GLENCORE

26 April 2019

Professor Flavio Menezes
Chair, Queensland Competition Authority
GPO Box 2257
Brisbane, QLD, 4001

Dear Professor Menezes

Thank you for the opportunity to lodge this cross submission in response to the DBCT Management (**DBCTM**) submission dated 11 March 2019 (**11 March submission**), in relation to the Dalrymple Bay Coal Terminal (**DBCT**) Service.

We have previously provided a submission supporting the Queensland Competition Authority's draft recommendation of December 2018 (**QCA Draft Recommendation**) that the access criteria are met with respect to the DBCT Service, in particular, by reference to our experience of the DBCT Service not being substitutable with any other coal export terminals (see our submission dated 13 March 2019). Glencore continues to press this view. Additionally, Glencore strongly supports the various submissions made by the DBCT User Group.

While these previous submissions evidence comprehensively the satisfaction of the access criteria, this submission seeks to add to these submissions and, in particular, respond to the latest assertions made by DBCTM in its 11 March submission. We have also commissioned Economic Insights to respond to some of these submissions and attach its report to this submission as Annexure A.

Yours sincerely

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GLENCORE COAL ASSETS AUSTRALIA PTY LTD

Cross Submission to the Queensland Competition Authority in response to the DBCT Management submission dated 11 March 2019 in relation to the Dalrymple Bay Coal Terminal Service

26 April 2019

1. EXECUTIVE SUMMARY

1.1 Glencore Coal Assets Australia Pty Ltd (**Glencore**) is lodging this cross submission in response to the DBCT Management (**DBCTM**) submission dated 11 March 2019 (**11 March submission**), in relation to the Dalrymple Bay Coal Terminal (**DBCT**) Service.

1.2 Glencore previously provided a submission supporting the Queensland Competition Authority's draft recommendation of December 2018 (**QCA Draft Recommendation**) that the access criteria are met with respect to the DBCT Service, in particular, by reference to our experience of the DBCT Service not being substitutable with any other coal export terminals (see our submission dated 13 March 2019). Glencore continues to press this view. Additionally, Glencore strongly supports the various submissions made by the DBCT User Group.

1.3 While these previous submissions evidence comprehensively the satisfaction of the access criteria, this submission seeks to add to these submissions and in particular respond to the latest assertions made by DBCT Management in its 11 March submission. We have commissioned Economic Insights to respond to some of these submissions and attach its report to this submission as Annexure A.

1.4 Glencore continues to have concerns with DBCTM's proposed deed poll/access framework (collectively, **Access Framework**), both in relation to its inappropriateness as a relevant counterfactual under criterion (a), and its ineffectiveness in addressing the QCA (and DBCT User Group's) concerns in relation to the material impact on competition in the coal tenements market that would arise absent a declaration.

1.5 Glencore has had specific experience with criterion (a) in the Port of Newcastle matter and in responding to the past approach of the National Competition Council **(NCC**) in the proceedings taken to the High Court as well as the access arbitration process before the Australian Competition and Consumer Commission **(ACCC)** involving Port of Newcastle Operations Pty Ltd **(PNO)** under provisions in Part IIIA of the Competition and Consumer Act 2010 **(CCA**), which are similar to those in the QCA Act 1997 (**QCA Act**). Glencore has experienced first-hand the difficulties in dealing with a monopoly infrastructure provider providing an undeclared service.

1.6 Glencore has had the benefit of seeing the DBCT User Group's latest submission and supporting material. Glencore strongly supports that submission and relies on the legal opinions contained therein. Based on that material and Glencore's own experience, Glencore considers that the QCA would commit an error of law if it considered the DBCTM Access Framework as the appropriate and effective counterfactual for the purposes of criterion (a), for the reasons we explain in this submission.

1.7 Glencore also submits that the acceptance of the Access Framework as an appropriate counterfactual by the QCA could set a dangerous precedent which would be used by monopolist service providers across Australia in dealing with all regulators seeking to manage market power issues for the benefit of Australian consumers. The use of such contractual artifices would not only impact on competition in the markets under consideration in this declaration review by the QCA, but also the various markets in industries that are at the whim of monopoly infrastructure service providers across Australia.

2. CRITERION (A)

Relevant Counterfactual

2.1 Glencore supports the previous submissions made by DBCT User Group regarding the inappropriateness of using DBCTM's Access Framework as the counterfactual for the criterion (a) assessment. Such an approach requires and necessitates a detailed analysis of the terms and conditions promised by the service provider. This is inappropriate, and contrary to the legislative intent behind criterion (a). For example, the explanatory memorandum to the bill that introduced the revised criterion (a) into the national access regime noted:[1]

> What are reasonable terms and conditions is not defined in the legislation. This is an objective test that may involve consideration of market conditions. *It does not require that the Council or Minister come to a view on the outcomes of a Part IIIA negotiation or arbitration.* (emphasis added)

2.2 Additionally, it is even more inappropriate to accept an approach which requires a detailed assessment of the legal effectiveness and terms and conditions of a purported access regime which has been proposed as the counterfactual but which is of highly questionable legal enforceability, which has never been relied on or shown to be effective and which could be changed subsequently to any decision not to declare on the basis of such a contrived counterfactual (which as detailed below is the case with the Access Framework).

2.3 This would undermine the declaration process by enabling service providers to sidestep declaration by providing terms and conditions to create an artificial counterfactual that is argued not to trigger the application of criterion (a), and then subsequently changing them to better suit their requirements.

2.4 The threat of a declaration application on a subsequent amendment of the access framework is unlikely to provide a sufficient disincentive to future monopolistic charging practices. Monopoly service providers are likely to consider the threat of a subsequent declaration application to be an acceptable commercial risk considering the lengthy delays inherently involved in a declaration application, and the possibility afforded by the precedent for simply offering acceptable terms and conditions to avoid the declaration. In the interim period before declaration, costs would be imposed on users and potential users that could not be recovered. Our own experience in the Port of Newcastle matter demonstrates the difficulties in having monopoly infrastructure services declared, with that declaration process starting in 2015 and still continuing.

2.5 Additionally, the QCA has acknowledged that it should not be required to examine in detail the terms and conditions offered under an alternative counterfactual scenario. At page 69 of the draft recommendation, it states that criterion (a) does not require:

> a detailed comparison of the terms that would be anticipated either if the service was declared, or if it was not declared... Rather, the QCA's focus is on assessing what access or increased access would look like in a future without declaration. Accordingly, the relevant issue for the QCA is the broader matter of assessing how DBCT Management would be constrained by its proposed access framework if it were in place in a future

[1] Explanatory Memorandum, Competition and Consumer Amendment (Competition Policy Review) Bill, [12.21]

without declaration. In this regard, the QCA has focused in particular on capacity allocation and approach to pricing.

2.6 Any proper examination of the Access Framework requires not only a review of its terms but also a consideration of its legal effectiveness and what (if any) legal remedies would be available to a party which wished to enforce the Access Framework. This is an untried mechanism, and differs fundamentally from normal commercial scenarios – such as an agreement between commercial parties to submit the price of already contracted capacity to review by an arbitrator in accordance with mutually agreed parameters.

2.7 As regards the terms of the Access Framework themselves, as detailed below, it is the detail of the proposed Access Framework in its totality that produces its commercial impact on access seekers and holders, including terms other than those directly relating to pricing, even where DBCTM has purported to solve any pricing uncertainty concerns in its new proposal by 'hard-coding' the price cap. It is only on an analysis of the detail of the Access Framework that the flaws and gaps in this submission are made apparent. It would be incorrect for the QCA to take account of any term of the Access Framework (i.e. pricing) without completing a detailed review of the entire Access Framework.

However, since, as the QCA acknowledges, the correct application of criterion (a) does *not* require a detailed analysis of particular terms and conditions which are or may be proposed by the service provider, the QCA should not conduct such a full and detailed review of the proposed terms of the Access Framework or find itself having to attempt to assess the extent to which any legal mechanics exist which might render the Access Framework effective in any degree to constrain the future conduct of DBCTM. This would be a fraught exercise and one where the QCA would be drawn into error.

2.8 The correct application of criterion (a) does not require the decision maker to compare a detailed assessment of an expected regulatory outcome with a detailed counterfactual – whether based on the decision maker's own assessment of likely outcomes, on the basis of currently available access terms, or on the basis of a highly artificial, contrived and ineffective counterfactual provided by the infrastructure owner – such as the Access Framework. Such an erroneous approach would collapse the process required to determine the outcomes of a regulated undertaking or price arbitration into the assessment of what is only one of the necessary criteria for the application of such processes.

