



QUEENSLAND
MINING COUNCIL

Submission

to the Queensland Competition Authority

in response to the Draft Access Undertaking –
Dalrymple Bay Coal Terminal



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Introduction

The Queensland Mining Council (Council) is the mining industry's peak representative body in Queensland and submits this response to the Draft Access Undertaking (DAU) submitted by Prime Infrastructure (DBCT) Management P/L. Council's response is on behalf of all its members and has been prepared in the knowledge of the response to be submitted by current users of DBCT, most of whom are also Council members.

Council's submission is intended as an adjunct to that of the DBCT Users. It does not repeat the proposals or criticisms and the rationale for the Users' stance that are considered by council to be well articulated. Council considers the DBCT Users' response and proposals represent an equitable basis for operational, pricing and administrative structure for both existing users and prospective users who may seek access to the terminal in the future.

The DBCT Users' submission is a comprehensive response to the DAU which addresses the issues raised by QCA in its Issues Paper but also raises other issues and importantly where appropriate makes alternative proposals to the approach adopted in the DAU.

Council considers the DBCT Users submission to have been developed on the basis of well reasoned and researched principles. It is noted that in a number of areas the DBCT Users' position differs from that put forward by Prime and that constructive alternatives are put forward. The DBCT Users' key objective is to construct an environment that will deliver port capacity on a cost competitive and sustainable basis. Key drivers are the requirement to attain the lowest whole of life cost to shippers recognising the legitimate claim by the infrastructure provider to receive a return on capital commensurate with the risk it is exposed to, in order that ongoing investment in the facility is encouraged.

DBCT's ownership and operating structure is unique in Queensland and while there are a number of issues raised in the Prime and DBCT Users' submissions, which could be applied to other port facilities, there are other areas where the proposed arrangements for DBCT may not be optimal. This is a common feature applicable to infrastructure in Queensland generally, not only ports. Each has its unique combination of existing and prospective users; ownership and operating structure; and historical financial structure. It is important that these are each considered in the entity's context when establishing a regulated access regime. While there may be certain generic principles and precedents already in existence and which may result from this current process, blind application without consideration of the individual infrastructure's characteristics carries the danger of resulting in uncompetitive charges, inequitable outcomes and / or unsustainable investment criteria.

Port Capacity and the Queensland Mining Industry

The mining industry is an important industry to the Queensland economy with the value of mineral production in 2002 totalling \$11.4Billion, mineral exports representing 40% of Queensland's exports by value and direct employment in the industry around 19000 in a number of regional locations where the industry is the largest employer. The vast majority of the State's mineral production is exported either in its raw or processed form. The coal industry is the largest mining sector with approximately 85% of the State's coal production exported – around 130Mtpa. This tonnage represents more than 20% of global coal trade with Queensland accounting for almost 50% of global coking coal trade and more than 10% of global thermal coal trade. DBCT's share of these markets is almost 20% and more than 3% respectively.

Port capacity is a vital link in the export chain for almost all mining commodities produced in Queensland with the industry selling its products globally to all regions of the world. Ports are also a vital link for some of the states mineral processors through the import or coastal movement of raw materials for downstream processing – bauxite, nickel ores and base metal concentrate for example.

Without access to these global markets the mining industry, and as a consequence the Queensland economy, would be a fraction of its current size and the ports are the vital link to these global markets by providing access to the international bulk shipping industry. Although port handling charges do not represent a particularly large percentage of total costs, in the extremely competitive global markets each link in the supply chain, including port charges needs to be competitive in its own right.

Of equal importance to the industry is that port capacity be available to meet its growing demand. In all commodities raw material buyers ascribe value to security of supply. Some commodities, notably coal in relation to DBCT, do not have a long shelf life and therefore raw material consumers require that they have confidence in their access to supply at relatively short notice. It is therefore important that port infrastructure can demonstrate its ability to meet both the capacity demanded of it in the near term and to be able to accommodate growth in the longer term. The mining industry also appreciates the need for competitive but sustainable whole of life costs, including return on capital, if infrastructure is to be supplied in the future.

The Queensland mining industry generally is considered to have the underlying potential for ongoing growth. It has prospective geology and established efficient mining and infrastructure assets available for incremental expansion. Specifically in the case of coal, Queensland, and DBCT, currently has a very competitive position in the global coking coal market and, while overall market growth is slow, there is the general view that it has the capacity to capture further market share. Queensland and DBCT have a smaller position in the thermal coal market but again there is the general view that Queensland can at least hold its share of this market which is expected to continue to demonstrate reasonable growth.

