DBCT User Group – Supplementary Submissions to QCA

22 January 2016

Background

1 In October 2015, Dalrymple Bay Coal Terminal Management Pty Ltd (***DBCTM***) submitted to the Queensland Competition Authority (***QCA***) its proposed draft access undertaking to apply to services provided by the Dalrymple Bay Coal Terminal (the ***Terminal***) from 1 July 2016 (the ***DAU***).

2 The DBCT User Group made initial submissions regarding the DAU to the QCA on 24 November 2015.

3 The DBCT User Group have determined, following further analysis and prompted by events which have occurred since that initial submission, that they should provide this additional supplementary submission on two additional points which were not addressed in as much detail in the DBCT User Group's initial submission.

4 In particular, this supplementary submission highlights:

(a) the need for strengthening of the obligation of DBCTM to invest in non-expansion capital expenditure (***NECAP***) under Section 12.10 of the DAU; and

(b) the incentives that the term and renewal option structure contained in DBCT User's existing User Agreements creates for existing DBCT Users to renew existing User Agreements, and how that is relevant to an assessment of the Terminal's remaining useful life.

Obligation to invest in NECAP

5 In section 6.10 of its initial submissions the DBCT User Group addressed concerns regarding DBCTM's attitude to future investment in prudent NECAP.

6 In particular, the DBCT User Group noted:

(a) the 'unambiguous threat to cease funding non-safety related NECAP, including for clearly prudent items like machine replacement', contained in DBCTM's letter to the QCA of 9 October 2015 (under cover of which the DAU was submitted);

(b) the concern 'that DBCTM will effectively be seeking for the DBCT Users to bear all of the additional costs of maintaining the Terminal (and thereby protecting the value of DBCTM's investment) despite the fact that DBCTM is apparently unwilling itself to invest in the sort of sustaining capital expenditure which is necessary for prudent upkeep of the Terminal'; and

(c) the DBCT Users' previous experience with Babcock & Brown Infrastructure as Terminal owner regarding refusal to undertake investment in prudent NECAP.

7 Through the current budgetary process regarding a series of NECAP projects which have been proposed by Dalrymple Bay Coal Terminal Pty Ltd (***DBCTPL***) those concerns have now been clearly realised.

8 DBCTM's letter to DBCTPL of 5 November 2015 (included as Annexure A) gives notice that DBCTM proposes to reduce the Terminal's NECAP budget by $12.9 million in respect of 'Series L projects' by deferring or cancelling most of the proposed projects.

9 A short description of the Series L projects is contained in DBCTM's letter, but relevantly in each case the independent operator of the Terminal, DBCTPL, considers they are prudent investments that should be made. As DBCTPL is user-owned, it has no incentive to make unnecessary investments in NECAP (as that would simply result in the Users paying a higher Terminal Infrastructure Charge to DBCTM).

10 DBCTPL has responded to DBCTM in a letter of 17 December 2015 (included as Annexure B), in which DBCTPL notes that:

(a) DBCTPL considers that the original NECAP series L project list (and related budget) is prudent and does not endorse the proposed reduction of the relevant projects; and

(b) by reducing the relevant projects and budget, practical and reasonably foreseeable solutions will not be implemented, which would otherwise have ensured a better and more effective operation of the Terminal in terms of lowest total whole of life cost, reliability and economy of performance and maximising the effective life of the Terminal.

11 DBCTPL has also suggested, as a potential compromise, completing certain projects as part of operations and maintenance activities (effectively demonstrating one of the concerns noted in the original submission that an underspend on NECAP would result in DBCTPL having to incur higher operations and maintenance costs which are effectively passed through to DBCT Users).

12 In reviewing how the DAU (and the existing Undertaking) seek to deal with investment in NECAP it has become evident to the DBCT User Group that the current DAU falls short of what is required to ensure appropriate future investment in NECAP. The DAU provisions regarding capital expenditure are principally focused on preventing gold plating or over-investment in capital projects and are ill-suited to effectively requiring efficient investment (which would be entirely consistent with the object of Part 5 of the *Queensland Competition Authority Act 1997* (Qld), section 69E) .

13 Clause 12.10 of the DAU is the current obligation to invest in NECAP, which requires DBCTM to invest in NECAP 'as is necessary to ensure that the Terminal complies with Good Operating and Maintenance Practice'.

