12 December 2014

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

By email: rail@qca.org.au

Dear Malcolm,

Aurizon Network's 2014 Draft Access Undertaking (UT4) – Maximum Allowable Revenue Draft Decision

Vale Australia Pty Ltd (**Vale**) welcomes the opportunity to provide a submission to the Queensland Competition Authority (**QCA**) in respect of the 2014 Draft Access Undertaking (**UT4**) Maximum Allowable Revenue Draft Decision.

Executive Summary

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, and Vale takes this opportunity to support the QRC's submission to the QCA. Vale also provides further comments below.

Vale supports the QCA's draft decision to reduce the Maximum Allowable Revenue (MAR) submission by Aurizon as it believes this has been an excessive claim that does not promote an efficient operation of the rail network. Vale believes the QCA should go even further by including productivity targets across the maintenance and operating costs to reflect the current market conditions that are significantly different from those that existed at the time of the approval of UT3. The most significant changes to the current market conditions are Aurizon's privatisation and the movement of the coal industry out of the previous growth cycle to a productivity cycle. Vale believes these two market factors are generating two competing goals within the UT4 envrionment as Aurizon's focus, as a private company, is to push the boundaries of regulation to increase their return while the coal industry is undergoing significant productivity programs within their operations and are seeking similar productivity improvements from its service providers to ensure the coal industry in Queensland remains competitive in the global coal market.

1. Market Conditions

Vale agrees with the QCA's comments about the state of the current global coal market and the challenge this is currently presenting to the Queensland coal industry. The global coal market has moved into a period of oversupply and this has moved the Queensland coal industry from a period of high growth into a productivity cycle. This has resulted in the coal industry challenging costs across all aspects of its operation to remain competitive in the global coal market. Vale believes a level of caution is therefore required when benchmarking costs between growth and productivity cycles as efficient costs under a growth cycle are significantly different to efficient costs under a productivity cycle. A productivity cycle is characterised by ongoing productivity improvements and high levels of innovation to maximise the performance of the infrastructure.

This is also the first undertaking that Aurizon has developed as a privately-owned business after the divestment by the Queensland Government in 2010. Vale believes this context is important in assessing the UT4 claim as the drivers of privately owned businesses are significantly different to the previous government owned shareholding that would have considered some level of community and state benefit by increasing access to the network. A privately owned business is driven to maximise returns for its shareholders, rather than increased access, and a revenue cap form or regulation creates an incentive to overstate cost forecasts to maximise its revenue allowance.

2. Maximum Allowable Revenue and Indicative Tariffs

Vale believes that Aurizon is substantially shielded from the impacts currently facing the coal market today due to the revenue cap form of regulation so it is important for the efficiency of the coal industry, now and in the future, that mechanisms are established to ensure that Aurizon continues to pursue prudency and efficiency in cost allocations. Vale supports the considered approach by the QCA that challenges the cost forecasts of Aurizon, but is concerned the assessment is based on a reasonable cost approach rather than prudent and efficient costs. Vale believes an assessment that a cost is reasonable is likely to have a lower level of proof than a prudent and efficient measure. In saying this, Vale also acknowledges the concerns raised by the QCA of the absence of suitable benchmarking options and a desire to develop a more robust baseline and measurement system post the 2014 DAU. Vale supports the future development of a robust measurement system which will allow the QCA to assess costs on a prudent and efficient basis.

3. Operating Costs

The QCA has outlined in its draft decision that it considered actual expenditure for system-wide and regional costs as the best estimate of efficient costs to evaluate the proposed Aurizon operating costs. Vale is concerned with the use of the actual expenditure as the effective benchmark as there is no clear understanding of the efficiency of these costs. The FY13 costs incurred significant cost for restructuring that are not likely to be incurred in future years as they are either one off costs or ongoing efficiency gains that are established by the restructuring. Vale believes using this as the base year is likely to overstate Aurizon's costs as this year has been identified in Aurizon Holding's investor briefing presentation of 18 July 2013 (Slide 26) as the base year in its drive to sustainable earnings growth. Aurizon Holdings has identified ongoing cost improvement initiatives to be undertaken by the business to reach these goals, and therefore, this suggests the FY13 is potentially the highest cost year. Vale is also concerned about using any actual cost history from Aurizon as it still represents business costs of a company transitioning from government ownership and Vale would expect to continue to see efficiency and cost reductions over the next few years.

