09 March 2012

Mr John Hall
Chief Executive Officer
Queensland Competition Authority
GPO Box 2257
Brisbane Qld 4001

By Email: To: rail@qca.org.au

Dear Mr Hall,

Electric Access Draft Amending Access Undertaking (DAAU)

I refer to the QCA's invitation to provide submissions regarding QR Network Pty Ltd's (**QRN**) Electric Access Draft Amending Access Undertaking (**DAAU**) dated December 2011 and QRN's submission in support of the DAAU (**Submission**). Vale Australia Pty Ltd (**Vale**) appreciates the opportunity to provide this submission as part of the consultation process on this very complex issue that will have a major influence on future pricing directions and the above rail market.

Capitalised terms in this letter have the meaning given in the 2010 Access Undertaking (**Undertaking**) unless otherwise defined.

Vale commenced coal operations in Queensland in 2007 through the acquisition of the coal interests of AMCI. Vale has a large pipeline of future coal projects throughout the state and wants the Undertaking to develop in a way that maintains a clear framework for allocation of economic benefit for future expansions of the coal rail network. This will facilitate Vale's ability to bring its pipeline of projects to production, which will provide many financial and social benefits to the local communities where they operate, and the state generally.

Vale outlines its comments/concerns regarding the proposed DAAU and Submission generally below.

1. DEVELOPMENTS WITHIN THE COAL SYSTEMS

1.1 History

The Goonyella and Blackwater systems operate as two separate systems within the Central Queensland Coal Network.

The multiple editions of the Coal Rail Infrastructure Master Plans (**CRIMPs**) were developed to gain endorsement by the respective users of each rail system of any infrastructure developments and investments to occur on that system. Based on this decision making process, each stakeholder contributes to the cost and shared in any benefits for each of the two systems under a "user pays" approach.

The CRIMP process demonstrates that QRN itself has and continues to treat the Goonyella and Blackwater systems as two separate rail corridors. QRN has developed the two rail systems at different rates and there is no process by which non-users of each system can participate in QRN's decision making process for that system.

One such difference in QRN's treatment of the two systems is QRN's delay in developing electric infrastructure on the Blackwater system. QRN states that the Blackwater system has been restricted in the use of electric traction due to the lack of infrastructure. This has created uncertainty for above rail operators and producers alike in respect of their future plans to invest in rollingstock assets. Consequently, above rail operators and producers using the Blackwater system are not currently in a position to choose to run electric services even if that is their preference. This has promoted sub-optimal investment and use of electric traction infrastructure on the Blackwater system by users of that system. Vale is of the view that this has led to the current problems with the Blackwater system, which include those alluded to by QRN in its submission to the QCA. Vale is also of the view that this is the reason why large investment is now required to create a step change to increase the electric capacity on the system.

In contrast, the Goonyella system operates on the basis of 100% utilisation by electric services. The 100% electrification of the Goonyella system stems from the capital contributions of above rail operators and producers using the Goonyella system as envisaged by the pricing principles of Section 168A(a) of the *Queensland Competition Authority Act 1997* (**QCA Act**) and the regime created by the Access Undertaking.

QRN in its submission has not been entirely transparent as to why or how the two systems have developed differently. In Vale's view, the reason for current inefficiencies on the Blackwater system are due to misguided investment decision making and lower investment and capital contribution on the part of Blackwater system users.

1.2 Cross system traffic

The Submission indicates that above rail operators are directing electric locomotives to the Goonyella system rather than the Blackwater system to derive costs savings. Vale believes this choice is being made by informed above rail operators to achieve their commercial outcomes in the competitive market and should not influence the QCA's consideration of QRN's DAAU.

Vale also considers that although there is some level of cross system traffic between the Goonyella system to the Blackwater system, this remains relatively minor in tonnage levels. Despite this minor cross system traffic, voting and expansion approvals by users are determined on an individual coal chain system basis pursuant to the CRIMPs.

That is, there is not a significant proportion of Goonyella system users who potentially operate on the Blackwater system and have the potential to influence decisions on that system.
Vale considers that low levels of cross system use should not be seen as a reason to socialise the costs for the upgrade and installation of electric infrastructure on a system.

Vale believes, therefore, that this cross system traffic should not be considered in the QCA's consideration of QRN's proposed amendment. To do so will set a negative precedent for future upgrades and developments of existing and future below rail systems. For example, the Northern Missing Link was not electrified due to a decision to "optimise the capital" by the users of this project. If the QCA approves QRN's proposal, Vale is concerned how future electrification of the Northern Missing Link may be funded.

2. PRICING

Given QRN's differential treatment of the Goonyella and Blackwater systems and the resulting difference in capital contributions made by the users of each of the two systems over time, Vale is very concerned with QRN's proposal to amalgamate the electric reference tariff of both systems.

