10 October 2013

Mr Paul Bilyk
Director, Rail and Ports
Queensland Competition Authority
GPO Box 2257
Brisbane Qld 4001

By email: rail@qca.org.au

Dear Paul,

Aurizon Network's 2013 Draft Access Undertaking (UT4)

Vale Australia Pty Ltd (**Vale**) welcomes the opportunity to provide a submission to the Queensland Competition Authority (**QCA**) in respect of the 2013 Draft Access Undertaking (UT4) submitted by Aurizon Network Pty Ltd (**Aurizon**). The UT4 submission involves a complete rewrite of the previous undertaking with no prior consultation with stakeholders. This is a critical document in setting the future direction of the Queensland Coal Industry and has been released at a time when the industry is facing many challenges to remain competitive in the global market.

Summary of Paper

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 submitting an industry submission, from these discussions, to the QCA and Vale takes this opportunity to support the QRC's submission to the QCA. Vale does not plan to outline statements or drafting in this submission as it supports the detailed submission and issues identified in the QRC submission and provides some additional comments that Vale believes clarifies its position on some of the key principles.

Generally, Vale does not endorse the approach that Aurizon has taken to the development of UT4. Aurizon had indicated on many occasions and at different forums that it proposed to undertake meaningful consultation with stakeholders in the development of UT4. Unfortunately this consultation opportunity was never provided prior to the submission to the QCA that has resulted in a document being developed in isolation. Vale has in the past and continues to question the claim by Aurizon that they wish to work with their customers given the inconsistent nature to the approach they take to consultation. This is a considerable concern with the UT4 document as Aurizon proposes to reduce the level of QCA oversight in exchange for greater consultation and negotiation with customers.

Given the dates of some of the documents included in the submission, it is clear the UT4 document has been developed over a long period of time and some level of consultation could have occurred. UT4 represents a fundamental shift in form and substance to previous undertakings, and Vale believes a level of meaningful consultation should have been undertaken to improve the efficiency of the development of the undertaking. One of the major difficulties confronting industry in reviewing and providing comment on the UT4 document are the significant changes in almost all aspects of the undertaking.

Aurizon claims its approach in UT4 is to:

> *"promote the long term competitiveness of the Queensland resources sector to ensure efficient and timely investment in the Network, and provide a commercial framework that will facilitate participants in the supply chain working in a co-operative partnership."*

Vale fails to see how this can be achieved with a document that includes the following key principles:

- Provides a natural monopoly with a negotiation framework that has limited oversight by the regulator.
- Provides limited control of access to information or conflicts of interest within a vertically integrated rail provider that operates in a competitive market, which also has future plans to develop or acquire port facilities.
- Seeks to increase the regulated return to Aurizon although reducing or holding limited risk.
- Seeks significant increases in maintenance and overhead costs and appears to have limited efficiency controls over costs, and scant consideration of allocation of costs between a standalone infrastructure based company and a commercially diverse above rail business.
- Has no commitment to fund future investments and controls a one-sided Expansion Process where Aurizon can choose which mines will gain access to the rail network and dictate the timing of the expansions.

The UT4 document promotes Aurizon's interests significantly more than would be consistent with Aurizon's legitimate business interests. Vale does not believe this represents a document that will ensure efficient and timely investment in, or use of, the Network, or facilitates participation in the supply chain as there is a lack of appropriate balance of the legitimate business interests between Aurizon and Stakeholders. Vale believes it would not be appropriate to approve the 2013 Draft Access Undertaking in its current form and would suggest that substantial changes are required to achieve this balance.

Negotiation framework

Aurizon has chosen to significantly change the regulated environment in which they would operate under the proposed UT4 document. Aurizon believe that it should be able to negotiate freely with customers with only limited regulatory oversight. Vale does not support this proposal as Aurizon has a natural monopoly that needs prescribed regulatory control to ensure it will not use this monopoly power to restrict or limit entry to the network, seek monopolistic rents, or gain commercial advantage as an integrated rail operator in Queensland. Access Seekers do not have countervailing power as there are no alternative forms of transport that are competitive to rail in transporting bulk commodities such as coal.

