



Final Decision

DBCT Management's Outstanding Costs from the DBCT 7x expansion

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1.1 Background

The Dalrymple Bay Coal Terminal (DBCT) is a coal export terminal located in central Queensland 40 kilometres south of Mackay. The terminal opened in 1983 as a common user coal export terminal, servicing mines in the Goonyella system of the Bowen Basin coal fields.

In 2008 and 2009, DBCT commissioned the 7x expansion project. This expanded the terminal to 85 million tonnes per annum (mtpa) in two phases – phase 1 to 68 mtpa and phases 2/3 to 85 mtpa.

In October 2009 and August 2010, DBCT Management submitted draft amending access undertakings (DAAUs) seeking to include the capital expenditure into the regulated asset base (RAB) as well as amendments to the annual revenue requirement (ARR), revenue cap and reference tariff. The Authority commissioned external engineering consultants, Flagstaff, to assist with the review of DBCT Management's submission. The Authority's consideration of these DAAUs also took into account the requirements of clause 12.5 of the 2006 DBCT access undertaking. Based on its consideration of these matters, the Authority approved DBCT Management's costs for phase 1 (\$619 million) and phase 2/3 (\$836 million) in December 2009 and September 2010 respectively.

At the time the Authority made those two decisions, it was accepted that there were certain outstanding cost items that would need to be considered at a later date. DBCT Management indicated that the majority of these outstanding costs related to completing certain post-commission works, managing the construction close out process, meeting certain statutory requirements and finalising miscellaneous minor orders required to complete the approved expansions.

The Authority's considerations and assessment of the prudence of outstanding costs

On 7 November 2011, DBCT Management submitted a DAAU seeking approval to amend the RAB, revenues and tariff based on \$8.7 million in outstanding expenditures related to the 7x expansion.

Section 142 of the *Queensland Competition Authority Act 1997* (the QCA Act) requires the Authority to consider a DAAU submitted to it and either approve or refuse to approve the DAAU. The Authority may approve a DAAU only if it considers it appropriate to do so according to section 138(2) and only on the conditions of section 138(3) of the QCA Act. In particular, the assessment criteria require the Authority to consider a range of factors in assessing a DAAU, including the interests of the operator of the service and of access seekers as well as the right of DBCT Management to generate sufficient revenue to meet the efficient costs of providing access to the service at the terminal and to create a return on investment.

In doing so, the Authority considers that, as a matter of regulatory principle, DBCT Management should be recompensed for the efficient costs of expanding the terminal. That is, that the actual costs of prudent capital expenditure managed in the best interest of the project to deliver a cost-efficient, fit-for-purpose terminal expansion and in the best interest of terminal stakeholders.

In its assessment of the prudence of the outstanding costs, the Authority also had regard to the key matters outlined in clause 12.5 of the 2006 access undertaking, and now reflected in schedule G of the 2010 access undertaking, namely:

- (a) scope of works undertaken;
- (b) standard of works undertaken; and

- (c) the contract cost of works undertaken and variations incurred.

In assessing the prudence of DBCT Management's outstanding costs, the Authority has had regard to advice from independent engineering advisors, Flagstaff Consulting, who also advised the Authority on its earlier assessments of the prudence of the 7x expansion costs.

Public Consultation Process

On 7 November 2011, the Authority published DBCT Management's DAAU and supporting information on the Authority's website (www.qca.org.au) and invited submissions from interested parties by 5 December 2011. Stakeholders were also advised that the Authority may proceed directly to a final decision if no submissions were received.

The Authority received no submissions from stakeholders.

Given this, on the basis of the information provided by DBCT Management and its own analysis, having regard to Flagstaff's advice as necessary, the Authority has decided to proceed directly to a final decision on DBCT Management's DAAU.

1.2 Prudence of outstanding costs

DBCT Management has sought approval to amend the RAB, revenues and tariff based on \$8.7 million in outstanding expenditures related to the 7x expansion. These outstanding expenditures are comprised of:

- (a) contract costs related to control system upgrades, previously approved by the Authority as part of the 7x capital expenditure approvals process, but yet not reflected in the RAB (\$2.3 million);
- (b) some expansion costs (i.e. offshore works) that DBCT Management did not previously submit, either due to timing issues or due to previous concerns raised by the Authority's engineering consultants, Flagstaff (\$0.7 million);
- (c) outstanding other costs¹ mainly related to owner's costs (i.e. team salaries and statutory compliance costs), project management costs, minor mechanical services and miscellaneous minor works required to finalise the expansion (\$4.3 million);
- (d) costs related to the phase 1 in-loading system 3 (IL3) post-handover protective treatment, previously not submitted to the Authority (\$1.7 million); and
- (e) financing costs and interest during construction (-\$0.3 million).