As a threshold issue, Vale notes that many of the original electric assets of the Goonyella system have been in operation for many years and are now approaching the end of their life cycle. . The value of these electric assets has depreciated considerably over this time, which is contributing to the users of the Goonyella system, who paid for the installation of those assets, now paying a tariff considerably lower than the tariff Blackwater system users would pay if electric assets were to be installed today. Vale notes, however, that the Goonyella system is currently undergoing an upgrade of the electric assets. This is discussed in more detail in paragraph 2.4 below.

2.1 A revenue maximising approach that does not directly address inefficiencies

Vale is of the view that the proposed amalgamation of tariffs and the introduction of an electric utilisation rebate will not discourage the inefficiencies within QRN but will increase the revenue for QRN without necessarily providing an incentive to decrease utilisation of diesel traction on the Blackwater system. QRN has said it will seek to pursue further price increases in future to ensure the cost of using diesel locomotives is fully reflected in the tariff. It is unclear why it is not doing so now where to do so may not result in it imposing two sets of price increases for above rail providers.

In this sense, QRN's proposal to socialise the costs of electric traction across the two systems first and then impose a price rise to discourage the inefficient use of diesel traction appears to be a strategic one. It will be more difficult to justify the socialisation of the tariffs across both systems if there is a pricing mechanism to address diesel traction choice already in place. Vale is of the view that this allows QRN as a monopolist to extract price rises on two separate occasions unnecessarily. The socialisation of the tariff, in fact will increase inefficiencies in the use of the systems by distorting pricing signals.

Arguments to the effect that Goonyella system users are deriving a benefit from the inefficiencies on the Blackwater system without paying for the benefit do not address the problem. Vale considers that QRN's proposed pricing structure does not encourage efficient use of capacity. In light of the historical development of the Blackwater system, it would appear that the better approach would be to use a pricing mechanism based on capacity and "user pays" principles where the allocation of costs is reflective of economic benefit. As QRN has outlined in its submission, there is a loss of capacity between diesel and electric locomotives due to slower cycle times. If this loss of capacity is proven it should be factored into the pricing structure to ensure there is a direct economic consequence for choosing a particular type of traction control where that type of traction control has a negative impact on the efficient operation of the system.

Vale believes valuing capacity will be the most efficient economic means for encouraging participants to seek more efficient use of the scarce resource of capacity rather than an approach that is not aligned with any clear economic driver other than a reduction of the risk for QRN. Additional costs will be incurred for services that do not meet the requirements. It will also be consistent with the pricing principles in the QCA Act, such that access charges for diesel services reflect the full cost that those services impose on the rail system.

A clear pricing mechanism for options that reduce capacity enables all stakeholders to make an informed choice on their above rail solution. This ensures the competitive above rail market continues to operate as it should with traction choice one of many options available to the operators for differentiation.

Accordingly, Vale would prefer to see the development of system assumptions and within this development of a standard train efficiency required to maintain optimal system capacity. This

alternative approach would provide a price signal which creates an incentive to reduce costs and increase rail system productivity in terms of traction mix and, in doing so, promote technology that provides the least cost system for end customers from a whole of rail perspective. The price signal provided by an approach that addresses the economic consequence of the use of diesel traction is a more viable price signal than deferring the recovery of revenue cap amounts as proposed by QRN. It would also directly conform with the pricing principles contained in section 168A of the QCA Act which guide the QCA in its determination of these issues.

2.2 A cost shifting approach

Vale is concerned that QRN's proposals as outlined in the DAAU and Submission are an attempt to transfer the cost of the inefficiencies and misguided above and below rail decision making on the Blackwater system to above rail users of the Goonyella system.

QRN's proposed approach fails to recognise:

(i) that Vale's competitors in the Blackwater system were able to commence operations with a cheaper upfront capital construction cost of rail infrastructure without electrified assets;

(ii) the value and cost that the Goonyella system users have spent, and are currently spending, to have a fully electrified system; and

(iii) that if Goonyella users are now required to absorb costs from the Blackwater system it would mean the Goonyella users will be required to assist users of the Blackwater system to pay the cost of upgrading the system to a fully electrified system.

Vale and other non-Blackwater system users have never had the opportunity to approve or even comment on any of the developments on the Blackwater system. As canvassed above, the CRIMP process is based on individual systems and only allows users of that system to vote on investment and developmental decision making for that system. This mechanism was introduced to ensure that voting was related to economic benefit and that users that had a right to vote also gained economic benefits from the new infrastructure. To suggest that non-users of the system should now share the costs between two systems is inconsistent with how each system has developed.

