

11 March 2016

Mr John Hindmarsh
Chief Executive Officer
Queensland Competition Authority

Dear John

DBCT 2015 DAU Supplementary Submission

DBCT Management (DBCTM) welcomes the opportunity to provide a response to the DBCT User Group's Supplementary Submission to the DBCT 2015 DAU (see Attachment 1). Furthermore, DBCTM would like to provide certain clarifications to section 3.7 Inflation in the 2015 DAU for the Authority's information (see Attachment 2).

The DBCT User Group's Supplementary Submission proposes that section 12.10(a) of the DAU relating to non-expansion capital expenditure (NECAP) is amended to include a new obligation for DBCTM to incur capital expenditure for which the minimization of whole of asset life cost is a primary consideration.

DBCTM submits that this amendment is neither appropriate nor feasible, and would be contrary to the Queensland Competition Authority Act 1997 (QCA Act). In summary:

- The QCA Act does not provide for the Authority to make such an amendment;
- The existing undertaking and 2015 DAU already require consideration of lowest whole of asset life cost, and;
- The whole of asset life cost analysis currently in use does not consider all access charges.

The DBCT User Group's Supplementary Submission also proposes the Terminal's useful life should remain unchanged, in consideration of a theoretical incentive to continually extend access agreements. DBCTM disagrees with this proposal and cites recent non-renewal of contracted capacity as evidence that the theoretical incentives to renew do not hold true. Furthermore, the expiring contracted capacity was offered to the DBCT Access Queue in early January, and at the time of this submission has not been re-contracted. These issues are further discussed in Attachment 1.

Please contact me directly if you require any further information.

Yours sincerely



Jonathan Blakey
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Attachment 1 – Response to DBCT User Group Supplementary Submission

On 22 January 2016, the DBCT User Group lodged a supplementary submission to the QCA on DBCTM's 2015 DAU to apply from 1 July 2016. The User Group's supplementary submission set out their position on two issues:

- the desire to strengthen DBCTM's obligation to invest in non-expansion capital expenditure (NECAP) by amending section 12.10(a) of the 2015 DAU to add an obligation to minimise "whole of life" Terminal costs; and
- the incentives embedded in the term and renewal option structure contained in DBCT users' agreements for existing users to renew their agreements and the relevance of these incentives to the assessment of the Terminal's remaining useful life.

This submission sets out DBCTM's response on these two issues.

1. NECAP

DBCTM does not support the implementation of an obligation to expend NECAP based on a "whole of asset life" cost test, as proposed by the DBCT User Group. This position is based on a number of concerns with the User Group's proposal, as set out below and in Appendix A.

Standards are established via contractual obligations

DBCTM has clear contractual obligations that establish the standard to which the Terminal services are to be provided, and which govern the way in which DBCTM must maintain and invest in the Terminal facilities.

The User Agreements oblige DBCTM to provide access to users to particular standards and to maintain the Terminal to a specific standard. Failure to comply with either of these obligations constitutes a breach of the access agreement under sections 16.1(a) and 16.1(b) respectively.

Secondly, DBCTM is required to undertake NECAP projects as is necessary to meet its obligations under the Port Services Agreement (PSA). These obligations include operating and maintaining the Terminal so as to achieve "Optimum" reliability and efficiency and effective life of the Terminal, with "Optimum" defined to include (without priority) "lowest whole of life cost", and "reliability, efficiency and economy of performance."

In this context, the NECAP requirement under the 2015 DAU is set to reflect DBCTM's contractual obligations under the User Agreements and the PSA. Section 12.10(a) of the 2015 DAU recognises that DBCTM will incur expenditure on NECAP projects as required to ensure that DBCTM complies with its obligations under the PSA and that the Terminal complies with "Good Operating and Maintenance Practice", which requires performance to a standard performed by a "competent, experienced and qualified operator." The 2015 DAU then establishes the processes by which the QCA will review and accept the costs associated with this NECAP into DBCTM's regulatory asset base (RAB) for the purpose of determining Reference Tariffs.

This reflects that it is the proper role of the User Agreements and the PSA to define the standard to which DBCTM must maintain the Terminal, while the role of the Access Undertaking is fundamentally to establish the process for negotiating access to the Terminal, including the setting of a reasonable price for access – being the Reference Tariff. It is not the role of the Access Undertaking to extend the obligation to incur capital expenditure beyond what has been agreed with the Queensland Government as owner of the Terminal and with the users of the Terminal.

Attachment 1 – Response to DBCT User Group Supplementary Submission

Indeed, an Access Undertaking cannot replace or overrule DBCTM's existing contractual obligations, and the inclusion of a different obligation in the Access Undertaking could place DBCTM in the situation where its obligations are in conflict.

Further, the use of a regulatory framework to impose specific additional obligations on an infrastructure owner in this way is without precedent. No comparable regulatory frameworks include a NECAP type obligation, including the Aurizon Network access undertaking, the Queensland Rail access undertaking, the Australian Rail Track Corporation (ARTC) Hunter Valley and interstate access undertakings, or the Western Australia Railways Access Code. These regulatory frameworks provide for access agreements to specify the safety and service level obligations of asset owners, who may then be required to justify to a regulator that their expenditure is prudent and efficient in order for it to be included in access charges.

Furthermore, the imposition of additional NECAP obligations on DBCTM would be contrary to the policy of the Queensland Competition Authority Act 1997 (QCA Act). Section 119 of the QCA Act provides that the QCA must not make an access determination that would, among other things, have the effect of requiring an access provider to pay some or all of the costs of extending the facility.

In essence, the QCA cannot require an access provider to fund an extension unless the access provider volunteers to do so. An "extension" is defined by the QCA Act to mean, in relation to a facility, an enhancement, expansion, augmentation, duplication or replacement of all or part of the facility. This definition would include a NECAP project.

