Queensland Rail's 2015 Draft Access Undertaking:

Submission on QCA's Draft Decision.

Volume 1

Introduction to NHC Submissions & regulatory framework

December 2015

1 Introduction

On 8 October 2015, the Queensland Competition Authority (**QCA**) released its Draft Decision in respect of Queensland Rail's 2015 draft access undertaking (the **2015 DAU**).

New Hope Corporation Limited (**NHC**) supports the Draft Decision, in particular the view of the QCA that the 2015 DAU is not appropriate to approve, having had regard to each of the matters in section 138(2) of the *Queensland Competition Authority Act 1997* (Qld) (**QCA Act**).

NHC generally supports the changes which the QCA has proposed to ensure that a revised DAU is consistent with the approval criteria across both pricing and non-pricing matters. We commend the QCA on the rigorous analysis and balanced application of the approval criteria which is evident throughout the Draft Decision. However, we consider that a number of aspects of the Draft Decision require amendment in order to avoid unintended consequences and to better reflect the matters the QCA is required to have regard to.

This submission will set out NHC's views on:

(a) supported elements of the Draft Decision; and

(b) elements requiring revision.

For those elements which are supported, the rationale for their appropriateness has been thoroughly documented in the Draft Decision, and, in many cases, in NHC's June 2015 submissions. Our comments on the supported Draft Decisions will therefore be briefer in nature (but, for the avoidance of doubt, that does not reflect NHC taking less issue with QR's position on those points).

2 Structure of NHC Submission

This submission is provided in four volumes, as follows:

(a) **Volume 1** (this document), comprising of:

  (i) an introduction and overview of NHC's submissions on the Draft Decision; and

  (ii) comments on the regulatory framework applicable to the QCA's consideration of the 2015 DAU and the role and powers of the QCA;

(b) **Volume 2**: submissions on the proposed West Moreton coal Reference Tariffs;

(c) **Volume 3**: submissions on all elements of the 2015 DAU other than reference tariffs and the Standard Access Agreement; and

(d) **Volume 4**: submissions on QR's proposed Standard Access Agreement.

3 Overview of NHC Submissions

NHC considers that QR's 2015 DAU is not appropriate (as it relates to each of the Reference Tariffs, Standard Access Agreement terms and body of the 2015 DAU) having regard to each of the matters set out in section 138(2) of the QCA Act.

In particular, in respect of each of those matters, it fails to give sufficient weight to the following matters:

(a) the object of Part 5 of the QCA Act – particularly regarding the efficient operation of and use of significant infrastructure;

(b) the public interest, including the public interest in competition in markets;

(c) the interests of persons who may seek access to the service;

(d) the pricing principles mentioned in section 168A; and

(e) any other issues the authority considers are relevant, which, as has been explained in the Draft Decision, includes regulatory certainty, the interests of access holders and end users and the undesirability of an infrastructure owner receiving windfall gains and monopoly profits.

QR's submissions in support of the 2015 DAU also appear to misinterpret the reference to the legitimate business interests of the infrastructure owner in section 138(2) of the QCA Act as being a justification for any position which is in QR's economic interest, unqualified by reasonableness.

NHC's June 2015 submissions contained a wide variety of suggestions about how the 2015 DAU should be amended in order to be appropriate for the QCA to approve (after properly weighing up the factors to be had regard to in section 138(2) of the QCA Act). Those suggestions concerned:

(a) the West Moreton system Reference Tariff, including the issue of adjustment amounts to reflect QR's prior commitment to apply the tariff from 1 July 2013. NHC's comments regarding West Moreton tariffs are provided in volume 2 of this submission and are summarised in Section 4 below;

(b) the Standard Access Agreement terms. NHC generally supports the Draft Decision regarding standard access terms, subject to the comments provided in volume 4 (the most critical of which are summarised in Section 6 below); and

(c) the balance of the 2015 DAU terms, including the investment framework. NHC generally supports the Draft Decision regarding the remaining terms of the 2015 DAU, subject to the comments provided in volume 3 (the most critical of which are summarised in section 7 below).

4 West Moreton reference tariffs

In regard to the tariffs proposed in the 2015 DAU, NHC strongly objected to each of:

(a) QR's proposed reference tariff;

(b) QR's proposed 'ceiling tariff';

(c) QR's attempt to define the QCA's role as being limited to the determination of a notional tariff which would have no relevance to actual tariffs for the term of the undertaking; and

(d) the methodologies which QR adopted in order to justify its claims.

NHC supports much of the methodology now proposed by the QCA in developing reference tariffs for the West Moreton system. However, we have two significant concerns with this aspect of the Draft Decision.

4.2 The underlying tariffs (proposed by QCA) remain excessive:

NHC considers that the tariffs proposed by the QCA remain excessive, based on two grounds:

(a) Consideration of the 'building block' elements.

