22 December 2015

Professor Roy Green
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By email: aurizon@qca.org.au

RE: Aurizon Network's 2015 Flood Review Event

Cockatoo Coal Limited ('Cockatoo') welcomes the opportunity to provide comments towards Aurizon Network's 2015 Flood Review Event ('2015FRE'), published by the Queensland Competition Authority ('QCA') on the 2nd December 2015.

During November 2015 Cockatoo was placed into voluntary administration, yet via its appointed administrators remains committed across all of its operations including the Galilee Basin, Surat Coal and Baralaba Coal projects.

Owned and operated by Cockatoo since 2008, the Baralaba project is located within the Bowen Basin along the Moura System of the Central Queensland Coal Network. In recently completing construction of a train load out facility and with the Baralaba mine ramping up its below rail tonnages to 3.5 million tonnes per annum ('Mtpa'), Cockatoo retains a substantial interest in the Moura system and any associated adjustments to its reference tariffs.

Therefore in summary, Cockatoo comments upon the 2015FRE are that:

- Due to numerous flood review events and continual upward pressure upon Moura system tariffs, Cockatoo advocates the lowest cost option and the recovery of costs within 6 months (what AN refers to as Recovery Option 1);
- However due to stakeholders potentially using the system to their advantage in advocating other cost recovery options, if a 6 month recovery is not supported, then the only option that should be considered is that which is supported by regulatory precedent, i.e., the recovery of costs within 12 months commencing as early as possible;

- Flood review events enhance system tariff volatility;
- Due to volatility imposed upon Moura system tariff components since 2011, Cockatoo believes that the objectives and principles of the Queensland Competition Act 1997 are not being adequately met;
- An alternative mechanism should be proposed so as to limit such volatility; and
- As per previous flood review events, AN's self-insurance arrangements continue to lack certainty.

It should be noted that this submission provides no attempt to assess or provide comment upon the reasonableness of the costs associated with the 2015FRE. Cockatoo requests that, as per similar flood events submitted to the QCA, all reasonable steps continue to be undertaken by the regulator to independently assess the prudency of costs so as to ensure that:

- the claims truly represent incremental costs;
- labour costs included within the claim are those associated with overtime hours and not those attributable to ordinary effort; and
- any costs attributable to employees or contractors are not attributable to reallocation from other tasks within the CQCN.

Recovery options

The 2015FRE submitted by AN in November 2015 seeks to recover AUD$4.5m[1] of incremental maintenance costs incurred as a result of Cyclone Marcia, which crossed into Queensland during the February of 2015. As per Schedule F, Clause 2.2.1 of the 2010AU and per previous flood review event submissions to the QCA, AN has sought to recover these incremental maintenance costs via a 50/50 allocation across both the AT3 and AT4 components of the Moura system tariff.

In attempting to balance both the legitimate interests of itself and also managing the impact upon the stakeholders of the Moura system, AN has also proposed to recover the costs via one of three options, either being across a six, twelve or eighteen month period. Although Net Present Value ('NPV') neutral, as the timeframe of the various options increases so too does the total amount of the recovery, ultimately reflecting rates of escalation through a combination of AN's adopted use of the UT4 Weighted Average Cost

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[1] Expressed in 2017 financial year dollars

of Capital ('WACC') – specifically 7.17% as positioned by the QCA within its September 2014 Draft Determination on AN's Maximum Allowable Revenue – and also the RBA Consumer Price Index ('CPI').

Hence as the 6 month recovery option (what AN refers to as Recovery Option 1) presents the lowest financial impact, Cockatoo prefers its selection.

Cockatoo notes that previous events did not present any options for the recovery of costs. For instance, in relation to the 2013 Flood Review Event ('2013FRE') AN proposed to recover the entire incremental cost via variations within a single 12 month period. Although stakeholder responses presented various positions towards the 2013FRE – most likely in response to the magnitude of the claim and subsequent increases upon the AT3 and AT4 components of the Moura system tariff – the QCA determined that approved costs should be recovered within the 12 months of the 2014–2015 financial year.

Therefore if a 6 month recovery is not approved by the QCA, Cockatoo refers to regulatory precedent – utilisation of a 12 month recovery option – as stakeholders could potentially take advantage of cost recovery options for their own financial benefit. Specifically, Cockatoo proposes that a hybrid of Option 3 should be strongly considered by the QCA, with the 12 month recovery period commencing on 1 January 2016. We believe this alternative would serve to balance all stakeholder's interests and not unnecessarily delay recovery until July 2016 and risk additional strain on reference tariffs for the reasons discussed in this section.

