



Peabody Energy Australia

Response to DBCTM's submissions on
the QCA's draft recommendation

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1 Executive summary

- 1 Peabody Energy Australia (**Peabody**) thanks the QCA for this opportunity to respond to the submissions made by DBCT Management (**DBCTM**) in response to the QCA's draft recommendation for continued declaration of services at the Dalrymple Bay Coal Terminal (**DBCT**).
- 2 Peabody is a member of the DBCT User Group, and supports the detailed submissions made by the User Group in response to DBCTM's submissions. This brief submission is intended to supplement the User Group's submissions, by providing additional information and comments which reflect Peabody's specific circumstances and experience.
- 3 Peabody is a major user of DBCT and a holder and trader of tenements in the Hay Point catchment region. We are therefore able to offer specific insights based on our experience in using DBCT and participating in dependent markets, including markets for coal tenements.
- 4 Over the past two decades, declaration of services at DBCT has delivered considerable economic benefits across the Goonyella supply chain. Declaration has provided for access to DBCT on a stable, transparent and non-discriminatory basis, with periodic common resets of the terms of access based on well-established, regulatory principles. The certainty provided for by this stable regulatory framework has in turn supported competition in dependent markets, and efficient investment across the supply chain. Indeed, the regulatory framework at DBCT is generally recognised as the most effective among Australian coal terminal access regimes.
- 5 In a context where declaration has delivered significant benefits, the question is whether the removal of declaration would see less opportunities for competition to be promoted. If the opportunities and environment for competition in any dependent market would be diminished with the removal of declaration, then it must follow that criterion (a) is satisfied.
- 6 DBCTM has proposed to replace the highly successful regulatory regime with:
 - (a) a deed poll / access framework that has been stitched together late in the process and which strips the regime of its key elements, such as transparency, predictability and oversight by an experienced regulator;
 - (b) a pricing framework which is likely to require a series of costly disputes to establish pricing for any new users of the terminal;
 - (c) principles governing pricing that are uncertain and likely to give rise to disputes, since they ultimately require determination of the TIC that would be set by the QCA; and
 - (d) a cynical attempt by DBCTM to second guess what level of monopoly margin it should be allowed to obtain to stay just under the radar for regulation.
- 7 The DBCTM deed poll and access framework clearly do not offer prospective users the same degree of certainty as the existing regulatory framework. In particular:
 - (a) despite the apparent attempt by DBCTM to cap its monopoly rent at \$3 / tonne above a self-regulated TIC charge (which represents a premium of approximately 121% in addition to the current TIC¹), there would be a high degree of uncertainty around pricing for prospective users under DBCTM's access framework;

¹ Current Terminal Infrastructure Charge (TIC) as at March 2019 is A\$2.4766

- (b) removing access to dispute resolution by the QCA – an independent, experienced and transparent regulatory authority – would create uncertainty around the determination of any future disputes;
 - (c) remedies and enforcement options would be much more limited under the DBCT access framework; and
 - (d) more broadly, there would be a high degree of uncertainty around the future operation of the access framework, given the scope for DBCTM to amend it over time.
- 8 Basic NPV analysis demonstrates that a \$3 per tonne price cap above the TIC (which would be based on a self-regulated building blocks WACC) creates an economic distortion of approximately A\$15M² for each 1 million tonnes of contracted port capacity required over a 10 year period. Assuming a realistic 4Mtpa operation and factoring the potential scope of price increases, then the economic distortion can conceivably be in excess of A\$100M~ (real) in respect of the premium. Unlike other mining costs and uncertainties, this is a form of material price distortion for which miners have no relative price offset.
- 9 Due to the uncertainty facing prospective users under DBCTM's access framework, efficient potential entrants into the coal tenements market are likely to be deterred, resulting in diminished competition for new coal tenements in a world without declaration. Peabody notes, in this regard, that most – if not all – of those parties that have acquired tenements from it in recent years have been new entrants or small users without existing DBCT access, and would be precisely the kind of market participants likely to be materially impacted by the costs and risks identified above. Given these recent experiences, Peabody considers that absent declaration, the market for the acquisition of tenements over recent years would be have been materially less robust and competitive.
- 10 In its submissions on criterion (b), DBCTM has once again erred in its approach to defining the relevant market, and has grossly overstated foreseeable demand. Among the errors made by DBCTM is a false link between the access queue (which represents a free option for access seekers) and current demand for services at DBCT. Once these errors are corrected, it is clear that DBCT is a natural monopoly facility, capable of servicing foreseeable demand at least cost.