DBCTM does not volunteer to expand its NECAP funding obligation. It would therefore be contrary to the policy of the QCA Act for the QCA to impose additional NECAP obligations. The Users' proposed amendment to section 12.10(a) of the 2015 DAU is therefore not supported by the QCA Act.

Classification of operating vs capital expenditure

As noted in the User Group's supplementary submission, DBCTM has proposed that several projects previously included in the NECAP budget be deferred or cancelled from NECAP Series L. A number of these projects may still proceed as an operations and maintenance activity.

It is important to note there is often significant ambiguity in relation to the classification of expenditure between NECAP and operating and maintenance expenditure.

Section 10.1(g) of the 2015 DAU defines operating and maintenance costs as "the actual operating and maintenance costs incurred for the relevant Financial Year including minor capital expenditure not exceeding \$3 million for the Financial Year – at a level of detail to be determined by the QCA."

The inclusion of minor capital expenditure in the amount to be recovered from users through the Operation & Maintenance Charge is indicative of the ambiguity that exists between small items of capital expenditure and operating and maintenance expenditure.

The works in the NECAP Series L budget proposed for deferral or cancellation include minor structural upgrades and remediation works; risk mitigation and hazard rectification works; minor facilities maintenance works; and trial projects and options studies. Given these works do not involve significant asset replacement, upgrade or refurbishment works that will expand the capacity

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or useful life of the Terminal facilities and are all, with the exception of one project, valued at less than \$1 million, it is not unreasonable for some of these works to be classified as operating and maintenance expenditure.

A "whole of life" cost test does not address the ambiguities between classification of works as NECAP or operational expenditure – theoretically under a "whole of life" cost test, assuming the regulatory Weighted Average Cost of Capital neither over nor undercompensates the asset owner for their actual cost of capital, the whole of life cost will be the same regardless of whether it is classified as capital or operating expenditure. In this case, a "whole of life" test is unlikely to provide any further guidance as to the appropriate treatment of these projects.

Importantly, DBCTM is not proposing to defer or cancel works that are necessary to maintain compliance with its obligations under the 2015 DAU, user agreements and PSA. Works have only been proposed for deferral or cancellation from the NECAP Series L budget where they are either not necessary to maintain compliance with these obligations or compliance can be maintained through prudent and efficient operating and maintenance activities.

Workability of proposal

Notwithstanding that it is properly the role of the User Agreements and the PSA, rather than the Access Undertaking, to establish the required service standards and maintenance obligations, DBCTM also notes the following concerns with the DBCT User Group's proposal:

- users may have an incentive to argue for more works to be classified as NECAP as this defers the recovery of these costs, resulting in additional costs being recovered from future users as opposed to current users;
- it is unclear as to the perspective to be adopted in undertaking the test (i.e. whether it would be from the perspective of DBCT Users, DBCTM, or from a societal perspective). The results of the "whole of life" cost test would differ depending on the perspective adopted;
- in many cases, the rationale for minor works (such as the projects proposed to be deferred or cancelled from the NECAP Series L budget) will not necessarily be cost minimisation – projects may be undertaken in order to improve availability of the facility, or to reduce current risk levels. These factors are not reflected in the "whole of life" cost of operating the Terminal; and
- the "whole of life" cost test would require several assumptions to be made regarding future throughput levels, appropriate discount rates, relevant cash flows and the remaining life of Terminal assets. The assumptions adopted are likely to have a significant impact on the outcomes of the test. This is problematic given the increasing uncertainty regarding the remaining useful life of Terminal assets and future throughput levels.

As noted in Appendix A, while the Operator has provided an assessment of "whole of life cost" in relation to NECAP Series L projects, this assessment does not consider the full impact on capital charges. This impact may only be assessed using the DBCT ARR model. Using DBCTM's Net Present Cost analysis based on the ARR model, a different outcome was identified¹. This illustrates some of the practical concerns associated with a whole-of-life cost assessment and further reinforces why it should not be the only consideration.

It is likely that given these ambiguities, the results from a "whole of life" cost test – were it to be applied to assess the appropriateness of NECAP – would result in disagreements between DBCTM

¹ Refer Section 4.2 in Appendix A for RL1 Slew Bearing Upgrade example

and the DBCT User Group. Additional mechanisms would need to be included in the 2015 DAU to provide a means of resolving these disputes. Resolving these disputes through a regulatory process would impose significant additional costs on all stakeholders.

2. Incentive to extend User Agreements

The DBCT User Group's supplementary submission argues that the current structure of the term and renewal arrangements in existing access agreements creates a strong incentive for users to renew agreements and that this needs to be considered by the QCA in assessing the remaining useful life of the Terminal.

However, the arguments put forward by the DBCT User Group in support of this position are only valid for so long as demand for Terminal throughput exceeds Terminal capacity. The User Group ignores the impact of the recent softening of the global coal market on users' demand for Terminal capacity and subsequently the reduced incentive for users to renew agreements.

Access to coal terminal capacity is an essential pre-requisite for the export of a mine's coal production. The incentive, as described by the User Group, to maintain capacity entitlements at DBCT has historically been driven by a shortfall between coal terminal capacity and demand. This shortfall has meant that there has been significant value for mining companies in continuing to hold DBCT capacity entitlements for their planned mine life or even beyond. This provided them with an option to extend production at existing mines or develop new mines, without needing to bear the costs and delays associated with accessing new coal terminal capacity. In the event that they did not ultimately need this capacity themselves, they could assign it to another producer who did wish to expand production.

However, if the demand outlook softens to the point where there is no unmet demand, there is no longer the same value in continuing to hold DBCT capacity, as costs and delays associated with accessing coal terminal capacity are less likely. In this case, users will be less willing to bear the ongoing take-or-pay obligations of holding capacity. They are more likely to relinquish capacity that they do not currently require and may be more willing to access available capacity on an ad hoc basis, rather than on a firm contractual basis.