Each of these cost categories is considered in turn below.

Contract Costs (previously approved by the Authority)

DBCT Management has sought approval for two contract variations (i.e. control system and anti-collision system upgrades) for phase 1 of the 7x expansions.

As part of its assessment of the prudence of the expansion costs of the phase 1 expansion between 2007 and 2009, the Authority had reviewed and accepted that these contract variations satisfied the prudence requirements of clause 12.5 of the 2006 DBCT access undertaking. In particular, the Authority accepted that:

¹ Other costs are the construction costs necessary to complete the expansion that are not contract costs and are not assessed under the tender and contract management processes.

- (a) the control system upgrades (\$2.2 million) were necessary to control the new yard machines and conveyor configurations and to meet updated safety standards; and
- (b) the anti-collision system upgrade (\$0.09 million) was necessary as an automated risk prevention tool for operating the terminal.

These costs were not included into the RAB, and therefore tariffs, as part of the phase 1 expansion cost DAAU as the time taken to complete these works was extended given their complexity and the interfaces with other contractors.

Accordingly, as the Authority has previously accepted the prudence of these variations and in the absence of any other material to the contrary, the Authority accepts the contract variations costs as reasonable to be included into RAB.

Contract Costs (not previously submitted to the Authority)

As part of the Authority's assessment of contract costs and contract variations over the period 2008 to 2010, DBCT Management had submitted information in relation to three contract variations. As the Authority's consultant, Flagstaff, identified concerns with each of these contract variations, DBCT Management excluded them from their phase 1 and 2/3 DAAUs. DBCT Management has now formally submitted the variations for inclusion in the asset base and has provided supplementary information to the Authority in support of its application.

First, DBCT Management has sought approval of \$241,436 in insurance costs for damage sustained to the reclaimer RL2 machine that occurred during its dismantling, relocation and modification. DBCT Management's claim is the amount it had to pay to repair the machine in excess of the deductible in its insurance contract. In reviewing this claim, Flagstaff indicated that if the RL2 insurance deductible had been aligned with the insurer's earlier suggestion, the resulting damage would have been covered by insurance; that is, when setting the contract Flagstaff believed that DBCT Management had inappropriately balanced the price and certainty as to final cost.

In support of its revised claim, DBCT Management accepted that it engaged the contractor on the basis of a deductible of \$150,000, rather than aligning the deductible with the 7x project insurer's required deductible of \$500,000. As such, when the contractor accidentally damaged RL2, DBCT Management reimbursed the contractor \$241,436, reflecting the difference between the contractor's deductible and the actual costs incurred by the contractor. DBCT Management argued the variation was reasonable as, *inter alia*, the variation was offset by lower contract prices.

Second, DBCT Management has sought approval of \$175,000 for a claim by the offshore works contractor due to DBCT Management suspending works because of a safety incident. In reviewing this claim, Flagstaff indicated that, while DBCT Management's project engineer gave a direction to suspend the works, the safety incident occurred as part of the offshore contractor's completion of the works and may not have been a valid cause for the contractor to claim a variation as, according to the contract terms, the contractor was responsible for safe management of their site.

In support of its revised claim, DBCT Management said that, while the safety incident occurred as part of the contractor's performance of the marine works, DBCT Management accepted that the suspension was due to the directions given by its project engineer. On this basis, DBCT Management said that, *inter alia*, it settled the variation at half of the contractor's legitimate claim to avoid a potentially lengthy and costly litigation process and reinforced a good working relationship with the contractor.

Third, DBCT Management has sought approval of \$269,185 for an incentive payment to an electrical contractor to achieve early demobilisation to meet the project's finishing date. In reviewing this claim, Flagstaff indicated that an incentive payment to the electrical contractor was not strictly required by the terms of the contract as the electrical works were part of the contractor's scope and responsibility, thus the contractor was responsible for the costs for meeting their contract dates.

In support of its revised claim, DBCT Management submitted that its incentive payment to the electrical contractor was necessary as it was becoming increasingly unlikely that the 7x works would be completed on time and the contractor could have missed the completion date by up to one month, creating risks to terminal throughput. Notwithstanding that the payment was not required by the provisions of the contract, DBCT Management considered that the incentive payment resulted in the contractor completing the works on time.