2 Overarching comments on the DBCTM submission

2.1 Declaration has been (and continues to be) valuable – reflecting the most effective access model of any Australian coal terminal – and its removal will damage competition

- 11 The QCA's analysis of the declaration criteria in its draft recommendation is properly informed by the market and historical context. The QCA recognises how declaration at DBCT has delivered material benefits over time, and how it has shaped the industry structure.
- 12 By contrast, DBCTM's submissions largely ignore key aspects of this historical and market context. In its submissions on criterion (a), DBCTM fails to recognise the degree of certainty that has been provided to prospective users by transparent regulatory oversight from an experienced and independent regulatory authority. In its submissions on criterion (b), DBCTM largely ignores the way in which the industry structure has been fundamentally shaped by declaration.
- 13 Peabody considers that a proper analysis of the declaration criteria cannot proceed without a full understanding of the benefits that have been delivered by declaration to date. These

² Based on A\$3 per tonne for 1 Million tonnes over a 10 year period with a 15% return rate.

benefits extend well beyond merely constraining the prices that DBCTM may charge for terminal access.

- 14 In addition to price constraint, declaration has provided for:
- (a) a well-structured access undertaking which can only be amended with the QCA's approval;
 - (b) a common set of terms, and a single tariff reset across all users by an experienced and independent third party regulator;
 - (c) access to dispute resolution by the QCA; and
 - (d) structural and behavioural constraints on DBCTM, monitored and enforced by the QCA.
- 15 This has provided users (and prospective users) with a high degree of certainty around future terms of access, thus promoting efficient entry and investment. Common terms across all users (and QCA-administered common resets) have also provided for a 'level playing field' in key dependent markets, including the coal tenements market.
- 16 The success of the DBCT access regime is reflected in the fact that it has been used as a model for access regimes at other coal terminals. It is widely acknowledged that the DBCT access regime is the most effective among Australian coal terminal access regimes. It is for this reason that key elements of the DBCT regime have been adopted in other access frameworks.

2.2 DBCTM's attempt to construct a comparable counterfactual

- 17 DBCTM has put forward an access framework (supported by its deed poll) which it says "preserves regulatory certainty",³ without any involvement from a regulator. This is clearly false.
- 18 The late, cobbled together amendments to the deed poll demonstrate it is little more than a contrived attempt to circumvent criterion (a) by trying to guess the level of monopoly profits that will be permitted, while removing regulatory oversight. Rather than support removal of declaration, the fact that DBCTM has sought to adopt so much of the undertaking in its replacement deed reflects a begrudging recognition by DBCTM that certainty around the framework for determining the terms of access to its infrastructure over the last two decades has supported efficient investment and competition in dependent markets.
- 19 The deed poll and access framework do not (and cannot) achieve the stated purpose of preserving regulatory certainty. As discussed in section 3.2 below, DBCTM's proposed framework is substantially inferior to declaration and effective regulation by the QCA. Most obviously, under the proposed access framework there would be no regulator to oversee amendments to the framework, resolve disputes, or determine the terms of access for new users (including prices). Instead, these matters will be left to DBCTM's discretion, and to a series of time-consuming and costly arbitral processes. Clearly, regulatory certainty cannot be effectively preserved without the involvement of an independent regulator, and where key pricing and access matters are left in the hands of the monopoly service provider.
- 20 More fundamentally, Peabody would be concerned if the DBCTM deed poll and access framework were to be accepted as the relevant counterfactual. This could set a dangerous precedent for service providers to contrive counterfactual frameworks for the purposes of defeating the declaration criteria.