Vale believes a productivity factor should be retained as it would continue to drive efficient behaviour and a focus on continuous improvements which reflects the stated aim of Aurizon Holdings and replicates the processes currently being undertaken by Aurizon customers in their productivity drive. SKM indicated that a productivity factor is not required as it is more appropriate for Aurizon Network to identify cost savings from specific and achievable changes to the operating environment. Vale believes this reliance on voluntary reductions by Aurizon, is important, but will not replicate market competition pressures that drive innovation to become more efficient in a timely manner. Vale notes that significant cost reductions have been announced to the market since the privatisation of Aurizon Holdings but the large majority of these efficiency measures appear to relate only to the non-regulated part of the business that is subject to market competition pressures. Therefore, Vale believes a productivity focus across the Aurizon business is appropriate to reflect a competitive market environment and is also important as Aurizon transforms from government ownership. Vale does not believe, as suggested by SKM that only identified productivity improvements are included as it does not promote a robust innovative and continuous improvement culture that reflects the market conditions of its customers.

Vale supports the concept of developing a more rigorous benchmarking approach for UT5 as it is likely that the Aurizon Holdings business will be significantly different as the company moves from an entity predominately operating as an integrated coal rail provider in Queensland to a company that has potentially multiple railway operations and ports. This will introduce an increased level of complexity in the allocation of overhead costs to replicate a stand-alone network business in the future.

SELF-INSURANCE

Vale is concerned with the process that has been undertaken by Aurizon to determine the level of self-insurance required in UT4. Vale believes the development of the premiums should be based on a robust and transparent process that assesses future risk, which is guided by past claims but not determined by history repeating itself.

Vale notes the comments by the QCA that is tis considering whether the current arrangements are consistent with an effective insurance arrangement. Vale welcomes further information on this proposal but provides the following comments. Vale believes the level of risk and exposure to potential review events are influenced by the following;

- The design of the infrastructure which is influenced by the stakeholders in that system.
- The level of maintenance within the system that can be influenced by stakeholders within that system.
- The geographic location of the infrastructure.

Vale believes all these items play a significant part in the risk and exposure to an event to a piece of infrastructure and that equally sharing this risk across the CQCN is not appropriate for an efficient allocation of costs as it does not reflect the historical decisions made by each individual coal system.

Vale also believes there needs to be a better understanding of the performance level and maintenance tasks undertaken in each coal system to ensure there is a consistent methodology across all systems. The QCA notes the recent review event on the Moura line as an example. Vale's understanding is that maintenance on the Moura line reflects the smaller tonnage operating over this line. Vale believes this raises the questions of whether the lower level of maintenance task was a contributing factor to the size of the review event. Vale believes it would be inappropriate to allow the users of a coal system to gain an advantage of lower tariffs, due to a lower maintenance task, but then socialise the premiums or cost pass through review events across all CQCN users.

POWERLINK

Vale would support a review of the prudency and efficiency of the Powerlink contract to consider the commerciality of the commercial terms settled between Aurizon Network and Powerlink. As this is a cost pass through to Aurizon Network there is very little incentive on the two monopoly infrastructure providers to ensure the costs are prudent and efficient. Vale would be interested to better understand the additional risks that Powerlink believe they are exposed to due to this arrangement to justify unregulated charges and would like to understand the details of Aurizon's prepayment proposal.

4. Maintenance Costs

Vale supports the QCA's reduction in the maintenance cost allowance but still has some concerns with the determination of costs being based on reasonableness rather than efficiency, and comparing of UT4 unit costs to UT3 actual costs. Vale raises the following key points on this assessment.

- Are the UT3 costs efficient given SKM has assessed that scope targets were not achieved during UT3.
- Are costs being duplicated as they are were previously included in the UT3 maintenance allowance.
- Aurizon has justified some of the increase in scope and expenditure due to the increased quantity from expansion infrastructure such as WIRP Stage 1. Vale acknowledges that WIRP Stage 1 will increase the quantity of track but also believes this needs to be offset by reduced maintenance associated with new track as it is likely to only require inspections during the UT4 period. As most of this infrastructure involves the duplication of the Blackwater System, there is also likely to be some additional benefits to track access for future maintenance tasks.
- It is also not clear to Vale whether the significant increase in capital renewals has been captured in the assessment of efficiency of the maintenance costs for UT4. There has been a significant shift in Aurizon's approach to capital renewals and it is unclear from the draft decision whether this was factored into the assessment of maintenance costs when comparing against the UT3 actual costs.

