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11 October 2013

Dr Malcolm Roberts
Chairman
Queensland Competition Authority
Level 27, 145 Ann Street
Brisbane, Queensland 4000

By email: rail@qca.org.au

Dear Dr Roberts

Aurizon Network 2013 Draft Access Undertaking (UT4)

Glencore welcomes the opportunity to provide this submission to the Queensland Competition Authority (QCA) in response to Aurizon Network's (Aurizon) UT4 submission.

Glencore rejects the Aurizon UT4 submission and urges the QCA not to approve UT4 because it fails the basic and fundamental regulatory objectives and criteria set out in the Queensland Competition Authority Act 1997 (Qld) (QCA Act).

The UT4 submission was prepared in isolation and in the absence of any genuine consultation with the coal industry. We do not believe that UT4 promotes efficient investment nor promotes effective competition in upstream and downstream markets. We believe if UT4 is approved in its current form it may significantly damage the investment environment in Queensland's export coal industry and make existing mining operations even more marginal in the current challenging economic circumstances.

Furthermore, UT4 is directly inconsistent with at least 3 of the very matters the QCA is expressly required to have regard to in determining whether a proposed undertaking is appropriate (under s 138 QCA Act). It is inconsistent with the object of Part 5 of the QCA Act, contrary to the public interest, detrimental to competition in markets and adverse to the interests of parties who seek access to the service.

Glencore would also make the observation that disappointingly most, if not all, instances of monopoly coal chain infrastructure being sold into private ownership over the last decade, has not translated into efficient provision of infrastructure capacity. Indeed, in an effort to improve returns and reduce risk, owners of monopoly coal chain infrastructure are increasingly pushing the boundaries of the regulatory regimes that are otherwise intended to protect the consumer and facilitate future market / economic growth.

In most instances privatisation has resulted in a significant increase in the cost of access and a transfer of all commercial risk associated with construction and operation of particularly the rail network back onto the users of the network. This is no where more evident than in the "fait accompli" that is currently before the Queensland coal industry in the form of UT4.

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Glencore has been an active participant in the Queensland Resources Council (QRC) working group which developed QRC Submission on UT4. Glencore endorses the QRC submission and therefore does not propose to specifically repeat in any detail the issues canvassed in the QRC Submission. Rather we wish to highlight key areas of concern regarding UT4.

1. UT4 highlights the risks of privatisation without adequate industry consultation and regulatory protections

The competitive pressures faced by the Australian coal sector have been well publicised and miners are undertaking substantial and wide ranging cost reduction initiatives and working with key suppliers to ensure improved productivity and the long term competitiveness of the sector. In this context Aurizon's UT4 proposal does nothing to improve efficiency, reduce costs of service delivery or underwrite the global cost competitiveness of a sector that contributes significant royalties to the State of Queensland and provides substantial direct and indirect employment and economic development for the State.

Should the UT4 proposal proceed the negative flow on impact for the Queensland coal sector will be significant:

- **Costs** to the coal industry increase which will in turn negatively impact on the Queensland coal sector's global competitiveness and relative contribution to the Queensland economy. The QCA has calculated that "customers will experience an average step change increase of 36%, on a dollar per tonne basis, as at 1 July 2013, compared with the last year of the 2010 access undertaking (2012-13)" ¹.

The effective cost of track access is a key risk for coal producers and is becoming a substantially greater proportion of total production costs. This is especially true for greenfield mines where track and port costs now represent up to 50% of total Free on Board (FOB) costs.

- **Risks** to the coal industry increase disproportionately to the risk profile of Aurizon but Aurizon argues for higher regulated equity returns in its weighted average cost of capital.
- **Vertical integration leveraged to maximum advantage** will be to the long term detriment of competition and hence the competitiveness of the Queensland coal sector. Aurizon is explicitly seeking to replicate the North American class 1 railway model. This model is generally regarded within the industry as having brought about the withdrawal of major investors in the North American coal sector and a relative decline in development of new coal mines and hence loss of market share for North America.
- Commercial positions adopted by Aurizon that represent short term gain for Aurizon management and shareholders will be at the expense of the long term interests of the Queensland economy.