NHC's most significant concern is the proposal to recover the cost of all infrastructure which is available for contracting by coal producers from the remaining operating coal mines. The basis of the QCA's proposal appears to be a view that either:

(i) coal producers as a group should collectively underwrite this spare capacity, because this capacity was once used by another coal producer; or

(ii) coal producers should pay the costs of this capacity, because it is available to them for contracting.

NHC strongly rejects the appropriateness of both of those views, and considers that in the commercial context of the West Moreton system those principles do not stand up to scrutiny.

In regard to the first point, coal producers did not collectively request investment in, nor promise to underwrite, this capacity, in the same way as could be said to have occurred in Central Queensland or the Hunter Valley (where the relevant assets were developed for a larger group of coal producers and where the producers as a collective have had a role in contributing to and/or approving investments). Many of the assets on the West Moreton network to which the relevant fixed costs relate would pre-date the use of this capacity by any coal producer. The fact that this capacity was used by a coal producer for a certain period of time should not artificially dictate a requirement that forever more the remaining coal users (currently, NHC and Yancoal) must assume this exposure, merely on the basis that they produce the same commodity as the former customer.

In regard to the second point, it is important to note that the capacity is not reserved for coal. To NHC's knowledge, there is no capacity reservation or guaranteed number of minimum train paths available for contracting by coal services. Rather there is an effective government policy cap on the maximum number of coal services. To NHC's understanding, there is nothing preventing non-coal services from contracting available paths from the 77 paths the QCA appears to have concluded are solely available for coal. While that maximum of 77 paths is theoretically available for coal services, any surplus paths above the current contract volume is equally available for contracting by general freight or other commodities. If 'availability for contracting' is the basis on which the fixed costs of this capacity are allocated to coal, then an equally strong basis exists for allocating the costs to non-coal services. Therefore some proportion of the costs of the unutilised train paths in that 77 should be allocated to non-coal services.

We do not consider that a tariff developed on the basis proposed will promote efficient use of the infrastructure or is consistent with the matters which the QCA is to have regard to under section 138(2)(a), (d), (e) or (h) of the QCA Act.

(b) <u>Consideration of the competitiveness of the tariff.</u>

The proposed underlying tariff (exclusive of the adjustment amount) remains at a level which is not competitive with that of NHC's Australian competitors in coal markets. The competiveness of the tariff and the impact which this has on the competitiveness of current and potential users of the system is clearly relevant to the matters under section 138(2)(a), (d), (e) and (h) of the QCA Act. It is key to whether the tariff is appropriate and will result in efficient use of the infrastructure. We note that QCA states (page 138) that relative prices of train services "*are amongst a range of factors we could give greater weight to when assessing a reference tariff under the approval criteria in the QCA Act, especially in the face of material falling demand on the West Moreton network*". NHC warned, in its October 2013 submission on the June 2013 DAU, that high tariffs could lead to reduced utilisation of the West Moreton system. Material falling demand has since become a reality with the closure of Wilkie Creek.

Similarly in the QCA's Draft Decision on the Aurizon Network access undertaking (Volume 3, page 134) the QCA recognises that other relevant matters under section 138(2)(h) of the QCA Act include "*market conditions – as the CQCR continues to face globally competitive conditions, a balance has to be struck between preserving individual stakeholders' business interests and promoting the public interest (i.e. ensuring the CQCN's medium-to long-term competitive position in global coal markets)*". This should be equally applicable to the West Moreton network.

Despite this, the QCA's Draft Decision states that:

(i) the decision "*has not given a material weighting to the issue of relative prices of other train services*" (page 138) and

(ii) the QCA did not take 'affordability' into account in its 2014 or 2015 Draft Decisions (footnote 139).

NHC considers that the QCA must give appropriate weighting to these issues, and that this must lead to a conclusion that tariffs which are lower than those proposed by the QCA are required. In the event that adjustments to particular building block elements lead to a competitive tariff which is not likely to result in further reductions in utilisation of the infrastructure, then a tariff based on those parameters will be appropriate. However, if this is not the case, then a decision to limit tariffs to an appropriate level below that which is indicated by the 'building block' approach is appropriate. This issue is discussed in Section 8.3 of Volume 2.

4.2 The proposed Adjustment Amount has not been calculated appropriately:

The QCA has provided a comprehensive and well-reasoned 14 page analysis of why an Adjustment Amount ought to be included in future tariffs, having regard to the approval criteria. We fully support that analysis. NHC has previously submitted advice from Allens lawyers (an updated version, which now also responds to legal advice included in QR's submissions, of which is enclosed in Volume 2) that the QCA has the power to determine that the appropriate form of undertaking is one which backdates tariffs to 1 July 2013 (whether through applying the existing Adjustment Charges regime or an alternative form of financial adjustment). The Draft Decision confirms that the QCA has this power to require an Adjustment Amount and explains why consideration of the matters in section 138(2) of the QCA Act must lead to a decision to use that power.