³ DBCTM submission, [401.2.2].

- 21 As discussed below, a particular concern for Peabody relates to the scope for DBCTM to amend its access framework. This greatly undermines the relevance of the access framework, as included with DBCTM's submission to the QCA, as an indicator of the likely state of affairs in the absence of declaration. Given the scope for DBCTM to amend its access framework, it should not be assumed that it will continue to operate in the form that it has been submitted. Rather, it would be reasonable to assume that DBCTM would seek to amend its framework in ways that allow it to exercise its monopoly power.
- 22 DBCTM is effectively asking the QCA to accept that it can mimic regulation through the deed poll and access framework. This submission must be rejected. Where a monopoly service provider has the ability and incentive to exploit its position in ways that are damaging to competition in dependent markets, there is no substitute for proper regulatory oversight. DBCTM should not be allowed to sideline the QCA by putting forward a contrived framework for self-regulation.
- 23 It is telling that DBCTM is working so hard in its attempt to have declaration removed and replaced with its deed poll / access framework. This suggests that DBCTM anticipates that it will have much greater freedom under its deed poll / access framework, compared to the status quo. Of course, the corollary of greater freedom for DBCTM will be greater uncertainty for prospective users.

2.3 DBCTM's attempt to shift the goal posts late in the process

- 24 Peabody is also concerned by the manner in which DBCTM has significantly changed its position over the course of the QCA inquiry. DBCTM is of course entitled to respond to issues that are raised by the QCA and other stakeholders. However DBCTM has gone much further than this, seeking to re-frame the QCA's inquiry by substantially amending the access framework which it seeks to have considered as the counterfactual.
- 25 Through substantial amendments to its deed poll and access framework, DBCTM has sought to shift the goal posts for satisfaction of the declaration criteria. This further highlights the risk of setting a precedent whereby access providers are able to construct a counterfactual for analysis of the declaration criteria.

3 DBCTM's submissions on criterion (a)

3.1 Access framework is not the appropriate counterfactual

- 26 DBCTM argues that its deed poll and access framework should "*put beyond doubt*" that it cannot act in any way that will adversely impact competition in relevant markets in a world without declaration.⁴ This submission appears to proceed on the assumption that the deed poll and access framework as submitted by DBCTM represent the appropriate counterfactual for assessing the likely state of competition in dependent markets in the absence of declaration.
- 27 Under the deed poll, DBCTM may amend the framework from time to time, so long as these amendments promote the Framework Objective, and provided that DBCTM has had regard to certain "mandatory considerations".⁵ In making any amendments, DBCTM would have a level of discretion that is akin to that exercised by the QCA in approving access undertakings (or amending access undertakings) under the QCA Act. Challenges to a DBCTM decision to make amendments would be limited to circumstances where the requirements of the deed poll have been breached – for example where a mandatory procedural step has not been taken, or where DBCTM has manifestly failed to take into account one of the mandatory considerations – and in

⁴ DBCTM cover letter [5].

⁵ DBCTM Deed Poll, cl 8.2.

such cases the DBCTM decision would need to be challenged in Court. In effect, DBCTM would play a role that is similar to the role currently played by the QCA in DAU / DAAU processes in considering amendments to its own access framework.

- 28 Clearly it is appropriate for the QCA, an experienced and independent regulator, to exercise discretion and judgement in considering amendments to access undertakings under the QCA Act. It is not appropriate for the same level of discretion to be conferred on a monopoly service provider in determining amendments to its access framework.
- 29 In light of the broad scope for DBCTM to amend its access framework over time, the framework as presented by DBCTM cannot be used as a basis for considering the likely state of affairs in the absence of declaration. Rather, it would be reasonable to assume that DBCTM would incrementally amend its access framework so as to allow it to exercise monopoly power in a way that is damaging to competition in dependent markets.