Queensland has high quality coal; in generally favourable geological setting; relatively close proximity to the coast. However the key to both maintenance of current market position and the achievement of further growth is the competitiveness of the coal chain, including port handling services.

The overall whole of life cost must be competitive. The key parameters in the determination of this cost under the regulatory environment currently in place in Queensland are the asset value and rate of return. Specifically in relation to the DBCT DAU and also more generally in relation to infrastructure pricing in Queensland, Council is concerned that asset values are inflated and that expected returns are high relative to the risk accepted by the access provider.

The combination of artificially high asset value and inappropriate risk / return profile will result in high infrastructure access charges which will reduce the competitiveness of coal supply through DBCT in this case and mineral output in Queensland more generally. This will discourage growth and in the medium term will have a negative impact on current industry activity.

The correct asset value / risk –return environment will still provide the incentive to the infrastructure sector while offering competitive infrastructure access to the mining industry and thereby the best opportunity for growth for the benefit of the mining industry itself, infrastructure providers and the Queensland economy generally.

Asset Valuation

Both Prime and DBCT User Group have submitted valuations of the DBCT assets. The valuations are substantially different. Council has not conducted its own assessment of asset value and it is noted that QCA intends to commission an independent group to assess the valuations submitted by Prime and the DBCT User Group.

Council has previously submitted its views on the alternative valuation approaches through the Rail Access Undertaking process. It accepts the Depreciated Optimised Replacement Cost as a valid approach. However as the current range in the two parties' asset values demonstrates, adoption of a particular valuation approach still involves a large degree of subjectivity as principles appear to be able to be interpreted quite differently. During the consultation process for the Rail Access Undertaking, Council chose not to conduct its own asset valuation, deciding to accept QR's approach and QCA's endorsement of its approach. Since that time over a number of tariff reviews and determinations that Council has found difficult to reconcile, there is a clear need for transparent asset valuations and clear definition of the process behind these.

It is important that QCA establishes a number of guiding principles with regard to asset pricing if it is to avoid having to take the position of arbiter. The following addresses some of the valuation components raised in Prime's DAU. Council's comments regarding these valuation components, relate to DBCT and generically to other ports and general infrastructure.

- **Capitalised interest** – It is appropriate that an allowance be incorporated in a valuation of an asset with a long construction lead time during which no revenue can be generated yet cash outflow is significant. Council agrees with DBCT Users that this should be assessed on the basis of the WACC and adoption of a realistic project path. Prime's submission is not justified, as it proposes a different interest structure and it is not seen to support the adoption of a 4 year construction period (eg Table 2 Prime Accompanying Submission).

- **Staging Cost** - It is common for infrastructure assets to be constructed incrementally driven by the requirement for efficient utilisation of assets. DBCT is such an example. It is recognised that, with the benefit of hindsight, staged construction can result in sub optimal asset layout and or higher construction costs. In principle, where capacity development is determined through a fully inclusive consultative approach, additional costs imposed by a staged approach should be recognised. However DBCT's existing asset base should be subject to a specific, rather than generic approach. In the case of DBCT, the historical charging regime; the structure of the recent tender for the long term lease; together with specific provisions in the Port Services Agreement are relevant to this issue. As a consequence it is considered inappropriate to include staging costs in the valuation of existing infrastructure.
- **Growth Capital**- Prime has included the cost of Stage 7A in its valuation. Council believes that the allowance for growth capital as proposed in the DAU cannot be justified. Its application also proposes a 7 year term over which the reference tonnage is not expected to grow. A transparent and simple asset valuation model should be able to incorporate any capital investment for capacity expansion as it is put in place. Under the proposed port planning, encompassing both short, medium and long term plans including the Master Plan, existing and potential shippers will be aware of capacity constraints and lead times for expansion. Capital and tonnage growth can be incorporated in the pricing regime accordingly.

Cost of Capital and Pricing Structure

Both the DAU application and the DBCT Users' response have detailed discussion on the derivation of an appropriate return on capital under a regulated regime and DBCT in particular. There are many references provided in these respective submissions and QCA is itself familiar with assessment of the general underlying economic parameters which are applicable.

It is imperative that establishing the return on capital is not considered in isolation of the proposed pricing structure as well as the specific risk of the underlying business. The risk profile borne by the infrastructure provider is very much determined by the pricing structure and the underlying business risk of the resource base being serviced by the asset base.

