



17 February 2010

Mr Paul Bilyk
Director
Queensland Competition Authority
Level 19 , 12 Creek Street
Brisbane QLD 4001

Dear Paul

QRNetwork Access Framework

Xstrata Coal Queensland (Xstrata) submits this letter in response to the Draft Determination issued by the QCA in relation to QRNetwork's draft access undertaking (UT3).

In summary, Xstrata strongly supports the QCA's Draft Determination to reject QRNetwork's draft access undertaking UT3. We believe the QCA's review of UT3 provides an important opportunity to rectify many of the shortcomings of the existing access undertaking (UT2). There are four major areas of concern:

1. **Expansion delays.** Track expansions are, in Xstrata's view, running up to two years behind expansions in port capacity at the three major export supply chains in Queensland of Abbot Point, Dalrymple Bay and Gladstone. UT3 must establish a commercial framework to ensure a coordinated approach to investment planning across the coal chain, and to encourage timely expansion so as to ensure these delays are not repeated.
2. **Excessive returns.** An objective of the regulatory framework is to provide QRNetwork with a return on capital commensurate with its risk. As such it should not be allowable for QRNetwork to make investments at returns exceeding the regulated rate. In scenarios where QRNetwork is unable to invest or is seeking a higher return, there must be a clear and defined mechanism whereby third-party proponents can develop competitive alternatives for expansion so as to avoid potentially having to pay excessive rents to a monopolistic provider exercising its market power.
3. **Lack of Coal Chain coordination.** Misalignment of coal chain contracts is a major cause of vessel queuing and associated demurrage costs which adversely affect the Queensland economy; this can be readily addressed in UT3 by ensuring coordination of master-planning and associated coal chain contracts. The industry has put significant work into addressing contractual alignment issues by developing a Long Term Solution (LTS) for the Dalrymple Bay Coal Chain, to which QRNetwork is a signatory. UT3 should bind QRNetwork to the principles of the LTS to ensure the misalignment and resulting costs of the current arrangements are not carried forward into future contracts.
4. **Foreclosure of competition:** It is critical to the establishment of a robust above rail market that competition be encouraged. This requires strengthening of the ring-fencing

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and equitable treatment provisions which exist under UT2. However the proposed drafting of UT3 actually weakens the ring-fencing arrangements and protections for above-rail operators to be treated equitably. This potentially creates unacceptable risks to new entrants and to investment in above rail capacity.

Rather than actively resolving shortcomings with UT2, it is Xstrata's opinion that the draft UT3 exacerbates these shortcomings. The substantial weakening of the regulatory arrangements proposed by QRNetwork represents a significant threat to the original objectives of National Competition Policy and the need to ensure that efficient, consistent and transparent rules of market conduct apply to monopoly providers of essential services.

The attached paper expands on the key issues with UT3, together with some proposed amendments designed to address shortcomings with UT2. We also recommend that the QCA and QRNetwork review the ACCC's Position Paper released last week on ARTC's Draft Access Undertaking, particularly with respect to the need to encourage aligned commercial arrangements across the supply chain.

While we believe our concerns in relation to UT3 are critical regardless of the ownership of QRNetwork, we are also concerned that, when considered in the context of the proposed privatisation of a vertically integrated Queensland Rail company, the draft UT3 poses a further material threat to the bankability of future mining projects which are reliant on continued investment in below rail infrastructure.

Under the proposed regulatory arrangements, a privately controlled QRNetwork could:

- Manage major investments in future network capacity outside of the regulatory framework which will effectively remove the protections afforded to users of the network by the QCA regulatory regime;
- Frustrate the efforts of third-party investors seeking to install rail capacity where QRNetwork is not willing to do so;
- Discriminate in its treatment of the above rail operators in favour of QRNational over other rail operators and act to foreclose competition; and/or
- Refuse to participate in critical coal chain reforms being pursued to align track capacity with the capacity of the rest of the supply chain, and hence fail to provide exporters with certainty of access to supply chain capacity.

Xstrata Coal is concerned that the privatisation of QRNetwork as proposed, even if delivering short term financial gains to the State, will be a medium and long term detriment to the Queensland and Australian economies in terms of exports, infrastructure investment and employment. In addition, we believe the proposed IPO is fundamentally inconsistent with the Competition Principles Agreement between the States and the Commonwealth (due to its lack of any assessment of impact on competition) and does not take heed of the lessons from telecommunications privatisation or issues associated with the regulation of Dalrymple Bay Coal Terminal.

