

Initial Submission on QR 2020 Draft Access Undertaking

17 October 2018



1 Introduction and context

Yancoal thanks the Queensland Competition Authority (the **QCA**) for the opportunity to make submissions regarding Queensland Rail's (**QR**) draft access undertaking as lodged on 14 August 2018 (the **2020 DAU**).

Yancoal Australia Limited (**Yancoal**) is a significant coal producer with interests in a portfolio of Australian coal mines, including the Cameby Downs coal mine which transports coal via QR's West Moreton and Metropolitan systems for export through QBH's coal terminal at the Port of Brisbane.

Cameby Downs is currently producing approximately 2.2 mtpa of product coal. It has significant coal resources and the ability to expand production, if reference tariffs were set at a level that made the mine economically viable and attractive relative to other investment opportunities in Yancoal's portfolio of other coal mines.

However, the prices proposed by QR would make Cameby Downs economically unviable at long term consensus coal prices.

Yancoal is therefore critically concerned with ensuring efficient and appropriate pricing and terms of access for the West Moreton and Metropolitan systems – that are both viable over the coal price cycle and incentivise further investment in Cameby Downs.

This submission responds to each of:

- (a) the 2020 DAU (including the reference tariffs and Standard Access Agreement (**SAA**) proposed to apply under it);
- (b) the QR Explanatory Document published on 22 August 2018 (the **QR Submission**), including the annexed reports it relies upon; and
- (c) the stakeholder notice regarding QCA staff topics for stakeholder comments (the **QCA Stakeholder Notice**) published on 21 September 2018.

Given the substantial departure from the methodology adopted in respect of the positions the QCA determined were appropriate just over two years ago for QR's current access undertaking (**AU1**), and the inappropriate increase from current levels that QR's proposed reference tariffs represent, the reference tariffs are the focus of this submission.

Yancoal does also oppose some changes to the undertaking and SAA wording. However QR deserves some credit for the more incremental approach taken to changes to the wording in those documents, and taking the trouble to explain their rationale, such that Yancoal's submissions on those matters are less extensive.

2 Need for further submissions - low tonnage scenario reference tariffs

QR's Submission proposes that different tariffs should apply based on a 'high tonnage' and 'low tonnage' volume forecast, with the latter applying where the New Acland extension/expansion either doesn't proceed or is delayed beyond the start of the regulated term.

That is obviously a departure from the more usual position of setting a single tariff for a reasonable volume forecast, with review events or endorsed variation events dealing with changes in volume.

However, Yancoal is not opposed to QR's proposed approach, given the substantial difference between the tonnages which appear to be involved, and the significant adverse implications for both Yancoal and QR of an inappropriate tariff in the 'low tonnage' scenario.

The ceiling price that QR has calculated for the low tonnage volume scenario is clearly economically unviable for coal users, and acknowledged as such in the QR Submission and subsequent consultation.

QR has advised Yancoal that the high tonnage scenario is based on 9.1 mtpa, and the low tonnage scenario is based on 2.1 mtpa (the latter solely reflecting production from Cameby Downs).

As foreshadowed in QR's submission, Yancoal has engaged in some initial consultation with QR. Those consultations have considered a range of possible pricing methodologies, including but certainly not limited to those referred to in the QR Submission.

At the date of this submission, Yancoal:

- (a) has concerns with loss capitalisation being employed in a context where (unlike in other regulatory determinations where it has been applied) there is not necessarily a high likelihood of substantial demand growth through which revenue capitalised during a low tonnage period could ultimately be recovered;
- (b) considers that optimisation of the asset base is likely to be more appropriate;
- (c) but considers it is premature to rule out particular options or provide detailed submissions on appropriate pricing to apply in a low tonnage scenario when the advantages and disadvantages for QR and users of various methodologies have not yet been fully explored; and
- (d) is hopeful that with further time for consultation there is some prospect of reaching agreement on at least some principles or issues relating to the appropriate pricing to apply in the low tonnage scenario, or at a minimum being able to make more informed submissions about the appropriateness of some of the potential options.

It is also critical that an appropriate approach is reached, as an inappropriate tariff may result in the cessation of operations at Cameby Downs and, ultimately, the elimination of the West Moreton coal industry and the employment, royalties, exports and other economic activity it supports.

Yancoal therefore requests that the QCA provide the opportunity for further submissions on low tonnage scenario reference tariffs, with a sufficient timeframe prior to those submissions being due for QR and Yancoal to further progress the consultation that has occurred to date.

Yancoal's principal concern in relation to the 'low tonnage' scenario tariffs is to ensure that:

- (e) the price payable by Cameby Downs in a low tonnage scenario does not result in it being uneconomic to operate Cameby Downs; and
- (f) the pricing methodology does not dis-incentivise Cameby Downs expanding or investments in new mines or mine life extensions by other producers occurring (such that the West Moreton system infrastructure becomes economically stranded).

3 Executive Summary

Yancoal has major concerns with the proposed West Moreton and Metropolitan tariffs proposed in connection with the 2020 DAU based on both:

- (a) Flaws in a number of the building blocks elements used to 'build up' that tariff including:
 - (i) an excessive asset beta;
 - (ii) an excessive allocation of the West Moreton system asset base (and fixed operating and maintenance costs) to coal services;

- (iii) excessive capital expenditure, operating and maintenance costs, with extremely high fixed costs, that cannot be prudent and efficient given the potential reduction in volumes; and
- (b) the proposed reference tariffs being economically unviable at consensus long term coal prices.