Before discussing NHC's concern regarding the calculation of the Adjustment Amount, we wish to comment on the importance of this decision. NHC considers that the approval of a DAU without appropriate Adjustment Amounts would demonstrate that QR is able to manipulate the regulatory regime to extract from its customers excessive charges to which QR has no rightful claim. The fact that QR has attempted to do this has increased NHC's assessment of the risks of investing in this region. A demonstration that the regulatory arrangements can be effective in preventing such a misuse of QR's position would go some way towards restoring confidence, while a failure of regulation in this case would extinguish any confidence in the regulatory regime and would extinguish regulatory certainty. NHC's assessment of investment opportunities in this region, including the New Acland extension project (on which a decision must be made over the coming year) would then be assessed on a basis akin to having a high sovereign risk rating. NHC has choices about where its money is invested, as was demonstrated by the recent decision to invest A$865m in a 40% share of the Bengalla mine in the Hunter Valley. Competitive access charges and regulatory arrangements which provide confidence that this will continue were important considerations in that investment decision. It is critical that a properly calculated adjustment charge be applied in order to avoid creating a strong disincentive to further investment in the West Moreton system. Evidence of this disincentive is likely to be available only after investment decisions have been taken and

investment has been lost. However, we submit that the disincentive effect is self-evident, while the counterfactual (that NHC will be no less willing to invest in a mine which depends on a monopoly service provider which can misuse the regulatory regime to extract material excess charges) is clearly implausible.

Regarding the calculation of the adjustment charges, we note that nothing in the QCA's 14 pages of analysis indicates that the application of the approval criteria could lead to a different conclusion in regard to over-recoveries arising on particular segments of the West Moreton network. However, the QCA states (footnote 630) that the over-recoveries have been calculated based on "*revenue and billing parameters provided by Queensland Rail for the Rosewood to Miles section of the West Moreton network*". It is clear from Appendix A of the Draft Decision that no Adjustment Charge has been reflected in the proposed Reference Tariffs for the section between Rosewood and the Port ("East of Rosewood").

The Draft Decision contains no indication that the question of an adjustment charge East of Rosewood was considered by the Authority, and we consider that the QCA's analysis of the issue of adjustment amounts must lead to the conclusion that the amount should be calculated across the full journey.

The over-recovery East of Rosewood is able to be calculated using the same methodology as was applied West of Rosewood, as:

(i) the revenue earned is readily available and presumably has already been notionally allocated to the East and West sections in the QCA's existing calculation; and

(ii) The annual revenue requirement can be calculated for the relevant years using the same methodology as is reflected in Appendix A of the Draft Decision.

We therefore support the requirement for future tariffs to include an Adjustment Amount reflecting the full difference between:

(i) access charges paid from 1 July 2013 until the date on which new approved reference tariffs are applied; and

(ii) the access charges which would have been payable over this period based on the revenue requirements which would have applied if calculated on a basis consistent with the Draft Decision.

Approving an Access Undertaking without an Adjustment Amount to reflect QR's full over-recovery during this period is not appropriate having regard to the statutory criteria, for the reasons which are well documented in Section 8.11 of the Draft Decision, and which are discussed above and in Volume 2 of this submission.

5 Standard Access Agreement

NHC generally supports the amendments to the Standard Access Agreement (**SAA**) proposed in the Draft Decision. In particular, NHC acknowledges that the QCA has proposed substantial amendments to the SAA as lodged by QR which will:

(a) facilitate efficient development and execution of Access Agreements;

(b) provide for more appropriate risk allocation;

(c) promote above rail competition; and

(d) provide customers/miners with the ability to directly control the access rights on which their businesses depend.

However, NHC has some remaining material concerns, plus additional suggestions for improvement and refinement. NHC's key concerns regarding the elements of the Draft Decision relating to SAA are:

(a) the SAA should provide for changes to train descriptions in cases where a new Reference Train Service is developed. This is required so that the SAA does not become an impediment to the transition to more efficient train configurations;

(b) the SAA should be revised to more clearly cater for the possibility of multiple operators providing services to an Access Holder (where the Access Holder is the mine operator);

(c) calculating take or pay at 100% of the access charges on unused train paths will over-compensate QR as it will provide QR with revenue to cover both its fixed and variable costs (without having incurred the variable costs); and

(d) the proposed KPI regime lacks any financial element, and therefore provides no incentive for QR to meet any particular performance targets. Reliance on commercial negotiation to develop financial incentives is unlikely to lead to helpful outcomes.

