Submission:

West Moreton coal pricing approach

19 December 2019

NEW HOPE GROUP

Contents

1 Introduction

This submission is made on behalf of New Hope Corporation Limited (***New Hope***) in relation to:

(a) the Queensland Competition Authority's (***QCA***) October 2019 Discussion Paper (the ***Discussion Paper***) on West Moreton Coal Pricing under the 2020 Draft Access Undertaking (the ***2020 DAU***); and

(b) the related submission from Queensland Rail (***QR***) of 22 November 2019 (the ***QR Tariff Submission***).

The submission sets out New Hope's views on the appropriate West Moreton reference tariff settings and explains the appropriateness of those positions.

While a number of the questions in the QCA Discussion Paper are implicitly answered in setting out New Hope's views on the tariff settings, for completeness the last section of the submission also seeks to address the remaining questions raised in the Discussion Paper.

2 Executive Summary

The appropriate West Moreton tariff regulatory settings for the 2020 DAU are:

1. Reference Tariffs approved by the QCA, determined based on affordability

- A reference tariff set at a level that is affordable for West Moreton coal producers.
- The affordable level is no greater than 5-10% above the tariff of $16.94/’000gtk proposed in the QCA's draft decision (i.e. **$17.787-$18.634/'000 gtk**).
- Revenue foregone, being the gap between revenue earned from the affordability-based reference tariffs and total revenue requirement (based on building blocks) to be subject to loss capitalisation.

2. Reassessment of the revenue ceiling

- The total revenue requirement, used in the calculation of capitalised losses, will be based on building block revenue requirements, with each building block component being completely reassessed for the low volume scenario.
- Where volumes subsequently increase within a specified range (e.g. up to 4.1mtpa) , the total revenue requirement will be adjusted to reflect any variable element of building block costs, using formulae approved as part of the 2020 DAU.
- Where volumes increase beyond that specified limit, QR will be required to propose, and QCA to approve (if appropriate), adjustments to the variable building block elements and the total revenue requirement.

3. Loss capitalisation

- Revenue foregone (the gap between revenue earned and total revenue requirement) to be subject to loss capitalisation.
- Capitalisation of losses provides an opportunity (subject to conditions) for QR to recover foregone revenue if volumes return to higher levels.
- Capitalised losses to have a limited 5-year life (as per the QCA Draft Decision).
- Recovery of losses commences when the forecast revenue from the affordability-based reference tariffs exceeds the total revenue requirement.
- While losses are being recovered, reference tariffs will remain capped at the affordable reference tariff, but subject to this requirement, will be reduced to the greater of (i) the building blocks price plus a premium of 15% or (ii) the tariff that would result in recovery across a 15-year period, based on future forecast volumes.

3 QCA approved affordability-based reference tariffs

3.1 A building-blocks based tariff will be unaffordable

QR's initial submission in respect of the 2020 DAU calculated the building blocks tariff for a 2.1 mtpa volume forecast as $52.58/'000 gtk (in $2020/21).

The QR Tariff Submission now seeks approval for a 'ceiling' tariff of $47.100/'000 gtk and confirms:

Queensland Rail accepts that the revised ceiling tariff level is still unaffordable for Yancoal, and an alternative method for setting a low volume coal reference tariff is required

Even if the latest figure was lowered further to reflect the approach taken in the QCA's Draft Decision (including the 87 path based allocation, a lower WACC and varied cost allowances) the charge would still be well above the level that is affordable for West Moreton coal producers.

3.2 The price of access must be affordable

A tariff which exceeds affordability levels will:

(a) prevent any future contracting of coal volumes on the West Moreton network; and

(b) at some point result in the closure of the remaining West Moreton coal mine.

That is clearly not an appropriate outcome, given that it would:

(c) strand the investments of QR (West Moreton network), Aurizon (rolling stock), QBH (coal terminal) and coal producers;

(d) result in the State being required to nearly entirely fund the continued operation of the West Moreton network; and

(e) result in significant loss of employment, economic growth, coal royalties and other public benefits.

Only a tariff at affordable levels will facilitate continued utilisation of the network by Cameby Downs and create the conditions for investment in efficient new projects which will increase volumes to sustainable volumes (such as New Acland Stage 3).