The Amended Access Framework is insufficient to counter QCA's conclusion that competition would be materially impacted in the coal tenements market

2.9 Even if the QCA were to accept the Access Framework as the relevant counterfactual, Glencore maintains that as a matter of law and practice it remains insufficient, even with the latest changes to the Framework and Deed Poll as attached to the 11 March submission (collectively, **Amended Access Framework**), to provide a counterfactual in which competition in a dependent market is not materially impacted by the lack of declaration.

(1) Impact of a $3/tonne price increase

2.10 *Firstly*, DBCTM contends that the newly inserted $3/tonne price cap would prevent it from charging $3/tonne more than what the QCA would determine for the existing terminal and that, based on the QCA's view, this amount would not have a material impact on competition. Putting aside the redundancy of a price cap where the floor is hypothetical, (as discussed at paragraphs 2.15 –2.18 below), this assertion does not take into account that the QCA's view was based on considering the $3 per tonne charge as a proportion of a forecast metallurgical coal price and not on the impact on profits which is critical for assessing the impact on investment incentives particularly for coal tenements.

2.11 The impact of an additional $3 per tonne charge can have a large impact on the value of a coal investment in the Goonyella system. The analysis of the impact of a $3 per tonne increase in charges must be in the context of the overall revenue, costs (and hence EVITDA margin), expansionary capital and sustaining capital as they are anticipated over the life of the project/asset. One of the typical investment measures considered for mining projects is the internal rate of return (**IRR**) (amongst others, including payback period, discounted payback period, net present value, return sensitivity, capital intensity).

2.12 When taking into account further considerations, the impact of a $3 per tonne increase in charges could materially change the assessment of a project, with the possibility of the charge changing a decision from a proceed to not proceed, where a required hurdle rate may not be met. In fact the unknown nature of the proposed floor leads to greater uncertainty and the potential for not only higher costs assumed with the $3 per tonne charge but the demand of a higher hurdle rate to progress the project due to riskiness of cash flows. Table 1 presents estimates of the impact of a $3 per tonne charge on the IRR of hypothetical, but typical coal mine project in the Goonyella system. Estimates are shown for a large thermal open cut mine, a medium sized coking and thermal coal open cut mine and a small coking coal underground mine.

2.13 The impact of the additional $3 per tonne charge is to reduce the internal rates of return for these mines by 1.8, 1.5 and 0.7 percentage points respectively. This quantifiable incremental impact could stop a project from progressing or materially change the value of tenements transacted in the market.

2.14 The additional charge would only be paid by new entrants or facility users that wish to contract for additional capacity. Thus new entrants and incumbents who wish to expand capacity would have to factor the additional cost of $3 per tonne into the prices they are willing to pay for tenements and this would affect their ability to be successful in the acquisition of tenements with a consequent adverse impact on competition in the market for tenements.

Table 1: Impact of a $3 per tonne charge on the internal rate of return of typical mines in the Goonyella system

	Internal rate of return **without** $3 per tonne **charge**	Internal rate of return **with** $3 per tonne **charge**	Impact of charge on internal rate of return
	%	%	% points
Large thermal coal open cut	11.7	9.94	-1.8
Medium coking coal open cut	12.7	11.2	-1.5
Small coking coal underground	11.6	11.0	-0.7

Source: Glencore calculations. Key assumptions:

Coal prices and foreign exchange rates used are mean of a consensus forecasts as at 4 April 2019. Volumes, mine site costs based on a typical hypothetical but representative project in the market for DBCT services.

Rail and track charges based on existing charges in the Goonyella system. Standard assumptions on royalties, tax and depreciation. Unit costs held constant.

(2) Pricing Uncertainty

2.15 *Secondly*, the 'hard-coded' $3 per tonne price cap does not remove uncertainty for access seekers, as claimed by DBCTM. The $3 cap is based on a 'Floor TIC' which is "the TIC that would apply under a QCA administered pricing regime". A TIC under a QCA administered pricing regime is one that is determined by an objective decision-maker with no self-interest in the outcome of the determination, after it has been provided with a significant amount of information and with the benefit of submissions by each of the interested and usually opposing parties (i.e. the access seeker and service provider), along with a bank of experience and expertise in adjudicating on such issues. Experience has shown that substantial and independent expertise and capacity are required to establish a price that takes appropriate account of the interest of both the access provider and access seekers. There is also considerable regulatory discretion that it typically applied in making decisions about efficient costs and an appropriate rate of return and this requires considerable experience and expertise in making price determinations.

2.16 It is not possible to replicate a TIC as would apply under a QCA administered pricing regime where the party administering the pricing calculations is not an unbiased objective decision maker but instead is one of the parties with a significant commercial interest in the outcome of the determination (unless the parties have the resources and incentive to resort to arbitration which for the reasons mentioned below is less likely under the Access Framework). The very fact that the QCA is being excluded from the role of determining a price that is defined as a price as would be determined under a "QCA administered pricing regime" means the Floor TIC becomes a completely hypothetical price with no certainty. The only certainty from the Access Framework pricing regime is likely to be that DBCTM will determine the Floor TIC to be at a higher level than would likely be determined under "a QCA administered pricing regime" where QCA is the adjudicator. This is highlighted by the fact that DBCTM has

consistently submitted pricing under the most recently approved access undertaking which the QCA has not followed.

2.17 Glencore's own experience in the Port of Newcastle matter is illustrative of these dangers as PNO claimed they were operating and charging under an asset base that would apply in a regulated environment. However, on review by the ACCC as part of the access arbitration process, it was disclosed that PNO included appropriated user funded channel dredging into its cost base which the ACCC disallowed.

2.18 In these circumstances, Glencore submits that the $3 per tonne cap is not a safeguard at all. Where the Floor TIC has the potential to be set at a level that would materially impact competition in a dependent market (i.e. the coal exploration tenements market), a TIC that is $3 more will materially impact competition to an even greater extent. As importantly, there is no correlation between the $3 added onto any determined Floor TIC and the pricing principles of the QCA Act. Section 168A(a) requires that the price for access should "generate expected revenue for the service that is at least enough to meet the efficient costs of providing access to the service and include a return on investment commensurate with the regulatory and commercial risks involved." As DBCTM is not facing any additional real commercial or regulatory risks under this scenario, it would seem inappropriate to enable it to extract a $3/tonne 'rent' from access seekers purely by virtue of its monopolistic position. This would enable an expropriation of miners' equity in its mining operations without DBCTM having to put any of its own capital at risk.

2.19 Additionally, the ceiling price which applies in addition to the $3 cap also provides no safeguards as it, again, provides for a hypothetical price. Glencore repeats the submissions made in this respect by the DBCT User Group including that the ceiling price is dependent on a "completely unworkable judgment about whether volume would remain the same at a different price" due to it requiring DBCTM to have complete omniscience.[2] In its 11 March submission DBCTM seeks to refute this suggestion by reference to "the requirement for the arbitrator to use data from an independent third party data provider to determine the ceiling TIC".[3] This is not a sufficient safeguard as it fails to appreciate that an access seeker will be reluctant to commence arbitration under the Access Framework due to the information asymmetry provided for under the Access Framework (which will prevent it from making an assessment of probable arbitration outcomes, as discussed below at 2.22.1) in combination with the addition of an obligation for costs of any arbitration to be paid by the unsuccessful party (discussed at 2.22.4 below).[4]

2.20 In circumstances where an access seeker has more limited access to information and greater downside in going to an unsuccessful arbitration due to the costs order risk, it is unlikely that an access seeker will see arbitration as a safeguard under the Access Framework. Again, Glencore's experience in the Port of Newcastle matter was that it was not able to obtain or test data put forward by PNO until the ACCC was able to use its compulsory information request processes in the arbitration to obtain data on the

[2] Dalrymple Bay Coal Terminal User Group, Declaration review regarding Dalrymple Bay Coal Terminal cross submission, 16 July 2018 (**DBCT User Group Cross Submission),** 65.

[3] DBCTM, 11 March submission, page 56.

[4] Section 16.4(1) Amended Access Framework.

regulatory cost base. Accordingly, in these circumstances DBCTM's suggested ability for an arbitrator to "use data from an independent third-party data provider to determine the ceiling TIC" is redundant.

2.21 The pricing uncertainty will only increase over time as the period between a QCA-administered TIC and a DBCTM-administered TIC increases. As DBCT User Group notes, "the hypothetical floor price (and the ceiling price that is inherently dependent on it) will become more and more uncertain over the longer term as it becomes harder to determine the prices and volumes that would have applied under a QCA regime."[5]

(3) Removal of key safeguards

2.22 *Thirdly*, the Access Framework further exacerbates this pricing uncertainty by removing a number of safeguards that are currently provided for under the Access Undertaking, in particular the following:

2.22.1 Removing the obligation on DBCTM to provide key information in relation to DBCT to an access seeker prior to its access application.

