

QRC

submission

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A large, stylized graphic of a leaf or petal shape, composed of several overlapping outlines. The outlines are in shades of grey and green, with the green being a vibrant lime green. The shape is positioned on the left side of the page, partially overlapping the text.

Submission in response to:
QCA's Proposed Investment Framework
for the Central Queensland Coal Network

To the Queensland Competition Authority
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ABN 59 050 486 952

Level 13 133 Mary St Brisbane Queensland 4000

† 07 3295 9560 ‡ 07 3295 9570 € info@qrc.org.au

www.qrc.org.au



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INTRODUCTION

The Queensland Resources Council (QRC) provides this submission to the Queensland Competition Authority (QCA) in response to the *Proposed Investment Framework* (Concept Paper) which was released for stakeholder comment on 22 July 2010. QRC welcomes the opportunity to present industry's view of the appropriate regulatory environment that will promote the economically efficient operation of, use of and investment in, QR Network infrastructure.

The Concept Paper outlines a broad range of matters, principally targeted at high-level principles and conceptual frameworks, which the QCA is considering for inclusion within the Authority's forthcoming decision regarding QR Network's most recently proposed replacement access undertaking (UT3.2).

The purpose of this submission is to provide QRC's position regarding:

- the **critical issues** which industry considers must be addressed with respect to the future investment framework;
- the Concept Paper's proposed **key principles and frameworks**;
- the importance of **implementation and administrative matters** that will be essential in transforming principles and frameworks into effective operational processes; and
- appropriate consultation processes that will be required to ensure that the approved principles and frameworks are **effectively institutionalised within the access undertaking**.

While timeframes to respond to the Concept Paper have not been sufficient to allow a full assessment of the entire range of implications of the proposed framework, QRC understands that the current stage of consultation is one, albeit significant, step in this process. QRC expects that further consultation with all stakeholders will be undertaken in order to ensure that the framework delivers its purpose.

→ QRC's Position on the QCA Concept Paper

QRC strongly endorses the overall approach presented within the Concept Paper.

While there are a number of aspects that require further clarification and/or development, the overall intent and objectives are supported by QRC, in principle. Further detail is provided within this submission and QRC strongly supports subsequent discussions on detailed implementation matters.

→ Critical Issue: Addressing the investment hold-up problem

QRC's previous submissions have documented industry's strong concerns regarding the potential for QR Network to misuse its monopoly position by seeking acceptance of onerous terms as a condition of expanding the network.

The issue arises from the "*Foundation Premise*" that QR Network cannot be obligated to fund an expansion. QRC has opposed this premise on the basis of the perverse incentives of a non-aligned vertically integrated monopolist. QRC has suggested that QR Network should be obliged to fund expansions, subject to safeguards (for the benefit of QR Network) which ensure that QR Network is not required to fund an expansion on unreasonable terms. However, given the position of a range of



parties in relation to this matter, QRC now accepts that UT3 will reflect the principle that QR Network will not be obligated to fund Network expansions. We note that exceptions are expected to apply:

- in cases where QR Network has voluntarily assumed an obligation to fund these investments (for example, expansions less than \$300 million).
- where QR Network is bound contractually to fund a project or invest in the network.

In the absence of an obligation to fund under UT3, it is critical that the regulatory framework contains mechanisms which provide Access Seekers with a genuine alternative to accepting the terms of funding ("Access Conditions") sought by QR Network. The Concept Paper seeks to address this issue in a number of ways:

- **Establishing a genuine 'user funding' option:** This safeguard, if effective, will constrain the ability of QR Network to seek onerous terms for funding, by exposing QR Network to a competitive market for financing.
- **Establishing mechanisms to ensure a level playing field in the competitive market for financing:** The user funding option will only be effective if it is supported by a range of mechanisms which ensure that users who select this option are not disadvantaged in terms of capacity allocation and project delivery (including timeframes). The Concept Paper proposes a number of such mechanisms.
- **Providing for QCA oversight and approval of Access Conditions:** Again, this constrains the ability of QR Network to seek onerous terms. This mechanism would arguably be unnecessary if the protections surrounding the user funding option were perfect (that is, if there was a perfect competitive market for finance, in which QR Network enjoyed no advantage due to its position as a monopoly service provider).

QRC notes that there are advantages and disadvantages in having QCA oversight and approval of the terms on which QR Network funds projects:

- **Advantages:** QR Network's incentive to use monopoly power to force acceptance of its preferred finance terms, and the cost to users if QR Network does act in this way, are both reduced, as QR Network will only be able to impose Access Conditions which are deemed reasonable by the QCA.
- **Disadvantages:** Users may find themselves in a position where they are satisfied with the terms offered by QR Network and where QR Network's terms are preferable to any alternative source of funds, yet users may be unable to accept QR Network's offer if the QCA determines that the terms are not reasonable. In this case, regulatory oversight has prevented a mutually beneficial agreement from being executed.