This use of the disparity in bargaining power has been highlighted in the recent Goonyella to Abbot Point Expansion and the Wiggins Island Rail Project. Both of these projects were significantly delayed due to reluctance of Aurizon to discuss scope and the desire to seek additional terms and conditions outside the access undertaking. It is important to note that in the previous undertaking the QCA had oversight of the terms and conditions but under UT4 Aurizon is seeking to have an almost unfettered right to claim additional terms and conditions. This process is unlikely to lead to an efficient investment in the network as Access Seekers will be faced with the choice between accepting terms that potentially include monopoly rents, with little or no risk, or facing significant delays to expansions.

Conflict of Interest (Ringfencing)

Aurizon has proposed to significantly reduce any ringfencing obligations in the UT4 document. This comes at a time when their related party above rail operator is pursuing growth opportunities in new coal basins via the provision of rail solutions, as well as the participation in potential developments of the construction of new coal terminals in Queensland. A lack of separation between the existing regulated business and these new growth opportunities could provide significant commercial advantage to their related competitive business as they would have access to information and knowledge that is not publicly available to their competitors.

Vale also questions if the ringfencing provision are consistent with the other parts of the UT4 document. Aurizon's ringfencing provisions suggest very limited separation between the regulated and non regulated entities within the Aurizon Group, however, seek to claim expenses for a standalone business. Vale would argue that it is inconsistent to benchmark costs based on a standalone business when the ringfencing provisions do not result in the business operating as a standalone business.

Rate of Return

Vale has had concerns for some time regarding Aurizon transferring risk to customers without any apparent recognition that this reduces the non-diversifiable risk of the business. These concerns are amplified by Aurizon 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 that 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 Aurizon.

Below are some examples of changes, or proposed changes, to the risk profile of Aurizon.

- Change from price cap to revenue cap form of regulation to reduce volume risk
- Stronger levels of take or pay which reduces any cashflow timing concerns
- Annual revisions of volume forecasts
- Annual adjustments for MCI and CPI
- Claims for cost pass through of additional costs due to the flooding events that occurred during the prior undertaking period.
- Proposed changes to the MCI to further reduce any risk or exposure to maintenance costs
- Proposed changes in the audit costs to reduce any risk or exposure to costs.
- Proposed limited regulatory oversight when seeking additional access terms and conditions
- Proposed changes to depreciation to reduce asset stranding risk

Vale believes that Aurizon's level of risk was already very low under the previous undertaking but with the proposed changes in UT4 it raises the question of what risks remain for Aurizon. A consideration of the substantial risk transfer which has been achieved leads to a conclusion that Aurizon is likely to face substantially lower non-diversifiable risk than the 'comparable' entities on which betas have been based. We note that even in the absence of these risk transfer mechanisms, the degree of non-diversifiable risk faced by Aurizon is likely to be lower than that faced by other regulated utilities, given its more limited exposure to domestic market factors.

Vale also notes the QCA has been conducting a review of the cost of capital methodology. One of the approaches used to determine the regulated return of a business identified during this review was the split cost of capital. Under this approach the return on each component of the regulated business is determined by the level of risk involved with that component. Vale believes this methodology would be a useful tool in the assessment of the current rate of return for Aurizon as Vale believes the level of risk that Aurizon is subject to is limited across all components. Vale would argue that during the prior undertaking period Aurizon has effectively been operating in a proxy split cost of capital approach as it has sought additional access terms and conditions based on a belief of higher risk. Therefore, Aurizon's revenue has been overcompensated during the previous undertaking as the rate of return should have only reflected the return on the Regulated Asset Base and Operating Costs. Vale would encourage the QCA to consider the split cost of capital principles, and how this would apply to the current Aurizon operations and risks when determining the appropriate return for the UT4 period.

Maintenance Costs

Maintenance costs continue to increase and a large portion of this relates to the ballast cleaning. Vale is concerned with the level of ballast cleaning that is being assessed as there appears to be contradictory advice coming from Aurizon as to what is the current level of ballast fouling on the network. It was only in mid 2012 that Aurizon was seeking approval from producers for them to purchase a 2nd ballast cleaning machine. The UT4 maintenance documents appear to suggest that the level of ballast fouling does not require a 2nd ballast cleaning machine. Given the significant cost of this particular activity it is important that the most efficient operation is conducted to meet the volume requirements of the network. Vale believes it is important that there be greater transparency on the delivery to scope of this activity to ensure the system is maintained to desired level.

