28 June 2013

Mr Mark Scanlan
Queensland Competition Authority
GPO Box 2257
Brisbane Qld 4001

By Email: To: mark.scanlan@qca.org.au

Dear Mr Scanlan,

QCA Pricing Principles Review – Capacity Expansion and Access Pricing for Rail and Ports

Vale Australia Pty Ltd (**Vale**) welcomes the opportunity to provide a submission on the Queensland Competition Authority's (**QCA**) review of the pricing principles for regulated firms. The QCA has released discussion papers as part of this process and this submission deals with the paper on Capacity Expansion and Access Pricing for Rail and Ports.

Summary of Paper

This paper investigates options for pricing access to major expansions of capacity for rail and port infrastructure in Queensland. The paper considers the circumstances in which access to one tranche of capacity should be priced the same or differently to another and identifies that a regulator needs to consider the objectives of economic efficiency, fairness, and regulatory governance when making a pricing decision. Vale notes the scope of this paper is based on pricing of access for major investments and pricing for access involving minor or incremental works is not considered in these pricing principles. The paper outlines that major expansions in Queensland logistics infrastructure require significant sunk costs of capital by the access seeker and the access provider, therefore, the common practice has been for parties to agree long term access contracts for volumes and rely on the QCA to determine the price of this access.

The paper asserts that most access buyers are indifferent to the price. This is based on the current contracting situation where contracts are generally negotiated on volumes and the pricing of that contract is left for the QCA to determine. The negotiated contracted volume is generally made up of a take or pay component, which is approximately 90% of the volume, and the remaining capacity, is considered an optional portion. Under the current access undertaking any shortfall in the optional capacity will be made up in future years based on the access provider seeking to earn its regulated rate of return under the revenue cap methodology. The paper also states access pricing does not change the decisions of access seekers as the cost of the access service makes up a small portion of the price of coal. Due to this the paper suggests that quantities of access purchased would change little whether access was priced according to say, a two-part tariff, or an average cost price.

Based on the discussions, the paper has identified 3 options for pricing of access:

- A uniform average cost based access price is charged across existing and new capacity
- A separate higher access price would apply for each expansion reflecting the average total cost of each expansion
- Separate access prices would apply for existing and new demand.

Comments on Discussion Paper

The paper concludes that if capacity is contracted over the long term, the structure of access prices can be expected to have relatively little impact on behaviour once long term contracts are signed.

When contracting for infrastructure services there is likely to be an implied understanding that expansions may increase pricing, although most of the existing contracts were more likely developed in a time when it was expected that prices would decrease. The critical change now is that expansions are now likely to trigger higher prices and from the rail perspective Aurizon is now choosing to seek access terms and conditions outside the Access Undertaking. These two points are contributing greatly to the discussion on pricing and fairness of that pricing.

Vale supports the conclusion raised in the paper that suggests a hybrid approach between the application of a uniform average cost and a separate higher access price. Vale believes this is consistent with the previous methodology suggested by the QRC and also is reflective of the methodology being used by WICET. Vale believes that any expansion should be cost reflective to ensure economic efficiency and fairness to other access buyers. If a new major expansion is developed that will lower the access pricing of all then Vale believes it is appropriate to socialise this across all access buyers as it recognises the previous contributions that access buyers have made to develop the infrastructure. If a major expansion is developed that will raise the access pricing then the cost of that increase should be allocated to the access seekers causing the expansion, and not affect the existing users.

One of the examples provided in the paper to assist in the pricing discussion is the new GAPE development where the Goonyella users claim the GAPE traffic will cause congestion and reduce capacity on the system. The paper identifies that the key point is the consideration of the degree to which Aurizon's decisions have degraded the capacity of the Goonyella system. The existing RAB values might not be appropriate following a reduction in the capacity of the Goonyella system. During the current consultation process on the GAPE DAAU, Vale has raised concerns regarding Aurizon Network's proposal that does not recognise the value of the Goonyella assets and capacity that will be fundamental to the railing of coal from the Goonyella mines to the Northern Missing Link. Aurizon Network (previously QR Network) stated, on page 7 of the explanatory notes of the September 2012 GAPE DAAU, that they traded off capital costs with rolling stock configurations and operational parameters to minimise the overall infrastructure required for GAPE, whilst providing the most cost effective above rail solution.