3.3 Affordability level

As the QCA Draft Decision notes:

At very low volumes, one of the key questions will be how much the remaining access holder(s) are willing to pay. It is difficult to assess this precisely.

The QCA Draft Decision also noted that current 2016 access undertaking reference tariffs can be assumed to be affordable as:

both access holders continue to rail coal, and have done so through fluctuations in the thermal coal price.

While the QCA recognised that that did not rule out the true willingness to pay being higher, the QCA's draft findings were:

that the price derived for the high-volume scenario should form the basis of the price at lower volumes as well.

In previous submissions, New Hope supported that assessment, and suggested maximum affordability levels would be no greater than 5-10% above the high volumes tariffs proposed in the QCA's Draft Decision (which New Hope calculates as $17.787-$18.634/'000 gtk).

New Hope continues to consider that is the best estimate available of affordability levels for the 2020 DAU term.

Accordingly, QR's proposed $25.72/'000 gtk is clearly not affordable and not appropriate. The only basis QR provides for that proposed tariff is an analysis that New Hope has pointed out in previous submissions is based on outdated and flawed analysis.

3.4 Affordability and QR cash costs

QR estimates its cash costs to be recovered by a tariff of $21.81/'000 gtk (which is notably higher than the estimated affordability level).

That raises the question of how to reconcile that affordability level with QR's proposal that:

An opening reference tariff being set at a level that recovers at least Queensland Rail's 'cash costs' ie. operating and maintenance costs of providing coal services in any year.

As the QCA Draft Decision recognises, the high proportion of fixed costs creates a challenge for achieving revenue adequacy from coal services on the West Moreton system at low volumes.

As discussed in section 4, and as foreshadowed in the QCA Draft Decision, a complete reassessment of efficient costs needs to be undertaken for the low volume forecast. Based even on the preliminary analysis of the QCA's expert economic consultant (Systra), and the extent to which it has been rejected by QR in the QR Tariff Submission, New Hope considers it is evident that QR's efficient cash costs are likely to be materially lower than the actual cash costs they are claiming.

Accordingly, New Hope considers that it is likely the gap (if any) between QR's efficient cash costs and the affordability levels will be fairly narrow, and may fall within the bounds of imprecision associated with estimating affordability. That is, QR’s cash costs, properly assessed for the low volume scenario, may be within or only slightly above the affordable range suggested in Section 3.3.

3.5 For access charges to be affordable the reference tariff must be affordable

Both QR and New Hope consider the appropriate way to set charges is a QCA approved reference tariff.

New Hope noted with serious concern the structure raised in the Discussion Paper of a building blocks based reference tariff, with the intention that it would form a ceiling price and the assumption that QR will negotiate a commercially appropriate price below that level.

First, that would have the outcome that existing access agreements (which are presumably on the terms of the relevant standard access agreement in this regard) would then automatically involve charging a building blocks based reference tariff that all parties consider unaffordable.

Second:

(a) the difficulty which stakeholders have experienced in seeking to commercially negotiate low volume tariffs;

(b) the lack of clear success stories of volumes on the West Moreton line being retained or increased through commercial negotiation of affordable tariffs; and

(c) QR's assessment of its cash costs being above New Hope's assessment of affordability levels,

strongly suggests it cannot be assumed that access charges will be able to be negotiated at an affordable level.

This issue is more fully responded to in section 6 below, which further addresses why the alternative model referenced in the Discussion Paper is not appropriate.

4 Reassessment of the revenue ceiling

4.1 Why is a “total revenue requirement” required?

As discussed above, all stakeholders consider it appropriate at low volumes for tariffs not to be based on building blocks based pricing.

However, as discussed further in section 5 below, while there is reason to believe that volumes are likely to recover to sustainable levels during the 2020 DAU period, New Hope is supportive of implementing a loss capitalisation methodology (having regard to the pricing principles and the legitimate interests of QR as required by the QCA Act).

By its nature a loss capitalisation method will require an assessment of the difference between the reference tariff based revenue and the total revenue requirement that reflects the total of the building block costs. Consequently an appropriate total revenue requirement is required to be determined as part of assessing the 2020 DAU.

