17 February 2014

Dr Malcolm Roberts
Chairman
Queensland Competition Authority
GPO Box 2257
Brisbane Qld 4001

By email: rail@qca.org.au

Dear Dr Roberts,

Aurizon Network Pty Ltd – 2013 Draft Access Undertaking (UT4): Consultants' Reports – Forecast Expenditure

Vale Australia Pty Ltd (**Vale**) welcomes the opportunity to provide a submission to the Queensland Competition Authority (**QCA**) in respect of the QCA's Consultants' Reports on the Forecast Expenditure in Aurizon Network's (**Aurizon**) 2013 Draft Access Undertaking (**UT4**). The forecast expenditure has a significant impact on the tariff and therefore it is important that it is efficient and encourages a continuous focus on cost improvements while maintaining a legacy for the operation of the network under future undertakings.

Vale has been an active participant in the Queensland Resources Council's (**QRC**) efforts to develop an agreed industry position regarding this matter. We note the QRC will be providing an industry submission, from these discussions, to the QCA, and Vale takes this opportunity to endorse the QRC's submission. In addition to the QRC submission, Vale wishes to provide some additional comments to highlight its position on some of the key principles it has identified in the QCA's consultants reports.

Vale is generally concerned that Aurizon has proposed to change the approach to the maintenance task based on efficiency although the maintenance costs show limited effect of any gains in efficiency to account for the changes in the maintenance approach. Aurizon, like any other company, is expected to continually review and monitor its cost base and processes to ensure it is operating efficiently. Vale believes that under the maintenance proposal Aurizon is looking to move to a planned preventative maintenance approach which SKM has acknowledged should lead to a more efficient approach, however, the any cost reductions of this maintenance appears limited once the extension volumes are removed. Using extension tonnes which are generally operated on new infrastructure with lower maintenance requirements can distort the need, or identification of, the savings due to the efficiency that should be gained by a move to a planned preventative maintenance approach. Vale therefore agrees with the SKM recommendation that a transparent detailed scope for maintenance should be established to ensure the actual maintenance scope is completed.

While Aurizon also claims that its operating cost allowance for previous undertakings were wrong, the UT4 proposed operating cost allowance does not appear to consider the savings of an integrated business, UT3 processes completed, nor the principle of negotiation that has been set as one of the key principles by Aurizon under UT4. Aurizon is part of an integrated group that has provided statements to the financial markets that it is seeking to reduce its costs, however, there does not appear to be any cost reductions forecast for the Aurizon business.

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Vale would also expect further cost reduction due to the completion of UT3 processes such as the new standard connection agreement and alternative standard access agreement which should provide significant efficiency into the operation and allocation of access on the network. The UT4 document has also been a complete re-write which Aurizon indicated would result in a more efficient operation. Aurizon has indicated that this re-write was important as it would allow for more negotiation which Vale would imply leads to a lower cost to resolution. Despite these potential savings the RSM report appears to suggest that Aurizon's operating costs are still significantly above other benchmarked businesses.

Vale believes that in a competitive market the changes to maintenance and operating approaches being proposed by Aurizon would only be contemplated and completed if it leads to a more cost effective solution. Vale believes that further investigation of Aurizon's costs should be undertaken to ensure that any efficiency gains are being considered within the cost allocation for UT4.

Maintenance

As indicated in the SKM report, Aurizon is proposing to move to a planned preventative maintenance approach and move away from the traditional unplanned approach. Vale supports the planned approach to maintenance as it should lead to an efficient approach to maintenance. SKM has highlighted in its report that "rail infrastructure owners around the world apply preventative maintenance techniques by performing planned maintenance and condition-based maintenance before faults occur"(Appendix A, Page 7). This approach to maintenance should also lead to a better alignment between the forecast and actual costs of maintenance.

SKM notes that asset condition and volumes are important in considering the maintenance scope required to maintain the asset. One of the key drivers identified by Aurizon for their increased maintenance spend is the increase in volumes over the UT4 period. Aurizon have indicated that a significant amount of this volume is expected to be from the WIRP project but as SKM has highlighted in their report, the extensions required to complete WIRP will require minimal maintenance over the UT4 period. One of the key points that Aurizon makes is that the cost of maintenance is declining however a significant part of this will be a function of increased volumes on new low maintenance track rather than improvements in maintenance activities due a change to the planned preventative maintenance approach. Vale believes that a planned preventative maintenance approach should provide a cost efficient solution and therefore the maintenance allowance should allow for an improved maintenance cost position excluding the new extensions and volumes.

Vale believes further cost reductions should be possible as a planned preventative approach to maintenance should have a significant effect on some of the maintenance task drivers highlighted in table 2-4 of the SKM report. A planned approach to maintenance should alleviate some of the costs and inefficiencies relating to the geographical location of the network as these will be approached in a planned manner. Planning of the location, time, and dates of maintenance will allow better allocation of maintenance personnel to assist in fatigue management as well as greater flexibility to find and manage accommodation to allow for these maintenance activities. Vale believes a planned approach will also improve the management and utilisation of maintenance plant and equipment.

