Submission in response to QR 2016 Access Undertaking Review Event

22 October 2019

1 Executive Summary

This submission is made on behalf of New Hope Corporation Limited (***New Hope***) in relation to Queensland Rail's submission of 22 September 2019, which proposes variations to the West Moreton and Metropolitan tariffs which apply under the current access undertaking (the ***QR Submission***).

Importantly, the question of how an undertaking should be amended when a Review Event occurs, including whether adjustments to reference tariffs should be made, is a matter of appropriateness. It is not simply a formulaic division of QR's same revenue amount across the reduced volume in the manner QR proposes.

The QR Submission clearly does not meet that appropriateness requirement, because it proposes reference tariffs which are not affordable. These same affordability concerns are raised by QR's submissions in respect of the reference tariffs to apply in the 'low volume' scenario under the 2020 draft access undertaking (the ***2020 DAU***). In that case, QR recognised the need to limit tariffs to an affordable level (although there is disagreement as to where that level lies) using a loss capitalisation mechanism. The QCA's Draft Decision supported the introduction of a loss capitalisation mechanism, with tariffs limited to an affordable ceiling level. The QR Submission proposes tariffs which are materially higher than the affordability limit proposed in the QCA's Draft Decision on the 2020 DAU, but without any recognition of the need for loss capitalisation or other revenue deferral measures of the type raised in that Draft Decision.

Accordingly, New Hope strongly considers the variations proposed in the QR Submission should not be approved by the Queensland Competition Authority (***QCA***), unless and until the QCA also has before it a draft amending access undertaking which introduces appropriate revenue deferral measures that the QCA approves contemporaneously.

As always, please do not hesitate to contact New Hope if we can be of any further assistance in the QCA's consideration of the QR Submission.

2 Regulatory Requirements for Review Event Based Variations

The QR Submission has been presented to the QCA as a 'Review Event', on the basis that QR considers the lower volume of contracted access rights to be 'a material change in circumstances' within paragraph (a) of the definition of Review Event.

The QR Submission falls to be considered by the QCA in the context of Clause 5.4 of Schedule D of QR's access undertaking, which sets out the threshold requirements for a reference tariff variation based on a Review Event to be approved.

In particular, to approve QR's proposed reference tariff variations in these circumstances, the QCA must be satisfied that:

(a) the Review Event has occurred;

(b) the variation has been calculated as if all other Reference Tariffs were also being recalculated due to the occurrence that caused the Review Event;

(c) the variation reflects the cost impact on QR resulting from the relevant Review Event (including the impact on incremental maintenance, and incremental capital, costs); and

(d) the variation is appropriate after having regard to the *Queensland Competition Authority Act 1997* (Qld) (***QCA Act***), including those factors listed in section 138(2) of the QCA Act.

New Hope acknowledges that its contracted access rights have reduced under its new access agreement. While the volumes are redacted in the version of the QR Submission the QCA has published, New Hope assumes QR will have demonstrated to the QCA that the volumes in the submission reflect those in the underlying access agreement.

However, even assuming that is the case, for the reasons set out below, New Hope considers that both the third and fourth of those requirements are not satisfied, such that the QCA must not approve the variations proposed in the QR Submission.

3 Variation does not reflect the cost impact

The QR Submission provides no indication that, in calculating the proposed revised tariffs, QR has taken into account the likely decrease in its costs (from the cost allowances assumed by the QCA based on higher volume forecasts) that would be anticipated to arise from the reductions in volume.

While New Hope appreciates that some of QR's costs are fixed, there would still be expected to be some reduction over the balance of the access undertaking's term in incremental operating and maintenance costs arising from a reduction in volumes, and potential deferral of sustaining capital investments.

As the QR Submission provides no information on how such a reduction in cost was taken into account in calculating the proposed reference tariffs, New Hope considers that the QCA cannot be satisfied that the variation reflects the cost impact on QR resulting from the relevant Review Event.

4 Variation is not appropriate

4.1 Section 138(2) factors

As discussed above, clause 5.4 of Schedule D requires that for a Review Event based reference tariff variation to be approved, the variation must be appropriate after having regard to the QCA Act, including those factors listed in section 138(2) of the QCA Act. This is an additional requirement which does not apply to an Endorsed Variation Event.

This differential treatment reflects, in our view, an intention that:

(a) Endorsed Variation Events should be a relatively mechanical exercise in which tariffs are updated to reflect the revenue and cost impacts of an event.