(a) Under the current Access Undertaking, prior to submitting an access application, an access seeker may request from DBCTM the below key information to assist it in its application including its pricing negotiations, as set out in section 101(2) of the QCA Act:

(i) information about the price at which the access provider provides the service, including the way in which the price is calculated

(ii) information about the costs of providing the service, including the capital, operation and maintenance costs,

(iii) information about the value of the access provider's assets, including the way in which the value is calculated,

(iv) an estimate of the spare capacity of the service, including the way in which the spare capacity is calculated,

(v) a diagram or map of the facility,

(vi) information about the operation of the facility,

(vii) information about the safety system for the facility,

(viii) if the authority makes a determination in an arbitration about access to the service under [the QCA arbitration regime] – information about the determination.

[5] DBCT User Group Cross Submission, 63.

(b) DBCTM must provide the information within 10 days. The provision of such information is key to balancing out the information asymmetry that otherwise exists between the service provider and access seeker.

(c) The Access Framework removes the obligation to provide this information completely. The only information that DBCTM would be obliged to provide to an access seeker is "reasonably available preliminary information relating to the Access Application (including copies of the then current Standard Access Agreement and Terminal Regulations)".[6]

(d) Removing these information provision requirements places an access seeker in a considerably weaker negotiating position in relation to access pricing when making an access application. It removes the ability for an access seeker to make an assessment of what would be reasonable pricing as administered by the QCA, so as to make it an unpalatable commercial risk to seek arbitration of pricing should the pricing offered by DBCTM seem excessive to the access seeker.

2.22.2 Removing the obligations on DBCTM to provide certain information to the QCA

(a) Under the current Access Undertaking, section 10 requires DBCTM to report on an annual basis on key information relating to its Regulated Asset Base – such as the opening regulated asset base value for the relevant financial year, indexation of asset base, depreciation, corporate overheads, new assets and operating and maintenance costs – and to provide a copy to relevant Access Holders. Further, section 7 provides the QCA with the ability to request "any information or documents that the QCA reasonably requires for the purpose of performing its obligations and functions in accordance with either this Undertaking or an Access Agreement developed pursuant to this Undertaking, or to determine compliance with this Undertaking."

(b) The provision of this information enables the QCA to have up to date and comprehensive information in relation to the aspects of DBCT which would be relevant to a pricing analysis. It puts the QCA in the best position to make an assessment of what reasonable terms and conditions of access would look like for an applicant seeking access DBCT. A third party arbitrator does not have a similar right to this information and as such cannot be as fully informed as the QCA would be. The relative inadequacy of an arbitrator selected under the Amended Access Framework process (a nominated by the Resolution Institute) is simply another factor reflecting the sub-optimal nature of the arbitration option under the Amended Access Framework.

[6] Section 5.2(d), Amended Access Framework.

2.22.3 Pricing to be determined by DBCTM *after* entry into binding access agreement

(a) Further, the Amended Access Framework provides that pricing may not be offered until *after* a binding access agreement has been signed by an access seeker.[7] This exacerbates the uncertainty facing a potential new entrant to the coal tenements market and the subsequent chilling effect. In circumstances where the pricing is not determined until after entry into an access agreement where there is no suitable recourse should the pricing not be agreed without a significant potential costs liability, potential tenement holders will simply not enter the market.

2.22.4 Imposing a costs obligation on unsuccessful party to arbitration

(a) Under the current declaration, the Access Undertaking provides for the QCA to arbitrate pricing and other terms and conditions should the parties not be able to agree (and the parties also do not agree on referring the dispute to an expert). Schedule 5 of the QCA Act sets out the process for a QCA administered arbitration. Notably, section 17.4(c) of the Access Undertaking notes that "the costs of the QCA and the reasonable costs of the parties are to be borne by the parties in such proportions as determined by the QCA."

(b) The Amended Access Framework instead provides a default position whereby the unsuccessful party is responsible for the costs of the arbitration. Section 16.4(l) states that "[u]nless otherwise determined by the Arbitrator, the costs of the Arbitration shall be paid by the unsuccessful party."

2.23 The removal of these key safeguards, would result in the below factors:

2.23.1 not knowing the pricing prior to being required to agree to an access agreement,

2.23.2 the risk of the offered pricing being unreasonable,

2.23.3 lack of recourse regarding unreasonable pricing to an objective third party without proceeding to arbitration,

2.23.4 an arbitration process which puts an unacceptable costs risk on the access seeker in circumstances where it is prevented from making a fully informed assessment on pricing,

2.23.5 a sub-par arbitration process, where the arbitrator would not be as fully informed as the QCA (due to, inter alia, the information reporting obligations on DBCTM to QCA under the QCA regime) and would not have the same level of specialist expertise and capacity as the QCA.

2.24 Glencore's experience in the Port of Newcastle matter was that after several years of litigation in having the channel declared, it was still a very difficult process in seeking to negotiate access and terms and conditions in circumstances where the access provider

[7] Section 5.4(6), Amended Access Framework.

being PNO had an information asymmetry. This meant that it was not possible to reach any negotiated outcome. Indeed it was only through the ACCC arbitration process that is relatively similar to the QCA process, that PNO's cost base and charges became transparent.

2.25 Accordingly, Glencore believes that the proposed approach by DBCTM would have a significant chilling effect on the relevant market for coal tenements by disincentivising new entry in the first place. As such, the practical effect of the removal of these key safeguards, which are currently available under declaration and would continue to be available under declaration, will be a material negative impact on competition in at least the tenements markets.

(4) Ability to amend the Amended Access Framework

2.26 *Fourthly*, DBCTM retains the ability to make amendments to the Amended Access Framework, further exacerbating the uncertainty prevalent in its proposed alternative counterfactual.

2.27 In the Amended Access Framework, DBCTM has hard-coded the 'Framework Objective' into the Deed Poll and added a further condition for future amendments to "be appropriate" having regard to the 'mandatory considerations'. The Framework Objective is derived from the list of factors set out in section 138 of the QCA Act, to which QCA must have regard to when determining whether to grant approval to an access undertaking. The 'mandatory considerations' are derived from the pricing principles set out in section 168A of the QCA Act.

2.28 DBCTM refers to these changes as addressing both the QCA and DBCT User Group's concerns regarding the ability for DBCTM to amend the Access Framework in a self-interested manner, i.e. by choosing from a range of amendments allowed under the broad-ranging and high-level factors set out in the Framework Objective. The DBCT User Group also highlighted that an obligation to "have regard" to the mandatory considerations "should be seen for what it is – an attempt to provide a thin veneer of credibility to the amendment process – that will actually provide no constraints on the type of amendment that DBCTM can make."[8] Glencore shares similar concerns as PNO made similar claims for its cost model in the ACCC arbitration and even claimed that the appropriation of the NSW coal industry's expenditure on channel dredging is appropriate having regard to similar mandatory provisions in section 44X of the CCA.

2.29 It is difficult to see how the minor changes proposed in the Amended Access Framework – ranging from adding the words "be appropriate" in relation to the mandatory considerations, providing another month in which to bring Court proceedings for any grievances over proposed amendments and extending the consultation period and notice requirements – actually resolve the key issues as raised by the DBCT User Group and QCA. None of these minor changes resolve the key issue of DBCTM having the ability to amend the Amended Access Framework to suit its own interests and to the disadvantage of access seekers or holders, while still being able to show that the amendment is within the bounds of the Framework Objective and are appropriate having regard to the 'mandatory considerations'. The final call in relation to whether an amendment is made or not still lies with DBCTM and the only recourse for

[8] DBCT User Group Cross Submission, p59.

an aggrieved access holder or seeker is to commence court proceedings for breach of contract (with any court-ordered remedies curtailed as addressed at paragraphs 2.32 – 2.35 below).

2.30 As noted in previous submissions, both the Framework Objective and 'mandatory considerations' are such a broad-ranging list of factors of such a high level that it would be very difficult to have a Court determine that a proposed amendment was outside the scope of these mandatory considerations. A Court would not and could not be asked to make an order determining how the objectives and mandatory considerations are *best* promoted, but only whether the amendment is one of many which would fall within the scope of the long list of considerations.

2.31 In contrast, under declaration the QCA would continue to have the role of determining the best outcome having regard to the relevant considerations, for example in its role of approving access undertakings. A court without the experience of the QCA and restricted to determining whether a strict breach of contract had occurred would not be in the same position to ensure an outcome that prevented a material (detrimental) impact on competition.