In considering these matters, the Authority accepts that there were clear whole-of-project benefits associated with these variations. The insurance cost variation and the settlement and incentive payment variations related to contracts on the critical path for completing phase 1 and 2/3 respectively. In particular, litigation on the settlement may have delayed the completion of the 7x works more broadly which would have reduced the availability of terminal capacity for users.

Further, the Authority considers that the DBCT Management's overall management of the 7x expansions was prudent and that given the scale of such works, some contentious variations are an inevitable commercial reality. In this context, the Authority noted Flagstaff's view that:

- (i) *On the 7x expansion DBCT Management processes are thorough and appropriate and have been followed in almost all cases. Where they have not been followed there is ample evidence of why a commercial decision has been made to vary from those processes and Flagstaff has approved of those strategies. On a number of occasions Flagstaff has reported that DBCT Management's management of the project was very good by any standard. (Flagstaff Report: 32)*

Given DBCT Management's variations are relatively minor (around 0.05% of the total cost of the 7x works) and were incurred in the context of DBCT Management's prudent overall management of the expansions, and in the absence of stakeholder comments, the Authority accepts the variations.

Other Costs

DBCT Management has sought the Authority's approval for outstanding 7x costs of \$4.3 million relating to:

- (a) owner's costs (i.e. including team salaries and statutory compliance costs) and project management costs necessary to close out expansion contracts (\$3.0 million); and
- (b) costs related to purchases of capital spares and miscellaneous minor works required to finalise the expansion (\$1.3 million).

DBCT Management submitted that these costs relate to overruns of the *other costs*, previously approved by the Authority, that occurred mainly because the project was extended in time. In approving these *other costs*, the Authority had previously accepted that the overall *other costs* budget was prudently developed and that items which came within budget should be approved without further review. Cost overruns were then separately reviewed for prudence.

The Authority accepts that, of the \$4.3 million of *other costs* now submitted by DBCT Management, \$2.6 million was either within the previously approved budget/forecast allowance or were less than \$100,000 per item. Consistent with its previous approach, the Authority accepts these costs as reasonable.

The Authority then considered material overruns (i.e. greater than \$100,000) on an individual basis, having regard to Flagstaff's advice.

Owner's team salaries and expenses and engineering, procurement, project and construction management (EPCM) services were above budget by \$624,000. The Authority accepts these costs as reasonable as they were time-related and not excessive given the works were extended for an additional four months. In this regard, the Authority notes the Flagstaff's view that:

- (ii) *...these are time related costs...[T]here are no instances where Flagstaff did not approve the strategies undertaken by DBCTM to manage the works, therefore where those strategies led to extension in time, it follows that there would be an over-run in the time-related costs to manage these works...[T]hese time related costs are prudently incurred... (Flagstaff Report: 24)*

Insurance, statutory compliance and licensing costs were above budget by \$791,000. Flagstaff noted that DBCT Management had limited discretion over this type of costs and that they are imposed by legislation. Accordingly, the Authority accepts the costs as reasonable and prudently incurred.

Finally, minor mechanical services and miscellaneous minor orders were overrun by \$379,000. The Authority accepts these costs as reasonable because, after the project was commissioned, there were clean-up works and small items in addition to the scope of major works. In particular, Flagstaff accepted that these costs are not unusual for large projects and are not excessive given the scale of the total project and the time extensions.

Given this, the non-materiality of the overruns (\$1.7 million comprise 0.6% of the previously approved *other costs*) and the absence of the stakeholder comments, the Authority accepts the variations.

Costs related to the phase 1 in-loading system 3 (IL3) post-handover protective treatment

DBCT Management has sought approval of \$1.7 million for the post-handover protective treatment works on in-loading system 3 (IL3). These works predominantly related to painting IL3 and were done following the commissioning of IL3 and were, therefore, not previously included in the DBCT Management's phase 1 DAAU.

The Authority accepts that the protective work was correctly done after the erection of the IL3 works and not before. In this regard, the Authority noted Flagstaff's view that the:

- (iii) *... process used for bringing steel components to the Dalrymple Bay 7X site was that after fabrication they were pre-coated at the fabricators and then touched up at site to repair damage which occurred during transport and during erection, the connection points between sections were then coated and painted ... [T]his method is appropriate given the size of the task and the paucity of space on site to do the work and that in these circumstances the extent of the coating repair work could never be entirely evident before erection of the steelwork was complete (Flagstaff Report: 9).*

The Authority accepts that the extent of the protective works was not excessive and accepts Flagstaff's advice that they were consistent with the relevant Australian Standards.