2. Potential Misuse of Monopoly Power by Aurizon will damage the Queensland Economy

The UT4 proposal positions Aurizon as the "king maker" with the ability to effectively decide which mines can be developed, when they can be developed and potentially which ports will see the benefits of expansion - something potential bidders for any privatised Queensland port assets should be mindful of. Such decisions under UT4 are made in Aurizon's so called "legitimate business interests" and ignores the legitimate interests of the companies that have already made significant investments nor those that may contemplate investing in the Queensland coal sector nor the public interest which is served by a strong, growing and confident coal sector.

¹ Queensland Competition Authority, *Consultation Paper Aurizon Network's 2013 Draft Access Undertaking (August 2013)* at 9.

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Under UT4 Aurizon has proposed a framework that:

- Effectively enables Aurizon to decide when mine developments occur, which mines are viable and hence can be developed, and to ignore and override other coal chain capacity allocation processes;
- Enables Aurizon to auction capacity to the highest bidder or to preference access seekers that agree to an integrated service offering by Aurizon for example haulage and/or port services (noting Aurizon has signalled its intent to enter the latter);
- Enables Aurizon to refuse to permit an Expansion even if Access Seekers are willing to fund the Expansion. This hands Aurizon an effective veto over the future growth of the coal sector in Queensland without regard to the broader coal sector commercial interests or willingness for future investment.
- Limits commencement of Expansion studies unless and until Aurizon determines at its discretion that there is likely to be sufficient demand for the service; and
- Reserves the sole right to design, procure and construct Expansions to Aurizon without any commitment to deliver value for money, nor provide any guarantee or accept any risk where the Expansion fails to deliver the promised capacity.

Taken individually or collectively these factors will substantially undermine the objectives of regulation and will act as a disincentive to investment in the Queensland coal sector and potentially chill or devalue appetite for any future privatised coal export infrastructure and ultimately harm the Queensland economy.

3. UT4 highlights a number of fundamental deficiencies in the effectiveness of regulation in Queensland

Aurizon holds a natural monopoly position in respect of infrastructure essential to the export coal industry. Regulation exists to promote economic efficiency by redressing inequality of bargaining power and preventing the misuse of monopoly power. The following provides a snapshot of how UT4 fundamentally fails to meet the intent of regulatory access regimes:

- Aurizon argues for primacy of commercial negotiations then seeks to reduce the effectiveness of dispute resolution processes and in some areas makes the outcome of dispute resolution binding on Access Seekers but not Aurizon (eg throughout part 8). In other areas Aurizon removes capacity for QCA oversight (see part 8 voting process).
- Aurizon publicly acknowledges its desire to expand up the coal supply chain into port ownership/operations but seeks to narrow and weaken the ring fencing protections while giving Aurizon sole discretion as to whether an expansion of the network that would benefit a competing port can proceed (eg see Part 8 in particular at 8.2).
- Aurizon argues the primacy of its “legitimate business interests” in adopting many positions in UT4 but ignores or downgrades the weighting required to be applied to the other factors the QCA must consider under the QCA Act (eg see again Part 8 at 8.2 and also Part 7 at 7.5.2 regarding capacity allocation). Further Aurizon seeks to define terms in the QCA Act (eg definition of matters that may be considered when assessing Aurizon’s “legitimate business interests”) to its advantage and give maximum weight to factors supporting its interests thus usurping the role of the regulator and the legal system in determining such concepts.

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- Aurizon's submission on the Weighted Average Cost of Capital (WACC) argues at every point for the extreme and maximum value for each parameter of the WACC presumably in order to seek to minimise the effect of reductions in risk and debt rates. In reality the risk profile of Aurizon is substantially lower than many regulated firms and should justify downward adjustment of Aurizon's equity beta not an increase as claimed by Aurizon.
- Aurizon puts forward arguments to justify cost increases which are significant (2000% increase in the case of corporate overheads) but cannot identify who the benchmarks are and hence leaves the appropriateness of the benchmarks seriously in question.
- Aurizon promulgates a number of commercial/structural changes to pricing which leave a strong impression that they are designed to prefer the interests of Aurizon Operations (see section 10.6.2.3 and 10.6.3.2 regarding UT1 Take or Pay matters) and yet argues for reduced ring fencing and lighter regulation.

