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09 March 2012

Mr John Hall
Chief Executive Officer
Queensland Competition Authority
GPO Box 2257
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Dear Mr Hall


Peabody Energy Australia Pty Ltd and Peabody Energy Australia PCI Pty Ltd (formally Macarthur Coal Limited) jointly "Peabody" Submission to the Queensland Competition Authority – Electric Access Draft Amending Access Undertaking.

In response to the QCA's request for submissions in relation to QR Network's Electric Access Draft Amending Access Undertaking, we enclose Peabody's submission.

We note that an extension to the closing date for submissions was granted until 9 March, 2012.

If you have any questions in relation to this submission please contact Chris Walsh on (07) 3018 2943 or Mark Smith on (07) 3333 5628

Regards



Mark Smith
Manager - Infrastructure

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1. Introduction

In December 2011, QR Network Pty Ltd ("QRN") submitted to the Queensland Competition Authority the Electric Access Draft Amending Access Undertaking ("DAAU") which aims to implement changes to pricing arrangements for electric traction services. The DAAU outlines the following as the platform for acceptance:

There are three main planks to the DAAU that are designed to provide better long term pricing stability and incentives for users of the rail network:

1. *Implementing network pricing*
2. *Maximising Asset Utilisation*
3. *Smoothing revenue cap adjustments*

QRN developed modelling to support these 'planks', and commented on above rail and below rail capital investment, total cost of ownership and cycle time analysis in an attempt to establish a need to approve the DAAU.

Peabody Energy Australia Pty Ltd and Peabody Energy Australia PCI Pty Ltd (formally Macarthur Coal Limited) together "Peabody" submit the following submission in response to the DAAU. In this submission, Peabody outline various reasons why it is unable to support the DAAU including: the principle of socialisation and the existence independent coal chains, inconsistencies with the modelling assumptions used by QRN, and the potential impact to competition.

2. Peabody

2.1 Background of Peabody

Peabody through its existing operations and recent acquisition of Macarthur Coal owns 11 coal mines in Australia with a total export capacity of over 30 Million tonnes per annum. Of these 11 operations, six are located within the Goonyella coal supply chain with contracted export capacity via the Dalrymple Bay Coal Terminal ("DBCT") located south of Mackay. These six mines represent a significant investment and volume capacity for Peabody and are the driver of continued development in the region and the country.

Peabody is not a user of the Blackwater system

2.2 Peabody's position on the DAAU

The DAAU submitted by QRN adds significant cost to Peabody's operations without any benefit in consideration for those costs.

Peabody, while not supportive of the DAAU, recognises the significant investment that QRN and other infrastructure providers contribute to develop and maintain a sustainable supply chain and understands the short and long term risk and reward profile as a result of various investment decisions. Peabody will continue to be an active and contributing member of the Queensland coal industry, but is unwilling to support a DAAU that seeks to socialise costs without full and transparent modelling and subsequent cost – benefit analysis for all coal chain participants on either a Goonyella centric coal supply chain basis or as suggested by QRN on a Central Queensland Coal Region basis.

Peabody objects to any change to the pricing regime which results in the socialisation of the costs of other system's infrastructure. For this reason, Peabody considers that the Queensland Competition Authority (**QCA**) should wholly reject the DAAU

3. Socialisation

3.1 Queensland Coal Supply Chains

The coal supply chains that operate within Queensland generally operate to support specific export handling facilities. The Goonyella system predominately services the DBCT and Hay Point terminals. The Blackwater system predominately services the RGTanna export terminal. In recent times, these systems have expanded to cater for some marginal increase in cross system traffic but remain independent with separate operating regimes, industry groups and participants, and independent master planning scenarios that encompass specific rail and port investment required for that system.