(b) Review Events should not lead to a simple mechanical update of tariffs, but rather require a full consideration of the effects of the event and of how the undertaking should be amended to appropriately reflect the change in circumstances.

New Hope considers that QR's submission takes an approach which would be appropriate for an Endorsed Variation Event, but which does not meet the requirements of the undertaking for a Review Event. The factors which must be taken into account under section 138(2) of the QCA Act are:

(a) the object of Part 5 of the QCA Act: to promote the economically efficient operation of, use of and investment in, significant infrastructure by which services are provided, with the effect of promoting effective competition in upstream and downstream markets;

(b) the legitimate business interests of QR (as the owner and operator of the service);

(c) the public interest, including the public interest in having competition in markets;

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

(e) the effect of excluding existing assets for pricing purposes;

(f) the pricing principles mentioned in s 168A; and

(g) any other issues the QCA considers relevant.

The QR Submission does not expressly respond to those factors, and appears to simply take it as a given that QR should be entitled to recover the same revenue based on the lower volumes, despite the fact that the outcome of that is a substantial jump in tariffs for West Moreton coal customers.

4.2 Affordability

As QR noted in its most recent collaborative submission on the 2020 DAU, the current West Moreton tariffs are at the upper limit of an affordable range. Increases above that as a result of a reduction in forecast tonnages (whether as a result of QR's proposals in the QR Submission or the 2020 DAU), require consideration of the affordability of the resulting tariff.

As discussed in New Hope's most recent submission on the 2020 DAU, New Hope considers that QR has substantially over-estimated the ability to pay of West Moreton coal miners.

In particular, that submission noted:

[redacted]

[redacted]

The QR Submission proposes a West Moreton tariff of $21.13/’000gtk (QR’s table 3). This is expressed in 2016/17 dollars, and would escalate to around $22.40 in 2019 dollars.

In contrast, the QCA’s draft decision on the 2020 DAU proposed:

(d) a tariff of $16.93/’000gtk in 2020/21 dollars;

(e) a 15% premium (to $19.47/000gtk) which would apply where losses are being capitalised.

The premium proposed by the QCA was based on considerations of affordability. New Hope suggests that, if a tariff of $16.93/000gtk in 2020/21 dollars reflects the QCA’s view of the limit of affordable prices, it cannot be appropriate to approve a tariff of $21.13/’000gtk in 2019 dollars.

We note that thermal coal prices have continued to weaken further since the time of the 2020 DAU Draft Decision, and there is no evidence to suggest that they will steeply increase in the remaining term of QR's current access undertaking (i.e. during the period in which the tariff increase is being sought), such that the concerns about affordability raised in respect of the 2020 DAU reference tariffs equally apply to the variations sought in the QR Submission.

Where affordability concerns of this type exist – it is clearly not appropriate for QR to simply seek to derive a tariff through a pure building blocks based model changing only the volume forecast.

4.3 Application of section 138(2) factors

The relevance of affordability to appropriateness of the tariff variations becomes clear, when the impacts of an unaffordable tariff are considered in light of a number of the section 138(2) factors (as required by clause 5.4 of Schedule D of QR's access undertaking):

s 138(2) factor	**Proposed variation is inappropriate because:**
Object of Part 5	The increase in prices is highly likely to discourage efficient utilisation of the network and delay any future investment in West Moreton coal projects (as even projects would be commercially attractive at efficient and appropriate pricing levels, it will become economically rational for new projects to only commence production during the term of the next undertaking when there is likely to be a loss capitalisation regime in place). New Hope is concerned that the proposal increases the risks of volumes not recovering and the West Moreton network and coal projects effectively becoming a stranded investment. That is all clearly inconsistent with the object of Part 5 of the QCA Act.