At this stage QRC considers that the user funding option, and the associated protections which should ensure that 'user funders' are not disadvantaged, are not sufficiently well developed and documented to conclude that regulatory oversight and approval of Access Conditions is not necessary. Similarly, QRC would not like to see the QCA constrained within an overly prescriptive set of rules regarding the terms which can be approved. QRC suggests that resolving this issue should be undertaken as per the process outlined in the section titled *Recommended approach to moving forward* below.



→ **QRC concerns with previous approaches to Significant Investments (UT3.2)**

QRC's most recent submissions to the QCA highlighted industry's concerns in relation to the inadequacy of the proposed UT3.2 provisions relating to future investment in, and expansion of, QR Network's below-rail.

In summary, these concerns surrounded

- Risk of inadequate enforcement of the investment obligations in UT3.2 – QRC has sought to address these matters in co-operation with Queensland Treasury within the current review of the *Queensland Competition Authority Act 1997*.
- Industry requiring a credible alternative to accepting the terms sought by QR Network.
- QR Network being able to seek higher rates of return and a reduced risk profile, regardless of whether this is justified by the underlying risk profile of the project.
- Users who fund a project would not have an effective mechanism with which to recover a reasonable contribution from subsequent users that use the infrastructure at a later date.
- QR Network to retain the right to control all aspects of the project despite user funding applying (that is, the level of user involvement and participation was at QR Network's discretion).
- Users being incentivised to strategically seek access when the subsequent expansions are not Significant Investments (that is, less than \$300 million), or when the next Significant Investment is a relatively low cost (per train path created) project.
- Commitment to create sufficient Available Capacity to provide Access Rights sought by an Access Seeker was not subject to explicit timeframes.
- Where QR Network agrees to undertake an expansion project, it was not required to prepare a draft project implementation timetable and there was no process for industry to consider the appropriateness of the schedule timeframes.
- Where QR Network does not progress a project based on the project schedule without adequate explanation, then industry did not have a right to intervene in the construction of the expansion project.

Overall, the Concept Paper has sought to address the abovementioned issues, although QRC notes that the proposed solutions are currently at a principle level. Further detail will be required to ensure the intent of the principles is able to be achieved.

At the time of finalising this submission, QRC had received a copy of QR Network's revised Investment Framework model which was recently provided to the QCA prior to the release of the Concept Paper. While QRC has undertaken only an initial review of QR Network's revised framework, it is important to recognise that QR Network has sought to address a number of industry concerns. In particular, the paper does seek to improve the 'user funding' model. QRC welcomes this constructive approach. We note that the QR Network Investment Framework is similar, in many respects, to the approach outlined in the QCA Concept Paper. A key difference is the level of QCA oversight of



Access Conditions. As noted previously, QRC considers that this oversight is critical at this time given the level of development of the investment framework at this time.

QRC looks forward to working closely with QR Network and the QCA to ensure the future regulatory framework provides for ongoing future investment in, and expansion of, QR Network's below-rail and associated network infrastructure.

→ **QRC's Investment Framework Requirements**

In order to highlight the essential elements of any effective investment framework, QRC presents the following threshold requirements:

1. Users must have the absolute right to provide the funding of enhancements to the network – and project delivery timeframes should be independent of funding sources. A robust industry funded investment model will need to be developed which enables access seekers to fund expansions of network infrastructure as an alternative to accepting the terms sought by QR Network.
2. QR Network must not be able to exploit its monopoly power in order to advantage itself in the competitive market to fund expansion projects. QRC notes the merits in extending participation in this competitive market beyond QR Network and users. That is, mechanisms should be established which allow for a third party to provide funding on behalf of a User.
3. The Investment Framework must apply to all QR Network extensions, expansions and other enhancements to the declared service.
4. All necessary provisions, processes, procedures and documentation must be sufficiently developed to ensure investment and project delivery are able to occur in a relatively automatic, timely and structured way. Development of specific timeframes for each step of the process, and effective mechanisms to prevent delay where these timeframes are not met, is critical to ensuring that user-funding options are effective and are a genuine alternative to QR Network funding.

Overall, the Concept Paper has sought to address the abovementioned issues although further detail will be required to ensure these matters can be transformed into tangible processes.

→ **Specific Responsibilities**

In order to develop suitable key principles which will underpin the necessary detail required, the following rights and responsibilities provides an overview of the necessary measures that will need to be translated into provisions within the replacement Access Undertaking, and the yet to be developed template agreements.

Coal Producers (Users):

- Users must have the absolute right to provide funding for any expansions, extensions *and* other necessary below-rail investments.
 - The source of funds should not influence QR Network's performance in terms of project delivery.
 - Users who fund must receive priority in the allocation of capacity resulting from that funding.