In particular Yancoal considers that QR's proposal in respect of reference tariffs is clearly not appropriate when regard is had to the mandatory factors that the QCA must have regard to in considering a draft access undertaking in accordance with section 138(2) *Queensland Competition Authority Act 1997 (QCA Act)*:

s 138(2) QCA Act factor	Relevance to assessment of QR's proposed reference tariffs
Object of Part 5 QCA Act	The reference tariffs are not consistent with the efficient use of and investment in infrastructure (with the excessively high pricing likely to result in inefficient decision making regarding investment in, and usage of, the West Moreton coal industry and falling volumes on the system).
Legitimate business interests of owner/operator	The reference tariffs go beyond the legitimate interests of QR –providing a return that is in excess of that corresponding to the risks assumed by QR in providing the service
Public interest, including the public interest in having competition in markets	<p>The proposed reference tariffs have the potential (if not amended) to:</p> <ul style="list-style-type: none"> • make the West Moreton coal industry economically unviable (with resulting damage to economic growth, employment and royalties); • economically strand the West Moreton system (require enduring and substantial government subsidies if it was to continue to support passenger and non-coal freight services). <p>That is clearly not in the public interest.</p> <p>There is a public interest in maintaining regulatory certainty – such that the major departures from the previously approved pricing methodology should not be accepted</p>
Interests of persons who may seek access to the service	Proposed reference tariffs are uneconomic and will provide a disincentive for investments in West Moreton coal mines by potential producers (and are likely to have consequences for the prospects of future non-coal freight due to leaving the West Moreton system economically stranded).

Pricing principles in s 168A	<p>The proposed reference tariffs are not consistent with important parts of the pricing principles in section 168A QCA as they::</p> <ul style="list-style-type: none"> • include a return on investment that is excessive and not commensurate with the regulatory and commercial risks involved and • do not provide incentives to reduce costs or improve productivity
Other issues the QCA considers relevant	<p>The QCA has previously found that the legitimate interests of access holders are also relevant.</p> <p>Existing access holders have a strong legitimate interest in tariffs being set at a level at which their mining operations are profitable and economically viable across the coal price cycle.</p>

Yancoal also have a number of concerns with the wording of the 2020 DAU itself (including the SAA).

As a result, and for the more detailed reasons set out below, Yancoal submits that the 2020 DAU is not appropriate, and the QCA should refuse to approve it, and provide a secondary undertaking notice to QR requiring the amendments described in this submission in accordance with section 134 of the QCA Act.

4 Reference Tariffs – Weighted Average Cost of Capital

4.1 WACC parameters adopted from the UT5 Decision

Yancoal acknowledges that for the majority of the parameters used to calculate the weighted average cost of capital (**WACC**) from which the reference tariffs are derived, QR has proposed to adopt the parameters determined by the QCA in its most recent decision in respect of Aurizon Network's reference tariffs.

Yancoal accepts that such an approach is typically appropriate, other than in respect of the market risk premium (**MRP**) where, as discussed in section 4.3 below, Yancoal considers that recent regulatory precedent suggests a lower MRP would be more appropriate.

4.2 Asset Beta

(a) Overview and AU1 asset beta determination

In respect of the 2020 DAU reference tariffs, QR has proposed an asset beta of 0.77.

In addition to being an extremely high asset beta for a regulated infrastructure service provider, that is a very substantial increase from the asset beta of 0.45 from which the AU1 reference tariffs were calculated. The AU1 asset beta of 0.45 was in fact proposed by QR itself (and therefore presumably considered appropriate by QR), due to it being adopted by the QCA for the closest comparator in Aurizon Network, and determined by the QCA to be appropriate for QR as recently as its Final Decision in respect of AU1 in June 2016.

The appropriate asset beta should reflect the systematic or non-diversifiable risks faced by QR in providing the reference service.

However, Yancoal submits that there has been no change in the systematic risks faced by QR since that time which would justify an increase in the asset beta.

It is worth repeating the reasoning from the QCA's Draft Decision in respect of AU1 in October 2015 (at page 68) that led to the QCA accepting the previous asset beta of 0.45 as appropriate:

Queensland Rail has taken the view of benchmarking itself with Aurizon Network. Proposing an asset beta of 0.45 and an equity beta of 0.8 (sub, no. 2:40).

Based on our analysis, we note that Queensland Rail's West Moreton network and Aurizon Network share similar characteristics, namely that they have:

- *operations in the Queensland coal chain, although there is some difference in the composition of product;*
- *cost-based regulation that is applied to coal traffic operations;*
- *revenue protection from take-or-pay contract provisions;*
- *cost-pass through provisions within access agreements*
- *similar institutional arrangements, in that they are both located in the same state and regulated by the same regulator.*

While there are some differences between Queensland Rail and Aurizon Network, we have not been presented with evidence from stakeholders at this time that Queensland Rail's coal operations are materially riskier than that of Aurizon Network.

Yancoal submits all of that reasoning remains just as valid today, such that Aurizon Network remains a close comparator, and the asset beta used to calculate QR's reference tariffs should be the same or very similar to that of Aurizon Network.

(b) Assessing the appropriate asset beta

As noted above, Yancoal continues to believe that Aurizon Network is the best and closest comparator for determining the asset beta for the purposes of QR's West Moreton and Metropolitan reference tariffs.

Accordingly, Yancoal is comfortable for the same approach to be adopted as was in AU1, with the asset beta being updated to the most recent asset beta the QCA has assessed for Aurizon Network (i.e. 0.42).

However, if the asset beta is to be re-estimated by QR from first principles, then it is critical to the object of achieving efficient and appropriate pricing that that exercise is done properly.

As discussed in the QCA's Risk and the Form of Regulation Discussion Paper (November 2012), the three major steps in assessing beta are:

- (i) identifying the primary, underlying drivers of the regulated firm's non-diversifiable (systematic) risk;
- (ii) identifying firms with similar drivers of non-diversifiable risk to obtain a set of 'comparable' firms; and
- (iii) estimating the betas of the identified comparators in order to infer an estimate of the underlying asset beta to apply to the regulated firm.

Yancoal addresses each of those steps in turn below.

(c) Identifying the primary drivers of QR's systematic risk

Changes in demand arising from coal commodity prices

Yancoal acknowledges that a primary driver of QR's systematic risk in respect of the reference service is the coal commodity price exposure of its customers, and the potential for that to impact on demand.

However, this risk should not be overstated. As coal mines make investments with high capital sunk costs, they do so on the basis of long term economic fundamentals, such that demand remains inelastic in the face of shorter-term changes in coal spot prices, and the risk of a material change in demand only eventuates through prolonged down turns in coal prices.

This primary driver of QR's systematic risk in respect of the reference service is a characteristic that it has in common with other coal infrastructure service providers, including for example Aurizon Network's central Queensland rail network, ARTC's Hunter Valley rail network, the Dalrymple Bay Coal Terminal and the Port of Newcastle shipping channel.