3.2 Access framework (even in its current form) is not an effective substitute for proper regulatory oversight

- 30 A key claim made by DBCTM is that its deed poll and access framework would “preserve regulatory certainty”.⁶ It appears to be suggested that, despite the absence of regulatory oversight in a world without declaration, the access framework would offer users a degree of certainty that is comparable to that offered by declaration and regulation by the QCA.
- 31 Peabody considers that the deed poll and access framework do not offer nearly the same degree of certainty as declaration and regulatory oversight by the QCA. In section, we highlight some key elements of the access framework which will create uncertainty for prospective users.

Price uncertainty under the deed poll

- 32 Under the DBCTM access framework, maximum prices would be set by reference to the TIC that “*would apply... under a QCA administered pricing regime*”, plus a \$3 per tonne monopoly rent allowance.⁷
- 33 Peabody has a fundamental objection to an access framework which locks in the ability to extract monopoly rent. In this case, DBCTM is seeking to make an explicit allowance for a premium of around 121% over and above its current efficient costs.
- 34 Putting this to one side, we note that the mechanism for setting prices under the deed poll / access framework would be highly uncertain and leave room for gaming by DBCTM. The reference point is the TIC that “*would apply... under a QCA administered pricing regime*”. There is clearly scope for argument around the approach that *would be* taken by the QCA on matters such as the rate of return, and hence uncertainty around what prices would be offered by DBCTM under this framework. There would be the potential for DBCTM to inflate key inputs into the ‘base TIC’ calculation, in the knowledge that QCA oversight would not be available.
- 35 Ultimately, given the scope for argument, it is likely that pricing under the deed poll / access framework would be driven by the outcome (or expected outcome) of disputes. This may be contrasted with a world in which declaration continues and pricing for all users is determined through a transparent and rigorous undertaking review process.
- 36 Therefore, price uncertainty would be amplified by uncertainty around the outcome of any disputes under the access framework, and a lack of transparency around these outcomes.

⁶ DBCTM submission, [18], [401.2.2].

⁷ DBCTM Deed Poll, cl 6.1.

Resolving the terms of access is therefore likely to become a time-consuming and highly uncertain process for prospective access seekers.

Dispute resolution

- 37 The access framework includes a mechanism for resolution of disputes, ultimately by arbitration.⁸ However, from Peabody's perspective, this mechanism is far inferior to the mechanisms currently available under the QCA Act.
- 38 Currently, users have access to dispute resolution by the QCA under Part 5 of the QCA Act. Access to dispute resolution by the QCA offers a degree of certainty to current users, given the transparency and rigour around the QCA's approach and its track record in dealing with complex access matters. Put simply, the QCA is a 'known entity' – it can be relied on to be consistent and rigorous in its approach to determining access matters.
- 39 Moreover, the set of matters potentially subject to dispute is currently relatively limited, at least in practice. Most matters – including the access price – are dealt with through the QCA's review of access undertakings.
- 40 Under the DBCTM access framework, a broader range of matters (including pricing) would be subject to dispute, and these disputes would no longer be determined by the QCA. Accordingly, the scope and scale of uncertainty around the future terms of access will greatly increase.

Impact of uncertainty

- 41 DBCTM seeks to down-play the impact of uncertainty for prospective users under its proposed access framework. It is claimed that "*miners face far greater uncertainty from a number of more significant factors*" and that uncertainty regarding the terms and conditions of access at DBCT could not be so significant as to deter potentially efficient new entry in the coal tenements market.⁹
- 42 DBCTM also says that it would be "absurd" to suggest that a \$3 per tonne price differential as between existing and new users could result in a material adverse impact on competition in the coal tenements market.¹⁰
- 43 The absurdity of DBCTM's submission is the focus on a cap of A\$3.00/tonne above a self-regulated building blocks methodology that can clearly be gamed to ensure that the base price or "starting position" is always at the highest point that the QCA might approve in a favourable market. In this regard, the monopolist price is not A\$3.00/tonne it is an unknown amount that could conceivably, on Peabody's estimation, be 300% or more of the current TIC. Given that the current TIC is based on efficient costs – that amounts to a substantial concession that DBCTM would be permitted to engage in monopoly pricing.
- 44 The effect of removing declaration would go well beyond a potential increase in the access price of \$3 per tonne. The \$3 per tonne increase cements a cost increase that has an effect that is twofold.
- (a) First, it sets a (high) cost into the cost assumptions for a mining project, where that cost has no offset capacity. While many operational mining costs have trade offs (e.g. an increase in an operational cost can be offset/mitigated by a capital cost), the implied port

⁸ DBCTM Access Framework, cl 16.

