THE IMPORTANCE OF GOOD POLICY AND EFFECTIVE REGULATION

By Michael Roche
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The Premier’s Queensland Plan Summit in October was the culmination of a valuable process for the QRC in mapping out our 30-year vision for the Queensland resources sector.

Assuming the feasibility of maintaining market share in rapidly evolving markets like gas, the resources sector in Queensland could treble in size over the next three decades, becoming a $100 billion export sector in today’s resources prices. The QRC vision, available on our website, www.qrc.org.au, shows how this can be achieved while balancing protection of the natural environment.

However, such growth is predicated on sound policy settings and efficient regulation including the competition laws governing monopoly operation of the state’s multi-user export infrastructure providers.

Regardless of business conditions, state and federal competition laws must reflect the public interest. They must ensure that prices charged by infrastructure providers are based on efficient costs, reflecting the provider’s risk profile and allowing for the legitimate business interests of the provider. Strong competition laws become critical when the provider is a natural monopoly; where there are attempts to extract monopolistic rents; and where access seekers have no countervailing negotiation power.

As our Value of Production Index on page two shows, coal production is on the rise but prices remain low because of global oversupply and a persistently strong Australian dollar. While many coal industry suppliers have risen to the challenge and have assisted companies in reducing costs and staying globally competitive, the same cannot be said for infrastructure providers.

A case in point is the recently privatised rail network provider - Aurizon, which is clearly working in a significantly different operating environment to its major customers.

In a draft submission to the Queensland Competition Authority (known as the 2013 Undertaking or UT4) Aurizon submits its tariffs should rise by an average of 36 percent on a dollar per net tonne basis compared with the last year of the 2010/UT3 undertaking.

This proposed hike in prices comes at a time when coal companies are cutting their discretionary costs deeply in a bid to restore some semblance of profitability or at least minimise losses in the face of weak prices for coal.

If approved, Aurizon’s pricing proposals would add $1.2 billion of additional costs on coal companies using the Central Queensland Coal (rail freight) Network (CQCN) over the four years from 2013-14.

Aurizon is also seeking regulatory approval for excessive returns despite being exposed to less commercial risk and the removal of previously hard-won protections against monopoly power under UT3 and previous undertakings.

UT4 is a critical document for the future of the Queensland coal industry. If Aurizon’s draft undertaking is not substantially revised through negotiation or regulation, the competitiveness of the coal industry’s current operations and future investment pipeline will be severely compromised.

Investors will not risk an environment where monopolistic powers of a key supplier are unchecked. They have every right to seek a stable, certain and fair operating environment in Queensland.

QRC is prosecuting the coal industry’s concerns with vigour through the Queensland Competition Authority and the Queensland Government.

This issue - noting the importance of strong competition laws, the economic risks, and a summary of changes proposed by QRC to UT4, is discussed further in our feature article on page three.

For more detailed information, refer to QRC’s UT4 submission with the Executive Summary and covering letter to the QCA on the QCA’s website: www.qca.org.au.

In addition to the ‘friendly fire’ from key suppliers that is confronting QRC coal members, all of our members reliant on access to shipping to and from ports adjacent to the Great Barrier Reef (GBR) continue to be confronted with the most deceitful of extremist NGO campaigns, designed to convince the World Heritage Committee of UNESCO that the GBR should be declared ‘in danger’. The mettle of our new federal environment minister is being tested as he considers some crucial environmental approvals in the face of these deceitful campaigns.

The QRC is working overtime to ensure that Australian and Queensland agencies, including key diplomats, are
working to promote the facts about the Great Barrier Reef with the international community. We have also enlisted the invaluable support of international industry bodies such as the International Council on Mining and Metals and the World Coal Association.

Closer to home, our sector’s opponents are making full use of the generous opportunities available to them to disrupt and delay projects through vexatious objections in the Courts. This is an area always ripe for reform by the state and Australian governments.

**KEY INDICATORS**

**QRC PRODUCTION INDEX**

The QRC production index is a composite weighted index that tracks percentage increases and decreases in the total production of Queensland bauxite, alumina, aluminium, coal, copper, gold, lead, silver, and zinc quarter to quarter.

Weightings are on a value of production basis; hence changes in coal production (representing 70 percent of the Queensland resource sector’s total value of production) have a proportionately larger impact on the index than changes in silver production for example (representing just 5 percent of total value of production). Note - because Queensland is not yet producing significant quantities of additional coal-seam gas this output has not been included.

The index at the end of the June 2013 quarter (latest available data) reached a record 122 points. This is an increase of 16 percentage points from the March 2013 quarter (June 2006=100). Coal exports increased from 42 Mt in the March quarter to 49.3 Mt in the June 2013 quarter. The largest increases were experienced at Hay Point and Gladstone. Coal exports in 2012/13 reached 180 Mt, up 9 percent from the 165 Mt achieved in 2011/12.