Number of customers is not a primary driver

QR and Frontier Economics (*Frontier*) appear to consider that another major driver of systematic risk is the smaller number of customers that QR has relative to other infrastructure providers.

However, what gives rise to the systematic risk in respect of the reference service is much more the coal commodity price exposure than the number of customers.

If the perceived risk is that a customer will become uneconomically unviable due to a prolonged down turn in coal prices and therefore reduce demand for the reference service, that risk presumably equally exists whether you have two large customers or many smaller ones.

To the extent that the QCA considers that the mere fact of having a small number of customers is a source of systematic risk, Yancoal notes the relevant example of the Gladstone Area Water Board as an entity with a concentrated customer base (according to the QCA's last price monitoring report approximately 80% of its demand is from 3 industrial customers), which was found to have similar systematic risk to other regulated water business due to protections which are very similar to those which exist for QR (long term take or pay arrangements, inelastic demand derived from a monopoly position and periodic regulatory resets of pricing).

Risk characteristics related to non-coal services are not relevant

QR and Frontier appear to consider that part of the relevant risk characteristics are:

- (i) transporting a mix of freight – specifically referencing non-bulk freight and passenger services;
- (ii) being exposed to competition from road haulage on non-coal services.

Frontier also makes reference to the revenue impact of the closure of Queensland Nickel.

However, each of those matters are very clearly not part of the risk characteristics of the service to which the reference tariffs relate.

The QCA is not being asked to determine QR's general asset beta (and if it was then coal price risk would obviously be of much lesser relevance than QR and Frontier assert).

Rather, as is evident from the QCA's previous reasoning in respect of the asset beta for AU1, what is relevant is the systematic risks relating to provision of the reference service – namely the systematic risk involved in *providing access to the West Moreton and Metropolitan networks for coal services*.

Consequently it is clear that in respect of the service relevant to calculating the asset beta:

- (i) QR is not exposed to competition from road haulage – for numerous reasons including the costs of road haulage, QBH's lease conditions requiring delivery to the terminal of coal by rail and mines' approval conditions requiring rail haulage;
- (ii) the service does not involve a mix of freight; and
- (iii) as discussed below, QR has significant revenue protection against decreases in volume / demand in respect of reference services.

Accordingly, the characteristics relied on by QR and Frontier are clearly inappropriate as criteria for identifying an appropriate comparator set.

Regulatory framework and form of regulation

As discussed in the QCA's Risk and the Form of Regulation Discussion Paper (November 2012):

- (i) regulated firms are in a different risk category to non-regulated firms; and
- (ii) a regulated firm's beta should not be determined independently from the applicable form of regulation and other ancillary mechanisms, as they impact the firm's cash flow volatility and the associated non-diversifiable risk.

The regulatory arrangements which apply to QR in its provision of the reference service are a primary driver of the extent of QR's systematic risk, including:

- (i) revenue protection from long term take or pay contracts;
- (ii) revenue protection from right to obtain security;
- (iii) revenue protection from the limits on optimisation of the asset base included in the access undertaking;
- (iv) cost-volatility protection through cost-based regulation;
- (v) cost-volatility protection through cost-pass through provisions in the access agreements;
- (vi) revenue and cost-volatility protection through review events under the access undertaking; and
- (vii) revenue and cost-volatility protection through the right to lodge draft amending access undertakings under the QCA Act.

In aggregate, those protections provide extremely significant protections and risk-mitigation for QR in respect of systematic risks that would otherwise be borne by QR.

Those protections are so strong, that some of the best comparator entities for the purposes of assessing QR's asset beta in respect of providing the declared service will be entities with similar regulatory arrangements.

The Frontier report acknowledges that the form of regulation can effect systematic risk, but asserts that the form of regulation 'is only one of a number of more minor factors'. However, Yancoal considers that assertion is completely unsubstantiated, contrary to the QCA's previous views and clearly at odds with the practical experience in respect of the West Moreton coal services. In particular, it is evident that when there was a significant change in demand in the recent past from the closure of Wilkie Creek, it is coal companies who bore the risk through lower demand forecasts increasing the reference tariffs, while QR's revenue was protected (without any optimisation of the regulatory asset base occurring as a result of the change in demand).

Long term take or pay in other elements of the coal supply chain

In addition to QR's own contractual and regulatory arrangements, its risk profile is effected by the arrangements for provision of other services in the coal supply chain, including coal handling services by QBH and rail haulage by Aurizon Operations.

For example, this issue was recently recognised by the ACCC as being directly relevant to Port of Newcastle Operations' systematic risk in providing channel access services, in circumstances where the coal terminals, rail haulage and rail access providers had long term take or pay contracts, which entrenched the inelasticity of demand for the channel service.

Coal handling services in particular at QBH's terminal at the Port of Brisbane are both long term and take or pay based, and rail haulage is take or pay based (and to the extent a new haulage operator entered the market would need to be long term). Consequently the risks of changes in volume (and therefore revenue) are even further reduced from those which might be assessed by solely considering QR's regulatory and contractual position in isolation. That is, demand for the reference service is more inelastic (and QR bears less systematic risk) due to the nature of the other coal supply chain arrangements.

(d) QR proposal based on flawed comparator set

QR seeks to justify its asserted asset beta by reference to the comparator set of businesses described in the Frontier report.

However, it is clear both from a review of the characteristics by which QR and Frontier selected that comparator set and consideration of the risk profile of the businesses in the comparator set, that they are not an appropriate set of benchmarks.

In particular, once:

- (i) exposure to competition and mixture of freight are excluded as not being relevant;
- (ii) less weight is given to the number of customers (and/or appropriate recognition is given to examples like Gladstone Area Water Board as a water provider with limited customers); and
- (iii) appropriate weight is given to the form of regulation and arrangements in other elements of the coal supply chain,

it is clear from first principles that the best comparators will in fact be:

- (iv) Australian coal supply chain businesses with similar exposure to coal commodity prices and regulatory arrangements; and
- (v) Australian water and electricity businesses with similar regulatory arrangements.

In addition, when particular entities within the QR / Frontier comparator set are considered, it becomes clear how many of them face substantially different risks, including through being:

- (vi) unregulated and therefore far more exposed to market conditions;
- (vii) more exposed to competition (as even assets like railways in the United States are more exposed to competition due to the significantly greater degree of rail interconnectivity in the United States and more diversified sources of demand);
- (viii) international and exposed to different risk profiles that come from operating in different jurisdictions such as Russia, China, India, the Philippines or Chile to take some examples or international trade more generally; and
- (ix) by their nature exposed to more volume uncertainty (i.e toll roads).

