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Queensland Competition Authority
Level 27, 145 Ann Street
Brisbane, Qld, 4000

Aurizon Network Response to the QCA's Approach to Climate Change Related Expenditure Draft Position Paper

23 June 2023

Dear Charles,

Aurizon Network welcomes the opportunity to respond to the Queensland Competition Authority's (**QCA**) Approach to Climate Change Related Expenditure draft position paper (**QCA Draft Position Paper**).

Aurizon Network also refers to its previous submission dated 16 December 2022 (**Aurizon Network Response Submission**) in response to the QCA's request for comments on its Approach to Climate Change Related Expenditure discussion paper (**QCA Discussion Paper**).

1. Transitional Risks

Aurizon Network's Response Submission noted[1]:

- the previous approaches applied by the QCA to the assessment of medium to long-term demand risk are not fit for purpose;
- the view of Aurizon Network's consultant, Frontier Economics, that[2]:

  Given the high degree of uncertainty over future coal demand and government climate change policies, the QCA should consider scenario analysis informed by plausible and reputable projections of:

  • future coal demand; and

  • future coal production, taking into account government climate change policies targeted at the coal mining industry.

- the QCA's climate change review should provide appropriate guidance to climate exposed regulated businesses and its customers on how transitional risks will be assessed by the QCA in subsequent regulatory reviews.

[1] Aurizon Network (2022) Submission to QCA Request for Comments on Approach to Climate Change Related Expenditure Discussion Paper, December, pp. 10-11

[2] Frontier Economics (2022) Climate related expenditure and frameworks: A Report for Aurizon Network, p. 56

In response to these points the QCA Draft Position Paper concluded[3]:

> *We note the points made by Frontier (on behalf of both Aurizon Network and DBI) relating to the need for our regulatory frameworks to allow a realistic opportunity to recover prudent investments over the long term (including resilience related expenditure) and for the expected economic life of regulated assets to be reassessed periodically. Our view is that our existing processes for reviewing, and from time to time amending, depreciation profiles (and regulatory asset lives) for regulated assets should already provide sufficient assurance to regulated businesses that these matters can be flexibly considered.*

The QCA is therefore seeking views from stakeholders as to whether its existing processes for considering financing costs and asset stranding risk are sufficiently developed and flexible to deal effectively with any such matters related to climate change.

While Aurizon Network acknowledges that an assessment of a draft access undertaking provides a process for the regulated business to propose alternate mechanisms to address medium to long-term demand uncertainty, there is an opportunity for the QCA through the climate change review process to refine its processes in relation to how these proposals will be assessed and the evidentiary requirements needed to support them.

Importantly, the QCA should recognise and evaluate how developed and flexible its existing regulatory processes are where:

- the drivers of the medium and long-term demand uncertainty are both on the supply side and demand side of the seaborne market for export coal;
- there is an inherent conflict between regulatory certainty and regulatory responsiveness particularly to a material and rapid change in circumstances; and
- the incentives of customers to support and negotiate effective arrangements to mitigate/compensate medium to long-term demand risks are either weak or misaligned.

1.1 Drivers of Medium and Long Term Demand Uncertainty

The demand for coal carrying train services in the Central Queensland Coal Network (**CQCN**) is derived from the:

- willingness of Queensland coal producers to supply coal into the seaborne coal export markets; and
- willingness of participants in that market to demand coal extracted by Queensland coal producers.

Historically, the QCA's regulatory processes have only addressed the willingness and ability of Queensland coal producers to supply coal. These processes typically assume the development of mine life extensions and new coal deposits. An example of this type of regulatory process is the Weighted Average Mine Life (**WAML**) approach applied by the Australian Rail Track Corporation for the purpose of estimating the economic life of the Hunter Valley Coal Network. The WAML is reset periodically at the commencement of new or extended regulatory terms.

The underlying assumption of ongoing development of mine life extension and new coal deposits may be challenged by direct or indirect policy or judicial intervention which either effectively prohibits their development or renders them economically or practically infeasible. In such circumstances, the value of the Regulatory Asset Base (**RAB**) may only be recoverable from extractable reserves from existing mining operations within each Coal System.