Aurizon Network has stated on page 25 of the explanatory notes, of the GAPE DAAU, that it does not believe the GAPE users pay for any Common Costs of either Goonyella or Newlands System as the existing tariff is already more expensive than the tariff on these two systems. Vale believes this appears to be contradictory to the remainder of the GAPE DAAU which does not consider if the tariff is too high but rather reflects a "user pays" approach. Vale believes the level of tariff in relation to other systems should not be relevant in the consideration of whether there should be a contribution to Common Costs but rather the tariff should be based on the cost impact that the additional GAPE Train Services have on the existing systems to ensure it is cost reflective and maintains a "user pays" principle. Vale notes that in a similar situation of setting tariffs for the Indicative Access Service in the Hunter Valley the ACCC in its decision paper, (dated 17 October 2012, page 3), stated that "if producers were paying supply chain costs that did not accurately reflect the consumption of capacity by that producer, competition in the export of coal may be distorted". Further to this the ACCC noted that whilst this answer may contribute to a higher supply chain cost for some producers in the short term, to not do this would have a distortionary effect on competition in related markets. The upgrades to the Goonyella System were minimal which, Vale believes, implies that Capacity from the Goonyella System is being transferred to the GAPE users and therefore a reflection of this value should be allocated to the GAPE tariff if Aurizon Network is proposing a standalone system.

The SBR discussions in the paper raises the question of "Do existing users have any claim to unused train paths on the existing system, assuming these are at a lower cost than the train paths that would be added with an expansion of capacity on the existing system"? If so, what access prices should apply for these paths? In determining a response to this question, Vale has considered the impact of SBR on the Moura System, the impact of GAPE on the Newlands System and the impact of GAPE on the Goonyella System. Vale concludes that existing users have paid for, or continuing to pay for the used and unused capacity through their access charges. This does not necessarily give them a claim claim to unused train paths of the existing system, but there needs to be consideration for the costs that existing users have contributed to establishing these train paths. Vale believes that a mechanism such as providing a contribution to Common Costs to the existing system should provide recognition of this previous value paid by existing users. Vale believes this issue becomes more complex with the current proposal for GAPE to be established as a separate system. Previously contributing to Common Costs considered that new users will be operating in essentially the same manner as existing users and their expansion would likely contribute positively to capacity or pricing. Under the GAPE proposal the new users access the

Northern Missing Link via the Goonyella System, will operate in a different direction to the historical operating mode and the pricing will not reflect the additional tonnages as it will be allocated to a separate system. Vale believes, in this situation the traditional calculation of Common Cost contribution needs to be reassessed as there are likely to be less, if any, positive impacts on the Goonyella System. Under the current Aurizon Network proposal it suggests that the Goonyella assets be shared between the systems but no contribution is made by GAPE users to these assets now or even in the future. This results in a situation where Goonyella users continue to pay for Goonyella capacity being utilised by the GAPE users, even though they will not be able to gain access to this capacity now or in the future. Vale does not believe this result is a fair allocation of costs between the users.

Further, the paper states the structure of access prices will likely have little impact on an access buyer's behaviour if the cost of access makes up only a small proportion of the access buyer's overall cost or revenue.

Vale does not agree with the assertion that access pricing is a minor cost compared to the price of coal and therefore it is irrelevant. Coal prices have clearly been in what has been regarded as a super cycle of pricing in the recent past. Generally most market analysts agree that this pricing is not sustainable and as with most commodities when there is a spike in world prices, it introduces opportunities for substitution and the development of competing sources that were previously uneconomic with additional coal competing for market share. It is important that in evaluating the long term viability of a new project, the long term competitive market pricing efficiency will need to be considered and therefore a comparison to coal prices must be viewed against long term averages rather than any short term spikes as these will be temporary in a competitive market. The cost of logistics has and always will be a significant part of the consideration of the economic viability of a new or existing project. Logistics pricing by infrastructure owners relies on their natural monopoly position that exposes an access seeker to a potential misuse of that monopolistic power. Many other cost structures for a mine can be competitively tendered and therefore subject to an economically efficient price, however, the logistics costs in Queensland leaves access seekers continually exposed to a transfer of risk to the access seeker and the same time as an increase in the cost of access. This issue has created the current consideration of unfairness as it does not reflect the actions of an economically efficient pricing market.