(e) Identifying an appropriate comparator set

Based on the analysis, described above, it is clear that to appropriately estimate the asset beta for QR in respect of the reference service, the QCA needs to determine a more appropriate comparator set.

As a useful starting point, the QCA and ACCC have recently determined the asset beta of a number of entities which are exposed to very similar systematic risks as QR, and provide useful benchmarks for determining the appropriate asset beta for QR in respect of the provision of coal services.

Decision	Asset beta	Systematic risk features in common to QR
Aurizon Network (UT5)	0.42	Monopoly service provider with no competing service Rail related operational risks Revenue protection from long term take or pay contracts Revenue protection from right to request security Customer exposure to thermal coal (admittedly with greater exposure to higher margin metallurgical coal) Demand protection as a result of other coal supply chain arrangements
ARTC Hunter Valley Access Undertaking (ACCC, 2017)	0.45	Monopoly service provider with no competing service Rail related operational risks Revenue protection from long term take or pay contracts Revenue protection from right to request security Customer exposure to thermal coal Demand protection as a result of other coal supply chain arrangements
Dalrymple Bay Coal Terminal (QCA, 2015)	0.45	Monopoly service provider with no competing service Revenue protection from long term take or pay contracts Revenue protection from right to request security Customer exposure to coal (admittedly with greater exposure to higher margin metallurgical coal) Demand protection as a result of other coal

		supply chain arrangements
Newcastle shipping channel access dispute determination (ACCC, 2018)	0.5	Monopoly service provider with no competing service Customer exposure to thermal coal Demand protection as a result of other coal supply chain arrangements (even through in clear contrast to QR it does not have protection from long term take or pay arrangements)

Yancoal acknowledges that there are some minor differences in risk profile between some of those entities, but, as is evident from the table above, the systematic risk profile of QR's reference service is extremely similar, such that each such entity should clearly form part of the appropriate comparators.

The QCA is better placed than Yancoal to determine an appropriate comparator set. However for completeness Yancoal notes the Gladstone Area Water Board also appears to have a similar systematic risk profile to QR's reference tariff such that it would also warrant inclusion.

Decision	Asset beta	Systematic risk features in common to QR
Gladstone Area Water Board (2015-2020 Price Monitoring)	0.4	Monopoly service provider Revenue protection from long term take or pay contracts Small number of large customers (80% of its demand is from QAL, CS Energy and Callide Power) Similar regulatory arrangements – as the government traditionally accepts the QCA's recommendations it results in a building blocks methodology with cost based regulation and price resets every 5 years

(f) Conclusions on an appropriate asset beta

It follows from the above that Aurizon Network remains highly relevant, and the closest comparator.

To the extent that QR bears greater risk than Aurizon Network in respect of the reference service, the difference is limited, and QR remains far more comparable to other regulated coal infrastructure providers (such as ARTC, Dalrymple Bay Coal Terminal Management and Port of Newcastle Operations) than the comparators proposed by QR.

Consequently Yancoal considers the appropriate beta is likely to be in the range of 0.42 to 0.45 (and definitely no higher than 0.5).

4.3 Capital structure / gearing

It follows from the different risk profile assessed above, that the extremely low gearing proposed by QR is likely to be inappropriate.

It is difficult for Yancoal to comment further on the appropriate gearing, however it strongly suggests that the QCA consider the efficient capital structure for QR closely including taking into account:

- (a) the low cost of debt that is available to QR as a result of its position as a government statutory authority; and
- (b) QR's low risk profile for the reasons discussed above.

4.4 Market Risk Premium

QR proposes a MRP of 7%, adopting the approach taken by the QCA in the most recent decision in respect of Aurizon Network's current draft access undertaking.

However, Yancoal considers that the weight of Australian regulatory practice now favours an estimate of 6% for the MRP as being more appropriate.

In particular, Yancoal notes the findings in each of the following recent decisions by the ACCC and AER:

Regulator	Relevant Decisions	MRP Estimate
ACCC	Determination of access dispute – Newcastle shipping channel	6%
	ARTC 2017 Hunter Valley Access Undertaking	6%
AER	Powerlink revenue determination	6.5%
	Roma to Brisbane Gas Pipeline revenue determination	6.5%

Yancoal also notes that subsequent to the AER decisions noted, the AER released a draft rate of return guideline (July 2018) which proposes that in future regulatory decisions the AER will adopt a lower MRP of 6%.

Yancoal submits that in light of the regulatory trend towards a lower MRP, and the fact that the MRP can (by its very nature) change over time as economic conditions change, it would be appropriate for the QCA to reconsider the appropriate estimate for the MRP which is utilised in calculating the West Moreton and Metropolitan system tariffs.

5 Reference Tariffs – Allocation of West Moreton Capex / Fixed Costs to Coal Services

5.1 Context – train path constraints and the AU1 determination on allocations

Yancoal considers QR' proposed changes to the allocations of the West Moreton regulatory asset base (and presumably fixed operation and maintenance costs) are highly inappropriate.

The issue of how to allocate the value of the West Moreton network was the subject of extensive submissions and consideration as part of the QCA's consideration of AU1.

In connection with AU1 the QCA determined that:

- (a) it was appropriate for the allocation of the West Moreton system asset base (and fixed operation and maintenance costs) between coal and non-coal services to correspond to the proportion of weekly return train paths able to be contracted for coal services;
- (b) of the 113 weekly return train paths from the West Moreton system, as a matter of practicality (irrespective of whether that practice was a strictly legal requirement), there was only 80 weekly return train paths able to be contracted for coal (with 87 paths for coal

through the Metropolitan system being available, but 7 of which were utilised at the time by Ebenezer).

Yancoal understands that resulted in a 70.8% allocation to coal services (calculated as 80/113).

QR now submits that the allocation should be substantially increased to 85.8%, based on there being 97 train paths able to be contracted for coal services – due to there being no constraints on coal services beyond the 16 paths legally preserved for passenger and non-coal freight services.