14 'Good Operating and Maintenance Practice' is then defined in the DAU to mean:

> *adherence to a standard of practice which includes the exercise of that degree of skill, diligence, prudence and foresight which would reasonably be expected from a competent, experienced and qualified operator of a facility comparable with the Terminal.*

15 The DBCT User Group is concerned that the definition's focus on operational matters may mean that the obligation is not well adapted to DBCTM's current behaviour of underinvestment in NECAP (particularly to the extent that DBCTPL is still able to operate the Terminal prudently, albeit through the higher operations and maintenance charges which are likely to be required to do so).

16 The fact that DBCTM is so clearly indicating it will not fund prudent NECAP is a clear indication that it does not consider clause 12.10 to restrict its ability to refuse to invest in that matter.

17 As a consequence, the DBCT User Group submits that clause 12.10 should be amended to also require DBCTM to invest in NECAP as is necessary to ensure that the whole of asset life costs of the Terminal, taking into account both future capital investment and maintenance and operating costs, are minimised.

18 For example, clause 12.10(a) could be amended to achieve this as follows:

(a) ***(Good Operating and Maintenance Practice and Port Services Agreement)*** *DBCT Management will incur Capital Expenditure which does not relate to a Capacity Expansion as is necessary to ensure:*

(1) that the Terminal complies with Good Operating and Maintenance Practice; ~~*and*~~

(2) that DBCT Management complies with its obligations under the Port Services Agreement~~*.*~~*; and*

(3) *the whole of asset life costs of the Terminal, taking into account both future Capital Expenditure and Terminal Operating Costs and the volume of Access contracted and anticipated to be contracted, are otherwise minimised.*

19 The DBCT User Group considers such a requirement is clearly within the powers of the QCA to impose in an undertaking.

20 In the absence of a clear requirement to invest in NECAP like the above, it will be impossible for DBCTPL to prevent similar conduct by DBCTM occurring in the future, and impossible for DBCT Users to ensure that the operational efficiency of the Terminal will be maintained during the Term of relevant Access Agreements (something that is particularly concerning given DBCTM's proposal to extend the minimum Term of some Access Agreements).

21 The DBCT User Group believes that the conduct of DBCTM, and their intention as stated in letters to the QCA and DBCTPL, as described above, provides incontrovertible evidence of the need for implementation of a positive obligation to invest in NECAP, as set out in paragraph 17 to 18 of this supplementary submission.

Increased Extension Incentive

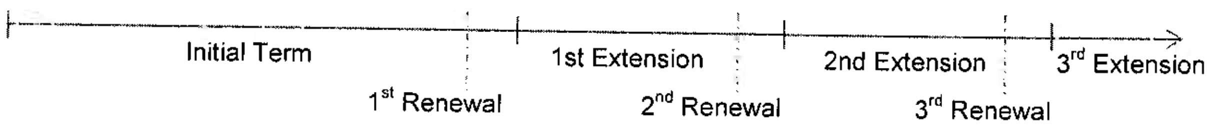
22 The term of the existing User Agreements in respect of the Terminal are structured to reflect:

(a) an initial term of 10 years (or more); and

(b) a renewal option which reflects clause 20 of the current Standard Access Agreement.

23 Clause 20 effectively gives the User an evergreen agreement with the option to extend the term in 5 year increments (unless a shorter period coincides with the end of mine life), exercisable upon 12 months' prior notice. Evergreen or rolling agreements of this nature are common features for user agreements in respect of a number of Australian coal export terminal.

24 The right to extend can be exercised again at least 12 month's prior to the extension term (resulting from the previous renewal) expiring. The renewal regime therefore effectively results in the term of an access agreement typically looking like the following:



25 DBCTM's submissions in connection with the DAU seek to make an issue of the risks of non-renewal arising from this model. In particular, DBCTM notes the proportion of capacity for which the contract term expires in the next 5 years. However, it should be evident from the above that the drop off in the contracted tonnage profile over that period is just a function of the 5 year renewal terms. The theoretical drop off in contracted tonnages is not new – it exists under the current Undertaking – but has continued to 'move out' into the future as renewal rights are exercised.

26 In other words, experience indicates that the drop off actually eventuating due to renewals not being exercised is a more theoretical risk than a real one.