4.2 Why is a complete reassessment required?

The QCA’s Draft Decision on the 2020 DAU derived Reference Tariffs, based on the building blocks, which reflected a 9.1mtpa volume scenario.

While the weighted average cost of capital (***WACC***) parameters would not be anticipated to vary with volumes, efficient and appropriate operating and maintenance costs and capital expenditure would be anticipated to reduce and allocation of common network assets and costs to coal services should also be reconsidered as the proportion of coal utilisation declines.

If these items are not thoroughly assessed, the total revenue requirement will be artificially high, and as a result the capitalised losses will be artificially inflated.

That is not appropriate, and has the potential to disincentivise the very contracting of future volumes on the West Moreton network that is required to address the current situation (by unduly prolonging the period over which capitalised losses are recovered, effectively making new projects marginal for longer).

Accordingly, New Hope considers a complete reassessment of the non-WACC building blocks is appropriate and required.

That is completely consistent with the approach foreshadowed in the QCA's Draft Decision.

4.3 Cost and capital allowances

A low-volume scenario based on as little as 2.1mtpa (that is, without any forecast New Acland services) clearly requires a fresh assessment of efficient operating and maintenance costs, including review by an expert.

Considerations would include:

(a) reduction in all variable costs (including usage-based maintenance requirements);

(b) potential for resetting fixed costs. For a substantially different volume scenario such as the scenario outlined above, opportunities are likely to exist to eliminate or reduce costs which, within normal ranges, would have been considered as fixed;

(c) a reassessment of the standards to which infrastructure must be maintained. For example, a lower standard involving potential for increased unplanned outages or more speed restrictions may be acceptable where ample spare capacity exists (allowing for recovery);

(d) reassessment of trade-offs between capital and operating costs; and

(e) reassessment of the allocations of network capital and operating costs to coal services.

QR has previously indicated that only a small portion of its costs can be considered variable, including capital costs (that is, most capital expenditure projects are still required at lower volume scenarios). While this is not a surprising conclusion for volume variances within a normal range (of one or two million tonnes), a reassessment is required in the current circumstances where volume is projected to fall to approximately 23% of the original volume forecast.

In relation to the parts of the QR Tariff Submission concerning cost allowances, QR has only made minor reductions in costs and has rejected much of what the QCA's expert consultant, Systra, indicated. New Hope notes that the previous report provided to the QCA by Systra referred to a number of the opportunities for lower costs that would be anticipated at lower volumes. Given that Systra's focus was on the 9.1 mtpa volume forecast scenario, New Hope envisages that further opportunities to create efficiencies and cost savings would be identified in the course of a focused review on the 2.1 mtpa scenario.

4.4 Allocation to coal

The QCA Draft Decision proceeded on the basis of allocating the regulatory asset base to coal based on 87 paths.

The appropriateness of that decision needs to be critically reassessed in the face of coal volumes now being forecast to be materially lower.

As discussed previously, the system was not originally designed for coal transportation, is not an optimal rail system for coal transportation given the significant axle load and train length limitations and the constraints imposed through the Metropolitan system. The 87 path allocation also already involved New Hope and Yancoal paying for capacity that is not currently utilised for coal, and that issue will only be further exacerbated as volumes decline towards the 2.1 mtpa forecast.

New Hope considers that this allocation should be reduced, and only returned to 87 paths if and when the volume trigger referred to in section 4.6 below is passed.

4.5 WACC parameters

New Hope's position on the WACC parameters has been set out in its previous submissions. There is no rationale for altering those parameters merely because a low volume scenario has arisen.

The risks involving the future of the New Acland mine relate to the approval of a mining lease in a specific set of circumstances. The risk can in no way be characterised as a systematic risk.

Equally importantly, the risks regarding the New Acland mine were well known at the time of the QCA's previous Draft Decision on the 2020 DAU and the situation is unchanged (i.e. the timing of grant of approvals for the mine remains uncertain, but with some progress being made).

If anything, the current submissions process demonstrates the clear extent to which the regulatory framework seeks to provide QR with revenue adequacy and protect it from volume risk. Despite coal volumes deteriorating in a manner which would leave an unregulated infrastructure provider simply being able to charge an affordable tariff, great effort is being gone to by the QCA to establish a loss capitalisation methodology which provides QR with prospects of its higher returns simply being deferred.