(5) Curtailed remedies

2.32 Lastly, even if an access seeker or holder were to be successful before a Court in finding that any amendments were a breach of the Deed Poll, the Amended Access Framework continues to curtail the remedies available to declaratory relief only. As such, there is clearly no incentive on DBCTM *not* to attempt to implement self-serving amendments as, in the unlikely event the Court is able to find them outside the scope of the broad ranging list of mandatory considerations, there is no consequence on DBCTM other than being prevented from implementing them.

2.33 This is in stark contrast to the remedies available to access users or seekers under the current regime. Section 158A of the QCA Act provides that if a court is satisfied the owner or operator has breached a term of the undertaking, the court may make all or any of the following orders:

2.33.1 an order directing the owner or operator to comply with the term;

2.33.2 an order directing the responsible person to compensate anyone who has suffered loss or damage because of the breach; and

2.33.3 another order that the court considers appropriate.

2.34 In addition to curtailing the remedies available for amendments made in breach of the Deed Poll, the Amended Access Framework also excludes damages as a remedy for any breach and limits remedies for other breaches of the Deed Poll to specific performance only.

2.35 In the context of such curtailed remedies, DBCTM has every incentive to seek to implement changes or apply the Amended Access Framework in a manner which suits itself even if to the detriment of competition in a dependent market. A monopolist would have every incentive to take the chance on an aggrieved user or seeker being reluctant to commence lengthy and uncertain proceedings in the comfort that there is

no real downside to DBCTM, even if one does commence proceedings, due to the limited remedies available. There can be no financial or other real consequences for DBCTM.

3. CRITERION (D)

3.1 Glencore supports the QCA Draft Recommendation's finding that criterion (d) is met. Criterion (d) requires that "access (or increased access) to the service, on reasonable terms and conditions, as a result of a declaration of the service would promote the public interest."

3.2 Glencore maintains and repeats the DBCT User Group's submissions in respect of criterion (d) including in particular the positive impact on investments a declaration would have in all of the coal tenements market, the rail network and rail haulage infrastructure market.[9]

3.3 However, Glencore also adds that there is significant public benefit to declaring the service including because it would signal the rejection of DBCTM's contrived deed poll counterfactual as an appropriate counterfactual under criterion (a). To allow such an approach would set a precedent for other monopolist service providers and would set in motion a process whereby declarations are sought to be avoided across Australia on the basis of behavioural promises as to the service provider's future conduct. Such a precedent would likely have the effect of a significant adverse material impact on competition and investment not only in the current markets under consideration but also other infrastructure markets across Australia.

[9] See, for example, DBCT User Group Cross Submission, page 82.

ANNEXURE A

to Glencore Coal Assets Australia Pty Ltd Cross Submission to QCA dated 26 April 2019

Meeting Foreseeable Demand at Least Cost Analysis in the QCA's Draft Recommendation to Declare the DBCT service – Criterion (b)

Report

Prepared for

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26 April 2019

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CONTENTS

1 INTRODUCTION

1.1 SCOPE OF THIS REPORT

This report provides an assessment of various aspects of the analysis of meeting foreseeable demand at least cost that is part of the QCA's Draft Recommendation in respect of the Dalrymple Bay Coal Terminal (DBCT) declaration review.[1]

The report has been prepared at the request of Glencore Coal Assets Australia Pty Ltd.

The focus of this report is on new material in response to the Draft Recommendation concerning criterion (b) as specified in s. 76(2)(b) of the QCA Act which is expressed as follows:

> (b) that the facility for the service could meet the total foreseeable demand in the market–
>
> > (i) over the period for which the service would be declared; and
> >
> > (ii) at the least cost compared to any 2 or more facilities (which could include the facility for the service)

Sections 76(3) and (4) of the QCA Act further provide that:

> (3) For subsection (2)(b), if the facility for the service is currently at capacity, and it is reasonably possible to expand that capacity, the authority and the Minister may have regard to the facility as if it had that expanded capacity.
>
> (4) Without limiting subsection (2)(b), the cost referred to in subsection (2)(b)(ii) includes all costs associated with having multiple users of the facility for the service, including costs that would be incurred if the service were declared.

The report focuses upon the analysis provided in the QCA Draft Recommendation and submissions and supporting consultants' reports, provided by DBCT Management (**DBCTM**) and the DBCT User Group.

1.2 STRUCTURE OF THIS REPORT

This report is structured as follows.

Section 2 discusses market definition.

Section 3 discusses estimating foreseeable demand and capacity

Section 4 discusses estimates of least cost to meet foreseeable demand.

[1] QCA 2019.

2 MARKET DEFINITION

2.1 QCA APPROACH

The QCA defines the market for the declared services by reference to the market served by the DBCT coal handling service and any substitutes in that market in the Goonyella system.[2] It found that there were no viable substitutes to DBCT's coal handling service.

The QCA was of the view that its approach was purposive which is consistent with the standard approach in defining markets for competition issues i.e. the purpose of market definition is to identify the product and area in which market power is likely to be exercised. This led to a focus on the extent to which other terminals provide a competitive constraint to the DBCT coal handling service.

The QCA analysis is essentially based on a small but significant non-transitory increase in price (SSNIP) test. This test entails determining whether a hypothetical monopolist could profitably impose a SSNIP and involves consideration of constraints that are likely to affect the scope to exercise market power.[3]

The QCA considered:[4]

- the demand for coal handling services in the Goonyella system and whether the relevant mines would consider coal handling services at other terminals as close substitutes (for instance, under a SSNIP[27] test)

- the demand for coal handling services outside the Goonyella system and whether the relevant mines utilising alternative rail systems on the CQCN would consider switching to DBCT (via the Goonyella system).

The QCA approach calculates the cost of using alternative terminals as well as considering a number of constraints and other economic factors that confine the market to coal handling services provided to miners in the Goonyella coal system. Key factors considered by the QCA include: average supply chain costs to Goonyella system users of accessing DBCT and other terminals; the unavailability of HPCT to non-BMA/BMC miners; various non-price factors relevant to substitutability (terminal capacity, rail capacity; metallurgical co-shipping and blending opportunities at DBCT, existing take or pay contracts, additional mine infrastructure investment); additional above and below rail costs that would be necessarily incurred (which indicate material differences); and the fact that the overwhelming majority of DBCTM's demand for contracted capacity comes from mines on the Goonyella coal chain.

[2] QCA (2018, pp.10-11).

[3] At the heart of the SSNIP test is substitutability in response to a relevant price increase. The test starts with the narrowest possible market. If imposing a SSNIP would be profitable, then this is the relevant market. If it is not profitable, then the market is widened and the test is re-applied, until it passes the SSNIP test. The hypothetical price increase is typically specified as 5-10 per cent.

[4] Ibid, p. 14.

In relation to the supply chain costs by themselves, the QCA found that even on an extremely conservative basis the average supply chain cost for a mine in the Goonyella system to access DBCT was substantially cheaper than other terminals.[5] Furthermore the estimates did not allow for the additional costs that Goonyella system users would incur on the Goonyella system before their coal was hauled through another system to access alternative terminals, which is clearly an understatement of costs and is something that can be reasonably estimated using Aurizon Network reference tariffs. As a result, the QCA's view was that in the absence of declaration, DBCT Management could significantly increase the terminal charge for accessing DBCT (i.e. by more than 5 to 10 per cent under a SSNIP test), and it would still be cheaper for a miner to continue to access DBCT. Consideration of the other non-price factors reinforced this finding.[6]

2.2 KEY OBJECTIONS FROM DBCTM

This section focusses on key points made in the Houston Kemp report that was submitted as part of the DBCT Management submission in response to the QCA Draft recommendation.[7]

Houston Kemp claim that:[8]

> "We note at the outset that there are significant differences between the approach that the QCA takes to defining the market in which the DBCT service is provided and the approach that we implemented in our previous criterion (b) reports. For instance:
>
> - ∂ we separately identify the product, geographic, functional and time dimensions of the market using the conventional approach; whereas
>
> - ∂ the QCA focuses on substitutability between the DBCT service and other coal handling services without explicit reference to the dimensions of the market.
>
> Some of these are differences of style, rather than of substance. However, there are important differences between the way in which we and the QCA assess the substitutability of services that are highly material to our respective conclusions in relation to the scope of the relevant market. In contrast to our views:
>
> - ∂ the QCA considers that only substitution due to changes in price or quality is relevant to defining the boundaries of the market and in implementing this approach:
>
> - > considers only the price and quality of the existing capacity at DBCT in this assessment, rather than the price and quality of expanded capacity at DBCT; and
>
> - > considers substitutability of coal handling services in very coarse terms by reference to representative users in the Goonyella system and

[5] Ibid, p. 16.
[6] Ibid, p. 31,
[7] Houston Kemp Economists (2019) and DBCT Management (2019).
[8] Houston Kemp Economists (2019, p. 3).

elsewhere, rather than by reference to the costs and incentives faced by each mine;

- ∂ the QCA considers that only transactions involving long term contracts are relevant to defining the boundaries of the market, and that transactions for throughput can be discounted from this assessment.

