QUEENSLAND
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COUNCIL

Resourcing Queensland's future

16th December 2022

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Queensland Competition Authority
145 Ann Street
Brisbane QLD 4000
(Submitted via QCA Online Submission Form)

RE: QCA Discussion Paper:
Approach to climate change related expenditure

The Queensland Resources Council ("**QRC"**), on behalf of the QRC's Rail Working Group, welcomes the opportunity to comment on the QCA's discussion paper on climate change expenditure and whether the existing regulatory frameworks are sufficiently responsive to support such expenditure ("**Discussion Paper**").

QRC's comments will be limited to the issues as they apply to Aurizon Network.

1. Introduction and summary

QRC considers the existing regulatory frameworks (as they apply to Aurizon Network) are well suited to support climate change related expenditure. This is primarily due to the customer consultation and approval processes on maintenance and renewals expenditure, and the scope for Aurizon Network to seek pre-approval of capital expenditure for expansions.

However, QRC refers to its comments below on improvements to particular areas, and on developing issues that may come into play in the future.

2. Adaptation / Resilience Expenditure

Under the existing Access Undertaking ("**UT5**"), Aurizon Network seeks customer pre-approval of its annual Maintenance and Renewals Strategy and Budget ("**MRSB**"). The consultation process provides opportunities for Aurizon Network to propose, and to obtain feedback on, the scope, standard and costs of its maintenance and renewals program. In considering the proposed scope and standard of maintenance and renewals activities, we expect that Aurizon Network will consider climate change risks, such as the risk of increased flooding and other severe weather events over the coming years.

QRC expects that Aurizon Network's customers would support increased costs for climate change risk mitigation where Aurizon Network presents a robust and detailed business case. Such a business case would consider each relevant option in detail, its costs and the risks under each risk mitigation option. Business cases presented to the Rail Industry Group to date have often lacked this type of detail. This concern has been expressed to Aurizon Network directly and it understands and, QRC hopes, is actively working to address the issue.

Importantly, UT5 does not obligate Aurizon Network to only complete maintenance, renewals or expansion capital expenditure that has gained customer pre-approval. Rather, Aurizon Network is free to unilaterally proceed with projects it considers necessary. Aurizon Network is also then able to recover its costs, if it can demonstrate to the QCA that the scope, standard and costs are prudent and efficient. Aurizon Network is also able to seek pre-approval of capital expenditure from the QCA. When considering expenditure related to the mitigation of climate change risks, QRC would expect the QCA to require a business case that demonstrates whether the expenditure is justified by the climate change risks it seeks to mitigate.

UT5 also contains a wide variety of mechanisms for the review of reference tariffs, and Aurizon Network can submit Draft Amending Access Undertakings.

Generally, we consider these mechanisms appropriate for the assessment of maintenance, renewals, capital expenditure and other expenditure related to climate change risks. While climate change may introduce new considerations into the assessment of future expenditure, the fundamental task remains unchanged. That is, to assess the prudency and efficiency of the scope, standard and cost of expenditure based upon a consideration of both the risks and benefits of a variety of options.

3. Insurance/self-insurance

QRC understands that securing insurance for certain climate change risks is likely to become more difficult/expensive in the future (e.g. some insurers are becoming more reluctant to cover entities with exposure to thermal coal).

Under UT5, Aurizon Network's risks are managed through a combination of external insurance, in-house (captive) insurance with an associated entity, informal self-insurance, and pass-through mechanisms.

QRC generally does not favour the use of self-insurance or captive insurance mechanisms. QRC would prefer that use of these options be reduced. Each of these approaches creates regulatory debates about the valuation of risks, the appropriate premiums, and whether there is sufficient transparency regarding the types of losses that are being insured. The QCA's December 2017 Draft Decision on UT5 provides at page 236 that:

> "*Aurizon Network's uninsured risks primarily relate to tracks and associated infrastructure that commercial insurance markets typically do not have the appetite to underwrite. Aurizon Network proposed self-insurance allowances for the following uninsured risks:*
>
> - *Derailment*
> - *Dewirements*
> - *weather damage (storms, floods and extreme heat)*

- *third-party repairs*."

Despite reference tariffs including an allowance for the self-insurance of these risks, there is a lack of clarity on the nature of the risks being assumed by Aurizon Network. For example, when additional corrective maintenance is required, due to wet weather, it is not clear whether this cost should pass through to customers as a maintenance cost, or whether it should be adsorbed by Aurizon Network as a self-insured risk.