Accordingly, New Hope considers it would not be appropriate to increase the asset beta from that set out in the Draft Decision, which is already materially higher than the closest coal rail network comparisons, and at the top of the appropriate range identified by the QCA's economic consultant, Incenta.

In relation to the comments in the QR Tariff Submission on this issue, an appropriate WACC cannot be simplistically derived (as QR once again proposes in the QR Tariff Submission) from comparing the WACC's determined for other infrastructure providers without analysing the degree to which the regulatory and commercial risk of those other providers is comparable to QR.

New Hope acknowledges that time-based parameters like the risk-free rate will be updated based on the relevant averaging period.

4.6 Trigger for reassessing the building blocks

QR proposes in the QR Tariff Submission that, upon volumes reaching 4.1 mtpa, it would be required to submit a draft amending access undertaking to reset the approach to the West Moreton tariff.

New Hope acknowledges that (at least in the short term) there are likely to be a range of low volumes at which costs are relatively similar and able to be reasonably extrapolated from the 2.1 mtpa estimate, and that at some point there will be a specified level where a step-change in costs is likely to occur. For the purposes of providing certainty to all parties about the approach, New Hope is willing to accept QR's assessment that 4.1 mtpa is the appropriate 'volume trigger' in this regard.

However, New Hope considers that to be appropriate, the only changes to be considered at the volume trigger point are the non-WACC related building blocks. That is, a reassessment of the total revenue requirement which is relevant to the calculation of the capitalised loss.

In particular, New Hope is opposed to the 'volume trigger' becoming an excuse to completely re-set the approach to West Moreton tariffs.

It is important for facilitating volume arising through future coal investment decisions that project proponents such as New Hope have as much certainty as is reasonably possible about how the tariff will operate, including the level at which the QCA has set the affordability based tariff and the loss capitalisation methodology that the QCA has implemented. It is not in the interests of access seekers, the public interest or consistent with the object of encouraging efficient investment and utilisation of the West Moreton network to create a high likelihood of major changes in tariff approach at a relatively small volume increase.

If QR's position was adopted it would seem to mean that New Hope would be placed in the position of determining its investment decision for New Acland Stage 3 without any certainty as to how the reference tariff might vary due to the project being developed (as the project will, at some point during its ramp up cause the West Moreton network to pass the 4.1 mtpa volume trigger).

New Hope sees no reason why the passing of the 4.1mt threshold should require a reassessment of:

- The affordable reference tariff.
- The approach to loss capitalisation or to the repayment of losses: the approach to ‘recovery premiums’ proposed by New Hope in Section 5.3 provides certainty to all stakeholders and will remain appropriate at any given volume level, until the point at which losses have been recovered.

Therefore, New Hope considers that a limited-parameter review is appropriate at 4.1mt, confined to an update of the total revenue requirement.

However, a further review of West Moreton pricing is appropriate at the point in time at which no remaining capitalised loss exists. At this time, recovery premiums should be removed from tariffs, reference tariffs may reflect full building block cost recovery, and a review of each building block element may be required.

4.7 Variations prior to the volume trigger

Even if the 'volume trigger' above is set at the point at which a step change in costs will occur and costs are largely fixed, there will still be some variable components of the costs incurred in providing West Moreton coal rail access services.

To provide certainty to all parties, New Hope proposes that for volumes between 2.1 mtpa and the proposed 'volume trigger' of 4.1 mtpa, formulae should be approved as part of the ultimate decision in respect of the 2020 DAU regarding how the non-WACC building blocks would appropriately move at different values.

5 Loss Capitalisation Methodology

5.1 Acknowledgement that loss capitalisation is appropriate at this point

As has been explained in New Hope's September 2019 submission on the draft decision, and in our October 2019 submission on the proposed Review Event, New Hope considers that limited-life loss capitalisation is appropriate in the circumstance where an affordable Reference Tariff, applied to forecast volumes, does not provide sufficient revenue to fully cover the efficient costs determined from the building block approach.

