28 June 2013

Mr Dan Kelley
Queensland Competition Authority
GPO Box 2257
Brisbane Qld 4001

By Email: To: dan.kelley@qca.org.au

Dear Mr Kelley,

QCA Pricing Principles Review – Regulatory Objectives and the Design and Implementation of Pricing Principles

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 Regulatory Objectives and the Design and Implementation of Pricing Principles.

Vale commenced coal operations in Queensland in 2007 through the acquisition of certain coal interests of AMCI. These coal interests included two operating mines in the Bowen Basin and other coal projects that are in various stages of development. Conditions of access to, and pricing of, essential infrastructure, such as gas, water, power, rail, and ports will be critical to the continued operation and development of these projects.

Summary of Paper

The QCA has released a paper on the Regulatory Objectives and the Design and Implementation of Pricing Principles. The QCA objective of this report is to propose a set of high level pricing principles for application to the monopoly activities regulated by the authority.

The paper states that regulation of monopolies is required as they often exhibit some combination of prices that exceed costs, costs that exceed efficient levels, quality of service levels that deviate from the optimum, inappropriate levels of investment, or slow rates of technological change. The paper states that previous pricing guidelines have focused primarily on the economic efficiency aspects of regulation with less focus on the issues of risk, fairness, and regulatory governance issues.

The allocation of risk between the regulated firm and its customers is an important aspect of efficiency. The paper cites recent research that provides useful insights into the economic relationship between economic efficiency and fairness. This research has implications for how regulators could address certain fairness issues and resolve conflicts among competing goals. It is acknowledged that an objective definition of fairness has not been defined but this has not stopped authorities making decisions that may require a determination about what is fair.

A competitive market model assumes that market participants have the ability to manage risk efficiently. In a regulated environment the question is asked whether a regulator should care about the allocation of risk which potentially exposes the firm's investors to revenue risk. The CAPM assumes that investors can diversify away certain firm, or industry specific risks by holding a diverse portfolio of assets. Therefore why shouldn't a regulator leave the regulated firm and customers to manage such risks through market mechanisms? The paper notes three important reasons why such an approach might not be optimal:

1. problems associated with a natural monopoly can also result in sub-optimal risk allocation. The regulated firm is likely to have greater bargaining power than a group of customers. This asymmetric bargaining position might enable the firm to pass more risk to its customers than is efficient because investors are concerned only with how the risk in question affects their returns and not about how it affects customer's welfare.

2. investors cannot diversify away aggregate or macroeconomic risks, as they affect the entire economy.

3. regulatory pricing mechanisms such as two part tariffs, linear prices, and revenue caps, affect the allocation of risk among stakeholders. Choosing a pricing mechanism, therefore, implies an allocation of risk.

The discussion paper states that an important result from the economics literature on risk preference is that the risk should be allocated in inverse proportion to each party's respective degree of risk aversion. An important implication being that unless one or more parties are completely averse to a risk, then parties should share the risk in some proportion. The QCA discussion paper addresses these recent discussions in understanding the relationships between economic efficiency, risk, fairness, and governance and develops a set of high level principles to guide the development of more detailed pricing principles for regulated firms.

Criteria 1 - Economic Efficiency

The Act requires the QCA to consider when determining economic efficiency a number of economic and non-economic objectives. The paper notes there are three types of economic efficiency: allocative, productive, and dynamic, and a competitive market is the best mechanism for achieving efficiency because prices tend towards marginal cost. Marginal cost is defined as the additional resources required in producing one more unit of output or the resources saved by producing one unit less. In competitive markets, if the price paid is above cost, a competitor will enter the market to exploit the profit opportunity. This level of efficiency is not feasible in a regulated environment which is characterised by large sunk costs that effectively prohibit costless entry and exit. Unconstrained pricing in these markets will lead to prices well above marginal costs. The role of a regulator whose objective is to promote economic efficiency in natural monopoly markets is to set prices, or provide the regulated firm with incentives to set prices that achieve efficiency objectives.

It is noted that economic efficiency also requires the optimal allocation of risk. It is proposed that in general, some form of risk-sharing between the firm and its customers is almost always more optimal than an extreme one-sided allocation. The concern is that a regulated firm reduces the risk to such an extent that it is not incentivised to help mitigate this risk. As the paper notes, the impact of risk allocation must be considered when determining the beta parameter in the Capital Asset Pricing Model (CAPM), used to determine the cost of capital.

Vale supports this view that an economic efficient outcome is achieved if there is risk sharing between the parties and that risk is reflected in the equity beta used in the CAPM. Vale believes this is becoming a critical consideration in the long term development of regulatory pricing in an environment where the regulated firms are being privatised. Vale has had concerns for some time regarding regulated businesses transferring risk to customers without any apparent recognition that this reduces the non-diversifiable risk of the business. These concerns are amplified by such entities capturing, through a variety of methods, returns which are in excess of the approved WACC. We now face a situation where the WACC is arguably set at a level which reflects a risk profile which no longer exists, actual returns (or, from a customer's perspective, costs) are higher again, while customers bear the cost of the risks which have been transferred from the regulated entities.