⁹ DBCTM submission, [190.4].

¹⁰ DBCTM submission, [347].

cost has no alternative or effective offset. It therefore becomes a firm cost in the cost methodology for a mining operation.

- (b) Second, the assertion that port pricing is not of material value to a mining project becomes a complete fallacy. By fixing the \$3 value, DBCTM has removed any doubt about their intentions to charge monopoly pricing for access to the port, absent declaration – given that this would reflect over 300% of the current rate and an increase of over 200% to the total current cost (TIC and operational cost defined as HCV and HCF).
- 45 From Peabody's perspective, uncertainty around future terms of access to port facilities is a key consideration in assessing potential future investments in coal tenements. The cost of uncertainty can be very high, in terms of its impact on the value of coal tenements.
- 46 Basic NPV analysis demonstrates that a \$3 per tonne price cap above the proposed self regulated building blocks WACC creates an economic distortion of approximately A\$15M¹¹ for each 1 million tonnes of contracted port capacity required over a 10 year period. Assuming a realistic 4Mtpa operation and factoring the potential scope of price increases, then the economic distortion can conceivably be in excess of A\$100M~ (real). This is price distortion with no relative price offset.
- 47 Where new users face this greater uncertainty than existing users, this will materially distort the market for coal tenements. In particular:
- (a) a more efficient new entrant may place a lower value on a tenement compared to a less efficient incumbent, purely due to the cost of uncertainty faced by the new entrant; and
 - (b) the value of presently saleable tenements is likely to be diminished, due to the erosion of value for potential new entrants from uncertainty around the terms of access to DBCT.
- 48 For existing users, this has the effect of diminishing the value of existing saleable tenements (including to the point of removing all residual value) because it reduces the number of likely buyers and the amount of competition in the market for tenements. Peabody notes that many, if not all, of the parties that have purchased tenements from it over recent years have either been new entrants or small users that did not have pre-existing DBCT access and which would therefore face the full effect of the price increases described above. Based on its direct recent experience in the tenements market, Peabody considers that an increase in the costs of port access of this magnitude – together with significant uncertainty about the future cost and terms of access – would have been highly likely to have adversely affected the number of potential buyers of those tenements and therefore the level of competition in the market.

3.3 DBCTM's incentive to maximise profit

- 49 DBCTM claims that that it will face "*strong incentives to maximise demand for the use of its services and promote efficient investment irrespective of declaration*".¹² It is said that, due to this incentive to maximise demand, declaration does not result in a materially different environment for investment in dependent markets.
- 50 This submission conflates the incentive for a monopoly service provider to maximise *profit* with maximisation of demand for / use of its services. A profit-maximising monopolist will not necessarily seek to maximise demand for its services. Indeed, to the extent that the marginal

¹¹ Based on A\$3 per tonne for 1 Million tonnes over a 10 year period with a 15% return rate.

¹² DBCTM submission, [401.2.4].

revenue from incremental use is less than the marginal cost, it would not be rational for the monopolist to do so.

- 51 Therefore it cannot be assumed that DBCTM will always face incentives to maximise demand for use of its services, particularly where it faces capacity constraints. Accordingly, declaration and effective regulation is important for promoting efficient investment and competition in dependent markets.