New Hope is willing to support loss capitalisation provided that there is a reasonable prosects of volumes returning to levels which can address the issue in the medium term.

New Hope continues to seek the required approvals for development of the New Acland Stage 3 project and, at this stage, continues to consider it remains reasonable to assume that (provided the tariff is set at an affordable level) it will be developed during the term of the 2020 DAU.

5.2 Limited life

New Hope's principal concern with loss capitalisation has always been that, if there is a sustained period of lower volumes (e.g. if New Hope continues to experience delays in receiving approvals in relation to New Acland Stage 3), the capitalised losses might accumulate to a point that they are realistically not recoverable in the medium term. In that regard, New Hope notes that special leave to appeal to the High Court has now been sought by the objector to the New Acland Stage 3 mining lease application.

If sustained delays were to occur, any new access seeker would be facing the prospect of the access charges being set at the 'affordability level' for an extended period, such that their project would presumably be relatively marginal for that significant period (given that, in our view, the 'affordable levels' being considered are affordable only in terms of allowing an existing mining operation to survive, and will not provide margins which justify significant capital expenditure). That will have a chilling effect on new investment, and thereby counterproductively hinder any future volume recovery.

New Hope is willing to support the limited-life loss capitalisation approach set out in the QCA's Draft Decision as representing a reasonable approach to overcome that issue (in conjunction with the approach to recovery premiums noted below).

In particular, New Hope supports the limited-life for loss capitalisation the QCA has proposed as:

(a) it provides a framework within which the applicable reference tariff can be set at affordable levels during the period where there is a (hopefully) temporary decline in volumes, while creating the potential for future recovery for QR when volumes recover;

(b) the amortisation of losses ensures that future access seekers would not be disincentivised due to facing long-term additional costs as a result of a sustained past period of low demand; and

(c) it creates the right incentives for QR to do what it can to facilitate volumes recovering more quickly.

New Hope understands, and agrees with, QR's view that the 5 year amortisation period is somewhat arbitrary. To us, the key consideration is how long a new entrant (or returning mine in the case of New Acland Stage 3) should expect to pay a tariff which is barely affordable, when the true building block cost of the service is actually below the level of the tariff being paid (but is inflated by the effects of an historical period of low demand). Under the QCA’s proposed approach, tariffs may remain at this level for up to a decade. This represents a significant portion of the economic life of most mining projects. The prospect of earning only marginal returns on a significant investment for up to a decade clearly has the potential to chill investment. However, New Hope understands the need to balance this consideration against QR’s legitimate business interests. While we consider that the capitalisation of losses for up to five years, followed by a further five years of amortisation, is a somewhat arbitrary and long period, we are unable to suggest an objective methodology for determining the appropriate amortisation period. We therefore accept that the QCA must apply its judgement to balancing the competing considerations.

5.3 Recovery premiums

New Hope supports the QCA's proposals that there should be a cap on the premium which QR can earn above the building blocks based tariff (once it falls below the affordability level used to set the initial reference tariff) – in addition to ensuring that in no case would the tariff rise above the affordability level.

In setting the premium, there needs to be a balance between ensuring the tariff remains affordable while incentivising future coal volumes by providing hopes of the tariff returning to more sustainable long term levels as soon as possible.

In relation to the level of the cap on the premium, New Hope considers that it is in all parties interests to ensure the recovery happens within a reasonable time once the building blocks tariff falls below the initial affordability based tariff, and acknowledges the QR Tariff Submission comments regarding a 10-15 year recovery period.

Consequently, New Hope suggests that rather than setting the recovery premium at a straight 15% (as proposed in the QCA Draft Decision), it should be set at the higher of 15% or the level that would (based on forecast future volumes) result in repayment of the capitalised losses within 15 years from the point at which repayment commences. This also results in the premium being less arbitrary – as it is designed to achieve the purpose of recovery within a defined period.

6 Responses to other issues from the QCA Discussion Paper

6.1 It is not appropriate to rely on negotiation to set an affordable access charge

As discussed briefly in relation to the need for affordable tariffs, New Hope considers it is not appropriate to either not set reference tariffs or set reference tariffs at unaffordable building blocks based levels and then assume that QR and customers will negotiate affordable pricing.