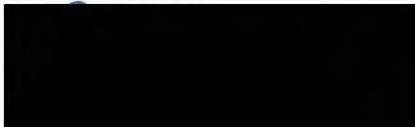
Future mining investment in Queensland is dependent on a regulatory regime which promotes timely and efficient investment in rail track infrastructure as an essential service. Commercial arrangements must support a competitive above rail market and deliver mining companies reliable access to efficient and competitive export supply chain infrastructure. The proposed privatisation of a vertically

integrated rail company which is able to operate substantially outside of the regulatory framework fundamentally undermines these requirements.

Xstrata Coal Queensland therefore believes it is imperative that the QCA intervene to address this risk on behalf of the mining industry and in the broader economic interests of the State and Australian exports. With the future ownership structure of QRNetwork uncertain, it is prudent to enshrine key elements of the regulatory regime into legislation and/or lease agreements to ensure they are not diluted or removed via future undertaking revisions and amendments.

Please do not hesitate to contact my office in relation to this letter.

Yours sincerely



Reinhold Schmidt
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Xstrata Coal Queensland Pty Ltd

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Attachment: Key Concerns re QRNetwork's UT3

Regulatory Timeliness

It is of significant concern to Xstrata Coal that the legislative timeframes contained in the *Queensland Competition Authority Act 1997* (QCA Act) for timely completion of regulatory processes have not been met in QRNetwork's draft UT3 process. The difficulties in the resolution of QRNetwork's Third Draft Access Undertaking (draft UT3) process, points to underlying weaknesses in the regulatory framework as prescribed in the QCA Act. This situation, combined with the impending privatisation of a restructured and vertically integrated QR National represents a significant threat to the original objectives of National Competition Policy and the need to ensure that efficient, consistent and transparent rules of market conduct apply to monopoly providers of essential services.

QCA Draft Decision

Xstrata Coal supports the QCA's Draft Decision and would like the QCA to consider key in-principle issues in order to deliver to industry the regulatory certainty necessary to underpin its existing and future investment in the Queensland Coal Industry.

The stifling of investment and QRNetwork's ability to effectively manage investment to bring it outside of the regulated network.

Over the last two years, QRNetwork has introduced significant commercial uncertainty to any industry discussions about future capital investment (either to the existing rail network or to major new rail projects). QRNetwork has implied that it requires a percentage uplift to the regulatory rate of return as an incentive to invest in any new capital investment required by the industry to meet future coal demand.

Of most concern to Xstrata Coal, is QRNetwork's ability to stand outside the regulatory framework. The QCA's view is sought on whether this position is sustainable under the QCA Act or Part IIIA of the *Trade Practices Act* (TPA Act), particularly where the regulated rate of return has been determined by the relevant economic regulator as being a reasonable commercial rate of return commensurate with the risk profile reflected in both the Access Undertaking and relevant Access Agreements.

The need for an obligation to invest

Importantly, there is a need for the QCA to strengthen the investment rights and obligations of the industry in the face of this QRNetwork position. Section 118 and s.119 of the QCA Act does provide an ability for coal producers to "require" QRNetwork expand its network, but it does not require the cost of that expansion to be paid for by QRNetwork. However, for these clauses to be effective and give sufficient commercial certainty to trigger investment, industry needs greater clarity and certainty regarding the processes to be followed should industry or individual coal producers seek to exercise a right to require a mine specific expansion of QRNetwork's infrastructure.

This is an important issue as it will underpin increased investment, employment and growth in regional Queensland.

Specifically, Xstrata Coal would like the QCA to consider including the following detail in UT3:



1. The clearly defined trigger mechanism and efficient process for third parties to follow should they choose to initiate, fund and construct a private expansion project for the necessary railway infrastructure to facilitate the raiing of the additional volumes, together with interface agreements with QRNetwork for existing infrastructure.
2. Clear entitlements arising from third party expansions, particularly with regard to the following matters:
 - o Co-ordination responsibilities of QRNetwork to assist and facilitate private expansion projects on or adjacent to its rail infrastructure, including access rights to the existing rail corridor;
 - o management and control of the project execution of private expansion projects, including rights to undertake a competitive procurement tender process for the design and construction of the private expansion project;
 - o terms and conditions of capacity rights generated by private expansion projects, including ownership rights to the capacity generated;
 - o recovery and return on investment from the private expansion project;
 - o financing models; and a
 - o Rebate or revenue model for the investors in the private expansion project.

Of fundamental importance to industry, is the concept that major projects (as defined by the QCA in the Draft Decision) should not be allowed to be effectively stifled by QRNetwork and negotiated outside the regulatory regime without recourse to a viable alternative industry funded private expansion model.

The Incentive to Invest

The incentive to invest in coal infrastructure is a combination of both the level of return the investment will make and the risk profile associated with that return. As the QCA correctly points out QRNetwork has experienced minimal business risk since the introduction of regulation and enjoyed relatively stable earnings despite wide swings in coal prices over this time. The fact that QRNetwork's regulatory framework has effectively insulated QRNetwork from any market risk volatility affirms the status quo in terms of return being considered in the light of the rights and protections afforded by the regulatory regime.