A number of commodities including alumina (1116kt to 1492kt), aluminium (139 kt to 140 kt), bauxite (5793kt to 6800kt), lead (102kt to 105kt), silver (350t to 397t) and zinc (219kt to 279kt) also recorded higher production volumes over the June quarter. Only copper (75kt to 68kt) showed a decrease in production. Production for gold remained static at 4t.

**PRICE OUTLOOK**

While traded volume growth rates for coal remain high as countries like China and India take advantage of weak prices, global prices for thermal coal continue to trend downwards due to significant oversupply as new supply enters the market. More positively prices for metallurgical coal are rebounding slightly.

Regarding thermal coal, Australian producers have settled September-expiry Japanese Power Utility (JPU) contracts at $85.80/t FOB. This is a step down from the $90/t benchmark for larger tonnage June-expiry JPU contracts, and is inching more close to current spot
levels for similar spec product of around $77/t in early September (basis is 6000kc).

Regarding coking coal, semi-soft negotiations for the October–December quarter (Q4) between Australian sellers and Japanese buyers have concluded at a price of $105.50/t FOB, up marginally on the Q3 price of $105/t FOB.

Japanese and Korean benchmark hard coking coal prices for Q4 appear to have settled at $152/t for premium hard coking coal. This is a $7/t increase on Q3 prices.

In relation to metals, prices are expected to continue to weaken given the slowing of the Chinese economy, lower than anticipated global economic growth and oversupply.

Prices for domestic gas are also expected to continue to increase in line with tight supply, increasing export prices and increasing discovery and conversion costs.

**UT4 SHORTCOMINGS AND SOLUTIONS**

While competition benefits society, so-called ‘natural monopolies’ mean that competition is not always practical.

It is in such circumstances that regulation is required to encourage efficient outcomes.

Regulation takes various forms but the key objective is to redress inequality in bargaining power between dependant users and monopoly service providers and to prevent the misuse of monopoly power.

Under Queensland’s competition laws, the owner or operator of a ‘declared’ service (ie a natural monopoly) can be required to submit a draft access undertaking to the Queensland Competition Authority (QCA) for determination and approval. The QCA enjoys the power to approve a draft access undertaking having regard to various factors.

On 30 April 2013, Aurizon submitted its voluntary draft access undertaking (UT4) to the QCA. UT4 is the mechanism by which network or ‘below rail’ access charges will be determined from 1 July 2014 for four years across the Central Queensland Coal Network (CQCN) (ie Newlands, Blackwater, Goonyella and Moura lines).

These systems are the lifeblood of the Queensland export coal industry. They facilitate enormous economic benefits today and potentially much more in the future:

- CQCN currently moves more than 180 million tonnes of coal a year with an export value of more than $23.5 billion.
- Helping to deliver $2.4 billion in annual royalties to the state government and company and income taxes to the federal government.
- Facilitating the direct employment of 26,000 workers, and significantly, 220,000 more people indirectly as a result of $19 billion in goods and services purchases from Queensland businesses (opex and capex) and the expenditure of related salaries.
- Integral to $50 billion of potential new mine development in this area of Queensland.

UT4 is wholly unacceptable to the coal industry. In conjunction with other structural cost issues, it will slash the competitiveness of current operations and curtail future investments.

On behalf of the coal industry, the QRC is concerned that:

- An obligation to invest in expansion projects valued at less than $300 million at the regulated rate of return has been removed. Furthermore, the proposed expansion processes will give Aurizon effective control over which mines develop and when, regardless of whether industry has a user-funding proposal in place.
- The User Funding model (SUFA) promised under UT3 remains in development, as does an incentive regime.
- Regulatory oversight of the mechanism Aurizon uses to capture above-regulatory returns (‘Access Conditions’) has been removed. The QRC considers Aurizon should be prohibited from seeking above-regulatory returns until a viable suite of expansion funding obligations is developed.
- Aurizon is seeking a cost of capital (WACC) of 8.17 percent. QRC’s expert advice supports a WACC of 5.65 percent. The WACC is a critical component in working out the maximum revenue AN can earn, and in turn, what the access charges are for each coal network system.
- Proposed maintenance and operating cost increases of 28 percent and 44 percent - greater transparency and contestability in service provision required.
- Tariff increases of an average 36 percent on a dollar per net tonne basis compared with the last year of the 2010 access undertaking. This is an average increase of $300 million in annual costs to industry from 2013/14 to 2016/17 (when industry was expecting lower tariffs from privatisation efficiency dividends and a considerably lower WACC).

The QRC is seeking a number of improvements to UT4:

- Access charges should be based on efficient maintenance and operating costs and on a WACC genuinely reflecting the low risk profile of Aurizon’s business.
- More prescriptive, objective and efficient expansion
Written and prepared by the Queensland Resources Council which is the peak representative body for more than 300 companies with interests in the state’s minerals and energy sector. The data and information for this publication is sourced from a number of public sources - notably members directly, mccloskeycoal.com, the Bureau of Resources and Energy Economics and the Australian Bureau of Statistics. For more information, contact the Queensland Resources Council on (07) 3295 9560 or www.qrc.org.au.

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