Underpinning the QCA's analysis is a conflation of the distinct concepts of 'demand for' and 'use of' a service. The QCA's approach assumes that demand in the market cannot include volumes that are served by other terminals."

Further Houston Kemp claim that:[9]

"The consequence of these fundamental differences in approach is that the QCA's draft recommendation finds that:

- ∂ the relevant market is 'the market for DBCT's coal handling service in the Goonyella system', in which DBCT is the only supplier, whereas we identify more than one supplier in the relevant market;
- ∂ coal mines in the Goonyella system that use coal handling services outside the Goonyella system are in the market, but their use of other coal handling services is not in the market, whereas we do not assume that demand in the market is capped at the existing capacity of DBCT;
- ∂ coal mines in the Goonyella system operated by BMA and BMC are either not in the market, or only in the market to the extent of their use of the DBCT service, whereas we include these mines in the market and do not assume that their demand is capped at the existing capacity of DBCT; and
- ∂ coal mines outside the Goonyella system are not in the market, whereas we assess this on an individualised basis for each mine based on its current and recent use of DBCT and the relative charges that it faces for using the DBCT service as against potential alternatives.

[9] Ibid, p. 4.

2.3 ECONOMIC INSIGHTS VIEW

Houston Kemp maintain that the market is much wider than the market defined by the QCA. However, this view essentially hinges on the scope for substitution as it is the scope for substitution that is the central consideration in applying a SSNIP test. The SSNIP test entails starting with a relatively narrow market definition and considering whether there are relevant constraints that would preclude a hypothetical monopolist from implementing a profitable price increase of 5-10 per cent. However, wherever the starting point is, the key aspect is consideration of relevant substitution constraints in the event of an increase in price by a hypothetical monopolist.

In response to the above claims by Houston Kemp it is relevant to recognise the following:

- It is not necessary to consider all the dimensions of market definition as the key consideration is what factors affect the scope for substitution and the QCA has considered a wide range of relevant information to form a view about the extent of competitive constraints.
- Given that the purpose of market definition is to define market power the approach of using a typical user by focussing on differences in average total costs is reasonable, particularly where there is also extensive consideration of non-price factors.
- The fact that some users may have been able to use DBCT if there was more capacity does not mean that an unregulated DBCT, including one with sufficient capacity to serve those users, would not have market power to increase prices above a level that would avoid the realisation of monopoly profits.
- The QCA does not consider that the existence of long term contracts is necessarily a factor that is relevant to assessing the existence of substitutes but rather a factor to be taken into account in estimating foreseeable demand.
- The market for assessing market power is defined by assessing substitution constraints and the scope for marginal switching does not necessarily demonstrate sufficiently close substitution.
- This report therefore agrees with the QCA approach as the best view of market definition, for the purposes of assessing market power, including the justification for excluding mines outside the Goonyella coal system.
- However, there are issues about the size of the market and least cost calculations that need to be addressed and these are discussed in Sections 3 and 4.

3 FORESEEABLE DEMAND AND CAPACITY

3.1 QCA DEMAND ESTIMATES

Foreseeable Demand

The QCA Draft Recommendation noted the considerable uncertainty in predicting demand for capacity at DBCT in the 2026-2030 period and the significant difference in estimates of total foreseeable demand between the parties over the 10-year period from 2021 to 2030.[10]

The QCA noted various concerns about the estimates of both the DBCT User Group and DBCT Management but focused on reviewing the estimates of DBCT Management's consultant Houston Kemp Economists and concluded that Houston Kemp appeared to overstate demand given its assumptions on rail capacity and the timing of new developments (QCA 2018, p. 42).[11]

The QCA engaged MMI Advisory to review the demand forecasts with various assumptions that reflect the QCA's market definition, contractual arrangements and MMI Advisory's views on the timing of projects. MMI Advisory estimated a 'base case' and a 'high case' with the high case assuming that all projects excluded from the base case are commissioned mid-way through the forecast period. The MMI Advisory base case estimates were somewhat lower than the initial DBCT User Group estimates for each year of the forecast period except for 2021.[12] The high case estimates were markedly higher from 2028 to 2030. The high estimates in the latter period have limited credibility as the MMI Advisory method is somewhat arbitrary and Glencore considers they would be likely to generate a maximum throughput that far exceeds even a maximum development profile.

The QCA's preferred preliminary position was to adopt an intermediate case. Table 1 contains the MMI estimates and QCA's preferred estimates. The capacity estimates reflect an assumption that throughput is on average 90 per cent of contract entitlements. The discussion on capacity in Section 3.4 below makes a number of points that question the need to have contracts for capacity that are 10 per cent above throughput estimates.

[10] QCA 2018, p. 37, p. 39.
[11] Ibid, p. 42.
[12] Ibid, p. 39 and p. 44.

Table 1: QCA total foreseeable demand estimates (mt)

	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
MMI base case	83.7	80.2	80.2	76.2	77.5	72.2	59.2	64.7	70.0	70.7
MMI high case	83.7	80.2	80.2	76.2	78.4	82.5	82.6	96.3	107.7	109.4
QCA preferred throughput	83.7	80.2	80.2	76.2	78.4	82.5	82.5	82.5	82.5	82.5
QCA preferred capacity entitlement	93.0	89.1	89.1	84.7	87.1	91.7	91.7	91.7	91.7	91.7

Source: QCA (2018, p. 45).

3.2 WOOD MACKENZIE UPDATED DEMAND ESTIMATES

Wood Mackenzie[13] prepared forecasts of throughput that were submitted as part of the DBCT user group submission.[14] The latest Wood Mackenzie base case forecasts of capacity entitlements (which are supported by estimates of a mine-by-mine build up) are presented in Table 2. They are broadly in line with the QCA preferred estimates of capacity entitlement for the period 2025 to 2030 but lower for the period 2021 to 2024.

Table 2: Updated Wood Mackenzie total foreseeable demand estimates (mt)

	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Wood Mackenzie base case throughput	74.5	74.9	71.9	73.9	78.2	82.5	79.2	83.8	83.1	80.2
Of which – suspended	1.5	1.5	1.7							
Of which – probable (1) & possible (2)	2.2	3.3	5.2	9.9	14.5	21.2	28.9	33.8	34.8	35.9
Wood Mackenzie (adjusted) capacity entitlement	82.8	83.2	79.9	82.1	86.9	91.7	88.0	93.1	92.3	89.1

Source: QCA (2018, p. 45), PwC (2019, p. 20) based on Wood Mackenzie (2019).

(1) Probable project – Project which is likely to enter commercial production in the future, but is subject to a significant degree of uncertainty, particularly with regard to timing, economic or technical matters.

[13] Wood Mackenzie (2019, 2018).
[14] DBCT User Group 2019, 2018).

(2) Possible project – Project which has a high degree of uncertainty and is usually at a very early stage of development.

Wood Mackenzie (2019, p. 6) drew the conclusion:

> "Expected DBCT throughput suggests that expansions of DBCT capacity are unlikely to be required. Any tonnages over capacity are small and there is uncertainty as to whether an expansion would be developed and contracted by users on a longer term basis given the transitory nature of peak demand. DBCT will be required to operate at high utilisation levels between 2025 and 2031."

3.2 KEY OBJECTIONS FROM DBCTM

According to the DBCT Management submission there is considerably more capacity requested by access seekers then estimated by the QCA such that it is not possible for (an expanded) DBCT to meet foreseeable demand at least cost, over the period for which the service would be declared, compared to any 2 or more facilities.[15]

DBCT Management has adjusted the MMI base case forecasts to include mines that were excluded based on the QCA's preferred view on market definition plus mines in the queue for access to DBCT:[16]

Table 4 presents the DBCT Management forecasts based on adjusting the MMI base case forecasts to include demand excluded based on the QCA market definition and access queue demand.

Table 4: DBCT Management forecasts of total foreseeable demand estimates based on adjusting the MMI base case forecasts and including access queue demand (mt)

	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Total DBCTM contracted	81.8	82.7	84.1	84.1	84.1	84.1	84.1	84.1	84.1	84.1
Total MMI mines not contracted	11.6	12.7	12.7	12.7	12.7	12.7	12.7	12.7	19.3	19.3
Total DBCT Access Queue	35.1	35.9	32.6	48.6	53.6	53.6	53.6	53.6	43.7	29.2
Total demand	128.5	131.3	129.3	145.4	150.4	150.4	150.3	150.3	147.0	132.5

Source: DBCT Management (2019, Appendix 4, p. 3)

[15] DBCT Management 2019.
[16] Ibid, 2019, Appendix 4, p. 97.