There are two recent examples that demonstrate the magnitude of this risk.

A current access holder has recently informed DBCTM that it will not exercise the option to renew 2.7 Mtpa of its contracted capacity at the Terminal. This capacity will therefore become available from 1 April 2016. This capacity was offered to all access seekers in the queue on 12 January 2016, with DBCTM requesting offers by mid-February. As yet there has been no offer to take up the capacity from any of these access seekers. This clearly demonstrates that the circumstance of excess demand, which underpins the User Group's claims regarding the incentive to renew agreements, does not currently apply.

The recent closure of a mine on the West Moreton system further illustrates the demand risk facing DBCTM. In response to the closure of the mine and subsequent relinquishment of supply chain capacity, the two remaining mines on the system have had less incentive to contract for supply chain capacity². The mines have opted not to contract for increased supply chain capacity, notwithstanding that they have continued to export coal at levels in excess of their contracts.

² Queensland Rail (2015); Explanatory Submission – Queensland Rail's Draft Access Undertaking 1 (2015), Volume 2; May 2015, p16

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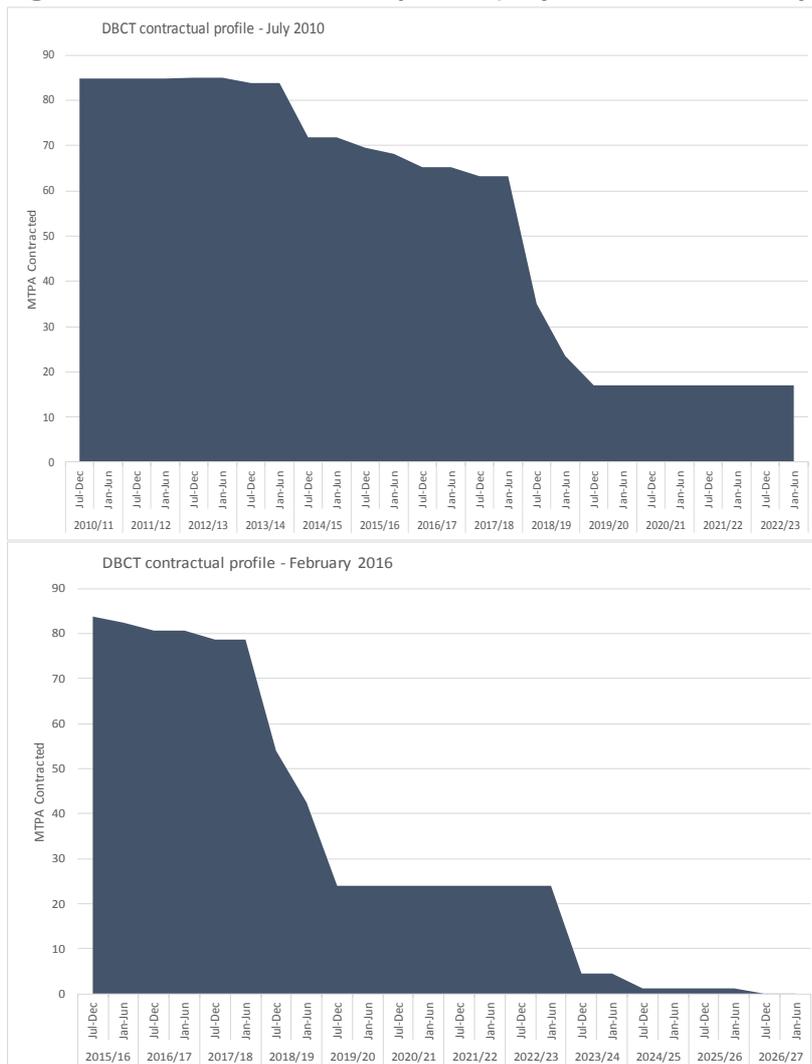
Instead, they have chosen to rely on the expected continuing availability of capacity and have offered tonnes on an ad hoc basis.

DBCTM maintains relatively short contract terms with users. This creates the potential for DBCTM to be exposed to significant volatility in its contracted tonnages. DBCTM is currently facing a significant reduction in contracted capacity from 2018 onwards, with contracted capacity dropping from 78.7 Mtpa in financial year 2017-18 to 54.0 Mtpa in 2018-19, down to 24.0 Mtpa in 2019-20.

Contrary to the User Group’s claims, this imminent ‘drop off’ in contracted tonnages has not been a feature of previous Access Undertakings with the ‘drop off’ simply moving out as renewal rights have been exercised. The figure below compares the current contractual profile to the contractual profile prior to the commencement of the current undertaking. While the magnitude of this decrease has been known for several years, it is now of increased significance as it is scheduled to occur in the forthcoming regulatory period.

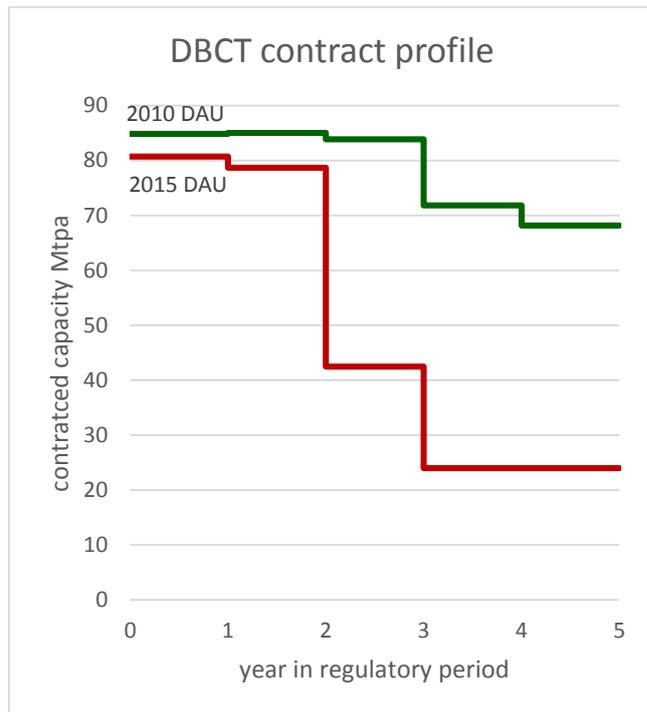
This is illustrated in the figures below – Figure 1 shows DBCT’s contract profile at July 2010 compared to now. Figure 2 translates this into a direct comparison of the contract profile applicable at the commencement of the 2010 DAU and 2015 DAU regulatory periods.