Cockatoo is also of the view that longer cost recovery options – like the 18 month tenure proposed by AN – increase the probability of compounding flood review impacts upon system tariffs. For instance, even though the Bureau of Meterology ('BOM') highlights its low forecast accuracy in predicting cyclones, the long-term average for Australia is still expected to reach 11 throughout the 2015–2016 tropical cyclone season, with four of those cyclones anticipated to impact upon Queensland.[2] Hence it is reasonable to assume further events could occur during the upcoming cyclone season and if AN declares additional Force Majeure events, Cockatoo believes added strain would be placed upon Moura system tariffs if a longer cost recovery option is selected.

Unfortunately, history has been a perfect illustrator of such impacts. Since 2011, Moura system tariffs above been impacted no less than three times by Force Majeure events, each with considerable consequences upon tariffs. As illustrated in the Table 1, costs associated with flood review events for the

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[2] BOM, 2015, *2015-2016 Australian Tropical Cyclone Season Outlook,* available at www.bom.gov.au

Moura system have totalled close to $13.5m, increasing AT3 and AT4 tariffs on an average basis of approximately 10–15% across the applicable years.

Table 1 - Moura Flood Review Events

Year	Costs ($'m)	Pre-event tariff		Post-event tariff		Percentage Adjustment	
		AT3	AT4	AT3	AT4	AT3	AT4
2011[3]	0.9	10.17	N/A	10.69[4]	N/A	5.11%	N/A
2013[5]	8.0	10.85	1.85	12.83	2.18	18.24%	18.24%
2015[6]	4.5	7.61	1.28	8.46	1.42	11.11%	10.93%
TOTAL/AVG	13.5					11.48%	14.58%

As producers are experiencing tighter margins under subdued economic conditions, rail costs are becoming a sizeable portion in delivering product to port. When combined with large and unpredictable system tariffs increases of between 10–15%, system tariff volatility is becoming unsustainable. Cockatoo is of the firm view that this volatility cannot be supported in what now appears to be a consistent event every second year, no matter the size of the mine owner or operator. Evidence of this is as recent as December 2015, where Wood Mackenzie provided a report indicating that on a global level, 65% of the total world coal output is lossmaking. In the same month, Anglo American – the second largest Australian coal producer and operator of mines within the Central Queensland Coal Network ('CQCN') – announced that it would be cutting 85,000 jobs worldwide.

Part 5, S.69E of the Queensland Competition Act 1997 ('QCA Act 1997') indicates that the object of regulating access to services is to:

> ...promote the economically efficient operation of, use of and investment in, significant infrastructure by which services are provided, with the effect of promoting effective competition in upstream and downstream markets.

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[3] QR National, 2011, *Review Event Submission – Central Queensland Flooding – 2010 Access Undertaking,* 1st December 2011, available at www.qca.org.au
[4] QCA, 2012, *QR Network's Review Event Submission – Central Queensland Flooding – Decision,* October 2012, available at www.qca.org.au
[5] Aurizon, 2013, *Review Event Submission – Central Queensland Flood – Final Costing & Recovery,* 4th March 2014, available at www.qca.org.au
[6] AN, 2015, *Flood Review Event Submission 2015,* pg. 27, 30th November 2015, available at www.qca.org.au

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Further, the Pricing Principles as outlined within S.168A state that price of access to a service should:

(a) 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; and
(b) allow for multi-part pricing and price discrimination when it aids efficiency; and
(c) not allow a related access provider to set terms and conditions that discriminate in favour of the downstream operations of the access provider or a related body corporate of the access provider, except to the extent the cost of providing access to other operators is higher; and
(d) provide incentives to reduce costs or otherwise improve productivity.

Given these objectives and principles, Cockatoo is of the opinion that an efficient price should not be subject to unpredictable or wide-ranging levels of variability and contests whether the current self-insurance arrangements provide for the most economically efficient operation of the CQCN.

Cockatoo believes a mechanism can be devised that better achieves the intent of S.69E and S.168A, further limiting the volatility stakeholders are exposed to time and time again. For example, so as to improve productivity whilst maintaining efficiency and whilst also recognising AN's pass through mechanisms, could the introduction of higher self-insurance thresholds become such a mechanism? Cockatoo nonetheless recognises that this is one of many possible mechanisms.