Yancoal considers that increase is inappropriate for the detailed reasons set out below.

5.2 QR has provided no evidence that the constraints have actually ceased to apply

QR's Submission contains its view, that no such constraints exist beyond the 16 legally preserved paths for passenger and non-coal freight usage.

However, it contains no evidence that the Department of Transport and Main Road (**DTMR**) (who had previously advised QR of the existence of such a constraint) or the shareholding Ministers (whose approval is required for entry into most access agreements) agree that 97 weekly return train paths can be contracted for coal services.

The QR Submission indicates that QR has sought confirmation from DTMR – but, to date, no such confirmation has been provided to Yancoal.

Clear and unequivocal evidence that all decision makers (QR, DTMR and the shareholding Ministers) support contracting 97 paths to coal services should be required before it could possibly be appropriate to change cost allocation on this basis, given the past evidence of such a constraint existing.

5.3 The past constraints have continuing impacts

The removal of the previously applied constraints (now or in the future) will evidently not automatically result in the capacity which was previously preserved for non-coal services being immediately taken up by coal services.

In other words, the extent of non-utilised capacity that coal producers in the West Moreton region have effectively been constrained from utilising in the past, might theoretically have become available, but it is not possible for the majority of it to be instantly contracted given the timeframe for development of new mines or expansion of production at existing mines (including the significant timeframe required to obtain any regulatory approvals).

The fact that QR has received access requests for more than 97 paths (as referenced in the QR Submission) is irrelevant because, as QR's concerns about the low tonnage scenario aptly demonstrate, there is a big difference (both in actuality and in timing) between an access request and capacity being contracted.

In that context it would be inappropriate to suddenly change the proportionate allocation to coal services, in advance of that theoretically available capacity being fully utilised.

5.4 No justification for allocation of unutilised capacity to coal

As QR has been quick to point out in other contexts, the West Moreton system is utilised by other services (passenger, grain and other general freight).

The QR Submission contains no justification for why additional costs of surplus capacity should simply be allocated to coal services in the current context where they are unlikely to be utilised by any customers.

5.5 Application to past capital expenditure

Based on the QR Submission, it also appears QR proposes to change the allocation for all capital expenditure not just from the start of the regulatory term, but from 1995 onwards.

No justification is given for this, and it appears completely inappropriate – particularly in the face of QR having made submissions itself in 2015 that there was an 87 train path constraint through the Metropolitan system and the QCA's previous finding that such a constraint was in fact being applied.

To the extent there is any change in allocation it can only be appropriate to apply that change to capital expenditure in the West Moreton system over the 2020 DAU regulatory term (not capital expenditure during prior periods).

5.6 Agriculture and non-coal freight investments

It appears from commentary in Attachment 3 in the QR Submission regarding the drivers of capital investment that some of the proposed West Moreton capital expenditure is part of a strategy to increase agricultural and non-coal freight on the West Moreton system.

To the extent that significant capital investment is being made for non-coal purposes, it is not reasonable that coal service pricing reflects the costs of such capital expenditure.

Yancoal requests that the QCA carefully considers whether there is any such capital expenditure that was clearly triggered by a government or QR strategy regarding non-coal freight, and if so ensures that no such costs are allocated to coal.

5.7 Conclusion on allocation

For the reasons set out above, Yancoal considers that:

- (a) is not appropriate to change the allocation of any capital expenditure prior to the 2020 DAU regulatory term; and
- (b) it is not appropriate to change the future allocation of the West Moreton system asset base (and fixed operating and maintenance costs) to coal services other than to:
 - (i) remove any allocation of capital expenditure invested in for non-coal services;
 - (ii) and reflect that Ebenezer has ceasing raiing, and that on Yancoal's understanding of the AU1 allocation decision, the rationale from the AU1 decision would indicate the allocation for truly common future capital expenditure would now be 87/113, being 77%.

6 Reference Tariffs – Regulatory Asset Base and Capital Expenditure

6.1 Roll forward of Regulated Asset Base

Yancoal does not understand the basis for the inclusion of an additional \$16 million in the West Moreton regulatory asset base on the basis of what the QR Submission refers to as the 'addition of \$16 million coal only sidings and balloon loop'.

To Yancoal's knowledge no new coal only siding or balloon loops have been constructed by QR during the AU1 period, such that this addition is surprising, and there is no further explanation provided in the QR Submission.

Unless this can be substantiated as being appropriate, this amount should not be included in the regulatory asset base.

6.2 Capital Expenditure is excessive relative to the RAB

QR's proposed capital expenditure forecast for the 2020 DAU regulatory period is extremely high.

Proposing \$159.384 million, relative to a proposed opening regulatory asset base of \$288.6 million (even assuming QR's excess allocation of past capital expenditure to coal services) – is claiming that it is efficient to spend over half the existing value of the network again on capital investment across a period of 5 years.

While it is acknowledged that the West Moreton system may require a greater extent of sustaining capital expenditure than built for purpose heavy haul railways, it seems implausible to Yancoal that such a high extent of new capital expenditure could be efficient.

6.3 Lack of transparency

Given the extremely high proportion of new capital expenditure relative to the existing asset base, Yancoal considers that significant scrutiny should be applied to determine whether capital expenditure at an individual project level is prudent and efficient.

However, QR has redacted significant information regarding its proposed capital expenditure with aggregate costs provided, but very limited information provided at a project level.

As a consequence, it is very difficult for Yancoal (and presumably other stakeholders) to provide informed submissions on the efficiency and prudence of the proposed capital expenditure.

Stakeholders are therefore heavily dependent on the QCA to scrutinise the prudence and efficiency of the proposed capital investment.

6.4 Greater deferral is likely to be efficient given the prospect of lower tonnages

In the context of QR itself considering a low tonnage scenario, Yancoal would have anticipated that it would be prudent to seek to minimise new capital investment, through deferring capital expenditure where possible. However, there is no real evidence of QR doing so.

Figure 2 on page 6 of Attachment 3 in the QR Submission shows capital expenditure being higher over this regulatory term than the previous regulatory term – which appears counterintuitive given the less certain demand outlook.

Yancoal's impression is that QR's capital expenditure proposals have been developed largely divorced from any consideration about demand outlook.