Figure 1: DBCT contract profile (July 2010 and February 2016)



Data source: Data provided by DBCTM.

Figure 2: Comparison of DBCT Contract Profile 2010 DAU period vs 2015 DAU period



This decrease in contracted tonnes coincides with a marked softening of the global coal market. Indications are that this is far from another short term slump in the commodity cycle. Key examples of this include:

- the downgrading of Peabody Energy to junk bond status. In providing its rationale for the most recent downgrade to Caa3, Moody’s attributed this to the ongoing decline in the market as well as "our expectation that market recovery will be slower and more protracted than previously anticipated";³
- the recent downgrade of Glencore to BB- by Standard and Poor’s, which is one notch above junk bond status;
- the significant changes that Anglo American is looking to make to its business as part of a worldwide restructure, including the sale of three of its mines in Queensland ⁴;
- the sale of the Isaac Plains mine for \$1 in July 2015.

In this demand environment, the short remaining contract terms constitute a significant risk to DBCTM.

The above examples demonstrate that the incentive for users to continue to hold DBCT capacity is subject to users’ perceptions of the strength of demand relative to the capacity of the Terminal. With the global coal market softening, it is increasingly likely that users will opt not to exercise options on contracted tonnages or contract for lesser tonnages upon renewal.

Given these circumstances, DBCTM believes that the QCA cannot place any reliance on the DBCT User Group’s claimed incentive to renew capacity contracts when considering the remaining useful life of the terminal. In the event of reduced overall demand for coal exports, this incentive clearly

³ Moody’s Investors Service (2015). https://www.moody.com/research/Moodys-downgrades-Peabodys-ratings-CFR-to-Caa3-outlook-negative--PR_341808 (accessed 4-Mar-16)

⁴ <http://www.abc.net.au/news/2015-12-09/anglo-american-to-cut-85000-mining-jobs-worldwide/7012784> (accessed 4-Mar-16)

reduces. In DBCTM's view, this supports its claim that the remaining useful life of the Terminal should be assessed based on the Weighted Average Mine Life, which provides the best available indication of overall demand for Terminal capacity.

Conclusion

In conclusion, DBCTM does not agree with the arguments put forward in DBCT User Group's supplementary submission with regard to the application of a "whole of life" cost test to assess the appropriateness of NECAP and the strength of the incentive for existing users to renew their current contractual agreements with DBCTM.

In relation to the "whole of life" cost test, DBCTM does not consider it appropriate for regulatory frameworks to impose obligations on infrastructure owners regarding the type or magnitude of expenditure to be undertaken. DBCTM's obligations with regards to the standard of service provision and maintenance of the Terminal are set out in clause 16.1 of its user agreement and through its obligations under the PSA. The NECAP obligation in section 12.10 of the 2015 DAU is currently set to reflect these contractual obligations. The imposition of additional NECAP obligations on DBCTM would be contrary to the policy of the QCA Act and would be inconsistent with the obligations applying to similar regulated assets. For further detail on these issues, please refer to Appendix A which provides a comprehensive legal response to the DBCT User Group's NECAP proposal.

The DBCT User Group's argument in relation to the strength of the incentive for existing users to renew current contractual agreements fails to take into account the impact of the recent softening of the global coal market on users' perceptions of demand relative to Terminal capacity and the subsequent impact on DBCTM's demand risk. This is evidenced by the recent non-extension of contracted capacity and subsequent lack of access seeker appetite to contract.



1 Users' new request for modifications to NECAP provisions

On 22 January 2016, the DBCT User Group (**User Group**) made a supplementary submission (**Supplementary Submission**) to the Queensland Competition Authority (**QCA**) in relation to a draft access undertaking proposed by DBCT Management (**DBCTM**) to apply to services at the Dalrymple Bay Coal Terminal (**DBCT**) from 1 July 2016 (**2015 DAU**). Much of the Supplementary Submission focused on the Users' concern in relation to DBCTM's approach to future investment in non-expansion capital expenditure (**NECAP**). NECAP is governed by section 12.10 of the current access undertaking in respect of DBCT (**2010 AU**). DBCTM has not proposed any change in the 2015 DAU from section 12.10(a) of the 2010 AU.

In particular, the Supplementary Submission proposed that section 12.10(a) should be amended so as to require DBCTM to invest in NECAP as is necessary to ensure that the whole of asset life costs (including capital, maintenance and operating costs) are minimised (see paragraph 17 of the Supplementary Submission). Paragraph 18 of the Supplementary Submission proposes drafting changes to section 12.10(a) of the DAU. These drafting changes are different to those proposed in the User Group's submission of 24 November 2015 on the 2015 DAU (**Original Submission**). Section 2.4 below addresses this inconsistency in the context of the process for review and consideration of submissions on the 2015 DAU under the QCA Act.

This submission responds to paragraphs 1 to 21 of the Supplementary Submission. DBCTM will separately respond to paragraphs 22 to 38 of the Supplementary Submission. DBCTM reserves the right to make further submissions on the Supplementary Submission and on the Original Submission.