Peabody as a Goonyella supply chain user actively participates and supports growth of that coal supply chain. Investment and operational planning initiatives are supported and Peabody generally supports socialisation of specific costs within a system centric operating environment that seek to promote effective and efficient utilisation of resources. However this does not extend to supply chains such as Blackwater to which Peabody is not contractually bound and has no firm contracted export capacity. Further, Peabody has no oversight of charges in the Blackwater system.

3.2 Whole of Network AT5 Charge

The proposal as outlined in section 6.2 of QRN's submission and the first plank of the submission is to introduce a whole of network AT5 charge that will introduce a single charge for the Blackwater and Goonyella networks. QRN refers the combined network as the Central Queensland Coal Region ("CQCR").

The Central Queensland Coal Region is a series of independent coal supply chain systems. On this basis the proposed socialised AT5 charge is not appropriate. The socialised AT5 charge submitted in the DAAU is tailored specifically to the benefit of QRN (both above and below rail) and not to the benefit of industry as is suggested by the Total Cost of Ownership concept put forward.

Should socialisation of costs occur, Peabody is extremely concerned as to the possibility of a precedent being set that may lead to investment decisions in adjacent or interconnected systems such as the Goonyella Abbott Point Expansion project (GAPE) being socialised across a network that receives no benefit in capacity. That is, Goonyella users may have to pay for incremental upgrades to the existing system which is being carried out specifically GAPE system users.

Furthermore, the QRN submission points to the investment decisions of the Wiggins Island Coal Export Terminal (WICET) and the potential to impact further on the utilisation of the electric network. Peabody is not a participant in Blackwater system and subsequently did not have input to any of the investment decisions for that system through the Coal Rail Infrastructure Master Plan (CRIMP) process. Further, Peabody is not a participant in WICET Stage 1 and is unable to comment on the relative investment decisions undertaken. Peabody notes however that the submission by QRN is an attempt to socialise costs to adjacent coal supply chains that gain no incremental benefit and to offset any potential risk of WICET users proceeding on a non-electric traction basis – again solely for the benefit of QRN.

Finally, while Peabody does not support the socialisation concepts in this submission, it recognises that the development of an investment framework within a multi-user environment, that the concepts of socialisation need to be considered for a range of interests as they provide signals of future direction on cost, technology use and availability. For example, future Goonyella investment could be on an individual user

pays or supply chain socialised arrangement following a review of the benefits of existing coal supply chain participants, the future impacts to that coal supply chain and requirements of a new or expanding user within that supply chain.


4. Pricing Principles of the AT5 Charge

Section 6.3.1 of the QRN submission comments that *“diesel locomotives operating on Blackwater effectively provide reserve locomotive capacity for the entire electric network”* and subsequently due to this buffer Blackwater is being overcharged and Goonyella system undercharged. It is suggested that as a result of this pricing and the AT5 pricing, that operators are placing electric assets in the Goonyella system at the expense of the Blackwater system. This in turn (QRN says) requires a Network tariff to ensure that electric traction as the most efficient traction type is not degraded further. Furthermore in the opinion of QR Network it *“considers that adopting a Network AT5 tariff will be the most effective way of setting the electric access charge in order to achieve this outcome”*.

In addition to 6.3.1, Section 7.3.2 of the QRN submission further seeks to support Whole of Network AT5 pricing by referring to the key elements of pricing principles for access charges which cover efficiency and productivity but also allows price discrimination and incentives to achieve the desired outcome.

Peabody submits that Blackwater diesel capacity has not provided significant buffer capacity to the Goonyella network and the Goonyella network has not been undercharged as it has and continues to pay for investment required within its own system. Additionally, any measure of price discrimination put forward on the basis of efficiency and productivity must be dismissed on the basis of network independence and haulage capacity requirements being largely dedicated to a particular network. Where degradation due to traction type or another issue occurs, it should be handled by effective mechanisms developed with regard to the relevant system.