In particular, the QR Submission indicates that the proposed capital expenditure has been developed in the context of the 2018-19 West Moreton System Asset Management Plan which is based on a continuation of the current tonnes.

There are also suggestions in the QR Submission that the capital expenditure is, at least in part, about upgrading the quality of the track, extending its useful life and reducing future maintenance spend. This particularly seems to be the case in relation to the largest capital project – being timber bridge replacements, where the QR Submission suggests that it is partly motivated by mitigating escalating maintenance costs arising from high gross tonnage (yet is somehow still described as not being tonnage dependent).

However, no prudent infrastructure manager would make such significant capital investments on the basis of such blithe assumptions and 'business as usual' approach, when QR's own submissions make it clear that it is concerned about a material decrease in volumes (and therefore presumably maintenance spend decreasing without the need for such significant capital investment) and there are suggestions that in the longer-term Inland Rail might take coal volumes away from QR's network.

In that context, Yancoal considers it is more prudent to seek to manage timber bridges and other technically life expired assets in other ways, such as implementing or increasing speed restrictions or increasing maintenance, unless and until it is clear that there is volume growth on the West Moreton system. In that regard, Yancoal notes that Attachment 5 of the QR Submission acknowledges that timber bridge repair costs are tonnage dependent – such that, where safe, that would seem likely to be more prudent and efficient course of action where a material decline in volume was possible.

Yancoal acknowledges that it is possible that some capital investments are required for safety reasons, but given the limited disclosure provided, QR has not demonstrated or substantiated that being the case.

Accordingly, Yancoal requests that the QCA pay particular scrutiny to which capital investments projects can prudently be avoided or deferred to a point at which future volumes and volume growth are more certain.

6.5 Lack of variance with changes in volume

QR appears to be proposing \$159.384 million of capital expenditure of the 2020 DAU regulatory term based on 9.1 mtpa and \$144.495 million based on 2.1 mtpa.

Yancoal considers that it stretches credibility to suggest that:

- (a) for a 77% drop in volumes, there is only a 9.3% drop in proposed capital expenditure; and
- (b) only 3 of the proposed 25 capital projects are in any way tonnage dependent.

The QR Submission indicates that the proposed capital projects are 'primarily asset renewal projects' and not growth projects. However, it seems unlikely to Yancoal that there are not more asset renewal projects that could be delayed, deferred, staged or reduced in scope, at least partially, such that (during a time of uncertainty of future volume) QR does not overcommit capital investment on the assumption of future volume that does not eventuate.

Yancoal notes there appears to be inconsistencies in the way the nature of various projects are described that should be carefully scrutinised by the QCA. For example Attachment 3 of the QR Submission indicates that:

- (a) the timber bridge replacement program and the culvert replacement program would not be required except for the traffic volume proposed by coal carrying customers;
- (b) yet both of those major capital expenditure projects are then said not to be tonnage dependent.

At a minimum, this tends to indicate that there is greater tonnage dependency in the proposed capital program than the QR Submission suggests.

The QR Submission creates the strong impression that QR has not given sufficient consideration to how it could be prudent to change capital program if volumes materially decreased, and the QCA will need to carefully consider that issue.

6.6 Comments on GHD Review

The QR Submission places significant reliance on the GHD review of a selection of QR's capital projects.

Yet Yancoal considers that review has a number of flaws and qualifications, such that the QCA will need to carefully scrutinize (and engage its own expert to review) the prudence and efficiency of each of QR's proposed major capital projects.

By way of illustration, Yancoal notes at least the following issues in relation to the GHD report:

- (a) the review was restricted to 6 out of 25 capital projects;
- (b) there was no apparent assessment of the prudence of the investments having regard to QR's uncertain demand outlook;
- (c) GHD simply assumed that QR's labour unit rates are efficient;
- (d) GHD did not review hire charges for plant and machinery relevant to numerous projects;
- (e) GHD did not assess unit rates for machinery or miscellaneous permanent way components in respect of the re-sleeper project; and
- (f) GHD did not review any details of labour costs, individual components of work to be completed or a breakdown of costs in respect of the minor signalling project – such that efficiency was not able to be verified for that project.

6.7 Optimisation

If the QCA determines, contrary to Yancoal's submissions above, that all or a substantial part of QR's proposed capital investment is prudent and efficient then it is likely that the resulting West Moreton reference tariff will be so high, that serious consideration needs to be given to optimisation of the West Moreton asset base.

7 Reference Tariffs – Operating and Maintenance Expenditure

7.1 Lack of transparency

Similar to its approach in relation to disclosure regarding capital expenditure, QR has redacted significant information regarding its proposed operating and maintenance expenditure with aggregate costs provided, but very limited information provided in respect of individual categories of operating and maintenance costs.

As a consequence, it is very difficult for Yancoal (and presumably other stakeholders) to provide informed submissions on the efficiency and prudence of the proposed operating and maintenance expenditure.

Stakeholders are therefore heavily dependent on the QCA to scrutinise the prudence and efficiency of the proposed costs.

7.2 High proportion of fixed costs

The QR Submission indicates that 100% of its operating costs are fixed and 57.3% of its maintenance costs. That is a very high proportion of fixed costs, which warrants detailed consideration.

In relation to maintenance costs, it is evident from Attachment 5 to the QR Submission, that for some types of maintenance activities QR has chosen not to use the QCA's previous approach in the AU1 decision to determine the extent to which the costs are fixed or variable.

QR's departures from the QCA AU1 methodology (summarised in Table 7 of Attachment 5, and section 5.2 of Attachment 5) appear to have resulted in higher fixed costs than would be the case if the QCA allocation methodology was used (and cost categories being classified as non-tonnage dependents when the QCA regarded a material proportion of such costs as variable for the purposes of calculating the AU1 reference tariffs).

In relation to operating costs it seems particularly implausible to Yancoal that the exact same operating costs would apply if there is 2.1 mtpa or 9.1 mtpa being railed. Even without a detailed breakdown of costs, it is plainly evident that where QR itself is concerned about reducing coal volumes, it cannot be prudent to operate on the basis of 100% fixed costs.

It must be prudent for QR to change its operating methodology and cost structure so that a much higher component of its costs are variable.

7.3 Train control

QR's proposed train control costs in particular appear outlandish. QR has proposed train control costs that are 58% higher than those approved as prudent by the QCA for inclusion in the AU1 reference tariffs.