The argument that Goonyella system users are deriving a benefit from the Blackwater system without paying for it does not factor in the fact that many of the inefficiencies of the Blackwater system are due to past investment decisions over which non-Blackwater system users have had no control or influence.

2.3 Encouraging poor decision making

Vale is also concerned that socialisation of the reference tariff across both systems will set a precedent in the market which will encourage or at least not discourage poor decision making in future. In a given instance, an access provider and users of a system can elect to not pay upfront capital investment towards upgrading the system in a way that encourages efficient use and the creation of economic benefit from that system in the knowledge that it may be possible for users of another spate system to absorb the costs of their poor decision making.

This is important for Goonyella users as modelling by the ILC and QRN indicates that the commencement of diesel traction from the GAPE users is likely to reduce Goonyella system capacity. The lack of investment towards avoiding the use of diesel on the GAPE system will lead to similar problems. Vale is particularly concerned that the adoption of QRN's current proposals will set a precedent to be applied as a "quick-fix" solution in the development of the GAPE system and any other system for which there has been poor and inefficient investment from a below rail perspective.

2.4 Future Goonyella Electric Asset upgrades

QRN has previously advised that the Goonyella Power System Assets are approaching the end of their life cycle. QRN is developing a renewal program to understand what assets need to be replaced and those that can be refurbished. QRN has indicated to users that the impact of not completing these upgrades on the 100% electrified Goonyella system would run the significant risk of stranded train movements due to electric asset failures. Given the critical nature of these works it is highly probably that Goonyella Producers will endorse the upgrades pursuant to the CRIMPs process.

Goonyella users have already approved $57M for the Wontonga feeder station, Grosvenor and Broadlea track section cabins in the 2010 CRIMPs. Under the CRIMPs process, it is the Goonyella users only who would have to fund the cost of the renewal program. QRN's pricing proposal does not identify how this would change if costs were to be socialised across the Goonyella and Blackwater systems.

3. ABOVE RAIL COMPETITIVE DYNAMIC

3.1 Above rail asset stranding risk is not a relevant consideration

QRN has expressed concern about the electrification of the Blackwater system being stranded unless it can socialise the costs across the two systems.

Stranding risk in the context of below rail assets was specifically considered in the decision on the current Undertaking. As such, Vale does not believe there should be further allowance for stranding risk unless there is a corresponding reduction in the return provided to QRN.

The concerns in the Submission, however, are expressed to be from an above rail perspective. Vale is of the view that QRN's concern about the stranding risk of above rail electric assets may actually stem from the market uncertainty of QRN delaying the upgrading of the Blackwater electrified assets. It appears from the data provided in the Submission that QRN's above rail operator has invested in electric locomotive assets on the basis that construction of the upgrade on the Blackwater system would occur. As this upgrade has not occurred, these above rail electric assets may not be used.

Vale considers that the proposals put forward by QRN in the DAAU may be a means to address this. In Vale's view, factoring in above rail costs incurred as 'stranded assets' in the determination of pricing within the regulated rail system is inappropriate and inconsistent with the purpose and objectives of the QCA Act, the Undertaking and access policy generally.

Vale is of the view that issues relating to business decisions of above rail operators are part of the competitive above rail market and should not influence the regulatory decision making process.

3.2 Above rail competition

In the context of above rail asset choice, Vale is also concerned that QRN's proposals are a reaction to greater competitive force created by its closest above rail competitor, Pacific National. Vale understands that Pacific National primarily hauls by diesel traction on the Blackwater system.

With respect to above rail competition generally, Vale is concerned with the reference made by QRN in the Submission indicating that the amendments to the DAU it proposes "*may impact on the opportunity for a new rail operator to be able to effectively enter the market on a small scale.*" Vale is of the view that this will introduce barriers to entry and will potentially restrict the development of further competition in the above rail market.

4. CONCLUDING REMARKS

Vale considers the issue of electric asset pricing as developed by QRN in their report to go much further than is necessary. Amalgamating the electric cost over both the Goonyella and Blackwater system does not align the economic benefit of the users with the costs of usage.

QRN has contributed to the above rail decisions on traction selection by delaying and providing an environment of uncertainty on upgrades. Vale believes the pricing principle should be related to system capacity loses. If a train configuration does not maintain a standard cycle time, to maintain system capacity, then a pricing mechanism should be implemented to promote or at least identify this differential. This allows the users of the system to clearly evaluate the above rail choices they make. This also encourages the customers that are evaluating the above rail options to understand the economic decision of their outcome. Vale is also concerned that the current proposal is bringing above rail decisions into the assessment.

Pricing principles should encourage better outcomes for system capacity and should be aligned to the customers with the economic benefit.

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

Yours sincerely,

[redacted]

Bob Skuza
General Manager Logistics
Vale Australia Pty Ltd