5. Financial Impact to Peabody



The costs that are likely to be incurred are unacceptable to Peabody. The DAAU provides no benefit for the additional substantial cost to a Goonyella user. Peabody believes that it employs through its above rail service providers what is considered an efficient above rail service based on the scope of the system to which it operates, the traction options that were available at the time of contracting in relation to network capability and consideration of the future direction for the Goonyella system.

Peabody submits that unless there is a clear benefit specific to the Goonyella system users that the proposed DAAU should be rejected by the QCA.

As stated in the DAAU, the current traction types operating in each coal supply chain relative to the cost of supporting that traction type is an important function of unit costs. While the Goonyella system is typically deemed to be 100% Electric it is recognised that that with the growth in Diesel traction in the Blackwater system the potential to creep into the Goonyella system, may over time lead to an increase in AT5 costs. On that basis, Peabody advocates a strategic review of long term investment that will protect existing long term contracted traction capability via appropriate grandfathering arrangements and recognise that there may be a future paradigm shift in the haulage operations for the Goonyella system.

6. Modelling Assumptions

The modelling submitted as part of the DAAU submission is stated to be in accordance with the QCA Act which sets out principles for access arrangements and access pricing.

Section 3.1 of the DAAU notes that, *this objective requires the QCA to consider whether the proposed changes will promote:*

- *The economically efficient use of the below rail network*
- *The economically efficient operation of the below rail network; and*
- *The economically efficient investment in the below rail network*

Further to this, the DAAU seeks to provide relevance for 'plank' number two, *Maximising Asset Utilisation*, in relation to the Total Cost of Ownership between electric and diesel traction which incorporates both operational and cost elements in the provision of above rail services utilising the below rail network.

Peabody submits that the elements of the evaluation used in the preparation of the modelling to support the Total Cost of Ownership ("TCO") are flawed and inconsistent with economic efficiency of use, operation and efficient investment.

6.1 Efficient Use and Operation of a Network

The economically efficient use of a network is to ensure that sufficient infrastructure is in place to support the contractual requirements of the participants of the network. In the case of a coal supply chain system, this rationale would be that the network is able to handle the available above rail rolling stock capable of delivering the required contracted capacity. When there is a choice of traction type available, market conditions, technology and cost will dictate the type of capacity delivery on a network.

The DAAU submitted does not explore the use and operation of the network in sufficient detail in relation to current and future operational practices of either the Blackwater or Goonyella systems to determine the efficient use argument put forward. The modelling information provided focuses on theoretical running time of a single train type (represented by total cycle time) throughout the network and does not sufficiently explore individual traction operations and the impact of both types of traction in relation to the network use.

The information provided seeks to suggest that diesel traction is significantly slower than electric traction. When considering that the provisioning of diesel traction is generally off the network and as such the margin between electric and diesel is only minor in the context of the modelling provided. Furthermore when reviewing the sectional running time of traction types of the network (the gap between trains) the argument is flawed when due to the electric capacity of the network, the headway (or gap) between trains is higher for electric trains than what would be required for all diesel trains operating on the system. This gap however has not been explained or explored in detail but is possible to

result in the improvement of diesel over electric traction as diesel is not subject to electric capacity infrastructure constraints.

Other factors that may affect the total cycle time of a train are the braking capabilities of the diesel and electric trains employed and the signalling systems in operation within the network. If there are varied breaking options available and in use, the cycle time would generally be designed around the greatest breaking time required (thus constraining the ability of new breaking methods until all trains that operate are able to meet that requirement). Also, it has not been explored whether the signalling or network operation is contributing to any variance in diesel and electric traction operation or if there is any preference to electric traction running due to other constraints in the system.

On this basis of the inconsistencies and lack of information provided, Peabody submits, that the variance in cycle time analysis presented by QRN is inaccurate and would require consideration of all network use and operation characteristics to fully ascertain the variance between diesel and electric traction, which may vary between the types of electric and diesel traction (technology) and the subsequent operation of the network.