Legitimate interests of QR	New Hope acknowledges that maintaining revenue is typically in the interests of QR. However, where that revenue increase is sought by way of a material spike in prices at the very time when demand is weakest and customers are most vulnerable, such that the price rise presents real threats of the prospects of volume returning – there is evident questions as to the legitimacy of the proposed increase.
Public interest	The QCA has previously recognised that promoting investment in the West Moreton coal industry is in the public interest. That is unsurprising given the substantial positive regional economic impacts such projects generate, both directly through employment, royalties and exports and indirectly though greater spending which benefits other businesses in the region. It is clearly not in the public interest for the tariff to be set at a level that damages the prospects of future investment in New Acland or other projects in the West Moreton coal industry and threatens the economic viability of Cameby Downs. The QCA has also previously acknowledged that there is a public interest in regulatory certainty – and substantial price increases of this nature, late in the regulatory period in the absence of a new undertaking, are clearly inconsistent with providing an appropriate level of certainty.
Interests of access seekers	Access seekers clearly have an interest in the tariff being at levels that make access to the West Moreton network affordable such that they can justify efficient investment in new West Moreton coal projects.
Effect of excluding existing assets	It is clear that excluding existing assets through optimisation would make the tariff more affordable than that proposed by QR. However, New Hope is not currently suggesting that solely on the basis that if tariffs are set at efficient levels for the current and next undertaking it is possible that volumes might recover. That does however, suggest, that some other mechanism needs to be implemented to ensure tariffs remain affordable and don't rise to the point of hindering future investment and any prospect of volume recoveries.
Pricing Principles	New Hope acknowledges that the pricing principle including that charges should 'generate expected revenue for the service that is at least enough to meet the efficient costs of providing access to the service and include a return on investment commensurate with the regulatory and commercial risks involved'. However, as the QCA has previously determined in the context of considering the tariffs under the existing access, that pricing principle is merely a single factor that needs to be weighed against each of the other section 138(2) factors, with the QCA determining the appropriate balance.
Other relevant issues	The QCA has previously recognised that the interests of existing access holders is generally a relevant factor. In this case, there is a real risk that an unaffordable tariff brings [redacted]

	[redacted], and/or results in earlier than anticipated closure of Yancoal's Cameby Downs mine.

It follows from the above, that based on balancing those factors, it would be inappropriate to simply increase the tariffs as QR is proposing.

5 Potential Solutions

5.1 2020 DAU submissions

As New Hope discussed in its recent submission on the 2020 DAU, reaching an appropriate tariff in a reduced volume scenario requires a solution, which could include cost reductions, asset optimisation or revenue deferral.

While New Hope continues to consider that cost reduction should be the preferred solution to the extent possible without comprising long term performance of the network, and considers that QR has not met the requirements for approval of a Review Event based variation due to not taking account of changes in costs, it appreciates there are likely to be limits in what can be achieved during the remainder of the term of the existing undertaking.

New Hope also considers that if tariffs under the current and 2020 access undertaking are set at levels based on affordability, there are enough reasons to suggest that volume will return during the term of the next access undertaking for it to not be appropriate to require immediate asset optimisation at this time.

Accordingly, if QR wants to seek tariff variations based on the changes in contracted volume, the most appropriate solution for the remainder of the term of the current access undertaking would clearly appear to be some form of revenue deferral, such as the loss capitalisation structures suggested in the QCA Draft Decision on the 2020 DAU (noting New Hope's comments on those structures in its 2020 DAU submissions).

This could be introduced by QR in a separate draft amending access undertaking. Consequently, unless and until the QCA also has before it a draft amending access undertaking which introduces appropriate revenue deferral measures that the QCA can approve contemporaneously it will be inappropriate to approve any proposed increase in tariffs.

5.2 Structure of revenue deferral

Given the limited remaining term of the current access undertaking, and the likely timing for any anticipated recovery of volumes, loss capitalisation will not be able to be implemented in a manner which assumes recovery during the remaining term.

Consequently, New Hope proposes that for a loss capitalisation structure to be appropriate, it would need to envisage capitalisation of losses during the remainder of the term of the current undertaking, but with a view those losses are then taken into account and recovered during the term of subsequent access undertakings, to the extent future volumes recover.

This actually does not require any change to the existing access undertaking, with the appropriate treatment of past 'under-recoveries' being something the QCA would be able to simply consider in assessing the appropriateness of the 2020 DAU (at a time when the prospects of volume recovery might be clearer than they currently are).

6 Conclusion

It follows from the above analysis that it is clearly not appropriate for the QCA to approve the tariff variations proposed in the QR Submission.

It is also disappointing that QR seeks to condition the productivity improvement reflected in the proposed reference train variation (to add an additional wagon) on the acceptance of tariff variations which are not affordable and are likely to hinder the recovery of coal volumes and increase the prospects of asset stranding for both the West Moreton network and West Moreton coal projects.

New Hope is supportive of the change in reference train characteristics, but not on the condition of approving the proposed tariff variations which it considers unaffordable and inappropriate.