Pricing of access for Rail and Port has become very topical as we have witnessed some very high profile logistics infrastructure projects such as the proposed Terminal 4 expansion in Newcastle, the proposed Multi Cargo Facility expansion at Abbot Point and BMA's Terminal 2 expansion also at Abbot Point either suspended or delayed due in part to the forecast costs of construction and access to these proposed projects. It is relevant to note that during the time from 2010 to 2013 the access charges for below rail in Goonyella have almost doubled yet the Brisbane CPI index, as quote by the ABS for March 2010 to March 2013 has only risen by approximately 10%. This also compares to DBCT, where the Terminal Infrastructure Charge has increased by approximately 13% over a similar period. Also of note is the recent reduction of the handling and access charge at PWCS by 35.6%. The rise in access charges has occurred when take or pay mechanisms have been strengthened and further risks has been transferred from Aurizon to Access Holders. Vale also believes that any comparisons of the magnitude of the cost of logistics compared to coal price must also consider the risk profile. A pure comparison of the dollar value does not reflect the security of revenue enjoyed by Aurizon under the revenue cap compared to the price volatility noted in the paper that a coal producer is subject to, in the competitive seaborne coal world market. The rise in coal prices over this last cycle has seen the introduction of many forms of energy substitutes for coal and often these substitutes also require significant sunk costs and once established are unlikely to be removed from the market which will impact on long term pricing of coal. This rapid increase in access pricing is placing more pressure on the long term sustainability of the coal mines in Queensland. Vale has seen this significant increase in costs, however, has not seen a corresponding increase in throughput and cost productivity from Aurizon to offset this change in pricing.

It is noted this rapid cost increase in the regulated environment corresponds with a frequent flow of cost pass through claims such as the flooding events in 2011 and the Blackwater electric traction DAAU, as well as Aurizon seeking additional terms and conditions to complete any major expansions of the network. This increase in cost claims has been highlighted further in the recent Aurizon Network 2013 Draft Access Undertaking, which is claiming substantial increases in costs across all the cost components use to determine the revenue cap and at the same time transfer more risk to access buyers. Vale believes that in a competitive market this approach would trigger the establishment of new players as this pricing approach is producing monopolistic rents. However, due to the natural monopoly that exists with the below rail infrastructure, the discussion of a return on investment commensurate with the regulatory and commercial risks involved, needs the assistance of the regulatory authority to resolve an economically efficient and fair outcome.

The other concern that Vale has identified with the increasing costs of the regulated firms is the level of governance of the use of contractors and the pass through nature of these costs. Vale is concerned that the establishment of some of these significant contracts to complete tasks are not subject to a rigorous competitive tender process to ensure that contracts are competitively priced. The cost pass through mechanism does not incentivise the regulated firm's to ensure this is the case. Vale believes there should be more transparency to the customers of these regulated firms on the methodologies and approaches to ensure prudency in the awarding of contracts as well as removal of potential conflicts of interest in the tendering processes. This issue is of even greater concern when the entity awarded the contract is a related party of the regulated firm. Vale is concerned that in some instances activities are being removed from regulatory oversight even though there is no genuine competitive alternative in the market. This allows the related company to achieve a non regulated return and then pass this cost through the regulated business. Vale believes this is a growing issue in the regulated environment and it would support an approach of greater regulated oversight on these issues.

CONCLUDING REMARKS

Vale supports the hybrid approach to access pricing as it believes this provides for the regulatory objective of being economically efficient and provides a level of fairness. Due to the increasing desire of Aurizon to seek to transfer the risks to access seekers it is becoming less attractive to socialise the costs as the negotiation of the terms and conditions are now confidential, as seen during the WIRP 1 and GAPE agreements. It is inappropriate to suggest these costs can now be socialised given that access holders not involved in these negotiations do not have an ability to negotiate the agreements or do not have access to the information. The question this raises for Vale is what should the risk profile of Aurizon be once the majority of the Regulated Asset Base is subject to these additional access terms and conditions? These agreements provide for further transfer of risk to a customer and therefore the risk exposure to Aurizon will be approaching that of a risk free asset and the access pricing should reflect a rate of return commensurate with the risk.

Vale is also concerned about the assertion that coal producers are indifferent to logistics costs due to the apparent small value relative to the coal price as asserted by Aurizon. Coal prices reflect a volatile competitive world market that is subject to new entrants in more competitive emerging countries and the possibility of substitution. These factors will generally contain prices as we have historically seen in the cyclic nature of the coal price. Vale believes the issues that needs to be considered is the lack of pricing pressure on a natural monopoly that is contributing to an ever increasing cost base for coal producers in Queensland. Of significant concern is the rapid increase in the cost of below rail access during a period where the below rail operator is transferring more risk to coal producers. When considering the cost of logistics it is important that risk is incorporated into this discussion as the level of risk will impact on existing and future access seekers.

For further information regarding this advice please contact myself on (07) 3136 0911.

Yours sincerely,

[redacted]

Bob Skuza
General Manager Logistics
Vale Australia Pty Ltd