6.2 Efficient Investment in the Network

The economically efficient investment of the network is to ensure that sufficient capacity is matched by the available above rail haulage options. In the Goonyella system the current reference train size is approximately 10,000 tonnes and in the Blackwater system the approximate reference train size is 8350 tonnes. These limits are due to the present infrastructure constraints such as the size of the passing loops in each system. Currently both traction types are able to accommodate the infrastructure capability of the network infrastructure and in the context of the efficient use and operation explored previously both traction types are capable of utilising the network effectively.

In the current operational environment, both Diesel and Electric traction are capable of utilising the current capacity of the network considering the maximum train sizes currently being run in the system. Subsequently it should be deemed that the investment in above rail assets has matched the concurrent investment in network capability.

A broader issue to capture economic investment is the base by which the modelling has been prepared and explored. With economic modelling that is aiming to provide a long term solution, there needs to be a review based on the historical investment and the clean slate (or new investment from the time of modelling) approach to determine variances in the current and long term framework. For example, the clean slate perspective could be the existing infrastructure with a simple comparison of a new electric traction fleet and supporting electric network (overhead) capacity versus a new fleet of diesel traction trains and any incremental off network provisioning requirements that may be required.

Historical investment in the Blackwater system has resulted in a mixed traction type operating in the network as the electric system was and may currently be unable to handle 100% of haulage services. This is important to recognise as a basis in determining future investment decisions where there is currently committed diesel and electric traction capability employed in haulage services with varied economic life remaining in those assets. The existing assets need to be reviewed carefully to ensure there is no bias in favour of one traction type and recognise the investment in all aspects. The DAAU submission provided by QRN typically dismisses historic or committed diesel traction services to focus on the electric assets being utilised. This unfortunately adds bias to the proposal which further negates the arguments on the submission provided.

The DAAU submission incorporates various measures into the efficient investment decision and categorises the overall principle as Total Cost of Ownership ("TCO"). TCO aims to incorporate measures of both above and below investment to deliver network

and haulage capacity which results in a lowest cost outcome. As mentioned above, the information is inconsistent and consequently, while the TCO principle may be sound, the results are not reliable.

The Powerlink break fee should not be considered in the context of the TCO for Diesel traction and the Rolleston electrification should be considered solely for the electric traction TCO. Secondly, the TCO basis must be explored on an individual network basis given that the networks are separated and need to be explored on a competitive cost basis. That is to ensure that current network pricing is not socialised across a greater base to potentially skew results for present purposes and possibly lead to inefficient investment decisions over the long term.

In the TCO modelling of haulage, the higher off-network provisioning time requirements of diesel traction may lead to a requirement for a greater number of diesel trains than electric for a comparative haulage task, however this could be substantially cheaper than the installation and maintenance of entire electric network to support electric traction. Conversely the distance of a network may make electric network traction uneconomic compared to diesel traction and finally the capacity of an electric system may not deliver the capability of a diesel based system if there are overhead electric constraints. These assumptions have not been explored in detail and in isolation from other elements of the TCO analysis

The modelling provided in the DAAU supporting submission is generally centric to the Blackwater system, but the submission notes that in the Goonyella system the majority of users through above rail haulage operators utilise electric traction that is the generally considered to be at present the most economically efficient for that system. With regards to the Blackwater system, Peabody is not able to determine whether the most economically efficient service would be diesel or electric traction.

Ultimately, Peabody submits that the Total Cost of Ownership modelling is flawed as it does not clearly base all aspects of the argument on the same economic basis. It fails to provide analysis or understanding of the complex issues that it seeks to incorporate for all users of the networks and is biased toward the goals of QRN in implementing the modelling as part of the submission.

7. Future operations of the Goonyella Network

The DAAU submission does not effectively model the impact on the Goonyella network as a result of the proposed whole of network AT5 charge. Peabody is concerned that the submission presented may create future issues as it is centred on the electric traction issue present in the Blackwater system and does not recognise the potential risks and opportunities to the future operation of the Goonyella network.