The Authority notes that the works were sole-sourced to an existing contractor who was already engaged on related works. Flagstaff noted that, as the contractor was already on site and familiar with the operational environment, it was reasonable to do this and avoid costs of another contractor having to "get up to speed". In addition, Flagstaff noted that:

- (iv) *... [a] measure of the benefit of having a knowledgeable contractor on site was that ... a Lump Sum price for the works [was agreed]. This is completely at odds with the risks of this type of work and is a very good outcome for DBCT. (Flagstaff Report: 11).*

The Authority also accepts the reasonableness of the project costs as they were consistent with works of this type. In particular, the Authority had regard to Flagstaff's view that the estimate

of costs by DBCT Management's independent contractor was a reasonable industry benchmark. As the final cost was less than the benchmark, Flagstaff accepted the costs were reasonable particularly as they were undertaken in an operational environment which is inevitably more difficult.

In reaching this view, the Authority also notes Flagstaff's view that there was no double counting of costs with normal repair and maintenance works undertaken as part of operating the terminal.

Given the above matters and in the absence of the users' comments, the Authority considers the costs of \$1.7 million for IL3 post-handover protective treatment to be prudently incurred and accepts that they be included in the regulatory asset base.

Financing costs and interest during construction (IDC)

In addition to \$9 million in outstanding costs, DBCT Management has sought approval for funding costs and IDC of minus \$0.3 million, reducing the total, sought for approval, costs to \$8.7 million.

The Authority accepts that the financing costs were offset by a negative IDC as the majority of outstanding expenditure were incurred after the commissioning date of the respective 7x phases, at which point DBCT Management was earning revenue on the facility, therefore negative weighted average cost of capital (WACC) rate applied to the outstanding construction costs.

The Authority confirms that DBCT Management calculated financing costs and IDC correctly in accordance with the requirements of the s.12.6 of the 2006 and 2010 undertakings and sound modelling practises, namely that:

- (a) the return on capital over the construction period was calculated at the appropriate rate as specified in the 2006 access undertaking;
- (b) the return on capital applicable from the first day of month following commissioning of the outstanding expenditure was also calculated at the appropriate rate as specified in the 2006 access undertaking;
- (c) the regulatory (benchmark) debt / equity ratio was applied (i.e. in the case of DBCT, 60/40) to the expenditure; and
- (d) financing costs have been included as part of the capital cost base to which IDC applies.

Given these matters, the Authority accepts DBCT Management's financing costs and IDC of minus \$0.3 million.

1.3 Revenue modelling

The Authority has reviewed the DBCT Management's proposal to include into the RAB the outstanding \$8.7 million of costs for the stage 7x terminal expansion.

In particular, DBCT Management has sought the Authority's approval for:

- (a) increasing the RAB by \$7,541,539 from 1 July 2011;
- (b) increasing the ARR (and revenue cap) by \$1,158,782 to \$247,133,830 for 2011-12;

- (c) increasing the reference tariff by \$0.0136/tonne to \$2.9136/tonne, effective 1 January 2012; and
- (d) a one-off payment from users of \$4,524,288 (assuming invoicing in February 2012) reflecting both the increase in the ARR and revenue cap for July-December of the 2011-12 financial year as well as for the preceding periods commencing after the commissioning of costs for respective 7x phases and before July 2011.

DBCT Management submitted that the methodology for calculating the ARR and the reference tariff is consistent with that used for the previous 7x DAAUs.

The Authority has reviewed DBCT Management's financial modelling of the outstanding expansion costs and has confirmed that DBCT Management's underlying ARR modelling assumptions and calculations are consistent with the Authority's building blocks methodology. In particular, DBCT Management has appropriately revised the ARR, revenue cap and tariff estimates based on the inclusion of the outstanding cost amounts into the RAB.

The Authority has also reviewed DBCT Management's estimate of its proposed one-off payment of \$4,524,288 from users. The Authority has confirmed that DBCT Management has correctly calculated the one off payment in accordance with the WACCs prescribed in the 2006 and 2010 access undertakings.

On this basis, the Authority accepts the proposed amendments to the ARR and tariff as well as the proposed amount of the one-off payment.