3.4 Relevance of DBCT being fully contracted

- 52 DBCTM states that DBCT is now fully contracted. It is argued that, as a result, there is no prospect that a potential new entrant to the coal tenements market could gain access to DBCT with or without declaration, and therefore declaration will have no impact on competition in this market.¹³
- 53 This submission reflects a gross misunderstanding of how markets for coal tenements operate. Coal tenements are typically acquired well in advance of planned production and export, as they can take several years to develop and start production. This is because, before production can commence, further development work, planning and regulatory approvals are required. Therefore, a decision to invest in a coal tenement with expectations around *future* capacity and access terms. A miner may well seek to invest in a new tenement notwithstanding current port / rail capacity constraints, if it is expected that capacity will be available in future.
- 54 Given lead times for tenement development, it is likely that new entrants will seek coal tenements over the proposed term of the declaration, notwithstanding any immediate capacity constraints at DBCT. Over this period, competition for new tenements will be materially distorted if those new entrants face the prospect of higher port access costs and/or greater uncertainty around the future terms of access to DBCT.

4 DBCTM's submissions on criterion (b)

4.1 Relevance of the queue

- 55 DBCTM's submission erroneously treats requests for capacity in the access queue as reflecting "foreseeable demand" in the relevant market. DBCTM considers the access queue to be "*probative evidence of the minimum current unmet demand at DBCT*"¹⁴ and treats it as "*clear evidence that the level of demand in the market exceeds the existing capacity of DBCT*".¹⁵
- 56 The access queue does not represent unmet demand at DBCT. Being in the access queue is a "free option" for users, and does not necessarily reflect current firm demand for services at DBCT. Where capacity is actually required, there is the ability for users to "leap-frog" the queue and simply sign an access agreement. Until such time as an access agreement is signed for the relevant capacity, a request for capacity in the access queue cannot be seen as reflecting current unmet demand.
- 57 For the reasons set out above, while Peabody has previously been in the queue, it has removed itself. Peabody did not withdraw from the DBCT queue due to any change in operational or production decisions, but merely because in its experience the queue does not offer a producer any specific value or rights beyond acting as an intrinsic placeholder requirement for some organisations. Joining the queue at DBCT is a free option and one that can be manipulated

¹³ DBCTM submission, [390].

¹⁴ DBCTM submission, [2.3].

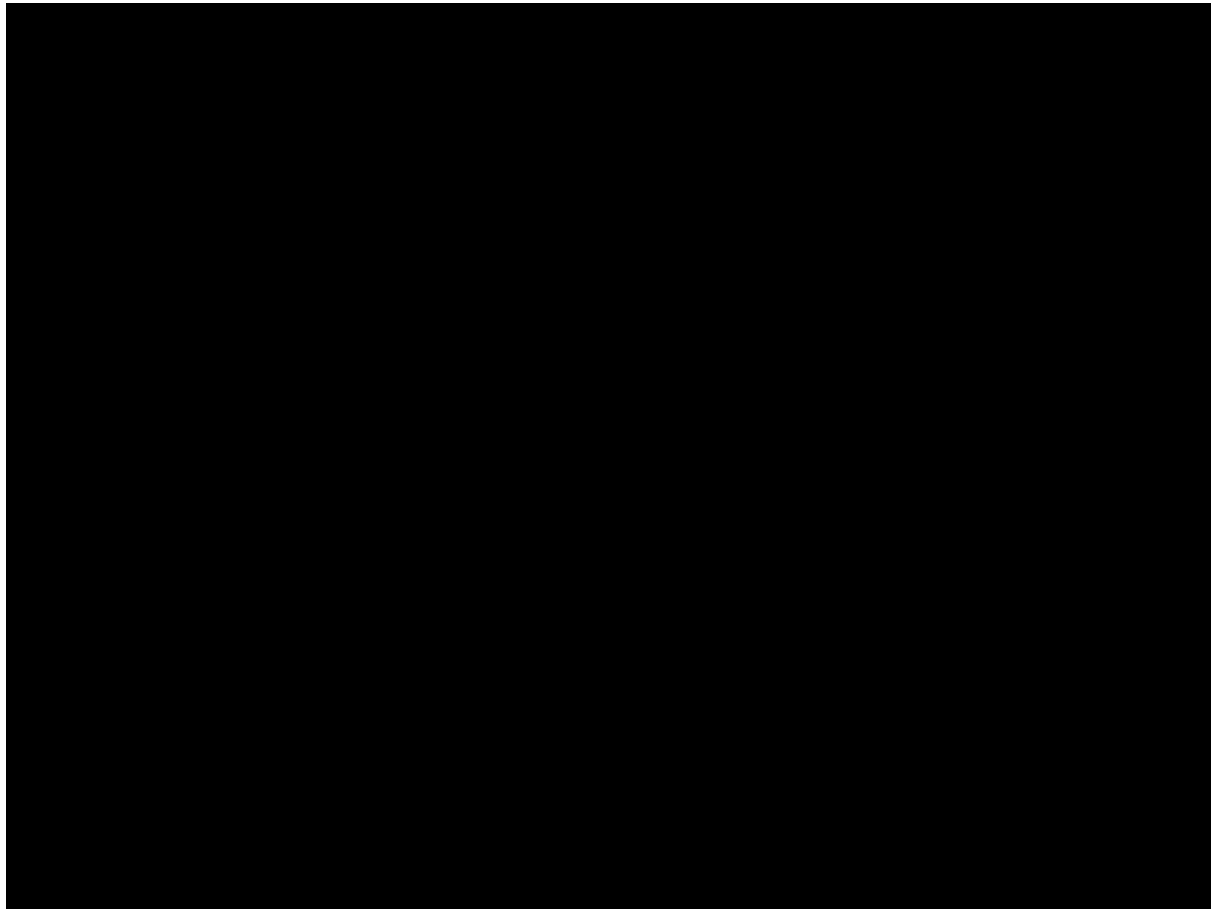
¹⁵ DBCTM submission, [38].