SKM has noted that Aurizon does not have sufficient information on the network and in many circumstances the condition of the assets are unknown. Vale supports the recommendations of SKM that Aurizon should detail for each year of the UT4 period the forecast condition of their infrastructure assets by location and state the location of its intended preventative activities and at the end of each year provide details and locations of actual maintenance spend. Vale supports this preventative maintenance approach because it should be improve efficiency in costs and network availability, as well as provide greater transparency. Vale believes one of the major issues with the current approach to maintenance is the limited transparency on what maintenance activities are required to be completed to maintain the network and importantly did Aurizon complete the planned maintenance.

One of the key issues to the move to a planned preventative maintenance approach will be determining what level of operations is to be maintained? Generally over maintaining the network can be just as inefficient as under maintaining the network. If you are maintaining the network to a point where there are no breakdowns, you are potentially over maintaining which will cost more but provide very little advantage in throughput and availability. SKM highlights the development of the Network Asset Management System by Aurizon and Vale would support this tool to assist in the development of a transparent process to find the efficient position on the maintenance curve between the cost of planned maintenance and the cost of unplanned maintenance. Without structured maintenance plans based on reliable data it is likely that you will generate inefficiencies in the maintenance task as you are likely to over maintain some parts of the network and under maintain others. Vale believes it will be important for the cost savings gained from the operation of this tool are clearly reflected in UT4 and future undertakings.

One of the key maintenance cost item that needs to be assessed to determine the scope required is ballast undercutting. SKM has indicated the ballast undercutting task is required to be high in the UT4 period due to an under-delivery of scope in the UT3 period. Achievement of the ballast undercutting scope is an important objective as it accounts for a significant proportion of the maintenance cost allowance. SKM has highlighted that historically the debt of ballast undercutting has continued due to the failure of Aurizon to achieve the scope that was set when the undertaking was approved. Due to the size of this maintenance cost and the historical under-delivery Vale believes the QCA needs to look at a different approach to the allocation of maintenance costs for this activity to provide some incentive for Aurizon to actually complete the ballast undercutting scope set as part of the maintenance cost allowance.

SKM, notes in their report, that Aurizon is planning to purchase new resurfacing equipment to replace the existing equipment which is reaching the end of its life. It is unclear to Vale whether SKM has included improved unit rates in the maintenance costs due to this new equipment as you would expect there to be efficiency gains from this purchase. The SKM report also appears to suggest the purchase cost of the new equipment is included in the maintenance task. Vale would ask that Aurizon confirm that this equipment is not utilised in any other non CQCN activities?

Vale notes that SKM have concluded that the maintenance cost should be adjusted if the forecast tonnage is lowered to reflect the Energy Economics report. Vale supports the approach to adjust the maintenance allowance to reflect the lower tonnages.

Vale notes that throughout the maintenance review SKM has indicated that many processes that are proposed to be implemented during the UT4 period will have a cost saving effect in the next undertaking period. The introduction of the changes now will only be of value to stakeholders when their impact flows through to a lower cost and more efficient maintenance task. Vale believes it will be important to ensure these gains identified now do actually flow through to the UT5 period.

Operating Expenditure

RSM Bird Cameron (**RSM**) has conducted a financial assessment on the operating expenditure proposed by Aurizon for the UT4 period. Aurizon has proposed a substantial increase in the operating costs for UT4 as Aurizon believe there was an error in the UT3 calculation. Vale is concerned that RSM has conducted only a high level review of the operating costs when a more detailed review may appear to be necessary given Aurizon's claim that an error occurred in the prior undertaking's calculation.

Vale believes it is important to review the operating costs in greater detail as RSM has identified that Aurizon's costs do not appear to consider the synergistic benefits of an integrated group and the costs are higher than other benchmarked businesses. Aurizon has proposed that costs be considered on a standalone basis but this ignores the reality of the Integrated Aurizon Group and would lead to an incorrect allocation of operating costs from the non regulated business to the regulated business. The allocation of the operating costs between the regulated and non regulated business will be very important as any costs incorrectly allocated to the regulated business will provide a competitive advantage to Aurizon Holding's non regulated business in the above rail market. Vale supports the RSM finding that this centralised approach has been adopted to derive cost savings and therefore it would be inappropriate to benchmark Aurizon on a standalone basis.

Part of these savings from the integrated business should include the cost reduction targets that have been announced by the Aurizon Group to the market and identified in the Aurizon Group reports. Vale supports the RSM finding that some allocation of these continuous cost savings of the Aurizon Group should be allocated to the regulated business.