Vale believes that a new method of determining maintenance cost efficiency needs to be established to assist in benchmarking and reduce the risk that customers are paying inefficient costs due to the failure to achieve scope. Vale would welcome the development of a transparent process that provides greater understanding of both the maintenance costs and scope that was completed. Vale would like to see a robust approach that considers items such as the evaluation of alternative projects as well as an ability to influence the maintenance tasks to reflect changing economic conditions and market demand. Past maintenance forums completed by Aurizon have provided limited information on the maintenance program but Vale believes that a new maintenance approach must go beyond this level of discussion to provide greater transparency to all stakeholders while maintaining incentives for cost and performance to achieve the most efficient outcome

5. Ballast Undercutting Costs

Vale believes it is difficult to provide a clear response on this topic as there does not appear to be a clear view on the state of the network and what ballast undercutting is required in UT4. The condition based assessment conducted by Evans and Peck in 2013 did not conclusively suggest that significant remedial work was needed, however, Aurizon justified their UT4 ballast undercutting costs on the basis that there were high levels of coal contamination. SKM's review of the ballast undercutting task suggested that it was high due to the existing fouling that was not addressed in the UT3 period. These views make it difficult for Vale to comment effectively on the ballast undercutting costs themselves so it provides the following comment on the principle for determining the appropriate cost. Vale believes that the uncertainty on the network condition leads to two options;

- Determine the ballast undercutting is high due to coal fouling and retain the impairment charge, write down the assets, and exclude the cost of remedial work as this would have been considered allocated under UT3; or
- Determine that the remedial work is not required and develop the UT4 ballast undercutting budget based on a network in good condition and RAB impairment charge discontinued.

The QCA has proposed to accept the second position and Vale supports this from the perspective that it applies this principle consistently.

As with the operating costs and the other maintenance costs, Vale believes a new approach is required to reach a transparent understanding of the state of the network and the appropriate level of the ballast undercutting task. The appropriate level of ballast undercutting has been discussed since the establishment of the first undertaking and transparency and clarity on the topic is still lacking. Vale is disappointed in this situation given ballast fouling was extensively used during the Coal Loss Management Project as justification for the implementation of veneering of coal wagons. Veneering has now been installed yet Vale continues to see an increasing claim for ballast undercutting.

Return on Investment

Vale supports the reduction of Aurizon's WACC and the QCA's views that there is no justification for adopting Aurizon's upper bound of its range estimates for each parameter. Vale supports the approach to determine the best estimate of each parameter rather than erring on the high side as this approach reflects the requirement to balance the different considerations of each parameter.

The QCA's draft decision is to allow a cost of debt of 6.15%. Vale supports the approach used to determine the risk free rate as it is based on the advice provided by Professor Lally. The draft decision on the debt margin proposes to introduce an econometric methodology rather than the use of Bloomberg data. Vale believes that it would be prudent to utilise both methodologies and base the debt margin on the average of the two mythologies as this is likely to produce a more robust result as it increases the number of data points which potentially limits any exposure to bias or error. Vale supports the QCA's draft decision on debt raising costs if the QCA has determined through comprehensive analysis that this reflects the costs that would be incurred by a prudent and efficient business.

The QCA's draft decision is to allow a cost of equity of 8.41%. The QC's draft decision on the market risk premium (MRP) has been to move away from the historical method of averaging the equal weighted estimates produced by the various methods and instead form a range from these methods and then apply best judgement to the determine the final point. It is noted that the MRP is not observable but Vale believes the QCA has undertaken a conservative approach to the point estimate and believe the proposal is at the upper end of a reasonable range.

One component of significant concern to Vale is the level of the asset/equity beta assessed for Aurizon. Vale supports the QCA's draft decision not accept Auizon's estimate and that Class 1 US railroads or Australian listed industrial transportation firms are not appropriate comparative firms for Aurizon as Vale believes that these firms do not have the same supporting mechanism to limit their risk exposure. Vale notes the QCA draft decision identified an asset beta range between DBCT as a lower bound and toll-roads as an upper bound. Vale believes the DBCT asset beta should provide a greater influence on the Aurizon asset beta as both firms operate within the coal industry in the Bowen Basin and have similar regulatory control under the QCA.

Vale believes Aurizon's revenue risk is closer to DBCT than the upper bound of other toll-road firms as it is shielded from demand shocks by the following regulatory mechanisms;

- revenue cap form of regulation,
- strong take or pay obligations,
- annual volume forecasts,
- annual adjustments for MCI and CPI,
- ability to claim additional cost for review events
- depreciation regime that reduces stranding risk

Vale believes the use of toll-road in the range of estimates is likely to result in an upward bias in the asset beta range as their level of risk is significantly higher than Aurizon's. Vale believes the utilisation of the toll-roads already introduces a conservative element to the assessment of the asset beta and therefore the QCA approach to round the equity beta up to 0.8 is not justified.

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

Yours sincerely,

Anneliese Mattos
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