- Users may choose to user fund the investment at any stage in the process.

QR Network

- UT3 will reflect the premise that QR Network cannot be forced to invest in expansions or extensions – except to the extent of QR Network’s voluntary commitment to do so.
- QR Network must be obliged to undertake replacement capital expenditure – as part of its obligation to maintain the network.
- QR Network must develop a specific employee Code of Conduct, or formal employee compact, for QR Network employees (or contractors) who will be the critical QR Network interfaces between Users and project delivery matters to clarify roles and responsibilities.

QCA

- QCA must ensure that QR Network is not exploiting its monopoly power, by ensuring that the Access Undertaking contains adequate protections to ensure that Access Seekers who choose user funding will not be disadvantaged, and, if necessary, through oversight and approval of Access Conditions.
- QCA must approve the suite of standard agreements required to enable User funding to be a genuine alternative to accepting QR Network’s terms. This includes:
 - Standard User Funding Agreement;
 - Network Protection and Safety Agreement – in the event the Users are forced to construct enhancement projects; and
 - Any other documentation which is deemed necessary to underpin the investment framework.
- QCA must publish an Arbitration Guideline to inform interested parties about the principles that are likely to guide the QCA when considering a binding arbitration regarding:
 - the scope of the project and project timelines; and
 - a user funding agreement including: security requirements, and any variations from the QCA approved Standard User Funding Agreement.
- QCA must publish an Arbitration Guideline with respect to the inform QR Network and Users about the principles likely to guide the Authority when considering access conditions referred to under the proposed structured negotiation process.

→ The importance of a range of implementation and administrative matters

The ability of User funding and expansion processes to provide for transparent processes that are effectively automatic in terms of execution will be essential in transforming principles and frameworks into effective rules and operational processes.

In addition, the development of standard agreement templates will provide significant certainty to users if they are clear, and provide appropriate incentives on QR Network with a fair and logical balance of risk. These should speed up commercial transactions, minimise time associated with contract negotiation and provide clarity as to the default roles and responsibilities of the parties.



QRC notes that the range of processes, timelines and deadlines will need to be developed to provide a disciplined-approach by all participants. Industry looks forward to participating in the development of these important implementation and administrative matters.

→ **Specific Points requiring clarification and/or further detailed development**

Given the Concept Paper outlines a broad range of topics, principally targeted at high-level principles and conceptual frameworks, there are a range of matters to which further clarification would be beneficial to the ultimate development of the regime. An attachment outlining various specific points is provided at Attachment 1. QRC looks forward to progressing through these matters within the forthcoming processes to develop the investment regime.

→ **Recommended approach to moving forward:**

QRC suggests that:

- an interim Investment Framework be established within UT3, based broadly on the QCA's Concept Paper.
- the interim arrangements should be less prescriptive than suggested in the Concept Paper in regard to the approval of Access Conditions, in order to ensure that the QCA is able to approve a range of possible outcomes in cases where these conditions are supported by access seekers.
- QR Network should commit, in UT3, to submit for approval a fully documented Investment Framework, including standard agreements, no later than June 2011. The need for continuing regulatory approval of Access Conditions would be reviewed at this time, taking into account:
 - Experience gained from implementation of the interim arrangements; and
 - The extent to which the proposed framework includes protections sufficient to ensure that users who select user funding (and projects which are entirely user funded) cannot be disadvantaged.

QRC considers that the establishment of an interim framework is essential not only because the experience gained from testing the framework will assist in the development of a detailed framework, but because some very significant projects must be progressed within the coming 12 months. In the absence of an interim framework, these projects must either be deferred or progress without the guidance or protection of any regulatory framework, neither of which is an acceptable outcome.

Further information

If the QCA would like further details in relation to any of the issues addressed in this submission, please contact Russell Silver-Thomas on 07 3316 2512.



Attachment 1. Specific Points requiring clarification and/or further detailed development

QCA Paragraphs 11, 15 and 17 – Further detail is required as to the QCA's approach to the position of small users who may not be able to fund the upfront capital cost of expansions being protected and how this will impact on Users that are committed to providing funding to network expansions.

QCA Paragraph 12 – QR Network will need to have an explicit obligation within the undertaking to ensure it maintains replacement capital expenditure - QR Network must be obliged to ensure its network is adequately maintained.

QCA Paragraph 12 – It is unclear how the aggregation of a number of projects will be applied and the extent to which aggregation of access requests could result in the QR Network's voluntary commitment to invest in all expansions valued at less than \$300 million being rendered meaningless.

QCA Paragraphs 12, 13 and 14 – The QCA timing and process of this requirement will need to be explored further such that this process does not adversely affect key project decision making matters.