Without a proper actuarial valuation of Aurizon Network's assumed risks or details of the risks assumed to the same standard as a commercial insurance policy, there is a risk that self-insurance by regulated entities is used to boost profits above regulated rates, while doing little to address the risks faced by customers.

For these reasons, QRC prefers the use of:

- commercial insurance with third parties, where this can be achieved at reasonable rates (and the QCA is able to verify that the rates are competitive); otherwise
- cost pass-through mechanisms where Aurizon Network can seek approval for the recovery of the actual incremental cost of uninsured events. In these cases, incremental costs should exclude costs recovered through other mechanisms, such as operating or maintenance cost allowances, and customers should be given an opportunity to comment on the claim.

4. Mitigation Expenditure

Mitigation expenditures (expenditure aimed at reducing emissions) may be incurred by regulated entities to:

1. comply with Government Regulations; or
2. meet the expectations of the community, investors, lenders, or insurers; or
3. maintain the reputation of the entity in terms of its environmental, social and governance matters.

The extent to which a regulated entity should elect to exceed the minimum mitigation requirements set by Government Regulation is a complex question, and has the likelihood of deviating greatly between each entity.

It is also unlikely that customers of regulated entities will have identical views regarding this question. For example, emissions arising from the generation of electricity purchased by Aurizon Network, for use by operators, are likely to be considered a Scope 3 emission for customers. While several customers have clear targets and strategies for the reduction of scope 3 emissions, these will differ between customers and will change over time.

It is important that Aurizon Network actively consults with its customers when considering mitigation expenditure which exceeds regulatory requirements, so that the preferences of its customers are understood when making such decisions. This consultation should include an appropriate customer vote in cases where such expenditure involves material costs. QRC does acknowledge that these preferences may differ between customers and preferences may not be the only consideration when making such a decision. Therefore, consistent with the MRSB process, a negative vote would not prevent Aurizon Network from incurring mitigation expenditure and from seeking QCA approval for cost recovery.

Further, the preferred mitigation mechanisms may vary between customers and could include direct mitigation (direct reduction in emissions) or indirect mitigation (e.g. carbon offsets). Therefore, an assessment of the prudency of the expenditure would need to be made by the QCA, taking into account all of the relevant factors, including customer preferences as informed by the outcome of the voting process, and a business case which supports the additional expenditure.

Importantly, the QCA's assessment of the mitigation expenditure's prudency should relate to the regulated entity on a stand-alone basis. Mitigation expenditure of the regulated entity should not be considered a prudent cost if it is used to support other sections of the business in meeting corporate targets. Also, mitigation expenditure should not be considered prudent purely by reason of contributing to Government targets, unless there is a clear benefit to the relevant entity and its customers in doing so (as demonstrated by a robust business case), or a requirement to do so. Regulatory decisions should continue to assess prudency from the perspective of the regulated entity and its customers, and not be used as a tool for delivering Government targets or policies.

Regarding the procurement of electricity by Aurizon Network, there has been little effective consultation to date on the extent to which Aurizon Network should incur mitigation expenditure (e.g. by procuring an increased portion of renewable energy). QRC considers customer preferences as a critically important consideration, and that consultation should be improved (including, as discussed above, consideration of a voting process). QRC are also interested in exploring whether alternative models of electricity procurement are more appropriate for the future.

Thank you for the opportunity to provide this submission.

Yours sincerely

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Queensland Resources Council

Attachment A: Responses to QCA consultation questions:

(1) To what extent are the risks of more frequent or severe extreme weather events already impacting the businesses of regulated entities? Please provide evidence where available and appropriate.

QRC considers that it is prudent for regulated entities to consider the risk of more frequent or extreme weather events when planning maintenance, renewals and capital expenditure projects.

(2) Is there evidence to suggest that regulated entities are facing difficulties in accessing insurance for their assets or accessing insurance at reasonable cost? Is self-insurance thereby becoming a more prudent option for these businesses?

As discussed in Section 3, QRC does not support self-insurance, and prefers cost pass-through mechanisms in cases where third party insurance cannot be secured at reasonable cost.

(3) Most organisations, including regulated entities, now have detailed climate change strategies and planning documents in place. To what extent are these strategies a response to government policies, and to what extent are they externally driven (e.g. in response to financing requirements or shareholder activism)? Do these external drivers put pressure on businesses to exceed the minimum requirements of government policies?

The extent of need to exceed minimum requirements of government policies differs significantly between entities and needs to be considered on a case-by-case basis.