The question therefore is whether the status quo of the regulatory framework effectively delivers market stability for QRNetwork at the rate of return proposed by the QCA without the need to introduce further protections via an accelerated twenty year depreciation profile for all new assets being brought into the regulatory asset base.

The issue for Xstrata is that all new rail infrastructure to be constructed in the UT3 regulatory period is of such significant size that it will probably result in increases to access charges, compared to the traditional reduction in access charges that occurs as existing and new producers enter the coal rail market. Accelerated depreciation will only serve to further increase rail access charges and will unnecessarily impact on the viability of mining investments currently being considered by the coal industry. These investments promise to generate significant long term economic benefits for the State of Queensland (i.e. governments, employees and communities). The fact that industry is prepared to invest large amounts of capital with a long term return horizon should stand alone as the testament of industry's long term commitment to the industry, without the need for QRNetwork to reap further benefit through adoption of an accelerated depreciation profile for new assets. The misalignment between the coal industry and QRNetwork's long term investment profile going forward could



potentially serve as a disincentive on coal investment, particularly given the future viability of many new coal investments will be reliant on low cost rail infrastructure expansions and enhancements.

Whole of Coal Chain Initiatives

The misalignment of track infrastructure expansions to the export coal terminal expansions targeting the same coal demand requirements has become a common feature of constrained central Queensland coal chains. The 2007 O'Donnell Review emphasised the need for investment in coal chain infrastructure to be effectively coordinated and contracted in order that it delivers optimal and efficient coal chain outcomes. Since this review Xstrata Coal, together with QRNetwork, has participated in the development of the Long Term Solution at the Dalrymple Bay Coal Chain (DBCC) and believes that this model, along with the HVCC contractual alignment model in NSW, provide important guideposts for the development of an overarching process across all coal chains comprising multiple service providers and coal producers.

The QCA Draft Decision, the current UT3 Draft and the proposed Part 11 Exposure Draft released by QRNetwork does not provide Xstrata Coal with the comfort that QRNetwork is required under its regulatory framework to provide a coordinated and contractually aligned framework for access rights to the rail infrastructure component of the coal chains within which it operates. Failure to provide such an outcome leaves industry exposed to potentially costly investment decisions which may have been more efficiently managed if viewed within the context of both upstream and downstream elements of the coal chain. Specific concerns with the Part 11 Exposure Draft include:

1. Part 11 is non-binding in nature and does not prevent QRNetwork from contracting capacity based on its own assumptions even where system assumption discrepancies have been identified either via the CRIMP process or via a whole of coal chain planning forum. Clause 11.3 only provides a best endeavours guarantee to the extent QRNetwork has (a) agreed to adopt the same system assumptions (it is not clear what onus there is on QRNetwork in this regard); (b) otherwise not contracted for that capacity on different capacity assumptions in any other (either current or future) Access Agreement; and (c) identified that compliance with contractual alignment is consistent with its commercial objectives.
2. Clause 11.3 provides no incentives to efficiently manage capacity generated through expansion projects. Where an expansion does not practically deliver its stated capacity level it simply results in a pro rata reduction without reference to liability, loss or the responsibilities of all supply chain parties. For example where capacity loss can be directly attributable to the actions of parties then those parties must be held accountable for those actions (eg by incurring the full impact of the resultant capacity reduction rather than spreading the impact across all customers).
3. Clause 11.3 does not include the basic key principles underpinning contractual alignment of the coal chains operating on QRNetwork's infrastructure, including the requirements that QRNetwork must:
 - o Contract coal chain capacity with reference to a common view on deliverable system capacity across the different coal chains;
 - o Coordinate and develop the CRIMP process aligned with any system master plan to optimise investment decisions and ensure any investment creates deliverable system capacity;
 - o Ensure growth tonnes can be accommodated but not at the expense of existing contracted capacity; and



- Optimise operational performance of the coal chains by ensuring parties (infrastructure providers and/or producers) bear the true costs of any under-performance.

To be effective, Part 11 must include a mechanism to explicitly require the same set of system assumptions between rail network and port terminal access regimes. Where there are differences between system assumptions of QRNetwork and the export coal terminals, there must be a trigger for QRNetwork to initiate a dispute resolution process and obtain a QCA determination on the appropriate system assumptions QRNetwork must apply in the rail access regime. Only in this way will contractual alignment between network and port be effective.