The proposed socialisation of charges between systems may result in a pricing signal for Goonyella users that results in a shift in traction type or long term investment in an inefficient traction type based on flawed and inconsistent modelling presented for an asset outside of the Goonyella system.

The Goonyella network will face a risk from Blackwater and Goonyella Abbott Point Expansion users where less efficient haulage services penetrate the Goonyella network to service the Abbot Point and Blackwater coal supply chains. These risks have the potential to be challenging in their own right without the additional complication of an imposed whole of network AT5 charge that may send incorrect pricing signals that impacts of present and future investment decisions.

While Peabody does not support the DAAU as submitted it is an advocate for the efficient investment and subsequent use of a network to ensure that capacity is not degraded through inefficient services such as undersized above rail haulage (typified by

the potential for smaller GAPE or Blackwater services to run on the Goonyella network). While the type of traction service employed is a separate economic decision, Peabody does recognise the need for proactive modelling and evaluation to determine the future direction of a network as it is impacted by adjacent systems and the availability of technology and future costs to support present investment decisions. Where there is potential for a price signal to impact on future investment and operation, sufficient grandfathering protection needs to be in place to protect existing users who have supported the existing system growth and development.

8. Revenue Cap Adjustments and Electric Traction costs for Diesel services

The DAAU that has been submitted proposes that all services operating in the CQCR will be charged the electric traction cost up to a 90% threshold as (in QRN's opinion) it acknowledges that some diesel traction is required to service each network. In addition it seeks as part of 'plank' number three to smooth revenue cap adjustments as an incentive mechanism.

The imposition of electric charges on diesel traction services following the long term investment decisions in above rail capacity is a clear direction to penalise past and force future investment decision that quite simply satisfies QRN in their attempt to utilise an expanded asset. The charging mechanisms presented have not been fully explored and modelled effectively as part of the submission and have the impact to further socialise cost across a greater base of tonnage and deem through this mechanism a traction type to be uncompetitive on a broad scale.

With regards to the *smoothing revenue cap adjustments*, the proposal as part of the DAAU to limit revenue cap adjustments to 5% is not definitive and only states that QRN *may defer recovery to one or more later years*. There is little evidence within the DAAU or its submission as to how this could be achieved.

Peabody submits that these two mechanisms of a possible 5% revenue adjustment and imposing electric charges on diesel services in an isolated modelling environment is forcing future investment decision in electric traction to satisfy QRN's own requirement of asset utilisation that may over the long term become inefficient. Further, to offer a unclear 5% increase may lead to significant adjustments in the long term that will create further regulatory issues in the long term.

Peabody further submits that these two mechanisms are a broader form of socialisation which it does not support in the context of this DAAU and has the effect of inappropriately creating a price signal through socialisation without full and proper evaluation as outlined with the modelling assumptions provided.

9. Competition

One of the risks most significant from the proposed DAAU is the potential effect of above rail competition. Given QRN and QR National are part of the one organisation and despite ring-fencing arrangements in place between the business groups there is potential for price setting from the above rail provider to offset the industry increases from the below rail business unit. As QR National apparently has a surplus of electric traction assets they could be priced on a basis that has the effect to constrain future competition but maintain the same or better overall result for QR National.

Peabody maintains that competition is paramount to maintain choice and drive effective and efficient investment and operating practices. Peabody is concerned with the ring fencing arrangements within QR National but also the long term implications for competition in above rail services and investment in below rail services if the issues of the DAAU are not adequately dealt with at an industry level. The broad effect may be to

create additional issues that drive a paradigm shift in traction, operations, investment that could be to the detriment of the coal industry.

10. Regulatory Certainty

The present undertaking as approved on 1 October 2010 is to remain in force until the earlier of 30 June 2013 and the date on which this Undertaking is withdrawn in accordance with the Act.

It is highly unusual to significantly change pricing arrangements part way through an access undertaking. Regulatory certainty is of paramount importance.