based on timing of the market. Peabody does not view the queue as an accurate or credible reflection of actual demand or production intentions.

4.2 Costs of rail access to DBCT and APCT, alone, demonstrate that demand for DBCT is distinct from other terminals

58 DBCTM's further submission continues to argue that the mere existence of producers utilising capacity at other terminals is evidence that DBCT does not operate as an effective natural monopoly.

59 Peabody certainly does not view any other terminal as an effective substitute for DBCT. Peabody agrees with and supports the various practical and commercial features identified in the DBCT User Group submission as distinguishing DBCT from other Queensland terminals.



5 DBCTM's submissions on criterion (d)

62 DBCTM's submissions on criterion (d) rely heavily on its position in relation to criterion (a). DBCTM repeats its claim that its access framework would "*preserve regulatory certainty*", and argues that declaration would therefore not result in a materially different environment for investment and no material economic benefits.¹⁶

¹⁶ DBCTM submission, [401].

- 63 The deficiencies in the DBCTM access framework, and the resulting uncertainty for potential new entrants, are addressed above and in the User Group submission. As explained above, Peabody considers that the impact of uncertainty on investment is likely to be very significant.
- 64 More broadly, DBCTM fails to recognise the economic benefits that have been delivered over the past two decades by declaration and effective regulatory oversight. These benefits have been widely recognised, not just by users of the terminal, but also by the Queensland Government and other stakeholders.¹⁷ Indeed, as noted above, other access regimes have sought to incorporate key elements of the DBCT regulatory regime, in an attempt to replicate some of its economic benefits. These benefits are unlikely to be maintained in a world without declaration, given the risk that DBCTM would exercise its monopoly power in ways that are damaging to competition and investment in dependent markets.
- 65 DBCTM also repeats its complaint regarding the administrative and compliance costs of regulation, and the risk of “regulatory error”. Peabody considers that the costs of effective regulation are likely to be dwarfed by the cost of disputes that would arise under DBCTM’s access framework, including likely disputes around pricing and framework amendments. Similarly, the cost of any “regulatory error” is likely to be small when compared to the cost of DBCTM exercising its market power in determining terms of access. In any event, these costs will be small compared to the economic benefits of effective regulatory oversight.
- 66 Peabody supports the finding of the QCA in its draft decision that, on balance, declaration would promote the public interest.

¹⁷ For example: Queensland Government, *Application to the National Competition Council for a recommendation on the effectiveness of an access regime: Queensland third party access regime for coal handling services at Dalrymple Bay Coal Terminal*, December 2010.