[3] Queensland Competition Authority (2023) Draft Position Paper: Approach to climate change related expenditure, April, pp. 78-79

Aurizon Network acknowledges these circumstances can be accounted for through variation to economic lives under the QCA's existing regulatory processes, albeit with a potential response lag as discussed in the following section.

In contrast, variations in demand for Central Queensland export coal may be subject to policy or technology shocks where the reduction in demand is deeper and more sudden than anticipated, such as the rapid decarbonisation scenarios associated with a Net Zero Emissions by 2050 Scenario (**NZE**). Queensland Treasury acknowledges the International Energy Agency (2022)[4] does not provide country specific projections for the reduction in coal demand under the NZE scenario. Notwithstanding, Queensland Treasury notes[5]:

> *Clearly, if global coal demand trends closer to those described under alternative scenarios such as the APS, NZE or IPCC's projections were to eventuate, there would likely be more significant implications for the state's coal industry, particularly in relation to the long-term outlook for thermal coal*.

It is not evident that existing regulatory processes are sufficiently developed or flexible to respond to these types of policy or technology shocks. For example, where those demand side shocks result in a material and sustained reduction in demand, flexibly responding to the shock after the event may not result in the access provider having the reasonable ability to recover its investment in the RAB where the regulatory rate of return has not provided ex-ante compensation. In this regard, the QCA's processes are not sufficiently developed to mitigate or compensate for asset stranding risks associated with a material and sustained reduction in the demand for coal.

Regulatory processes which rely primarily on mitigating stranding risks through depreciation must therefore ensure a depreciation profile which provides a sustainable price path under the worst-case plausible scenarios regardless of whether that scenario transpires. It is necessary for the regulated business to be provided a reasonable expectation of recovering its investment in the facility providing the declared service. Conversely, it may transpire that there is no sustainable price associated with the worst case plausible scenario, or that demand may ultimately be lower than that scenario. In such an instance, ex-ante compensation may be sufficient and necessary to address the residual stranding risks. In addition, the longer the time period for ex-ante compensation to commence, the greater that compensation needs to be under a fair bet approach[6], which as noted by the DBCT User Group, may increase prices and accelerate the transition[7].

Aurizon Network does not consider the QCA's regulatory processes to be sufficiently developed to evaluate how asset stranding in response to demand shocks associated with climate change policy interventions should be assessed and mitigated outside of its current rate of return and depreciation methods.

1.2 Balancing Regulatory Certainty and Regulatory Flexibility

Aurizon Network notes that both customers and access providers place value on regulatory certainty as evident by the recent conclusion of negotiations between DBCT and the DBCT Users[8] and the long-term UT5 regulatory arrangements negotiated with customers. Consequently, there is an implicit trade-off between regulatory certainty and flexibly responding to a material change in circumstances.

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[4] International Energy Agency (2022) World Energy Outlook 2022

[5] Queensland Treasury (2022) Queensland's Coal Industry and Long-Term Global Coal Demand, November, p. 27

[6] Frontier Economics (2022) Climate related expenditure and frameworks: A Report for Aurizon Network, p. 40

[7] DBCT User Group (2022) Submission on QCA climate change expenditure review discussion paper, December, p.5

[8] DBI (2022) ASX Announcement, "DBI Announces 10 Year Pricing Agreements and Significant Increase in Distribution Guidance:, 11 October.

For example, assume that the WAML for the marketable reserves of the existing producing mines in a Coal System one year before the commencement of a five year regulatory term is 18 years. However, the regulatory framework assumes development of replacement mines and the economic life of the system when depreciation policy for the next regulatory period is set (one year before commencement) at 25 years.

Two years into the regulatory period, a change in government policy has the effect of sterilising remaining resources in that Coal System such that the remaining life of the marketable reserves is now 15 years. If the economic life is not reset until the commencement of the next regulatory period, then the remaining life at that point in time will be 12 years rather than the assumed 19 years. A flexible regulatory framework would reset the economic life in response to the policy change within the term of the regulatory period.

Aurizon Network considers this flexibility could be given effect through either predefined policy or supply trigger events. Aurizon Network also considers stakeholders may likely prefer this approach as it provides clearer guidance on the circumstances that would require the economic lives to be adjusted within a regulatory period relative to the increased regulatory uncertainty on how material a change of circumstances needs to be to adjust the depreciation settings prior to the next regulatory reset.