In Peabody's view, it would be inappropriate to accept such significant change to an undertaking part way through its term. Peabody believe that the issue should be the subject of far more consultation than has occurred to date.

11. Alternative Options

While Peabody does not support the DAAU as submitted by QRN, it is open to working with QRN to develop an appropriate solution to the issue to ensure that QRN continues to invest in network capacity and be an active contributor to the Queensland coal industry.

While an obvious conclusion would be for QRN to incur an optimisation charge on the existing assets to allow a write down and price reset to maintain competitiveness this is obviously not QRN's most desired outcome.

Potential solutions to the QRN issue could be to internalise some of the elements of the DAAU to promote competition without socialisation across a CQCR. The effect would be to place electric traction on a similar basis to Diesel traction and capitalise (defer) any cost differential to a period when in the opinion of QRN the unit volume in the Blackwater system is sufficient to handle the historical costs without reigniting the debate over traction types. This solution is dependent on QRN internalising short term electric asset costs and taking a long term position based on their TCO modelling that electric assets are the most efficient and effective investment in the long term.

The most important decision that can be made at present is to understand the direction of the coal industry in respect of current and future traction types available, the forward scope and size (distance) of the network investment required and the relative drivers of the total investment. The DAAU does not effectively review the future investment decisions being made and the technology available has not been considered such that the submission is retrospectively looking at current investments which may not be representative of future directions.

Peabody submits that without full industry consultation there is a risk to current and future investment. Without evaluating current and future investment, replacement and upgrade timelines, direction of industry and overall scope that the DAAU submitted aside from the other issues put forward, narrow and specific in view of a particular issue.

12. QCA consideration of the DAAU

Peabody would like to work with QRN and industry to develop options for the future direction and efficient operation of the Goonyella network and where possible the Blackwater and Abbot Point Systems as they reflect on the operations and future direction of Peabody.

As the coal industry and infrastructure providers attempt to work together there is inherent competition and conflict that will arise from time to time, and while economic efficiency is important the regulatory regime must continue to support the principle that socialisation of cost is limited to those parties who receive a corresponding benefit from that cost. Peabody will continue to work with industry on issues as they arise and provide input to the future direction of the industry.

13. Summary

The Electric Access Draft Amending Access Undertaking submitted by QRN in December 2011 seeks to implement a whole of network access charge to effectively manage the electric traction assets in Blackwater system. As outlined in this submission Peabody rejects the DAAU for the following reasons:

- The Blackwater and Goonyella coal supply chains are separate systems with minimal interaction and should not have selective elements of socialisation.
- The pricing principles seek to subsidise a Blackwater investment within the Goonyella coal chain.
- Peabody as a significant Goonyella coal chain user with no contracted capacity on the Blackwater network would be unfairly penalised for investment decisions to which Peabody is not a party.
- It is inconsistent with the regulatory framework to amend pricing during a regulatory period.
- The principles of socialisation as presented may set a precedent which would allow future investment decisions to be attributed to existing system users that gain no benefit from an investment.
- The modelling assumptions presented as part of the submission are flawed and skewed to favour the proposed outcome of QRN in an effort to socialise cost and increase electric asset utilisation on the Blackwater network
- The total cost of ownership premise is based on inconsistent information and is based on a socialised basis which is rejected due to separated coal supply chains.
- Peabody has concerns over the effect of competition on the above rail service provider market, the impact on previous investment decisions and supply of efficient services on a long term basis.
- QRN has failed to provide detailed customer (Peabody) specific information prior to submission deadline further restricting formal cost – benefit analysis to be undertaken
- The long term impacts of either traction type have not been discussed with industry prior to the submission to review the direction of industry in the provision of above rail services.

While Peabody does not support the DAAU as submitted it remains committed to working with QRN to ensure that in the long term effective and efficient investment continues to be made to support the Queensland coal industry.