3.3 ECONOMIC INSIGHTS VIEW ON DEMAND

The MMI high case estimates for 2028 to 2030 in Table 1 are very high relative to the earlier years and they reflect a quite strong arbitrary assumption that all projects excluded in the base case (except for BMA projects which are assumed to use the Hay Point Coal Terminal) are commissioned mid-way through the forecast period.[17] It is reasonable to conclude that the very high estimates in the MMI high case in the 2028 to 2030 period are not well founded given the arbitrary nature of the underlying assumption about new projects and so not the best estimates to use for the purposes of implementing a natural monopoly test.

It is also relevant to note that Wood Mackenzie's base case assumes significant volume from uncertain future projects, particularly between 2025 and 2030. Thus, the Wood Mackenzie base case forecasts are not conservatively low but there are downside and upside risks to the forecasts as discussed in the Wood Mackenzie report.

The Wood Mackenzie estimates in 2021 are markedly lower than the QCA with contracted capacity of 82.9mtpa. Given this difference it is important to try to identify the key differences between the MMI forecasts and the Wood Mackenzie forecasts particularly in the early forecast period. Both consultants provide forecasts for operating mines and projects.

Two key differences relate to the following projects:

- Eagle Downs is included in the MMI estimates at 3.5 mtpa in 2021 and 4.5 mtpa from 2022 to 2030 but does not start production in the Wood Mackenzie estimates until 2025 at 0.4 mtpa increasing to 3.9 mtpa by 2030. It is noted that a feasibility study has still not been completed for the Eagle Downs project and that a final investment decision is scheduled the for the December 2020 half year[18] which suggests that it would be unlikely to see production by 2021, nor full production in 2022.
- Hillalong is included in the MMI estimates at 3.6 mtpa from 2021 to 2028 and 3.5 mtpa from 2029 to 2030 but not included in the Wood Mackenzie estimates. The Hillalong project in the Houston Kemp report[19] is owned by Shandong Energy Group. Public information on this project shows an EIS process has been completed but there is a significant number of further items that are required to commence.[20] In addition, the EIS indicates that construction would occur over a period of three years, which given the Queensland mines data base indicates there has yet to be an application for a mining lease for this project (as of 18 April 2019)[21] means production is very unlikely by 2021.

Considered collectively, the MMI estimates for the early years of the forecast period and particularly 2021 seem too high and it is suggested that the QCA should examine underlying assumptions for operating mines and projects in more detail to confirm its view of

[17] QCA 2018, p. 44.
[18] South 32 2019, p.3.
[19] Houston Kemp 2018, p. 62
[20] Department of Environment and Heritage 2017, Table 33.
[21] https://environment.des.qld.gov.au/management/impact-assessment/eis-processes/documents/hillalong_eis_assessment_report.pdf, page 2, accessed 18 April 2019.

foreseeable demand forecasts and also consider whether the requirement for contracted capacity to be set at 10 per cent above estimated throughput is valid.

Turning to the estimates of demand provided by DBCT Management, the adjustments to include demand from mines excluded by the QCA are not justified if the QCA's market definition is the best view of market definition. This issue was discussed above in Section 2. To recap, it is considered that the QCA has presented well founded reasons for excluding various components of demand that are included by Houston Kemp and DBCT Management.

Turning to the information provided by DBCT Management in relation to the access queue, inclusion of the access queue demand is not justified unless it is reasonably likely that demand in the queue will be converted to contracted capacity in a relevant time frame. The DBCT User Group (2019, pp. 38-39) submission makes a number of points that support the view that:[22]

> "Consequently, the DBCT User Group considers that the access queue provides limited if any guidance as to what actually constitutes foreseeable demand – and certainly can't just be added to the existing contracted capacity to produce a demand forecast."

In support of its view, the DBCT User Group makes the following points:

- it is relatively rare for access queue requests to convert into contracted capacity (at least in the timing and tonnages initially sought by access seeker):
- there is no cost to being in the queue and being in the queue is effectively a free option for a potential access seeker;
- if the near term access requests in that queue were actually representative of near term demand then they presumably should have sought access during the recent notifying access seeker process (which was generally known in the industry to be likely to be the last opportunity to acquire DBCT capacity without an expansion in the short to medium term);
- to the DBCT User Group's knowledge no expansion of DBCT is currently the subject of a feasibility study;
- no DBCT User Group member is aware of being approached by DBCTM under clause 20 of their access agreements indicating that no current access seeker is willing to contract capacity which can only be provided if the renewal rights of existing access holders are waived or an expansion is developed;
- access requests in the queue do not necessarily represent additional aggregate demand even to the extent they represent demand, as queue access seekers may replace existing users (either through trading or through existing capacity not being renewed by existing users such that it reverts to becoming available for contracting).

[22] DBCT User Group 2019, pp. 38-39.

The PWC report made similar points as follows:[23]

> "Importantly, it is clear that the access queue does not realistically reflect the total foreseeable demand above ongoing existing capacity, as the access requests have not been converted to take-or-pay arrangements and related to development proposals at varying stages of maturity, many of which are yet to reach financial close (and it is evident from the limited degree to which the historical queue levels have been converted into executed access agreements that many access applications are never, in fact, converted into an executed access agreement).
>
> Indeed, this appears to be reflected in DBCTM's own view of future contract cover at DBCT, which indicates that only a small proportion of the existing access queue is likely to be converted into contracted capacity."

As can be seen from Table 4 exclusion of the access queue data has a very large impact on total demand such that the demand estimates are much more in line with the QCA's preferred estimates of foreseeable demand.

It is also relevant to note that new entrants would have access to capacity over time if existing users do not renew all of their capacity, by use of secondary market trading and if capacity is expanded over time.

If expansion is not required at DBCT in the declaration period, then there is no need to consider a comparison of the cost of an expanded DBCT and a combination of supply from DBCT and another terminal. But in these circumstances there is still a need to compare the cost of an unexpanded DBCT and alternative supply by another terminal.

3.4 ECONOMIC INSIGHTS VIEW ON CAPACITY

The QCA assumes that DBCT's nameplate capacity is 85mtpa[24] and that DBCT's capacity will need to be expanded to meet the total foreseeable demand. Based on these figures the QCA considered that the Zone 4 expansion of 4 mtpa and the 8X phase 1 expansion of 4.5 mtpa would be required by 2021. However, Houston Kemp[25] and the DBCT Management[26] submissions claim these expansion projects would not be complete until September 2023 and September 2025 respectively. If this were the case DBCT could not service total demand assuming the QCA estimate of existing contracted capacity from 2021 to 2023.

However, capacity would be sufficient to service QCA's preferred estimate of throughput for each year of from 2021 to 2030 and it is arguable that estimated throughput is more relevant then contracted capacity in the context of a temporary increase in demand which could be accommodated by squeezing the system rather than expanding it. To elaborate, the system could potentially peak for a year performance wise with a temporary increase in vessel wait time as the main cost (which results in demurrage costs) which is likely to be far less than the

[23] PwC 2018b, p. 24.
[24] Ibid, p. 135.
[25] Houston Kemp 2019, p. 34.
[26] DBCT Management 2019, Appendix 6.

cost of expanding the system.

This issue is discussed in the DBCT User Group submission[27] where it is noted inter alia that: the DBCT User Agreements allow users to permit third party shippers to utilise their capacity; there is clear evidence of a secondary trading market; and there are other factors that are likely to support a conclusion that the estimate of through put being 90 per cent of contracted capacity is too low.

There is also information that indicates terminal capacity at DBCT is considerably higher than 85 mtpa and that 85 mtpa is a system capacity constraint at the port rather than a constraint at the terminal itself. The DBCT Management submission to the QCA Draft recommendation included a report prepared by the Integrated Logistics Company published in October 2018 that established a terminal capacity of 95.4 ± 1 and a system capacity of 84.4 mtpa in the 2021 fiscal year.[28]

Figures for contracted demand provided by DBCT Management and estimates prepared by the Integrated Logistics Company for terminal capacity and system capacity for each of the years from 2019 to 2021 and 2022 onwards are presented in Table 3.

Table 3: Integrated Logistics Company Capacity Estimates

Financial year	Contracted demand	Existing Terminal Capacity Estimate	System Capacity Estimate
FY19	79.3	90.1 ± 1	81.9 ± 1
FY20	81.1	90.8 ± 1	82.3 ± 1
FY21	83.6	95.4 ± 1	84.4 ± 1
FY22 onwards	86.1	94.7 ± 1	84.2 ± 1

Source: Integrated Logistics Company Pty Ltd (2018), part of Appendix 3 of DBCT Management (2019).