New Hope considers that past history does not demonstrate such an appropriate would be successful noting that:

(a) despite that loss of coal and grain volumes, to New Hope's understanding prices have not been altered in a way designed to incentivise the retention or increase of volumes on the line; and

(b) in the face of softening coal prices and declining volumes QR has submitted a review event submission (and now a further submission) seeking tariffs known to be well above what is affordable for the remaining producers.

QR also has a different set of incentives that operate in relation to the West Moreton network, which mean they are likely to respond differently to the challenges of declining utilisation than a private monopolist would be expected to (i.e. being incentivised to negotiate a commercial tariff that encourages additional volumes to return to the point where economies of scale makes the system profitable again). Whereas, the Discussion Paper seems to implicitly assume QR would be incentivised to negotiate affordable tariffs – presumably on the basis that that might be argued to occur on QR's other major systems (Mount Isa Line and North Coast Line).

For example:

(c) unlike a private monopolist, QR is not solely motivated by profit maximisation such that it can be assumed they will reach agreement on an affordable tariff as part of maximising longer term coal revenues. QR's clear priority is the provision of passenger services, given the direct impact on individual consumers and significant media and political scrutiny they receive in relation to that aspect of their business. Lower coal volumes actually assist QR in operating its passenger services by reducing use of the Metropolitan system by non-passenger services. While we recognise the genuine efforts of many QR staff to provide services to the coal industry, it is not clear this would extend to decisions at board or shareholder level to voluntarily offer services to coal customers at a price which QR perceived as being below cost;

(d) QR is not exposed to losses or asset stranding in the same way as a private monopolist. QR presumably anticipates that the State will continue to fund the operation of the West Moreton network irrespective of whether coal volumes continue, given the grain, passenger and other non-coal freight which utilises the line (as the State does for numerous other parts of QR's regional network);

(e) there are likely to be real difficulties for QR, as a large statutory authority which is used to charging coal customers the QCA determined reference tariff, to be sufficiently informed about the economics of coal producer's affordability and commercially nimble enough to negotiate a tariff at that level (despite it being perceived as a below cost tariff);

(f) QR needs Ministerial approval for major access agreements, and may understand or suspect that such approval is not likely to be forthcoming for what might be perceived as subsidising thermal coal, which may have some political sensitivities;

(g) where there is uncertainty about the State's views on long term plans for coal transportation with theoretical alternatives like the Inland Rail (or even Surat Basin Rail), QR may not believe it will recover costs that it absorbs at lower volumes when volume recovers;

(h) as discussed in the QCA's Draft Decision concerning the declaration review, QR has market power and the incentives to exercise it through monopoly pricing due to road being uncompetitive for coal haulage, and other non-cost factors preventing road haulage being practical. Where QR considers its tariffs are not a determinative factor in the investment decisions of coal producers (which is a position argued by QR in the declaration review process) there is a high risk of QR setting the tariff at unaffordable levels; and

(i) existing access agreements require payment of the reference tariff on a 100% take or pay basis – such that there is a period (i.e. for the term of the Cameby Downs access agreement) for which QR is likely to have the view that volume will not decline further even if they do not negotiate affordable tariffs.

It is clear to New Hope that the above set of circumstances mean that it is not appropriate to regulate access charges in a way that assumes that an affordable tariff would be reached through negotiation (and such an appropriate will impede any volume recovery and potentially eliminate the remaining volume on the line).

6.2 It is not appropriate to rely on disputes to set an affordable access charge

For completeness, we note the suggestion in the Discussion Paper of an alternative approach in which the reference tariff is considered a ceiling, and in which, where access charges are disputed, the QCA would not be bound by the reference tariff.

We also do not consider this to be a workable approach, because:

(a) for the term of existing Access Agreements, there is no scope to dispute access charges (that is, QR is contractually entitled to charge the Reference Tariffs and, based on past behaviour, would be expected to insist upon those rights);

(b) for additional ad-hoc or temporary services – an access dispute will not be resolved in the time required – such that any theoretical dispute rights are practically useful; and

(c) for new Access Agreements, the process of negotiating with QR, then initiating a dispute for determination by the QCA, will be inefficient, expensive, and will cause extensive delays and uncertain outcomes.