27 The DBCT User Group understands that the total aggregate contracted tonnage for the Terminal has not significantly reduced since the last terminal capacity expansion to 85 million tonnes in 2009 and does not anticipate material future reductions.

28 As set out in the DBCT User Group's initial submissions, the DBCT Users consider that no other coal export terminal competes with the Terminal, and that even if it was physically possible for a DBCT User to send coal to a different terminal the costs in term of below rail, above rail, port

costs; and consequences regarding matters like blending, co-shipping and other rail infrastructure arrangements, make it uneconomic and impractical to do so.

29 As a consequence, every DBCT User has an extremely strong incentive to continue to renew the existing User Agreement for the current life of their mine at the absolute minimum. Such life may lengthen significantly over time (beyond that originally estimated at the time of initial contracting) as incremental mine expansions and extensions are made based on new resources being discovered or being proved up as economic. For example, in the last five years, both Rio Tinto and Peabody have effected extensions to User Agreements based on continuation of the mine life of a mine for which capacity was initially contracted.

30 Even where mines of a DBCT User have been temporarily closed (as for example Isaac Plains was in late 2014), the relevant User has continued paying the Terminal access charges with a view to being able to sell the mine with port access in place (as recently occurred in October 2015).

31 However, the strength of the incentive extends beyond renewals for existing mines.

32 For major mining companies with multiple mines, renewable access to the Terminal facilitates future development. Companies commonly plan to use existing access rights at the Terminal beyond the life of current mines for new mining projects and expansions of other mines within their portfolio. A clear example of that having occurred is the access rights at the Terminal now used by Clermont, which were originally used by the nearby Blair Athol mine, which is now on care and maintenance. That transition was part of a clear strategy by Rio Tinto (the majority owner of Blair Athol and Clermont at the time) to ramp up one mine at the time the other was closing.

33 That is the position of most of the major mining companies that are DBCT Users.

34 Even for the minority of companies that cannot themselves utilise the future access rights:

(a) merger and acquisition activity has often resulted in such DBCT Users becoming part of larger users with much greater prospects of renewing the future rights for use elsewhere in their portfolio of projects (e.g. Anglo American acquiring Foxleigh and Peabody acquiring Macarthur Coal); and

(b) a company without an alternative use for the access would be likely to seek a commercial arrangement for the assignment of its access rights to a third party miner who would utilise those rights, rather than forfeit them by failing to renew a user agreement. That third party miner would then be expected to utilise the rights (and exercise renewal rights) for their mine until they again sought an assignee close to the end of their mine life.

35 The renewal incentive will arguably become even stronger if the QCA accepts longer minimum terms, and the requirement to give five years notice of decisions not to extend, which DBCTM is seeking for new access agreements in connection with the DAU.

36 It should also be noted that there is one circumstance under clause 20 of the existing Access Agreement, where the option to renew can be triggered early where an access seeker is ready to sign an access agreement with DBCTM, but an expansion will be required if the existing DBCT Users were to exercise their rights of renewal. This both:

(a) effectively makes existing DBCT Users more likely to renew – as they have to make a decision further out about their future needs; and

(b) in the unlikely event of a non-renewal, effectively provides an immediate way to replace them with a new access holder (which from DBCTM's perspective is the same as a renewal, if not better, as the new access holder will likely be taking more than a 5 year initial term).

37 Of course, in the rare scenario where, despite all of the factors noted above, renewal rights are not exercised, there is also an existing queue for capacity at the Terminal, such that the rights may be taken up by Access Seekers.

38 Consistent with the analysis above, the DBCT User Group considers that the structure of the term and renewal arrangements in existing Access Agreements is a factor that creates very strong incentives for existing DBCT Users to renew User Agreements, and that this needs to be taken into account by the QCA in assessing the remaining useful life of the Terminal.

Conclusions

39 For the reasons set out in this supplementary submission, in addition to the matters set out in its initial submission of 24 November 2015, the DBCT User Group considers that it is not appropriate to approve the DAU unless:

(a) it is amended to include an obligation to invest in NECAP of the type set out in paragraph 17 to 18 of these supplementary submissions; and

(b) the Terminal's remaining useful life is not reduced from the QCA's previous assessment, particularly due to taking into account the strong incentives the existing DBCT User's have to renew their existing User Agreements in light of the term and renewal option structure of those User Agreements.

Annexes A and B are commercial in confidence correspondence that we have not published at this time.