As the Supplementary Submission takes the position that DBCTM's current obligations are insufficient and need to be made more onerous, this submission first considers DBCTM's current obligations before discussing the position proposed by the User Group.

2 DBCTM's current obligations

It is DBCTM's position that its current obligations with regard to Capital Expenditure for NECAP are sufficient and appropriate. It is also our submission that the current NECAP section already exceeds what could legitimately be asked of an infrastructure provider.

2.1 The QCA's power to expand or impose a mandatory funding obligation

Imposition of a requirement on an infrastructure owner to bear the cost of extensions is contrary to the *Queensland Competition Authority Act 1997* (Qld) (**QCA Act**). Notably, section 119 of the QCA Act provides that the QCA must not make an access determination that would, among other things, have the effect of requiring an access provider to pay some or all of the costs of extending the facility. There are very few circumstances where the QCA may make such a determination. These include where that determination is consistent with an approved access undertaking and if the QCA is satisfied that the legitimate business interest of the owner of the facility are protected (see sections 119(4) and 119(5) of the QCA Act).

In essence, the QCA cannot require an access provider to fund an extension unless the access provider volunteers to do so. An "extension" is defined by the QCA Act to mean, in relation to a facility, an enhancement, expansion, augmentation, duplication or replacement of all or part of the facility, and would include a NECAP project.

DBCTM does not volunteer to expand its NECAP funding obligation. It would be contrary to the policy of the QCA Act for the QCA to impose additional NECAP obligations. The Users' amendment to section 12.10(a) is therefore not supported by the QCA Act. The QCA does not have the power to impose the Users' change to section 12.10(a).

2.2 No obligation to 'invest'

The Supplementary Submission asserts that DBCTM has an obligation to make investments in NECAP.⁵ That is incorrect: DBCTM's obligation under section 12.10 of the 2010 AU and 2015 DAU is to incur Capital Expenditure to ensure that DBCT complies with certain standards, which are discussed further below. 'Capital Expenditure' is defined in the 2010 AU and 2015 DAU as expenditure which relates to certain matters but which is not recovered through handling charges under access agreements. These matters include expenditure which 'relates to the refurbishment or upgrade of Terminal plant and/or infrastructure which is reasonably expected to improve whole of life cost'.⁶ This definition of Capital Expenditure already contemplates that DBCTM will incur expenditure to upgrade or refurbish DBCT to reasonably improve whole of life cost. However, this is subject to that Capital Expenditure being required in order to meet one of the two standards specified at section 12.10(a), which are discussed below. That is, the reference to whole of life cost in the 'Capital Expenditure' definition does not automatically mean that expenditure must be incurred if it will reasonably improve whole of life costs.

Sections 12.10(b) & (c) set out the processes for the inclusion of prudent Capital Expenditure in the regulated asset base for DBCT, which is then recovered from access holders through the access charges.

2.3 DBCTM is already required to meet relevant standards

The NECAP obligation is currently set to reflect DBCTM's contractual obligations under the standard access agreement (SAA)⁷ and the PSA. DBCTM is required to undertake Capital Expenditure to ensure that DBCT meets two standards. The standards which DBCTM is required to meet are:

- ensuring that DBCT complies with 'Good Operating and Maintenance Practice'; and
- compliance with the Port Services Agreement with the State of Queensland (**PSA**).

The 'Good Operating and Maintenance Practice' standard is defined in the 2010 AU and the 2015 DAU as set out in paragraph 14 of the Supplementary Submission. It should be emphasised that the definition is the same in the 2015 DAU as it is in the existing 2010 AU; that is, DBCTM has not proposed a change in this standard in the 2015 DAU.

This standard is a well-established concept which is at the heart of DBCTM's obligations with respect to the operation of DBCT. The obligation is enshrined in DBCTM's obligations to users under the SAA, which requires DBCTM to maintain DBCT in accordance with this standard.⁸ It is also one of DBCTM's obligations to the State of Queensland under the PSA, which requires DBCTM to operate and maintain DBCT in accordance with this standard. The standard uses the criteria of a competent, experienced and qualified operator as the measure of how DBCT should be operated and maintained. It does not mandate how that standard should be achieved and does not require DBCTM to prioritise lowest whole of life costs in a decision to undertake or not undertake Capital Expenditure on NECAP projects. It does, however, require DBCTM to act prudently in expending capital to ensure the compliance of DBCT with the required standard (as a competent, experienced and qualified operator would not fail to expend prudent capital if required for the upkeep of the Terminal).

The second of these standards imports the relevant obligations which DBCTM has to the State of Queensland under the PSA. DBCTM's obligations under the PSA include operating and maintaining the Terminal so as to achieve 'Optimum' reliability and efficiency and effective life of DBCT.⁹ The definition of 'Optimum' includes a consideration of what will achieve the best and most cost-effective outcomes, including but not limited to lowest

⁵ Supplementary Submission, paragraphs 4(a), 5, 6(b), 9, 12 and 16. There is some contradiction in the User Group's position, as while these paragraphs state that DBCTM has an obligation to invest, paragraph 21 then argues that there is a 'need for implementation of a positive obligation to invest in NECAP'.

⁶ Schedule H of 2010 AU and 2016 DAU, 'Capital Expenditure' definition part (c)

⁷ All current access agreements between DBCTM and the access holders are materially on the terms of the SAA.

⁸ SAA (accompanying 2010 AU), clause 16.1(b). DBCTM also has the obligation to ensure the availability of each component of DBCT 'to operate to at least its rated design capacity'. If DBCTM does not comply with either clause 16.1(a) or 16.1(b), it will be in breach of the access agreement.

⁹ PSA, clause 5.1(b)

whole-of-life cost.¹⁰ DBCTM therefore does have an obligation to pursue cost-effective expenditure on NECAP projects with consideration of what will achieve lowest whole-of-life cost. However, DBCTM is not required to **prioritise** lowest whole-of-life costs over other considerations such as reliability, efficiency and economy of performance (which may potentially lead to a different conclusion than only considering lowest whole-of-life cost). In other words, DBCTM is already required to consider the whole of life costs of expending or not expending capital on a NECAP project **in conjunction with** the other considerations.