(4) Are regulated entities being encouraged or pressured by their customers to take further action on climate change? For example, do customers want regulated entities to reduce their scope 2 emissions by using an increasing proportion of renewable energy in their businesses? How do customers value actions taken by regulated entities that might provide for the customers to claim reduced scope 3 emissions in their supply chains?

As discussed in Section 4, customers will have a variety of preferences in terms of both the level of mitigation and mechanisms for mitigation. Customer consultation, and a formal process for capturing customer preferences (such as a voting mechanism) is vital to ensure that these preferences are understood and reflected in decision-making by the entity, and by the QCA.

(5) Do the QCA's existing regulatory frameworks create appropriate incentives for regulated entities to efficiently manage risks associated with climate change? If not, how might the frameworks be improved in this regard?

QRC considers that existing frameworks are generally appropriate, but should be enhanced by formalisation of customer consultation, including voting processes. Reforms are also required to provide meaningful customer input to Aurizon Network electricity procurement decisions.

(6) Are existing mechanisms in the QCA's regulatory frameworks for dealing with newly arising expenditure requirements (e.g. pass-through mechanisms, review events and draft amending access undertaking (DAAU) processes) sufficient to deal with climate change related expenditure? If not, how might these mechanisms need to be amended?

Existing mechanisms are generally appropriate, subject to the comments under item 5.

(7) The QCA's standard approach to assessing the prudency and efficiency of capital expenditure claims by regulated entities involves applying frameworks that assess scope, standard and cost. Are these existing frameworks suitable for assessing climate change related expenditures? And do they

provide the right incentives for entities to appropriately have regard to climate change considerations—and alternative ways of
achieving the desired objectives—when undertaking expenditure? If not, how should they be enhanced? For example, in considering the prudency of capital expenditure, is there a trade-off between efficiency and least cost, and robustness and resilience? If so, how can these trade-offs be managed?

Trade-offs such as those noted above are a feature of most investment decisions. As discussed in Section 2, a properly prepared business case should deal with such trade-offs and with a variety of options for achieving objectives.

(8) Are processes in the regulatory frameworks that are designed to provide regulated entities with a degree of certainty to make investment decisions (e.g. provisions that allow for preapproval of the scope of projects or customer vote mechanisms) sufficiently flexible to enable climate change related investments to proceed where appropriate?

QRC considers that the existing Aurizon Network access undertaking is sufficiently flexible to enable climate change related investments to proceed where appropriate.

(9) How should differences between regulated entities' willingness to supply and customers' willingness to pay for adaptation and/or mitigation expenditure be reconciled? What if the willingness to pay differs among customers or groups of customers? In considering these matters, how should potential externalities be assessed? This includes positive externalities that may accrue to the broader community from increased mitigation activities.

As is discussed in Section 4, QRC favours enhanced customer consultation processes to ensure that customer preferences are understood and considered by Aurizon Network and the QCA. In the absence of strong customer support, QCA's decisions regarding the prudency of adaptation/mitigation expenditure should be based on a robust business case provided by Aurizon Network.

(10) How do organisations justify climate change related expenditures to their boards and other internal stakeholders? To what extent can these processes inform the QCA's assessment of this type of expenditure?

QRC acknowledges that the benefits of climate change related expenditure may be difficult to quantify (particularly benefits arising from, for example, an enhanced social licence to operate). Despite this, QRC considers that a business case must still be prepared which demonstrates the prudency of expenditure. The fact that the task is more difficult should not absolve the regulated entity from making the case in support of its proposal.

(11) How do organisations consider different types of mitigation expenditures? How do they decide between alternative options (e.g. direct mitigation versus purchase of offsets) and justify those decisions? What lessons can be learned for the QCA's regulatory processes?

This will differ between organisations and would need to be considered on a case-by-case basis.

(12) What lessons can be learned from the insurance industry's assessment of climate change related risks? How should the QCA approach the assessment of actuarial information provided to it as part of future expenditure claims? Does the QCA's approach to assessing self-insurance claims provide a model for assessing proposed climate change related spending? What might the criteria be for a climate change related application? What types of supporting material should an entity provide?

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QRC considers that an actuarial approach should be taken to the valuation of risks. For significant expenditures, we consider that the QCA should obtain independent expert advice regarding the valuation of risks. As is discussed in Section 3, we do not support self-insurance by regulated entities.

(13) Do stakeholders have experiences with other regulatory work or frameworks, in Australia or overseas, that the QCA ought to have regard to in undertaking this climate change project? If so, what lessons could be learned from such experiences?

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