In addition, any such dispute in the context of new access would likely centre around the affordability of the reference tariff, rather than on the reference tariff itself or on the underlying building blocks (given that the QCA's views on the building blocks will already be reflected in the reference tariff). Case by case disputation of this issue would add significant time, cost and uncertainty to the development of any new coal projects. Where the decision the QCA makes as an arbitrator on the affordable reference tariff will have significant consequences for the profit margin of a project, it is likely that any new developer of a coal project may have to defer the investment decision until the outcome of that arbitration is finalised. That level of delay and uncertainty obviously hinders volume recovery and is impractical where an access seeker will also be trying to make investment decisions and contracting other supply chain capacity and operational inputs in parallel.

While we acknowledge the challenges of establishing an affordable reference tariff for the term of the undertaking, we consider that it is better that these challenges be faced now, and an outcome determined, in order to provide certainty, enhance the prospects of volume recovery and avoid a series of future disputes.

6.3 Flexibility for negotiated tariffs below the reference tariff

(a) Conditional support for negotiated tariffs below the reference tariff

New Hope appreciates that if QR had the right to negotiate tariffs below an affordability based reference tariff, in an environment where QR's costs are largely fixed, it would be possible for some incremental volumes to be provided profitably at a below reference tariff price (and thereby mitigate the capitalised losses).

While allowing QR to negotiate access charges below the Reference Tariff appears reasonable and has the potential to assist to some degree in volumes recovering, New Hope considers that:

(i) reference tariffs must be set at affordable levels, rather than relying on QR to negotiate (as discussed above);

(ii) assuming that reference tariffs are set at an affordable level, it is highly unlikely that QR will be persuaded to offer a negotiated access charge below this level; and

(iii) negotiated access charges below the reference tariff would present a range of challenges, most of which revolve around potential impacts on other access holders or access seekers.

(b) Resolving the challenges

In relation to the challenges that would need to be navigated to make this proposal appropriate:

(i) where loss capitalisation is in place, it would need to be calculated such that:

(A) the difference between the lower access charge and the reference tariff did not increase the capitalised loss (as QR would presumably only agree to the service at the lower access charge if it generated profits or reduced losses); and

(B) any net profit generated should be deducted from the capitalised loss for the relevant year; and

(ii) consideration would need to be given to how to manage any adverse consequences and equity issues involved in different access seekers facing different levels of access charges (where that price discrimination is not driven by cost or risk) – with consideration given to how differential pricing of that nature might impact on competition in dependent markets.

Similar issues in relation to potential impacts on other access holders or access seekers arise from the other proposal noted in the Discussion Paper of de-coupling take or pay or relinquishment fees from the reference tariff.

By raising the above issues, we are not suggesting that the QCA should rule out the possibility of allowing QR to negotiate an access charge below the reference tariff. Rather, we consider that:

(iii) if the reference tariff is set at an affordable level, which it should be, this issue (of a negotiated tariff) is unlikely to arise; and

(iv) if the issue does arise, then, given the potential impacts on other customers and the need to address each of the issues discussed above, it may be more appropriate to approve the alternative access charge via a draft amending access undertaking. This will allow stakeholders to consider and address all of the issues which such an arrangement may raise, at the time, taking into account relevant information. Anticipating these issues and developing solutions based on hypothetical scenarios is challenging, and unnecessary given the low likelihood of negotiated access charges below the Reference Tariff being agreed with QR.

6.4 Endorsed Variation Event: Change in Volumes

The question of whether an Endorsed Variation Event should apply for increases in contracted coal services above the forecast volume levels on which reference tariffs were based depends on how reference tariffs were developed, and whether QR is recovering its full building block costs (total revenue requirement).

As discussed earlier in these submissions, where the QCA agrees that an affordability base tariff should be established with a loss capitalisation methodology (as per New Hope's submission), the notional 'building blocks' would be revised (to the extent that particular building blocks contain a variable element) with changes in volume for the purposes of calculating the total revenue requirement. An Endorsed Variation Event (in the true sense of an event that changes the reference tariff) is not required until full recovery of building block costs is achieved, and any capitalised loss is repaid. This submission has instead separately discussed a 'volume trigger' process for how the building blocks would be reviewed for the purposes of determining the total revenue requirement (and therefore extent of capitalised losses) as volumes increase from those envisaged at the time of setting the initial total revenue requirement.