The industry is also investing in veneering stations at each loadout. Veneering was identified as a significant activity required to be completed to assist in the reduction of ballast fouling. Based on this Vale would expect to see a reduction or stable level of expenditure over the period to reflect this investment as recent presentations from Aurizon on the train dust monitoring system indicate that veneering is having a significant effect on the reduction of coal dust from trains.

Aurizon is also proposing to increase asset renewals throughout the UT4 period but there does not appear to be any decrease in maintenance costs to reflect this change in approach. Aurizon has identified a need for asset renewals to be increased to reflect the age of the network. Vale believes asset renewals should be based on a trade off between the capital costs of replacement of the asset versus the continuing maintenance cost, and therefore, this cost benefit should be reflected in the maintenance costs.

The Aurizon maintenance cost includes an overhead cost allowance that is justified on the basis of a standalone business. Vale is concerned about the efficiency of this allocation as the costs are determined with relation to the Aurizon Group which is not a standalone business and includes other growth business that are likely to include higher overheads in pursuing this growth. Vale also raises a concern about the potential for duplication of the overhead allowance given there is also a separate overhead cost allowance in the Aurizon claim.

Vale believes that the maintenance approach needs to be assessed to provide greater transparency that the maintenance scope identified is complete and the efficiency of these costs. In prior undertakings a maintenance allowance has been provided to Aurizon for the maintenance activity but there has been limited transparency on whether the scope of works used to determine the allowance had been completed or whether some items in the scope had been removed. Vale believes some consideration should be given to:

- The scope required and the allowance or cost recovery method for maintenance
- Transparency on the achievement of the scope of works
- An incentive regime that encourages innovative ideas that improves the efficiency of the costs and total works completed.

Overhead Costs

Aurizon has justified many of the proposed changes to the regulated environment on the basis of efficiency. Aurizon claim the changes will streamline processes and provide a more timely response to customers. Vale would have expected to therefore see a reduction or at worst maintaining of the existing overhead cost allocation given the justification provided for the changes in UT4. Unfortunately the overhead costs have not only increased but increased by a very significant margin. Vale believes a complete review is required on these costs and the methodology to establish this cost to ensure there is a correct allocation between the relatively simple infrastructure business and the commercially diverse above rail business that is seeking substantial growth and investment within Australia and overseas. This allocation becomes critical within the Queensland Coal Industry as any allocation of overheads to the regulated below rail business will provide a commercial advantage to the related above rail operator and could impact on competition in the above rail market.

Expansion Process

In UT4 Aurizon has amended the process to determine when and if an expansion is required. The experience of industry has been that expansion scoping and negotiation has been inefficient, unnecessarily protracted and one-sided despite prior undertakings being adjusted to provide an incentive for Aurizon to invest. This has resulted in difficulties in alignment with other expansions in the coal chain. UT4 proposes to provide even greater power and control of the expansion process which Vale believes will continue to cause fragmentation in the development of the coal chain.

The proposed changes to the expansion process

- Introduces a new Network Planning process that does provide a longer term view of the industry but still appears to lack meaningful data to provide Access Seekers with an ability to assess the impact of the options
- Removes the $300M expansion funding obligations on Aurizon Network
- Provides Aurizon with absolute discretion over the expansions to be completed and the selection of the Access Seekers allowed to participate.
- Standard funding agreements that appear to be one-sided

Vale acknowledges that the latest SUFA model that has been provided is an improvement on the initial versions, however, the QRC has identified many concerns with this model in its submission to the QCA on the 30 August 2013. Vale does not believe the SUFA model that is currently before the QCA for consideration, is sufficiently robust to provide a clear and credible alternative to counteract the monopolistic power that can be imposed by Aurizon under the proposed UT4 expansion process and is unworkable for smaller expansions.

Vale does not believe the UT4 submission satisfies the object of Part 5 of the QCA Act to promote the economically efficient operation of, use of and investment in, significant infrastructure and should not be approved. Vale believes the UT4 submission will result in greater power and control to Aurizon as the monopoly infrastructure owner that will at best delay and create inefficiencies in the operation of the network, and at worst will provide monopolistic rents and inefficient practices, that can also lead to failures in the competitive above rail market, as well as failures in the development of future coal resources, and reduced competitiveness of the Queensland Coal Industry.

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

Yours sincerely,

[redacted]

Bob Skuza
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Vale Australia Pty Ltd