Self-insurance arrangements

To partly address the consequences of cyclones and floods, AN has chosen to apply a self-insure mechanism, a risk management technique that is undertaken by an entity to set aside money into a fund in the event of loss. Hence with no typical insurance in place, the entity draws upon the fund and compensates itself for associated loss in the occurrence of certain events. As a result, the self-insurance fund is run in a comparable fashion to the way an insurer would typically operate their own claims department.

However in 2008, AN reduced its proposed pass through self-insurance threshold from AUD$8m to AUD$1m, with the QCA accepting the revision within its Final Decision upon the 2010AU.

Cockatoo understands that due to onerous insurance premiums, AN has decided not to insure the majority of its below rail infrastructure against flooding for some time. Because of this reluctance, it is understood that the Insurance Unit – located within Aurizon Holdings – does not have a mandate to seek quotations from the market on insuring the CQCN. Due to the integrated nature of the insurance market – especially for large infrastructure assets – Cockatoo is not aware of any recent appraisal being requested by AN, nor undertaken by the Aurizon Holdings Insurance Unit since the Finity Consulting evaluation undertaken in 2012. As a matter of prudency, Cockatoo queries why market approaches are not performed on a more regular basis and as a result, questions the accuracy of statements made by AN within the 2015FRE relating to the procurement of a range of insurance policies.[7]

Concerningly since the 2008 downward revision, uncertainty has stemmed from what AN is actually being compensated for. The QCA has indicated such concerns for some time, where in the October 2012 Decision upon AN's (then QR Network) 2011 Flood Review Event ('2011FRE'), the QCA stated that it had [emphasis added]:

> **...concerns regarding QR Network's approach to demonstrating the adequacy or otherwise of its self-insurance arrangements (especially the late provision of additional analysis by Finity).**[8]

As part of its decision upon the 2011FRE, the QCA requested AN to complete a series of actions to remedy such concerns. Partly due to the non-performance of the request, the QCA re-iterated its concerns within its May 2014 Draft Decision upon AN's 2013FRE. Specifically [emphasis added]:

> **We continue to have concerns about Aurizon Network's approach to demonstrating the adequacy or otherwise of its self-insurance arrangements. We maintain the same view as discussed in our 2012 decision on the central Queensland flooding.** We are concerned significant uncertainty regarding the coverage and nature of the self-insurance arrangements continues to exist...that coal producers fund certain insurance coverage through reference tariffs, but have no visibility of the coverage obtained.
>
> **We note the definition of review event in the 2010 undertaking specifically provided for Aurizon Network to recover the costs of developing and implementing a self-insurance function, providing it was to be in place by no later than 31 December 2010.**
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> **Despite the opportunity to recover the costs of implementing a self-insurance function, Aurizon Network chose not to do this. We consider this means that the level of certainty that could have been provided around the self-insurance arrangements has been, and continues to be, lacking.**

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[7] AN, 2015, *Flood Review Event Submission 2015,* pg. 19, 30th November 2015, available at www.qca.org.au
[8] QCA, 2012, *QR Network's Review Event Submission – Central Queensland Flooding – Decision,* pg. 5, October 2012, available at www.qca.org.au

We note that Aurizon Network has proposed similar self-insurance arrangements for UT4. We will outline our concerns in respect of transparency in more detail as part of our assessment of UT4.[9]

Since the 2011FRE, certainty around the adequacy of self-insurance arrangements has been lacking and in what has become a troubling trend, AN has indicated little impetus to rectify such obscurity, even though CQCN stakeholders and the QCA have constantly provided recommendations.

As flood review events have now unfortunately become a regular occurrence, CQCN stakeholders require confidence that AN will not receive allowances in both regulated approved reference tariffs and flood review events. With recommendations already provided by the QCA and with seemingly little action taken by AN, Cockatoo questions what is ultimately required so that AN can finally address such uncertainty and provide stakeholders of the CQCN the appropriate clarity regarding the adequacy of its self-insurance arrangements.

Cockatoo would welcome the opportunity to contribute to any future discussion on this issue and confirms that this submission is public.

Yours Sincerely

[redacted]

Martin Ford

Administrator

[9] QCA, 2014, *Aurizon Network's 2013 Review Event Application – Draft Decision,* pg. 10, May 2014, available at www.qca.org.au

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