Vale believes the use of a revenue cap form of regulation provides a very clear reduction of revenue risk to a regulated firm. Vale sees this position being strengthened even further with cost pass through mechanism, strengthened take or pay provisions, earlier depreciation periods, and yet there is still a reluctance of regulated entities to invest unless they are provided with terms and conditions above these regulated settings. Vale is concerned, that as the paper identifies, that the transfer of risk is now causing a sub optimal pricing mechanism. The pricing structure has moved the risk to an extent that it neither provides certainty for regulated pricing nor promotes future investment in the upstream and downstream markets as it allows the natural monopoly to gain monopolistic rents.

Criteria 2 - Fairness

The paper notes that there is no objective definition of fairness established but this has not stopped authorities making decisions that may require a determination about what is fair. Social norms can be used to determine what is considered fair. The paper notes that the objective of fairness is applicable not only between the regulated firm and its customers but between the customers as well.

Vale supports the principle that the actions of one customer should not adversely affect another. Vale believes that the pricing principles should be cost reflective to ensure that each user is accountable for the cost they impose. Vale believes this cost reflective principle will incentivise customers to seek an efficient transaction because they are exposed and consider the full cost of their decisions. If a socialised approach to pricing is taken it is likely to lead to inefficient decisions as the total impact of these decisions are not being contemplated by the customer in its decision making process.

Vale believes the issue of fairness between a regulated firm and its customers relates to the allocation of risk and the return provided to the regulated firm. In a robust competitive market this trade off between the elements of risk and return will be negotiated between the parties within an environment of competitive tension. As highlighted in the paper, this competitive tension is not present between a regulated firm and its customers and runs the risk of decisions not achieving a fair outcome.

Criteria 3 – Regulatory Governance and Practice

Vale believes the application of these social norms to a regulated environment would suggest that the setting of regulated rules, such as an undertaking should be based on the spirit of the document and not be reopened throughout the term. To this extent Vale believes that a review event or the trigger to allow a reopening of the undertaking should be very restrictive. Making changes to one particular point without consideration of the rest of the document and subsequent change in risk profile is neither efficient nor fair, especially when only one party may be allowed to initiate a change. It is unlikely these changes will consider any potential trade-offs that were made, between risk and return, during the initial setting of the undertaking. Vale believes that once an undertaking is set it forms a contract between the service provider and its customers. In a competitive environment when a review event on a contract is triggered the final outcome is likely to involve some trade-off between risk and return by both parties to achieve the desired outcome of the original review event. Vale believes the trend in regulated review event generally only considers the risk of one side of the transaction and does not provide an efficient or fair solution.

Vale believes the current Aurizon Network regulatory environment has become increasingly inefficient due to their belief that their return does not compensate for any risks at all, yet at the same time it is requesting an increase in its return. This has created a high level of tension between Aurizon Network and its customers resulting in continual disagreements on the proposed outcomes. Vale believes the regulated governance must be able to adequately deal with this situation of identifying the transfer of risk with a reduction in returns. The maintenance of this tension, between risk and return, by the regulator would act to simulate a competitive market. If a regulated firm continues to pursue an agenda to transfer risk this must be countered by an appropriate reduction in the return to reflect an economically efficient market experience. Vale also believes this is adjustment in return is consistent with the pricing principles under Section 168A(a) of the QCA Act.

CONCLUDING REMARKS

Vale supports many of the propositions contained in the QCA's discussion paper. Regulation of the pricing of these essential pieces of infrastructure is vital to the resources industry given an infrastructure provider's monopolistic position. To ensure the continued viability and competitiveness of the Queensland coal industry Vale believes that it is important to ensure an appropriate relationship between risk and return when considering the pricing principles. Vale believes that the QCA's regulated governance must support a process that includes a creditable incentive to a regulated firm to ensure an economically efficient and fair decision is made on pricing. Vale is concerned this is not being reflected in the current environment which is causing inefficiency with the development of pricing between customers and Aurizon Network. Aurizon Network is seeking a risk free environment yet is still pursuing an agenda for higher returns. Vale believes this situation is the exact reason why regulation has been established as a competitive market would not allow a reduction of risk with a higher return as it would encourage other entries to the market or substitution. Vale believes it is important for the QCA to consider these issues given the monopolistic position of the services provided by these essential pieces of infrastructure.

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

Yours sincerely,

[redacted]

Bob Skuza
Manager Logistics
Vale Australia Pty Ltd