In terms of the QCA Draft Decision and the draft UT3, and the Master Planning Process, Xstrata Coal also has reservations as to the effectiveness of the CRIMP process in managing and implementing industry's expectations for a coordinated and timely coal chain investment process. Xstrata Coal believes the CRIMP process would become more effective if QRNetwork was required to:

1. Provide greater detail and clarity on the investment projects proposed for customer vote, the project's alignment (both infrastructure and timing) with other coal chain investments and the level of sustainable coal chain capacity that will be created through the investment.
2. Adhere to clear timeframes and deliverables when undertaking customer approved feasibility studies.
3. Be actively involved in joint decision making processes within defined timeframes (as opposed to current ad hoc consultation) with relevant coal producers and coal chain service providers throughout the critical value add stages of a feasibility study.
4. Actively engage with coal producers and coal chain providers regarding the commercial terms and conditions underpinning access to that expansion capacity to enable industry to accelerate that investment when it is required to align to other coal chain and mine investments.
5. Provide greater clarity on QRNetwork's investment stage gate process and the associated timeframes reasonably required to take a project from concept through feasibility, execution and into operation.

Operational Performance Incentives

The UT3 needs to include a process and mechanism by which system capacity is managed, performance and consumption of system capacity is reported and any adjustments to contracted access rights are made. Whilst not dictating what that process should look like, the following elements must be included in the development of an operational performance regime:

1. Performance measurement criteria to extract efficient capacity utilisation from the existing infrastructure;
2. A measurement and performance reporting framework;
3. Incentives and penalties for over and under performance;
4. Capacity segregation into two tranches (a) what the network can deliver in isolation of the coal chain; and (b) what the network can deliver taking into account the coal chain system



assumptions. Key outcome being that network capacity must be sold taking into account the coal chain system assumptions;

5. Obligations with respect to availability and provision of train paths on an origin destination basis (e.g. provision of services less than 90% over 12 months attract a penalty); and
6. Protections to ensure QRNetwork considers optimised rail based solutions based on coal chain performance criteria.

QR National Privatisation and Segregation Arrangements for QRNetwork

The impending privatisation of QRNetwork raises the need for industry to fundamentally reconsider the regulatory framework governing QRNetwork's operations. Other regulatory regimes elsewhere in Australia provide regulatory protections embedded in legislation rather than reliance on access undertakings to deal with issues pertaining to segregation arrangements and market power prohibitions (e.g. prohibiting any discrimination in the provision of services, cross subsidisation and margin squeezing).

The main question raised by Xstrata Coal is whether the current reliance on the Access Undertaking processes in the QCA Act provides sufficient certainty regarding the rights, obligations and market conduct of QRNetwork under a privatised model. Certainly, the access undertaking process is open to amendment and change over time and so many of the rights and obligations industry considers sacrosanct may be at risk if QRNetwork continues to push regulatory boundaries in future regulatory processes. Of relevance to this, is the number of fundamental undertaking features QRNetwork sought to relax through the UT3 process, including the:

1. Removal of the requirement for QRNetwork to demonstrate good decision making processes have been followed
2. Removal of protections to ensure QRNetwork does not give preference to related parties when negotiating and executing access agreements; and
3. Relaxation of QRNetwork's ring-fencing arrangements, for example, in the handling of an access seekers' confidential information

Interestingly, instead of having a more robust access regime with protections for industry from a vertically integrated above and below rail services provider, the ring fencing, information confidentiality and access principles appear to have been lowered.

There is a need to consider the merits of enshrining some of the Access Undertaking's key regulatory principles in the QCA Act or a related instrument eg an Access Code under Division 6 of the QCA Act. Such principles could include a number of explicit obligations on the part of the privatised owner of QRNetwork, including:

1. Recognition that QRNetwork's rail infrastructure meets the access criteria under Part IIIA of the TPA and Part 5 of the QCA Act;
2. An obligation to maintain and invest in all necessary works to upgrade, replace or add to the rail infrastructure to meet future demand projections in a commercial and efficient manner;



3. An obligation to maintain a separate QRNetwork corporate structure which ensures strict segregation arrangements to:
 - Maintain separate entities with separate cost allocation and accounting frameworks;
 - Protect access seeker and access holder confidential information;
 - Avoid conflict of interests;
 - Incorporate a duty to act fairly and equitably;
 - Ensure compliance with anti-hindering and restrictive trade practices provisions;
 - protect access seekers and access holders from QR National allowing individual rail businesses to cross subsidise between their operations and QRNetwork; and
 - Outlines a complaints handling process to manage its compliance with its obligations in relation to segregation arrangements.

In this context Xstrata Coal fully support's Pacific National's submission on the "Elements of an Effective Rail Access Regime" and its consideration by the QCA in the context of UT3. A QCA considered approach to consolidating and identifying the obligations and responsibilities of QRNetwork within a privatised industry model is essential to providing industry with the required certainty around the future operating and investment landscape for the coal network in Queensland going forward.