The Integrated Logistics Company report defines terminal capacity as "name-plate capacity" and system capacity as "being an objective of maximum reasonably achievable capacity for the Terminal without unduly increasing vessel waiting times as a result of operation of the Terminal".[29]

There are two reasons for using the terminal capacity estimate as a measure of maximum capacity:

[27] DBCT User Group 2018, pp. 38-39.
[28] Integrated Logistics Company Pty Ltd (2018), part of Appendix 3 of DBCT Management (2019).
[29] Ibid, p. 2.

- First, system capacity as defined takes account of the need to avoid unduly long vessel waiting times at the port, the costs of which may not be sufficient to impact on demand at the terminal i.e. to provide an incentive to switch capacity, particularly if there are only temporary delays.

- Second, and importantly, the service as defined by s. 250(1)(c) of the QCA Act 1997 is 'the handling of coal at Dalrymple Bay Coal Terminal by the terminal operator.' And as per s. 250(5) 'handling of coal includes unloading, storing, reclaiming and loading.' Given that system capacity and importantly rail may be increased by other service providers, then there is no basis of limiting DBCT capacity to anything other than the terminal's own capacity, particularly as the regulated asset base will be determined based on the service as defined.

Significantly, if terminal capacity is used as the measure of capacity to implement a natural monopoly test and the QCA's preferred demand forecast is adjusted to reflect likely delays in the Eagle Downs and Hillalong projects, then there would be no need to consider the need for expansion over early years of the declaration period.

4 LEAST COST ESTIMATES OF MEETING FORSEEABLE DEMAND

4.1 THE NATURAL MONOPOLY TEST AND RELEVANT COSTS

In a regulatory context, the assessment of the least cost option for supplying terminal services to the customers of DBCT or a similar facility is in effect a test of a natural monopoly. This has been recognised by the QCA[30] in the current matter and the Australian Competition Tribunal[31] in relation to rail facilities in Western Australia under previous declaration criteria.

The definition of a natural monopoly is that it refers to a situation where the lowest cost option for supply is supply by a single firm or facility rather than by multiple firms or facilities. For example, according to an authoritative industrial organization text:[32]

> "A market or industry is a natural monopoly if costs are minimized by concentrating production in a single firm."

The definition does not refer to sunk costs, but the standard textbook interpretation is that it relates to the total cost for a firm to supply the relevant demand and this includes all costs including sunk costs.

Additional aspects that need to be considered are whether the supply options represent capacity that will be available in the relevant time frame, as this is relevant for determining the costs that customers face, and whether to take account of other relevant factors that affect the value to customers of a particular option, as this will affect their willingness to purchase the service.

4.2 QCA VIEW

The QCA endorses a total cost test for identifying a natural monopoly rather than an incremental cost test. A total cost test is also consistent with the recognition in a regulatory context of the need to ensure revenue is sufficient to cover all costs in order to ensure there are appropriate incentives for efficient investment to serve the market. This is particularly important where a service entails large sunk costs, otherwise there may not be sufficient incentive to ensure efficient investment.

Thus, a total cost test is also in effect an ex ante test that recognizes the relevance of all costs of a facility or combination of facilities in meeting the specified demand. A total cost test can be implemented by estimating average total costs of different options to supply the relevant demand.

[30] QCA 2018, p. 47.
[31] ACT 2010, summary para. 18 and para 949.
[32] Church and Ware, 2000, p. 754.

In some cases it is possible to implement an (average) incremental cost test if relevant sunk costs cancel out in the comparison of cost options. However, the validity of an incremental cost test requires the same sunk costs to be present in the cost comparisons.

4.3 HOUSTON KEMP VIEW

Houston Kemp contends that the QCA has made an error in implementing an average total cost test because it has ignored the sunk costs of other terminals in calculating the average total cost of supply by DBCT.[33]

Houston Kemp contends that these sunk costs of an alternative supply option to DBCT should be included both in the scenario where DBCT supplies the terminal services as well as where the alternative terminal supplies the terminal services and so they will cancel out. If this were the case, then an average incremental cost test would provide an equivalent conclusion.

4.4 ECONOMIC INSIGHTS VIEW

If the Houston Kemp approach were accepted it would mean that the base scenario of supply by DBCT would include **the costs of more than that single facility** which is not consistent with the standard definition of a natural monopoly nor a literal interpretation of the meaning of cost in the relevant legislative provision.

Furthermore, the sunk costs of other options are not necessarily linked to supply by DBCT alone and they may well be incurred and expected to support other demand. In determining the cost of an alternative option for supply, as noted, there is also a need to determine if the assumed alternative capacity is available to supply the relevant customers in a relevant time frame.

Houston Kemp contends that the Australian Competition Tribunal's decision in relation to Fortescue Metals Limited took as given the capacity and costs of existing facilities and sought only to address the additional costs of meeting demand in each scenario. In particular Houston Kemp contends there are some sunk costs involved in one alternative option (expanding the Chichester line) that were in effect treated as cancelling out.[34]

Such an approach would in effect mean that the sunk costs associated with capacity from alternative terminals that can service demand should be excluded in the comparison. However, if one takes an ex ante perspective with respect to sunk costs as is done in defining a natural monopoly and as is assumed in setting charges to recover all relevant costs then the sunk costs of alternatives should be included. For clarity, the comparison should be on an average total cost basis where the sunk costs of the existing facility should be recognised in the base scenario and the sunk costs of the alternative facility should be included in the alternative scenario.

Houston Kemp maintain that there is a need to consider the costs to society from an

[33] Houston Kemp Economists 2019, pp. 24-35.
[34] Ibid, 2019, p. 29.

incremental perspective and this justifies the exclusion of sunk costs already incurred. Houston Kemp uses the term 'cost to society' in its incremental cost assessment[35] and the term 'resource cost' in its earlier report.[36] However, the costs it refers to are just incremental costs that ignore existing sunk costs. They do not incorporate the costs to society if non-declaration meant that market power led to prices that meant lower production and investment.

From the perspective of users of the service and the scope for the exercise of market power, the sunk costs are relevant because they will be reflected in user charges. Users of regulated and unregulated infrastructure do not face charges that reflect incremental costs they face charges that reflect average total costs for regulated infrastructure and potentially higher charges for unregulated infrastructure with market power, and they make investment and production decisions based on the charges that they face. In the context here, the capital charges that users face are encompassed in a user cost of capital and reflect return on and return of capital components that are linked to the willingness of suppliers to continue to make capacity available to receive these charges. If the capital charges are not paid, then the capacity would not be available with adverse economic efficiency implications.

In alternative terms, 'society' is not making decisions to utilize existing capacity or to switch capacity by reference only to incremental costs that ignore sunk costs because users face prices that include sunk costs, and this is necessary to provide efficient investment signals. The Houston Kemp approach also assumes that there is minimal restriction on the ability of users to switch between terminals even when capacity has been fully contracted to other users.

It is also relevant to recognise the policy purpose that motivated the Competition Policy Review Bill that led to the changed declaration criteria. The declaration criteria were changed, first at the Commonwealth level, to make it clear that a natural monopoly test was required and that the test was market based requiring the market in which the infrastructure service under application is supplied to be defined:[37]

> "12.22 Paragraph 44CA(1)(b) asks whether the facility that provides (or will provide) the service could meet the total foreseeable market demand at least cost over the declaration period. This is in comparison to a scenario where there are two or more facilities. The amendment to this paragraph is intended to refocus the test to a 'natural monopoly' test instead of a 'private profitability' test. [Schedule 12, item 2, paragraph 44CA(1)(b)]
>
> 12.23 The approach under the new paragraph is market-based, requiring the market in which the infrastructure service under application is supplied to be defined. This includes any substitute services that serve or will serve the market."

It is reasonable to infer that the natural monopoly test was specified because of a concern

[35] Ibid, p. 32.
[36] Houston Kemp Economists 2018, p. 21.
[37] Commonwealth of Parliament of Australia 2016-2017.

about the potential exercise of market power since a natural monopoly by definition has market power over price. In addition, according to the explanatory memorandum, the assessment of natural monopoly is required to be market based which requires defining a market and supply options using the actual prices that customers face or are most likely to face.

Furthermore, in assessing purpose, there is not likely to be an effective constraint on the exercise of market power at an unregulated DBCT if only marginal alternative capacity is available at a competitive price, an outcome that would likely arise if DBCT were not declared.

It is also clearly the case that where there is not sufficient existing excess capacity to serve relevant demand then there is a need to include the relevant sunk cost of building a new facility assuming that can be done in a relevant time frame.

4.5 COST COMPARISONS

The QCA, Houston Kemp, PwC and GHD cost comparisons are presented below to help clarify the different approaches.