It is implausible for such an increase to be prudent.

QR can of course choose to organise its train control functions as it sees fit.

However, based on the advice provided to the QCA by its consultant B&H in the AU1 consideration process that:

In Train Control for example, the "boards" used to manage a network can be split or amalgamated depending on the amount of traffic

it cannot be efficient for the West Moreton and Metropolitan system train control functions to be located and operated separately as coal volumes are potentially falling, and for coal users of those systems to be required to pay for that inefficient choice.

7.4 Comments on GHD Review

The QR Submission places significant reliance on the GHD review of a selection of QR's maintenance activities.

Yet Yancoal considers that review has a number of flaws and qualifications, such that the QCA will need to carefully scrutinize (and engage its own expert to review) the prudence and efficiency of each of QR's proposed major capital projects.

By way of illustration, Yancoal notes at least the following issues in relation to the GHD report:

- (a) it is self-described as predominantly a desk-top assessment;
- (b) GHD's assessment of efficiency is qualified by reference to 'where data was available';
- (c) GHD acknowledges in section 2.3 of the report that in some cases they were unable to extract useful maintenance scopes;
- (d) GHD acknowledges that *'our assessment has focused on: prudence ... rather than the quantum of works to support that deed; and efficiency, on an exceptions basis, in that only if we observed anomalies in the data or our site visit that indicated we should review the efficiency associated with the relevant maintenance activity, then we should do so.'*; and
- (e) the assessment of efficiency (for example in section 10.3) seems to have occurred without having sufficient regard to the potential that long term maintenance costs may not arise if volume deteriorates,

There is no similar review provided for operating costs.

8 Undertaking wording

Yancoal acknowledges that QR has not sought to make the type of wholesale changes that were sought during the AU1 process.

Yancoal has no concerns with some of the proposed changes, but has summarised below those changes it does have concerns with (including those which were the subject of QCA's questions).

Reference tariffs have been separately addressed above in sections 4 to 7 (and Yancoal considers that consequential changes to the wording of the undertaking in respect of reference tariff issues should also be reversed).

The changes to the SAA (in Schedule H of the 2020 DAU) are separately addressed in section 9 of this submission.

Clause	Issue	Yancoal concern
1.5	Master planning – industry funding requirement	<p>Planning for future investment in the West Moreton network should be ordinary course of business and is something that has become more critical given the change in volumes that QR is concerned about. Consequently, Yancoal considers that, at least in respect of the West Moreton system, the cost should be funded (or materially contributed to) by QR – as occurs for other regulated infrastructure providers (DBCT Management and Aurizon Network).</p> <p>In any case, QR's proposals are clearly inappropriate as they require customers to commit to funding a master planning process in the absence of:</p> <ul style="list-style-type: none"> • QR being required to publish a scope, budget or timeframe for the master planning process prior to seeking approval • Any protections for funding customers if the cost overruns any such budget; and • funding customers being provided with any input or oversight in relation to the master planning process.
2.1.1	Permitting access to be applies for other than through an Access Application	A (likely unintended) outcome of the amendment seems to be to make access applications in other forms not an 'Access Application' for the purposes of the undertaking, which has consequences for how Part 2 of the 2020 DAU operates. Yancoal suggests that changes be made to the QR drafting and the definition of Access Application to ensure that applications for access in other forms are still treated as Access Applications for the purposes of Part 2.
2.1.2	Accountability for preliminary information	QR's proposed exclusions of accountability and liability for information provided to access seekers, has the prospect of resulting in a deterioration in the quality of information provided to access seekers (with the reality being that access seekers do rely on the preliminary information provided by QR).
2.2.2(d)	Permitted disclosures of confidential information	Yancoal is willing to accept the extension of permitted disclosures, provided that access seekers/holders are also permitted to make disclosures to their related bodies corporate and joint venturers.
2.9.3	Renewal rights	Renewal rights should be 'evergreen' not one-off in nature or limited to 5 years (given the long term payback period involved in mining operations).

		<p>The concerns expressed by HoustonKemp regarding allocative efficiency do not seem to apply where the renewed services would have an applicable reference tariff (as would be the case for West Moreton coal services).</p> <p>It is important at a time when there is some uncertainty regarding the demand outlook, to ensure that renewals and other regulatory settings incentivise further investment.</p>
3.3	Limits on price differentiation	<p>It should be made clearer that it is not just that QR is permitted to make adjustments for non-reference tariffs coal services operating on the West Moreton and/or Metropolitan system for differences in costs and risk – but that is the only basis on which such charges should vary from the reference tariffs.</p>
4.3 / Sch G	Removal of Operating Requirements Manual (ORM) from undertaking	<p>The QCA determines in its June 2016 Final Decision on AU1 that the inclusion of the ORM in the undertaking (such that amendments could be made through a draft amending access undertaking process) was an appropriate balance between providing QR flexibility to make amendments, the public interest and access holders/seekers' interests in having a consistent set of operating requirements..</p> <p>Given the ORM provides operational parameters – both in relation to how services operate and operational / risk management aspects relevant to obtaining access rights, it is appropriate it continues to remain transparent and changes to it remain subject to regulatory oversight.</p> <p>QR's proposal to consult on amendments with those stakeholders it judges will be materially affected does not afford appropriate protections – as there is no remedy for an access holder where it is not consulted or has genuine concerns with a change following such consultation.</p> <p>Yancoal understands that QR wants greater flexibility to change the ORM – but the draft amending access undertaking process is appropriate and the QCA can presumably be relied upon to expedite that process where the change QR proposes is time critical or important (noting the lack of any attempts by QR to amend the ORM during the term of AU1 to date).</p>
5.1.2	30 minute threshold for late possession timing	<p>Yancoal considers that a 30 minute grace period is greater than what should reasonably apply (again, given the significant consequences for possessions running over the estimated time).</p>
6.1.2	Dispute rights	<p>Access holders should have a right to dispute changes to the MTPs (as otherwise the rules regarding when the MTP can be modified in Schedule F are pointless) – given the consequences of variations (typically demurrage and take or pay liabilities being incurred by the user).</p>