Neither of these standards mandates investment in NECAP (or otherwise) by DBCTM. Expenditure is required by section 12.10(a) of the 2010 AU and 2015 DAU if it is necessary to meet these standards. This is not a requirement for 'efficient investment' as the User Group has suggested should be the case,¹¹ but rather for expenditure to the extent required to comply with Good Operating and Maintenance Practice and to achieve reliability, efficiency and effective life of DBCT. In addition, the 'Capital Expenditure' definition discussed above also requires DBCTM to incur capital on refurbishment and upgrades which are reasonably expected to improve whole of life cost, to the extent that this is required to ensure that DBCT complies with Good Operating and Maintenance Practice and that DBCTM complies with the requirements of the PSA.

DBCTM refutes the suggestion that it has not had regard to and is not compliant with section 12.10(a) of the 2010 AU and 2015 DAU, as suggested by the User Group.¹² Section 12.10(a) does not allow DBCTM to refuse to incur Capital Expenditure for NECAP unless that expenditure is not required for the DBCT to comply with the Good Operating and Maintenance Practice standard and for DBCTM to comply with its relevant obligations under the PSA.

2.4 DBCTM's actions with regard to NECAP Series L projects are compliant and appropriate

The User Group has presented DBCTM's letter of 5 November 2015 in relation to the 'Series L projects' as a cancellation or deferral of certain NECAP projects and therefore a refusal to invest in certain capital works.¹³ As discussed above, DBCTM does not have an obligation to invest but rather an obligation to expend capital to ensure compliance with certain standards. In any event, the User Group's characterisation of DBCTM's letter is incorrect, in particular the statements that these projects 'will not be implemented'¹⁴ and that 'DBCTM is clearly indicating that it will not fund prudent NECAP'.¹⁵ DBCTM has determined that these projects will not be included in the next series of NECAP projects ('Series L') as it is unnecessary to do so to meet its contractual and compliance obligations, which include its obligations under the 2010 AU, access agreements and the PSA. The projects may be completed in the future as NECAP projects. Alternatively, it is open to the Operator of DBCT (that is wholly owned by members of the User Group) to undertake these projects.

The fact that the Operator has recommended and considers that these projects 'are prudent investments that should be made'¹⁶ is not determinative of whether DBCTM is required to proceed with these projects. Additionally, DBCTM does not rely on the Operator for investment advice, given this is not a requirement of the OMC. Under the 2010 AU and 2015 DAU, the relevant consideration is whether Capital Expenditure is necessary in order for DBCTM to comply with the standard and obligations specified at section 12.10. This is a factual test that is not influenced by the Operator's support or otherwise for the projects. As a matter of practice DBCTM consults with the Operator and wishes to reach agreement with the Operator wherever possible. However, DBCTM must ultimately form its own view with regard to Capital Expenditure and its obligations under the 2010 AU and PSA.

2.5 Inconsistency between User Group's submissions

The User Group's Original Submission proposed that the Operator's recommendation would be relevant to establishing whether a NECAP project was required to ensure that DBCT complies with Good Operating and

¹⁰ The other considerations that DBCTM must have regard to are reliability, efficiency and economy of performance; Good Operating and Maintenance Practice (which has the same definition as under the 2010 AU and 2016 DAU) and a principle of non-discrimination between existing and prospective users of DBCT.

¹¹ Supplementary Submission, paragraph 12

¹² Supplementary Submission, paragraph 16

¹³ Supplementary Submission, paragraphs 7, 8, 10(b) and 16

¹⁴ Supplementary Submission, paragraph 10(b)

¹⁵ Supplementary Submission, paragraph 16

¹⁶ Supplementary Submission, paragraph 9

Maintenance Practice. The Supplementary Submission appears to withdraw that proposal and replace it with the 'whole of asset life' test which is discussed below.

DBCTM does not support the inclusion of either the amendments to section 12.10(a) in the Original Submission or in the Supplementary Submission. However for the purposes of the QCA's decision on whether to approve or refuse to approve the 2015 DAU, it is important that there is clarity for all stakeholders about what position the User Group proposes for section 12.10 of the 2015 DAU. DBCTM suggests that it is appropriate for the QCA to:

- consider the User Group's Supplementary Submission as its proposed position on section 12.10; and
- treat the Original Submission insofar as it relates to section 12.10 as having been withdrawn by the User Group.¹⁷

If the QCA takes a different view, DBCTM requests notice of this as soon as possible to allow it to consider its position further.

3 User Group's proposed new obligations for DBCTM

The Supplementary Submission proposes that DBCTM be subject to an additional obligation to incur Capital Expenditure for NECAP projects to minimise whole of asset life costs of DBCT. As discussed above, DBCTM is already required to consider whole of life costs in determining whether to expend NECAP capital. However, DBCTM is not required to do so in preference to other relevant considerations and is not subject to a positive obligation to minimise these costs. DBCTM opposes the inclusion of this obligation, for the following reasons.

3.1 DBCTM reasons for opposing the new obligation

(a) DBCTM's existing obligations are sufficient and appropriate

DBCTM is already required to incur capital to ensure compliance with its contractual obligations, both to users under the access agreements and to the State of Queensland under the PSA. These standards require DBCTM to consider whether expenditure is required to achieve improved whole of life cost. An additional obligation which prioritises whole of life cost above other considerations (for example, the reliable operation of DBCT) is not justified and may have unintended consequences. One likely consequence is that projects would proceed which are not necessarily consistent with DBCTM's obligations to ensure DBCT's compliance with Good Operating and Maintenance Practice or the PSA. For example, the expanded obligation may force DBCTM to expend capital on a project which may improve whole of life cost but which may significantly impact the reliable operations of DBCT in the short term.