From New Hope's perspective, it appears that there are three possible scenarios to consider:

Scenario	Approach to Endorsed Variation Event	Comment
QCA Draft Decision scenario: Reference Tariffs reflect full building block costs (not constrained by affordability considerations) AND forecast volumes fully utilise the capacity reflected in the cost allocations.	Little need for Endorsed Variation Event. If volumes exceed the forecast, this represents utilisation of additional capacity, the cost of which is not reflected in the building block costs. The additional revenue will compensate QR for the use of this capacity. However, QR may be over-compensated for certain fixed costs.	This scenario aligns with the basis of the **QCA's draft decision**. At a forecast of 9.1mt, coal customers were utilising all of the capacity which was reflected in the building blocks. On this basis, the QCA concluded that an Endorsed Variation event was not required.
AU1 scenario: Reference Tariff reflect full building block costs (not constrained by affordability considerations) but forecast volumes do not fully utilise the capacity reflected in the cost allocations.	Endorsed Variation Event is required. Reference Tariffs include payment for some level of excess capacity. At higher volumes, continuing to pay the same Reference Tariffs will represent double payment for that capacity.	This scenario aligns with the situation under **AU1**. On this basis, the QCA concluded that an Endorsed Variation event was required.
Low volume scenario: Reference Tariffs do not reflect full recovery of building block costs (i.e. are constrained by considerations of affordability). Loss capitalisation applies.	The notional 'building blocks' tariff would presumably be recalculated with changes in volume for the purposes of calculating the total revenue requirement (which is needed to determine the extent of capitalised losses). An Endorsed Variation Event (in the true sense of an event that changes the reference tariff) is not required until full recovery of building block costs is achieved, and any capitalised loss is repaid.	This reflects our expectations under the **'low volume' scenario**. The Endorsed Variation Event would not apply until total revenue requirement was being achieved and any capitalised losses were repaid.

Given the current volume outlook, New Hope considers the third of those (the low volume scenario) represents the appropriate approach for the 2020 DAU.

7 Conclusions

For the reasons set out above, New Hope confirms that it considers the appropriate West Moreton tariff regulatory settings for the 2020 DAU are:

1. Reference Tariffs approved by the QCA, determined based on affordability

- A reference tariff set at a level that is affordable for West Moreton coal producers.
- The affordable level is no greater than 5-10% above the tariff of $16.94/'000gtk proposed in the QCA's draft decision (i.e. **$17.787-$18.634/'000 gtk**).
- Revenue foregone, being the gap between revenue earned from the affordability-based reference tariffs and total revenue requirement (based on building blocks) to be subject to loss capitalisation.

2. Reassessment of the revenue ceiling

- The total revenue requirement, used in the calculation of capitalised losses, will be based on building block revenue requirements, with each building block component being completely reassessed for the low volume scenario.
- Where volumes subsequently increase within a specified range (e.g. up to 4.1mtpa) , the total revenue requirement will be adjusted to reflect any variable element of building block costs, using formulae approved as part of the 2020 DAU.
- Where volumes increase beyond that specified limit, QR will be required to propose, and QCA to approve (if appropriate), adjustments to the variable building block elements and the total revenue requirement.

3. Loss capitalisation

- Revenue foregone (the gap between revenue earned and total revenue requirement) to be subject to loss capitalisation.
- Capitalisation of losses provides an opportunity (subject to conditions) for QR to recover foregone revenue if volumes return to higher levels.
- Capitalised losses to have a limited 5-year life (as per the QCA Draft Decision).
- Recovery of losses commences when the forecast revenue from the affordability-based reference tariffs exceeds the total revenue requirement.
- While losses are being recovered, reference tariffs will remain capped at the affordable reference tariff, but subject to this requirement, will be reduced to the greater of (i) the building blocks price plus a premium of 15% or (ii) the tariff that would result in recovery across a 15-year period, based on future forecast volumes.

Please do not hesitate to contact Alistair Baben Der Erde if you have any queries in relation to this submission.