		There is no justification for deleting the ability to dispute change to the line diagrams (which are important in delineating the scope of regulation).
6.1.4	Safety expert in access disputes	QCA needs to be able to break the deadlock and nominate an expert if the disputing parties cannot agree. Given most disputes will not involve safety matters, this clause should only apply where safety matters are relevant to the dispute.
7.1	Deletions from definition of Endorsed Variation Event	<p>An increase in coal volumes or a change to the QCA levy are both clearly appropriate grounds for an Endorsed Variation Event, such that QR is required to approach the QCA with changes to tariffs where those circumstances occur.</p> <p>Without those grounds, Access Holders would seem to be entirely reliant on QR to seek such changes (which it will have no incentive to do as these circumstances are likely to decrease the applicable tariffs).</p>
Sch D 3.1(f)	Removing reference to train path constraints	<p>As discussed earlier in this submission, Yancoal has been provided with no evidence by QR, DTMR or the relevant shareholding Ministers that the train path constraints have in fact been removed (practically or legally).</p> <p>Even if they were to be removed legally – it is unreasonable and inappropriate to use that to increase the allocation of costs to coal carrying services for the reasons discussed further above in this submission.</p>
Sch E, 1.5, 3.2(e), 4.2(c) and 5.3(c)	Capital expenditure process	QR has not demonstrated that it is currently being provided with inadequate reasons (which is the only time clause 1.5 would be justified) or that there are circumstances where the mandatory factors are not relevant to consider in assessing the prudence of capital expenditure, prudence of standard of works and prudence of costs.
Sch F, Defn in 7.1	Varying the MTP for Ad Hoc Planned Possessions	<p>There is no justification for the introduction of a new type of possession which permits variations from the MTP, particularly given the scope of the existing categories of Emergency Possessions, Urgent Possessions and Planned Possessions.</p> <p>If a possession is truly planned, then Yancoal does not understand why they could not be Planned Possessions that are scheduled in the MTP in the normal way. Changes to the MTP for 'ad hoc' possessions can cause significant costs in terms of take or pay liabilities and demurrage (as well as lost sales opportunities).</p>
Sch F, 2.2, Defn in 7.1	Varying the MTP for 'Special Events'	2 business days' notice is an insufficient and inappropriate amount of time on which to make variations to the MTP for 'Special Events' which are either major events which should be able to be anticipated in advance (and therefore incorporated into the MTP as planned possessions where

		<p>appropriate) or so loosely defined that the create material potential for significant take or pay liabilities and demurrage cost for uses (as well as lost sales opportunities).</p> <p>The concept of changes to the MTP for Special Events should be rejected.</p>
Sch F, 2.4	Ability to dispute variations to the MTP	<p>By removing the right to raise disputes, QR is effectively empowering itself to proceed with possessions that contravene the Network Management Principles.</p> <p>Possessions - which can cause significant costs in terms of take or pay liabilities and demurrage (as well as lost sales opportunities). That is clearly not appropriate. If the concern is (as Yancoal understands from QR's consultation) that disputes can be raised just before the possession is due to occur, a minimum prior notice of a dispute could be required (subject to QR having given sufficient notice of the possession for that to be workable).</p>

9 Standard Access Agreement wording

Yancoal acknowledges that QR has only sought to make incremental changes to the SAA, and has no concerns with most of the proposed changes to the Standard Access Agreement, most of which are required by changes to rail safety regulation or reasonable in the context of the impact of ipso facto reforms on termination rights.

The table below summarises the changes Yancoal has concerns with:

Clause	Issue	Yancoal concern
1.3(a)	QR obligation in respect of productivity and efficiency variations	<p>The amendments reduce the extent of QR's obligations in respect of productivity and efficiency gains.</p> <p>Given the high cost of infrastructure, the obligations in respect of productivity and efficiency variations are critical to the ongoing viability of coal services on the West Moreton and Metropolitan region – such that these changes should be rejected.</p>
6.7(c), 8.8(b), 18.2(c)	<p>Removal of good faith obligations regarding:</p> <ul style="list-style-type: none"> • negotiation of performance levels • consultation prior to substantially varying or amending interface standards 	<p>Good faith has a role to play in each of these scenarios.</p> <p>Through case law it is well understood what good faith means (contrary to some of the assertions in the QR Submission).</p> <p>Performance levels are extremely difficult to negotiate, as may be the adjustments for a Material Charge, and the more cooperative and honest consultations regarding varying interface standards can be the better.</p> <p>Consequently, Yancoal considers it appropriate to retain the obligations for the parties to act in good faith in respect of these issues. a</p>

	<ul style="list-style-type: none"> adjustments for a Material Change 	
13.4(a)(iv)	Limit of QR liability for failure to meet performance levels	<p>Limiting QR's liability for failure to meet performance level to the extent set out in the agreed performance levels is unworkable given that:</p> <ul style="list-style-type: none"> to Yancoal's knowledge, no users have agreed performance levels with QR; and if such levels were agreed, because they are not part of the SAA, any financial consequences are limited to be minimal if not non-existent. <p>This change should be rejected.</p>
Sch 1	Increase in security	<p>The security amount has been increased from 'an amount equal to 12 weeks' to 'an amount equal to at least 6 months'.</p> <p>This increase is unreasonable as:</p> <ul style="list-style-type: none"> no justification has been provided by QR for the very substantial increase (approximately double) in security levels sought to Yancoal's knowledge no West Moreton or Metropolitan coal customer to which the standard access agreement applies has defaulted on its payment obligations to QR (such that there is no past evidence supporting QR needing to increase its protections against such a risk) it is expressed as a minimum (without any expressed maximum), such that there would no longer be any limit on the security QR could ask for; and there is no threshold in terms of past history of non-payment or financial substance of the access holder before QR seeks such increased security. <p>Yancoal submits it is appropriate to leave the security requirement at the existing 12 weeks.</p>

10 Conclusion

For the reasons set out above, where due regard is had to the matters in section 138(2) QCA Act, Yancoal considers it is clearly not appropriate to approve the 2020 DAU.

Accordingly, the QCA should refuse to approve the 2020 DAU, and issue a secondary undertaking notice requiring QR to amend the 2020 DAU (and the reference tariffs under it) in the manner referred to in this submission.

If the QCA has any queries in relation to this submission, please do not hesitate to contact Mike Dodd on + 61 2 8583 5300.