This is a significant concern for DBCTM as its contractual obligations to access holders are to operate and maintain DBCT in accordance with Good Operating and Maintenance Practice. The existing access agreements do not prioritise minimising whole of life cost over other considerations in the way proposed by the User Group. DBCTM is concerned that the expanded obligation proposed in the Supplementary Submission may lead to a potential breach of its access agreement obligations to access holders. DBCTM does not have the power to unilaterally alter the terms of the existing access agreements.

(b) Proposed obligation is potentially inconsistent with the PSA and exposes DBCTM to risk of non-recovery

In a similar vein, the obligation proposed by the User Group is potentially inconsistent with the PSA, which requires consideration of what will achieve lowest whole of life costs **in conjunction with other considerations**. Those considerations are discussed at section 2.2 above.

The PSA also includes a protection for DBCTM against a requirement to undertake capital expenditure which would be unreasonable and uneconomic for DBCTM. This protection allows DBCTM to pursue a modification or delay in capital expenditure that would otherwise be required having regard to DBCTM's long-term investment in DBCT. In the context of a NECAP project, this protection may support the delay of a project in a similar way to what DBCTM has determined is appropriate for the Series L NECAP projects. This protection is

¹⁷ DBCTM assumes that this is what is being requested by the User Group at paragraph 39 of the Supplementary Submission.

not available to DBCTM under the 2010 AU, the 2015 DAU or the access agreements: section 12.7 of the 2010 AU only allows DBCTM to seek a modification or delay of a Terminal Capacity Expansion which would otherwise be required. Section 12.7 of the 2010 AU does not extend to NECAP projects.

This distinction is important, because section 12.7 not only reflects the PSA but also serves as a protection for DBCTM against a requirement to expend capital that either:

- it may not be able to recover from access holders as there is a risk that it would not be accepted by the QCA as prudent Capital Expenditure in accordance with section 12.10(b); or
- it is uneconomic and unreasonable for DBCTM to incur notwithstanding that it may later be accepted as prudent (this could be the case for large capital projects that must be funded by DBCTM upfront but only recovered from users on a depreciated basis over many years).

DBCTM is of the view that an obligation to expend capital to minimise whole of life cost has the very real prospect of exposing DBCTM to either or both of these risks.

(c) User Group is motivated by short-term concerns

The obligation proposed by the User Group gives undue weight to short term considerations which are apt to change. As discussed above, the existing NECAP obligations require DBCTM to consider many factors in a decision as to whether to expend capital on a NECAP project, including whole of life cost but also including reliability, efficiency and best practice for operation of DBCT. The User Group has provided no justification for why minimising whole of life cost should be given preference to other considerations.

It appears from the Supplementary Submission that the User Group wishes to force DBCTM to fund the upfront cost of as many NECAP projects as possible and thereby minimise the operation and maintenance charges which are directly passed through to access holders.¹⁸ An over-emphasis on minimising whole of life costs, as the User Group is proposing, is likely to result in DBCTM being obliged to proceed with NECAP projects even where DBCTM would meet the standards that it is already subject to (as discussed at section 2 above) by adopting an alternative solution. It is not the case that the User Group – and the Operator of which its members are shareholders – have no vested interest in this increased requirement, as the Supplementary Submission suggests.¹⁹ Rather, the User Group and the Operator have a significant incentive to seek to impose more onerous requirements on DBCTM to proceed with NECAP projects. Doing so would increase DBCTM's capital expenditure and upfront funding burden, while minimising the Operator's funding obligations and the amount passed through to access holders, as the project cost would be payable on a depreciated basis, as opposed to the costs of an alternative solution such as change in maintenance practices being directly passed through to access holders.²⁰ In particular, this would assist access holders with access agreements that will expire in the near future, as it would minimise their contribution to DBCT costs and instead shift those costs to future access holders.

DBCTM is conscious that the current economic and market environment requires its customers to seek to minimise their immediate costs where possible. The User Group's proposal may be influenced by these short-term concerns. However, it is important to recognise that in the present context, this is in direct contradiction to the position previously taken by access holders. In the past, it has been access holders that have urged DBCTM not to undertake NECAP projects the Users viewed to be unnecessary or non-essential, despite the Operator's recommendation and DBCTM's willingness to do so. DBCTM has not undertaken NECAP projects without support from access holders or the Operator.

It would not be appropriate for section 12.10(a) to be amended as proposed to require expenditure by DBCTM to minimise whole of life costs and therefore access holders' immediate and short-term costs simply because the User Group now believes the funding burden should fall upon DBCTM. While this may be a legitimate concern for the User Group, it is no reason to introduce a new obligation in the Undertaking when history demonstrates that this is a cyclical, market-driven concern which may very well change in the five years that the 2015 DAU is proposed to be in force. DBCTM is also seeking to minimise costs where possible, however is firmly committed to continuing to comply with its existing contractual obligations and its obligations under the 2010 AU and 2015 DAU, if approved.

¹⁸ Supplementary Submission, paragraphs 11 and 15

¹⁹ Supplementary Submission, paragraph 9

²⁰ This assumes that relevant costs are accepted by the QCA as prudent and included in the regulated asset base. As outlined at section 3.1(b) above, DBCTM is concerned that this may not be the case if the User Group's proposal is accepted.

(d) Current requirements are already onerous

The User Group has presented the current NECAP obligations as insufficient. However, these obligations are already highly favourable to access holders. No other similar regulated asset has a NECAP type obligation. The Aurizon Network access undertaking does not. Outside of Queensland, there is no similar obligation in any of the ARTC Hunter Valley access undertaking, the ARTC interstate access undertaking or the Western Australia Railways Access Code.