The QCA comparison

The QCA compares the average total costs of an expanded DBCT (including sunk costs of an unexpanded and expanded DBCT and the sunk costs of expanded rail infrastructure but no sunk costs of an alternative terminal) with the average total costs of supply from another terminal required to meet additional demand (including the sunk costs of the existing terminal capacity and the sunk costs of expanded rail infrastructure).

The QCA notes that its estimates will overestimate the below rail cost of using the Goonyella system (with expansion) for accessing DBCT and that it has considered the highest estimate of expansion costs that are available without seeking to comment on the prudency of those expansion costs.[38] The QCA notes that its lower bound estimates (used in the comparison) do not include the cost that Goonyella system users would incur on the Goonyella system before their coal is hauled through another system to access alternative terminals.[39] The QCA also notes the extent that other coal systems require capacity upgrades to accommodate coal traffic from mines in the Goonyella system both the lower and upper bound estimates for accessing other terminals are an underestimation.[40]

In relation to the latter point, Glencore understands that the Blackwater track system is a key limitation to switching between DBCT and RGT. The Blackwater system is understood to be running currently at its physical limits. In order to rail from the Goonyella system to Blackwater, rail must move through the constrained sections of German Creek and Burngrove. It is therefore very likely any incremental tonnes would require sizeable and costly expansion of this section of track, as well as the main Blackwater trunk, meaning the

[38] QCA (2018, p. 51).
[39] Ibid, pp. 129-130.
[40] Ibid, p. 130.

incremental below rail costs would be significant.

Table 5 presents the QCA comparison based on the lower bound estimates

The Houston Kemp comparison

As noted, Houston Kemp maintains the QCA understates the cost of the expanded DBCT option because it does not include the sunk costs of alternative terminal capacity in the base case scenario. According to Houston Kemp the correct comparison needs to recognise the relevance of sunk costs from another terminal in both scenarios or the test needs to be implemented on a strictly incremental cost basis.

Houston Kemp presents an average incremental cost assessment that excludes the sunk costs of alternative supply so that a comparison is made between the average incremental cost of expansion at DBCT which includes sunk costs of expansion and other incremental cost of supply via another terminal.

Table 6 presents the Houston Kemp comparison.

The PWC comparison

PwC In its initial report compares the average total cost of DBCT expansion to meet additional demand (including sunk costs of the expansion) with the average total port and average incremental rail costs at other terminals that are assume to be able to serve the demand that requires expansion.[41] This in effect leads to the same conclusion as the QCA approach but with a focus on the incremental expansion and with different estimates of certain costs. A subsequent PwC report submitted as part of the DBCT user group submission to the QCA Draft recommendation compares estimates of average supply chain costs to the QCA estimates and arrives at similar order of magnitude conclusions.[42]

Table 7 presents the PwC initial comparison.

The GHD comparison

GHD notes that in estimating the costs in the situation where demand exceeds existing capacity at DBCT the QCA compares the average supply chain cost of DBCT meeting 93 mtpa of demand with the average supply chain cost of a Goonyella mine using RG Tanna Coal Terminal (RGTCT).[43]

GHD notes that this is not consistent with the approach the QCA described in the Draft Decision and in the Staff Issues paper which is described as the average supply chain cost of DBCT (expanded) meeting 93 million tonnes per annum (mtpa) of demand with the average supply chain cost of meeting demand with a combination of DBCT (unexpanded) meeting 85 mtpa and RGTCT meeting 8 mtpa. When the latter scenario is applied the average supply

[41] PwC (2018b), pp .31-34.
[42] PWC 2019, p. 17.
[43] GHD 2019.

chain cost is $11.90 per tonne compared with the QCA estimate of $12.05 per tonne.

Table 8 presents the GHD comparison.

Table 5: QCA average supply chain costs to Goonyella system users of accessing alternative coal terminals with Goonyella and DBCT expansions ($ per tonne)

Cost components	DBCT	AAPT (GAPE)	RG Tanna	WICET
Below rail cost (2016-17), lower bound estimate for accessing other terminals	$3.61	$10.69	$7.25	$7.25
Above rail cost), lower bound estimate for accessing other terminals	$3.25	$5.03	$4.54	$4.54
Coal handling cost	$5.14	$7.01	$5.18	$14.67
Other port and shipping costs	$0.05	$0.05	$0.05	$0.05
Supply chain cost	**$12.05**	**at least $22.79**	**at least $17.02**	**at least $26.51**
Cost difference relative to accessing DBCT		*at least $10.71 (89%)*	*at least $4.97 (41%)*	*at least $14.46 (120%)*

Source: QCA (2018, p. 51 and p. 138)

Table 6: Houston Kemp incremental cost assessment of supply chain cost to society ($ per tonne)

Cost components	Expanded capacity at DBCT	Existing capacity at AAPT	Existing capacity at RGTCT	Existing capacity at WICET
Below rail cost	$0.62	$1.82	$1.23	$1.23
Above rail cost	$1.63	$2.52	$2.27	$2.27
Coal handling cost	$8.50	$1.54	$1.14	$1.23
Supply chain cost	**$10.74**	**$5.87**	**$4.64**	**$6.73**
Cost difference relative		*$4.87 less (45%)*	*$6.10 less (57%)*	*$4.01 less (37%)*

to accessing DBCT				

Source: Houston Kemp (2019, p. 32)

Table 7: PwC estimates of total port and incremental rail cost of options to serve additional demand beyond existing capacity($ per tonne)

Cost components	Expanded capacity at DBCT – Zone 4 +8x	Dudgeon Point Stage 1	Existing capacity at AAPT	Existing capacity at RGTCT	Existing capacity at WICET
Supply chain cost	**$8.02**	**$28.46**	**$18.00**	**$12.50**	**$30.00**

Source: PwC (2018b, p. 34)

Table 8: GHD total supply chain cost assumptions

Coal tonnages	DBCT (unit cost)	DBCT + RGTCT
85 mtpa	$11.42	$11.42 (DBCT)
8 mtpa	$18.74 (inferred by GHD)	At least $17.02 (RGTCT)
93 mtpa (average cost)	**$12.05**	**$11.90 (inferred by GHD)**

Source: GHD (2019, p. 8)

4.6 ECONOMIC INSIGHTS VIEW OF COST COMPARISONS

If one adopts an ex ante perspective and recognizes the need to consider available capacity then the only comparison that would seem to make sense if expansion is required is the average total cost of an expanded DBCT (including DBCT sunk costs but no sunk costs for alternative supply) with the average total cost of an unexpanded DBCT and supply using the available (excess) capacity of alternative terminals, assuming there is sufficient relevant excess capacity.

The GHD criticism of the application of the methodology is valid, however the difference in estimates is small and recognising the conservative nature of the QCA estimates (conservatively high rail costs associated with DBCT expansion, non-recognition of additional rail costs for using RGTCT and lower bound estimates of accessing other terminals) the DBCT expansion option is still likely to be the lowest cost. It is noted that GHD contends, based on its calculations, that the estimate of $12.05 is not overstated although GHD does not appear to address the issue of the non-recognition of additional rail

costs for using RGTCT, including the costs to construct physical infrastructure to gain incremental capacity in the other systems where constraints currently exist to limit capacity. There is also a need to consider whether there is spare capacity at RGTCT as discussed below.

The QCA's preliminary view in its draft recommendation is that there is no spare capacity at RG Tanna or AAPT over the proposed declaration period and that RG Tanna is fully contracted.[44] It noted this was the view of the DBCT user group and consistent with data collated by the Department of Natural Resources and Environment for the Port of Gladstone. It also noted that it had not received compelling evidence of the availability of spare capacity at RG Tanna or AAPT over the proposed declaration period.[45]

GHD in its report as part of the DBCT Management submission to the QCA Draft recommendations contends that, based on throughput volumes recorded in recent annual reports there is spare capacity at RGTCT of at least 8.4 mtpa.[46] The throughput figures at RGTCT have averaged around 60mtpa for the 2016 to 2081 financial years which converts to contracted capacity of 66.6 mtpa and the QCA estimate of capacity of 75 mtpa.

However, Glencore has advised that RGTCT is a dedicated stockpile facility, which means that a user must have their own stockpile sufficient to support volumes they want to achieve, and constraints on stockpile capacity are not reflected in the name plate capacity.

Constraints provided by stock pile capacity would need to be recognised in establishing the extent of any spare capacity at RGTCT and may mean that in implementing the natural monopoly test there is a need to make use of alternative capacity at WICET where the cost of access is considerably higher than for RGTCT.

[44] QCA 2018, p. 17.
[45] Ibid, p. 18.
[46] GHD Advisory (2019 p. 11)

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