4. Light handed regulation cannot be contemplated for Aurizon

Aurizon is a natural monopoly and there is no countervailing power, regardless of the size and sophistication of the coal companies. As there is no prospect of bypass, negotiations cannot, by definition, be commercial. The only prospect of achieving an equitable and economically efficient outcome if negotiation between the parties fails – is reliance on a robust, predictable and decisive regulatory framework.

The risk of foreclosure of competition or discrimination is significantly magnified now that Aurizon has highlighted its desire to extend up the coal supply chain into port ownership. The weakening of ringfencing provisions and Aurizon's proposed expansion process in UT4 provide ample opportunity for Aurizon to discriminate in favour of its own position in related markets. For example Aurizon could only permit expansions of the network which support use of, or expansion of, a port they own and/or operate or only permit expansions for customers which will use Aurizon's related above rail operators for haulage services.

The coal industry's experience in 2011 in negotiating for capacity (WIRP) required for the participants in the Wiggins Island Coal Export Terminal was that the Access Conditions process in UT3 was easily and seemingly intentionally circumvented by Aurizon.

The QCA's public correspondence with Aurizon and decisions on the WIRP access conditions give a flavour of Aurizon's conduct, including Aurizon denying it was negotiating access conditions (despite admitting being in discussions about such access conditions), denying early works access conditions were actually access conditions and litigating to seek to prevent disclosure of the access conditions being sought so that non-WIRP access seeker stakeholders could assess what was being proposed. More critically, the absence of any viable alternative funding options for the extensions effectively left Aurizon able to extract rates of return well in excess of the regulated tariff for no real additional risk.

In its final decision to refuse to approve the penultimate draft of UT3 on this point the QCA noted as a reason for incorporating the UT3 access conditions approvals process:

It is also now a matter of the public record that the counterparties to those access negotiations are significantly dissatisfied with how some of the negotiations have progressed in the past and that the undertaking has been deficient in assisting them to address their concerns. These coal and train companies are particularly concerned about how negotiations may progress in the future without significant protections being added to the 2010 access undertaking²

² Queensland Competition Authority, Final Decision, QR Network's 2010 DAU (September 2010) at 25.

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That statement is as true now as it then was. In the intervening years those concerns have been realised, and the protections of UT3 have proven illusory when put to the test. Aurizon's conduct in the intervening period warrants a strengthening of regulatory protections against abuse of its market power, not the authorisation for further abuse being sought in UT4.

An effective regulatory failsafe is critical where a monopoly infrastructure owner can engage in tactical delays to ensure its desired outcomes. In Glencore's view the failure to produce and negotiate an effective Standard User Funding Agreement (SUFA) within the timeframe of the WIRP negotiations, the drawing out of resolution of SUFA past the original expiry of UT3, the segmentation of SUFA from the expansion process and the unbankability of the proposed SUFA regime are clear warnings against inadequate regulatory protection for access seekers.

There must be a demonstrable case for reducing regulatory protections. In our view Aurizon's conduct to date indicates a more robust regulatory framework should be applied rather than a lighter touch or reliance on "commercial negotiations".

Conclusion

UT4 was prepared by Aurizon without consultation with industry. UT4 is a complete rewrite of UT3 and represents a fundamental shift in the balance of power towards Aurizon when previous experience suggests that Aurizon will game existing regulatory settings to its advantage.

UT4 presents a clear risk to the Queensland economy through its expected impact on investment in coal production in the State. UT4 fails to balance the range of factors to which the QCA must have regard when considering whether to approve an access undertaking. UT4 seeks to give primacy to Aurizon's so called "legitimate business interests" without recognition of the equally weighted other factors pertaining to a regulated monopoly. The public interest would not be served by the approval of UT4.

Should you require further information or discussion on any aspect of this letter please contact Dierdre Mikkelson on 3115 5396 or myself on 3115 5363.

Yours sincerely



pp Anthony Pitt
Glencore