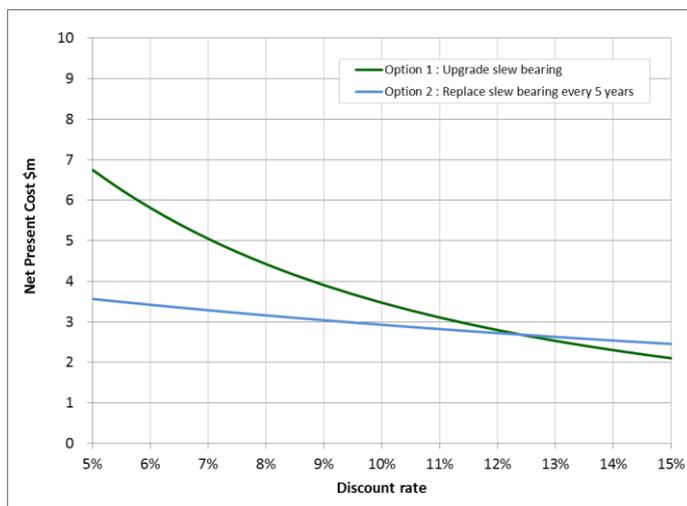
As a result of DBCTM's prudent review and re-categorisation of \$12.9m of potential NECAP projects, the User Group now seeks to further expand DBCTM's obligations, so that DBCTM is not only required to comply with its existing obligations to incur Capital Expenditure, but also to undertake what the User Group argues is 'efficient investment'.²¹ The User Group have provided no justification for why the proposed new obligation to incur Capital Expenditure to minimise whole of asset life costs would constitute 'efficient investment'. As discussed above, the existing requirements already oblige DBCTM to incur Capital Expenditure to achieve reliability, efficiency and effective life of DBCT. DBCTM does not agree that the additional obligation proposed by the User Group would be consistent with the promotion of efficient investment, whether for the purposes of section 69E of the QCA Act or otherwise.

This submission outlines why the obligation proposed by the User Group is unnecessary and undesirable, as well as why this would be contrary to DBCTM's legitimate business interests (while giving undue weight to the interests of the Operator and the User Group).²² In addition, DBCTM submits that a relevant consideration (including for the purposes of section 138(2) of the QCA Act) in relation to the proposed new obligation is the discrepancy between DBCTM's existing obligations (which would be increased if the User Group's proposal was adopted) and the obligations of comparable access providers under similar regulatory regimes.

3.2 Lowest whole-of-life cost analysis is not a reliable indicator

As set out in this submission, DBCTM opposes the User Group's proposal to amend section 12.10(a). In order to consider the proposal properly, DBCTM reviewed the 'whole of asset life' approach proposed by the User Group, having regard to the analysis presently used by the Operator. This review shows that the 'lowest whole-of-life cost' approach that is proposed by the User Group does not in fact support the Operator's position that the relevant 'Series L projects' should be undertaken, as the User Group has endorsed.

In previous NECAP project justifications, DBCTM has typically accepted the Operator's view of lowest whole-of-life cost. The Operator uses a traditional NPV approach to inform their view. However, in consideration of the pressure on capital expenditure, DBCTM recently developed a Net Present Cost (NPC) analysis which assessed the impact of the options on both handling (OMC) and capital (TIC) charges. This is based on the DBCT ARR model, a trusted source²³ for calculating capital charges.



For example, the Operator proposed the upgrade of reclaimer RL1 slew bearing as one of the projects included in the NECAP L series. The Operator's analysis showed a positive NPV for the investment, therefore the upgrade (on capital charges) was considered preferable to replacement (on handling charges). However DBCTM's NPC analysis showed the opposite over a range of discount rates, as illustrated in the chart at left.

These different conclusions reinforce that lowest whole-of-life cost should not be the only consideration.

²¹ Supplementary Submission, paragraph 12

²² DBCTM's legitimate business interests are a relevant consideration for the QCA's decision on whether to approve the 2016 DAU under section 138(2) of the QCA Act.

²³ The DBCT ARR Model is regularly reviewed by the QCA for correctness, as part of annual roll-forwards and RAB additions.

Attachment 2 – Clarification of 2015 DAU section 3.7 Inflation

DBCTM wishes to withdraw section 3.7 Inflation from its original submission, and replace it with the following.

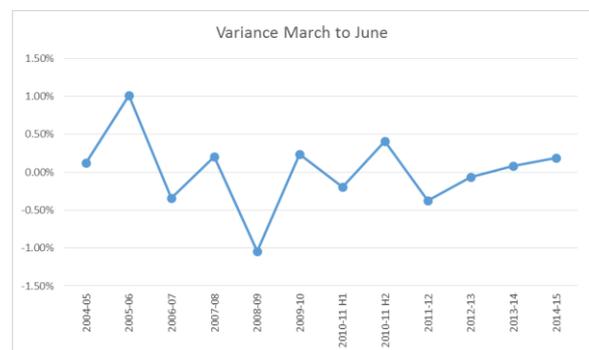
3.7 Inflation

As part of the regulatory reset, the default inflation rate is typically set in consideration of the mid-point of the RBA target range of 2% to 3%. However this range has never been adjusted in consideration of historical performance.

In April of each year, the March-March annual CPI (the outturn inflation) is released by the ABS. During the annual roll-forward, this outturn inflation is applied to the indexation of the RAB in the current year, to calculate the RAB for the following year.

This process introduces significant volatility in the calculation of the ARR:

- it is the only input to the revenue building blocks for which the value is not predetermined by the regulatory process.
- the outturn inflation is particularly difficult to forecast, with a high level of variability
- it is a poor proxy for the true outturn inflation from June-June (refer chart right)



Therefore, in order to eliminate the volatility associated with this process and uncertainty for stakeholders, DBCTM proposes that the outturn inflation be set the same as the default inflation for the duration of the regulatory period.