RSM appears to have relied on the Aurizon statements on business differentials when considering the appropriate benchmark to consider the reasonableness of the Aurizon costs. Aurizon claims that it is different to other businesses due to the following reasons

- Significant electrification
- Remote location with extreme weather conditions
- Supply chain complexity
- Interconnectivity of the four systems
- Introduction of a short term transfer system.

Vale believes the first two points raised could have an impact and has been included in the maintenance activity of Aurizon but it is unclear how this would create additional operating costs compared to other operations such as the Hunter Valley. Aurizon has indicated that additional operating costs are incurred due to the operating mode at DBCT yet the Port Waratah Coal Terminal in the Hunter Valley operates under the same mode of operation at a capacity almost double DBCT. The interconnectivity of the four systems is potentially the most significant difference between the CQCN and other rail networks but even this difference appears to be reduced as Aurizon has now consolidated the train control function into one location at Rockhampton. Vale does not believe the introduction of a short term transfer system would significantly impact operating costs as ARTC has been operating a short term transfer system since the approval of their undertaking in June 2011. It is not clear to Vale that RSM undertook any significant evaluation of the identified Aurizon benchmarking differences to ascertain the relative merits of them before making any conclusion about the reasonableness of Aurizon's operating costs. Vale believes that Aurizon is likely to be very similar in operation to ARTC and any potentially operating differences between the two would be negated by the integrated nature of the Aurizon Group.

RSM has identified that Aurizon has proposed to use revenue as part of its operating cost allocation methodology for UT4. Vale supports RSM's recommendation that direct costs would be better than revenue to determine the operating cost allocation given the nature of the Aurizon business. RSM has identified that one concern with the direct costs methodology could be the high proportion of energy costs for the Aurizon business. Vale believes one option would be to remove the energy costs from the direct costs as they are largely a cost pass through component. Vale believes the operating costs involved in the supply of energy would be limited and therefore excluding this from the allocation would still provide a reasonable approach to determine the direct operating cost allocation.

RSM has indicated that it is unable to assess the reasonableness of the proposed FTE numbers in the train control costs from the desk top review that they performed. This increase in numbers has been identified by RSM as a significant contributor to the 13.7% increase in the train control costs. Vale believes further investigation of this cost increase is required given the recent consolidation of the train control operation to Rockhampton. Vale believes this consolidation would have been completed due to the identification of cost savings and improved efficiency. It would appear to be inconsistent to complete this consolidation and propose there is a significant increase in costs. Vale would welcome further investigations of these costs to determine if they are reasonable.

Vale also believes further investigation needs to be completed on the costs included for the preparation of UT5. RSM has identified that $4.8 million in costs were incurred in the preparation of UT4 and that $4.5 million has been identified for the preparation of UT5. The cost allocation for UT5 appears to be very high given UT4 was a complete re-write of the document which Aurizon stated at the time was necessary to clarify drafting and make the document clearer and more efficient. Vale does not believe the allocation for the preparation of UT5 should be considered reasonable given the significant changes made to the undertaking during the UT4 process, and would welcome further investigation of this cost.

Vale does have some concerns about the efficiency of costs involved for insurance. In the recent review event for flooding in the Blackwater system in 2011 Aurizon sought recovery of costs under the insurance policy for damage to a bridge. The submission presented to the QCA advised that this claim was not allowed. Vale would request the QCA carefully consider the efficiency of the type of cover required and the likely benefits this policy actually provides in mitigating the risks of exposure to major costs given the failure of the policy to cover the bridge damage during the 2011 flood event.

Vale would welcome further investigation into the reasonableness of the inclusion of the enterprise branding costs. Vale believes enterprise branding is generally driven by a marketing strategy to distinguish your business from other businesses that you compete against. The need for branding appears limited given Aurizon provides access to monopoly infrastructure and it would not appear to be required to differentiate itself in the market or promote an image to encourage customers to use its services. Vale believes the significant increase in enterprise branding costs are likely to be related to the non regulated businesses in the Aurizon Group pursuing opportunities in the Gallilee Basin, coal terminal at Abbot Point, port and rail opportunities in the Pilbara iron ore region, and other growth projects.

RSM in its report has highlighted several other areas where they believe it would not be unreasonable for an adjustment to be made to the UT4 corporate overhead costs. Vale would support further adjustments to reflect the items identified by RSM.

RSM has indicated in their review that the Aurizon Group is continuing on a process to consolidate cost centres within the Group. Vale believes this consolidation is likely to lead to less transparency of costs between the regulated and non regulated businesses within the Aurizon Group. Without this clear separation of costs between the regulated and non regulated business the allocation of costs will become increasingly subjective as it will be completed via an allocation methodology. Vale believes this highlights the conflicting nature of the Aurizon submission which seeks to be assessed on a standalone basis, but continues to strive for costs and operational efficiency as an integrated business.

For further information regarding this advice please contact myself on (07) 3136 0923.

Yours sincerely,

Anneliese Mattos
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