QCA Paragraphs 15, 16 and 17 – It is not clear what approach will *actually* be undertaken with respect to the scoping of expansion projects. Given that projects are generally constructed to achieve a defined scope, there are number of questions as to how this will include all users seeking capacity. Item 15 is clear in requiring that expansions should accommodate the needs of all users who are willing to commit to the approved terms and conditions. However, if QR Network is unwilling to provide funding based on these terms, how will the funding be provided? Clearly there are only three options:

- Compel QR Network to invest: which is not the approach being taken under this framework.
- Scale the project to match the available funding: which does not seem to meet the principle stated in item 15, if that principle is to be strictly applied.
- Delay the project until some party is willing to provide funding to meet the needs of all users. Users who are willing to fund their share would then be faced with a choice to (a) provide funding for the benefit of the other users on terms which were unacceptable to QR Network or (b) wait until all users are willing to provide funding.

QRC seeks clarification of the QCA's intent.

QCA Paragraph 17 – The calculation process or principles for the proposed Premium to be paid for by users that choose to not participate in user funding is of interest. For example, will the premium be negotiated between users, regulated and determined in advance for a regulatory period, or determined on a case by case basis by the QCA? QRC is also interested in what other measures are available to deter free riding.

QCA Paragraph 18 – QRC does not understand this paragraph.

QCA Paragraphs 18, 19, 20 and 36 – The apparent imposition of the “current capacity resumption provisions” is of a concern to QRC. QRC suggest that the QCA should consider approving specific relinquishment provisions where justified, and that the provision of user funding is a relevant consideration. This could include consideration of the proposed production demand profile (ramping-up expectations from mines), the timing of available capacity of current and planned unloading facilities and the overall scale of the investment. QRC is mindful that these provisions should not be



misused to eliminate access from other potential users or create unnecessary competition policy concerns, therefore there may be merit in providing a level of flexibility in these arrangements.

QCA Paragraphs 23 – We assume that “the same rate of return that QR Network would receive in the circumstances” includes any uplift approved by the QCA (ie. is not limited to the standard WACC).

QCA Paragraphs 25, 26 and 27 – There will need to be a standard agreement that outlines the roles and responsibilities of QR Network and Users (Network Protection and Safety Agreement) in the event the Users are forced to construct enhancement projects. Given that this right will be required if “*QR Network unnecessarily delays the construction of an approved expansion*”, then there needs to be an automatic process, including an existing standard agreement, which can alleviate further unnecessary delays around the process for a third-party to undertaking construction activity with QR Network’s infrastructure. Specific timeframes are required in order to give definition to “expeditiously construct” and “unnecessarily delay”. Clearly it is not possible to define timeframes for all projects within an undertaking, therefore dispute resolution must operate within clear guidelines and timeframes.

QCA Paragraphs 25, 26 and 27 – There are a number of issues associated with project timing and QR Network capabilities with respect to User funded expansions. In the event that Users entirely fund an expansion project, QR Network could seek to strategically schedule these projects at the end of its preferred project pipeline. Greater transparency around timing and delivery of projects will need to be examined further within the Investment Framework.

QCA Paragraph 35 – The proposed universal application of “the current average pricing approach should be adopted (i.e. a uniform tariff that sits between incremental and stand-alone costs)” for approved expansion projects is not supported by QRC. While this approach may be appropriate in a number of circumstances (such as relatively small expansions made to existing systems), there are a range of other expansions that are currently treated based on a number of other tests and criteria. For example, contribution to common costs, system premiums and even new system pricing approaches. QRC considers that there needs to be sufficient flexibility to ensure the particular nature of expansion projects are able to be taken into account when determining pricing rules – as is the current regulatory practice (within draft amending access undertakings).

QCA Paragraph 33 – We assume that the timeframes mentioned in this paragraph will cease to apply if users elect to terminate negotiations and proceed with user funding at any earlier date.

QCA Paragraph 36 – QRC is interested in how the carry-forward of excess capacity to be “carried forward” will be determined.

QCA Paragraph 41 – In terms of the triggers to initiate an Expansion Process, QRC notes:

- Fundamentally, any User(s) willing to fund investments should be able to initiate this process;
- Users should be able to trigger investment in the system which is not strictly an expansion (such as the ‘robustness’ projects proposed by QR Network in past Master Plans). seek a level of system capacity to meet operational performance requirements- this may require an Expansion project; and
- All unloading facilities (single and multi-user) should have the ability initiate an expansion process.



QCA Paragraph 42 – Close attention will be required to the development of appropriate timetables, deadlines and information requirements. In addition, project governance processes should be central to any investment framework as these establish the parameters to which the parties will work together, outline how decisions will be made and provide a process resolve disputes. Establishing project objectives and then tightly defining the scope, time and costs required to achieve those objectives is in the best interests of both users and QR Network. In addition, the obligations of each party must then be clearly set out to avoid ambiguity or conflict and facilitate efficient project delivery.