In addition, credible guidance on the appropriate regulatory response to an event or risk prior to its occurrence promotes greater regulatory certainty. This guidance provides better incentives to ensure ongoing investment during the current regulatory period in providing reliable and efficient services over the remaining service life of the CQCN.

1.3 Misalignment of Customer Incentives to Respond to Elevated Stranding Risks

In circumstances where the regulator does commit to continuously review and adjust regulatory settings to ensure the access provider has a reasonable expectation of recovering the capital invested in the RAB, the depreciation policy has the practical effect of changing the timing of that capital recovery. The depreciation profile is then a distribution of the RAB recovery between current and future users. Consequently, current users have weak incentives to ensure an efficient asset recovery profile and will prefer to defer cost recovery to future users. In circumstances where a current producer expects to not also be a future user, either through resource depletion or industry exit, then that producer will also not share the same incentives as current producers who may also be future users.

A key difference between the customer orientated businesses regulated by the QCA under part 5 of the QCA Act and the consumer-orientated utilities under other parts of the QCA Act is the direct engagement and negotiation of access arrangements with customers under the former. In negotiating agreed amendments with customers for Aurizon Network's 2017 Access Undertaking, the depreciation policy was not included within the scope of the negotiations. Aurizon Network considers these negotiations are better informed and more constructive where all parties have a clear understanding and expectations of how the regulator would approach the depreciation arrangements in circumstances where a negotiated agreement cannot be reached.

This point was acknowledged by the QCA in its Final Decision on the depreciation arrangements for the Dalrymple Bay Coal Terminal 2019 Draft Access Undertaking[9]:

[9] Queensland Competition Authority (2019) Final Decision; DBCT 2019 Draft Access Undertaking, March, p. 163

> *In our view, it is appropriate to specify a depreciation methodology for the purposes of the 2019 DBCT DAU. Doing so will address information asymmetry issues associated with the value of depreciation and the capital base proposed by DBIM, leaving access seekers more appropriately informed during negotiations. We consider the existing depreciation methodology applying during the 2017 AU period should be retained as a default method for the next undertaking period.*
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> …
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> *Importantly, establishing this methodology is intended to provide information and guidance for negotiations. It does not preclude parties reaching agreement on a TIC developed using an alternative approach to depreciation, including potentially different assumed asset lives.*

The development of clear guidelines and principles on how the regulator would evaluate the rate of return and depreciation arrangements in response to an increase in climate change transitional risks and how those arrangements should flexibly respond to a material change in such transitional risks within the term of an access arrangement represents an appropriate and essential regulatory benchmark to inform negotiation with customers on replacement regulatory arrangements. This is particularly important where customer incentives may not be aligned with the interests of future users or the legitimate business interests of the access provider.

As past regulatory decisions regarding depreciation have not needed to address climate change related transitional risks, Aurizon Network does not consider the position stated by the QCA in its Final Decision on the DBCT 2019 DAU to respond to a material reduction in demand only when it manifests as being either well developed or responsive to emerging medium to long-term demand uncertainty:

> *We do accept there is significant uncertainty relating to the demand for all forms of coal arising from current trade conditions and future environmental regulation including but not limited to carbon emissions. However, if these uncertainties manifest in material demand reductions in the future, DBIM can put a case to us in the future to address these.*

It can reasonably be expected that these emerging risks will become more prominent but retain a higher degree of uncertainty as to their impacts. As such, the QCA's climate change expenditure review provides an appropriate opportunity and mechanism for the QCA to provide the necessary guidance to inform regulated businesses and customers as to what the minimum requirements are for ensuring the regulated business has a reasonable expectation of recovering its invested capital in the event of all plausible medium to long-term demand scenarios.

Aurizon Network appreciates the opportunity to respond to the QCA Draft Position Paper and looks forward to further contributing to the QCA's framework development in 2023.

Should you have any questions in relation to this submission, please contact Dean Gannaway, Principal Regulation Strategist.

Kind regards,

Jon Windle
Manager Regulation