NHC has provided a fully marked-up SAA and selective amendments to the DAU containing suggested improvements which address these and other issues. Volume 4 focuses primarily on the suggested improvements within the SAA.

6 Access Undertaking

NHC generally supports the amendments to the other parts of the 2015 DAU proposed in the Draft Decision and commends the QCA for a well-reasoned decision that as a whole presents a much more appropriate attempt at balancing the factors the QCA is to have regard to than the 2015 DAU as originally proposed by QR.

However, as outlined in detail in Volume 3 of NHC's submissions, NHC considers further refinements are required to complete that balancing appropriately.

NHC's key concerns regarding the elements of the Draft Decision relating to the body of the DAU (excluding reference tariffs and the Standard Access Agreement) include:

(a) the term of the Undertaking. The proposed undertaking contains numerous provisions which are new and untested. We consider that a range of additional review provisions must be included in the undertaking in order for the proposed five year term to be appropriate.

(b) the definition of 'Access' could be interpreted narrowly such that it excludes certain services which go beyond mainline running but are essential to the operation of Train Services in the normal course;

(c) the investment framework and the extension and user funding regimes require a range of amendments in order to provide confidence that necessary extension projects can be studied, scoped, procured, constructed and funded efficiently and on reasonable terms; and

(d) the approach to train planning and the requirements for changing train plans require improvements to encourage better planning and minimise the impacts of changes to schedules.

7 Regulatory framework and powers of the QCA

This section outlines NHC's view of the regulatory framework in which the QCA is to consider the 2015 DAU. NHC's view remains as set out in our June 2015 submission, which was

supported by legal advice from Allens (an updated version of which is included as Annexure A to Volume 2):

(a) the QCA has a wide discretion when determining whether it is appropriate to approve an undertaking;

(b) the QCA is only limited by:

  (i) the requirement to approve an undertaking which it considers 'appropriate' after it has ‘had regard to’ the factors set out in Section 138(2) of the QCA Act;

  (ii) the requirements to consult, invite and take into account submissions received (and otherwise provide natural justice more generally); and

  (iii) the QCA not having a right to refuse to approve a DAU only because the QCA considers a 'minor and inconsequential' amendment should be made to a particular part of the undertaking;

(c) contrary to QR's assertions regarding section 168A(a) QCA Act, no single factor listed in section 138(2) QCA Act is 'a cornerstone requirement', or a dominant or paramount factor that is required to be given greater weight;

(d) the QCA has the power to approve an undertaking which is inconsistent with any of the factors set out in section 138(2), including any of the pricing principles set out in section 168A QCA Act;

(e) in fact, the QCA must seek an undertaking which is inconsistent with a pricing principle in Section 168A if it would be appropriate to do so, having regard to all of the section 138(2) factors; and

(f) the QCA is not bound to follow any particular regulatory precedent and, while the QCA may often do so, the QCA must not follow a precedent if to do so would result in the approval of an undertaking which is not appropriate having regard to the factors set out in section 138(2).

NHC appreciates the efforts of the QCA, evident throughout the Draft Decision, to consider each of the factors set out in section 138(2) and to apply weightings to those factors which are appropriate to the issue under consideration. We particularly welcome the QCA’s views (page 211 of the Draft Decision) which support NHC’s view that no single factor listed in section 138(2) is a ‘cornerstone requirement’ or a dominant or paramount factor that is required to be given greater weight. This includes the pricing principles mentioned in section 168A.

As demonstrated by the Allens advice, the QCA has the power to approve an Adjustment Amount in the manner proposed in the Draft Decision, and NHC considers that is clearly appropriate, subject to the calculation issue noted above.

8 Conclusions

In summary, NHC considers that while the Draft Decision's proposed approach is an improvement, the 2015 DAU remains flawed and inappropriate, particularly in relation to:

(a) the excessively high tariffs that are proposed (seemingly without reference to affordability and competitiveness);

(b) the flawed nature of the Adjustment Amount calculation (which will result in QR retaining unjustified windfall gains);

(c) the lack of protections for Access Holders under the proposed Standard Access Agreement (particularly in relation to QR's underperformance); and

(d) the uncertainty for access holders arising from a variety of positions in the access undertaking (such as QR's wide discretion in relation to matters like planning and scheduling and extensions).

For those reasons and others set out across the 4 volumes of NHC's submissions, NHC considers that:

(a) the 2015 DAU (as submitted by QR) is clearly not appropriate to approve where proper regard is had to the matters in section 138(2) QCA Act;

(b) the 2015 DAU (as amended by, and incorporating the pricing approach proposed in, the Draft Decision) is a substantial improvement, but would need to incorporate the further refinements and improvements set out in NHC's submissions in order to be appropriate.

If the QCA has any queries in relation to this submission, please do not hesitate to contact Sam Fisher, General Manager Marketing and Logistics on (07) 3108 3668.