Prime proposes a hybrid pricing structure which is neither a price or revenue cap approach. The DBCT Users propose a revenue cap model with volume risk accepted by the shippers themselves as it is considered they are the parties most able to manage that risk.

Council agrees with the Users' view that Prime has overstated its risk exposure in support of its WACC and that the lower risk pricing structure proposed by DBCT Users – the revenue cap approach - supports a substantially lower cost of capital.

Under DBCT Users' proposal, Prime would accept the credit risk of the shipper, however Council believe that consideration must be taken also of the underlying competitiveness of the resource base which the port services. This resource base has a very strong competitive position in the global coal market and, as has been demonstrated in the past, even were the entity owning the resource to encounter financial difficulties, there is a very low risk of asset stranding as the resource is likely to be sold to an alternative shipper and demand for port services will continue.

Council considers that the DBCT terminal operates in a low risk business environment and within this the proposed pricing structure suggested by Prime reduces the risk further. The pricing structure proposed by the DBCT Users' is their preferred alternative and offers even lower risk to Prime. Above all else however is that the pricing structure and the WACC must be considered in combination. It is inappropriate to determine a WACC in isolation of the pricing structure.

Council considers there to be no merit in the inclusion of any allowance for asymmetric risk in the WACC as is proposed in the DAU.

OPERATIONS MANAGEMENT AND COST PASS THROUGH

It is proposed that the current operations management structure which is controlled by the users continues and the current mechanism for operating cost pass through be retained. The existing structure of separation of asset ownership and operations management has resulted in a coal terminal that has been assessed as one of the world's most efficient which suggests that it has been effective to date. The fact that the coal shippers control the operations management is considered sufficient incentive in itself to ensure efficient operations. The intention to retain the structure which allows ownership to any current and new DBCT user is supported by Council as is the intention for cost pass through.

While the concept of cost pass through is endorsed for the DBCT operation this should not be taken as an endorsement for such a model to be applied to other ports and infrastructure facilities. The cost pass through model is appropriate for DBCT due to the fact that the shippers have management control and that ownership of this management control is open to all users.

In examples where users do not have management control and or ownership of the management structure is restricted, such a model is considered inappropriate and an alternative model which has an incentive / penalty structure resulting in an efficient management and cost structure would be necessary.

The DBCT Users' submission details areas of the current ownership and management arrangement which lead to potential inefficiencies or inequity. Included in this is the maintenance versus replacement capital trade off and also the allocation between long term maintenance activity and capital "double dipping". It is important for both intergenerational equity, the funding responsibility and efficient whole of life costs, that the interface between operations maintenance and capital is clearly and efficiently delineated. The Users' submission provides an appropriate structure to achieve such an outcome.

Pricing

Both Prime and the DBCT Users recognise the need for the pricing mechanism to incorporate an incentive structure to drive the efficient utilisation of assets through user pays concepts. While the two proposals are different they have the same objective.

The DAU proposes to vary the threshold rebate through application of an efficiency factor based on each user's use of inloading, stockpiling and outloading assets relative to total use.

This approach is less direct than that proposed by the DBCT Users and is therefore likely to have less impact on behaviour. Any user pays incentive type structure, if it is to be effective, should be simple, easily understood by users and not able to be manipulated so as to result in behavioural distortions. It should be easy to administer so as to avoid the imposition of significant administration costs either at the DBCT Management / DBCTPL level or to individual users. A significant cost in administering a structure that has the objective of efficiency is contradictory. The DBCT Users have the benefit from the experience of operating the terminal for many years and have structured their proposal with the objective of a simple easily administered structure which should drive behaviour towards an efficient utilisation of assets.

As regards the pricing mechanism itself, the DBCT Users propose a revenue cap model as opposed to the hybrid proposed by Prime. The Users support their proposal by pointing to the fact that from both the ability to manage the risk and to ascribe the lowest valuation of the risk, volume risk is best borne by the Users.

It is reiterated that the rate of return assessment is inextricably linked to the pricing structure.

RING FENCING

The current composition of the DBCT Users and the current status of Prime Infrastructure and its asset base are such that there is no requirement for ring fencing for either operational or capital negotiations. The DAU adequately provides for this issue to be reviewed in the event of a change in circumstance.

Contact

Any enquiries relating to this submission should be directed to Mr Keith Barker, Industry Policy Adviser, Queensland Mining Council.