as a scapegoat to protest a decision that has not gone its way. Aurizon has complained that Green failed to disclose the extent to which he held talks with the Port of Newcastle's owners before accepting the chairmanship of the port in mid-December, just after the QCA released its draft decision.

The Port of Newcastle was sold by the NSW government in 2014 and is now privately owned in a 50-50 joint venture by The Infrastructure Fund and China Merchants Group.

Aurizon claims Green failed to explain how he would manage potential conflicts of interest in letters exchanged with the rail group's chairman, Tim Poole.

Poole specifically asked Green in mid-February whether he intended to recuse himself from all matters involving Aurizon's networks business.

The QCA said in December there was no "direct" conflict of interest between Green's chairmanships of the QCA and the Port of Newcastle, and that he would exclude himself from decisions where there was a potential conflict of interest.

But Aurizon remains unconvinced that Green has indeed absented himself from all conversations involving its rail tracks, even though Green has told the company that he has not "participated in any substantive decisions" by the QCA on the networks business after being appointed chairman of the Port of Newcastle.

