



07 November 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 FY14 Revenue Adjustment Amounts and Increments

Vale Australia Pty Ltd (**Vale**) welcomes the opportunity to provide a submission to the Queensland Competition Authority (**QCA**) in respect of Aurizon Network's FY2014 Revenue Adjustment Amounts and Increments explanatory memorandum. Aurizon Network (**Aurizon**) is seeking to recover a revenue adjustment and a claim for an Increment relating to the performance on the Goonyella and Blackwater System in FY14.

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

1. Revenue Cap Adjustments

Aurizon has submitted a claim for a Revenue Cap Adjustment for FY2014 based on an over-recovery of electric traction costs and an adjustment for the rebateable revenues. Due to confidentiality claims Vale is constrained in its ability to draw conclusions or make absolute recommendations on the values of the adjustments that have been presented. As such, the process of independent verification by the QCA is critical to ensuring a thorough assessment by the QCA of Aurizon's submission.

2. Increment

The second part of Aurizon's submission seeks to claim an Increment for FY2014 in the Blackwater and Goonyella Systems. The Undertaking allows Aurizon to claim an Increment for a relevant Individual Coal System when the Total Actual Revenue is greater than the System Allowable Revenue. The QCA, when considering the variation, is to be reasonably satisfied that the difference between the Total Actual Revenue and the System Allowable Revenue (**Difference**) for the relevant Individual Coal System Infrastructure has, in whole or part, arisen as a direct result of whole of coal chain activities or initiatives of Aurizon which have increased

the efficiency of the Below Rail network. The Increment, for the relevant Individual Coal System Infrastructure, equals that part of the Difference, as determined by the QCA taking into account the extent to which the Difference has in whole or part arisen as a direct result of the whole of coal chain activities or initiatives of Aurizon. The Increment for an Individual Coal System Infrastructure is not to exceed an amount equal to 2 percentage points of the System Allowable Revenue for that Individual Coal System Infrastructure.

Aurizon view the Increment as an incentive relating to the performance of the Blackwater and Goonyella Systems during FY2014. Aurizon has sought to retain an Increment for the FY2014 of \$4.3M in the Blackwater System and \$4.6M in the Goonyella System. Aurizon states the Goonyella System achieved 111.2Mt in FY2014 compared to the volume forecast of 99.0Mt, while the Blackwater System achieved 66.4Mt in FY2014 compared to the volume forecast of 57.7Mt. In achieving these volumes, Aurizon claimed it achieved 95% of contract or better in 3 months in the Blackwater System and 1 month in the Goonyella System. Vale believes it is important to note that while these results are an improvement on previous years, Aurizon has not indicated that any month has achieved or exceeded 100% of contract.

Vale does not support the provision of an Increment for FY2014 as it does not believe a sufficient case has been established to support the Aurizon claim that its activities caused the additional revenues achieved in FY2014. The contracted tonnages for the network is significantly above the tonnages achieved in FY2014 which suggests there is spare capacity in the network which casts doubt over whether any activities are actually required to enable the capacity to be utilised. Vale believes the increased volumes also could have been achieved due to items such as;

- The current low coal price is incentivising producers to increase their production levels to lower the cost of production.
- Continuous improvement projects being developed and implemented by the various coal chain groups. For example the Integrated Logistics Company (ILC) has been undertaking various projects to understand the throughput constraints in the DBCT coal chain and seek improvements.
- Some the stakeholders in the DBCT coal chain have established the Dalrymple Coal Chain Co-ordinator (DCCC) to identify and improve planning and scheduling efficiency within the coal chain.
- Improved weather conditions which has caused fewer delays in railing during the year.

Vale also does not believe it is fair and reasonable for Aurizon to seek an incentive for the achievement of a volume level lower than its contractual obligation. Under the Revenue Cap Aurizon achieves a return on its investment regardless of the volumes that have been achieved during the past years. Vale believes an incentive should only be provided for outperformance and innovation and this must be referenced against Aurizon's regulated regime, which does provide other forms of incentives, such as the WACC to invest in the network, minimise responsibility for capacity losses, and a maintenance cost allowance to encourage efficient maintenance practises. Vale does not believe a further incentive should be applied for activities that have been established to encourage Aurizon to maximise its position while maintaining an appropriate performance of the network.

Vale also believes outperformance must not only apply to the volumes achieved but also to the level of involvement by Aurizon. Aurizon, as the Infrastructure owner, will be required to participate in most discussions as the network owner and expert to ensure it manages its risks on the below rail network. Vale believes that the provision of advice or an assessment of a proposal, by Aurizon, for an option proposed by a third parties is likely to be part of the normal operation of the below rail network and should not qualify as initiative and activities for the purpose of assessing and Increment.

3. Activities

Vale provides the following views on each of the activities listed in the Aurizon submission.

3.1 Longer Trains

Aurizon claim that almost 40% of the equivalent additional extra train paths came from the trial to operate longer trains in the Goonyella and Blackwater System. The trial included the addition of 4 wagons on an electric consist and 2 additional wagons on a diesel consist. Aurizon has listed the benefits of this initiative as being improved above rail profitability, network availability, and additional capacity. Aurizon includes a range of tasks that it completed as part of this trial such as engineering assessments of the infrastructure, studies on Aurizon's planning and scheduling, and risk assessments. Vale believes these are normal activities that any network owner would complete when requested by a train operator to operate a different consist on the network. Vale does not believe the tasks listed involve a greater level of outperformance or innovation that would trigger a consideration of an incentive.

The paper notes that Aurizon Operations and BMA Rail participated in the trial but there is no information on whether Pacific National was offered the opportunity to participate in the trial, or if it did, what concerns Pacific National had with the change in the consist configuration. Vale believes that if Pacific National was not involved in the trial it is unlikely that this activity was a whole of coal chain initiative but rather an activity completed by the 2 train operators to gain a competitive advantage in the above rail market.

Aurizon also claim this initiative resulted in improvements to the network availability and capacity. Vale believes network availability and capacity are a function of contractual position and therefore Aurizon cannot be compensated for availability and capacity twice. Under the Revenue Cap Aurizon is already compensated for the contracted network availability and capacity, and therefore, no further compensation is required as the volumes achieved did not exceed the contractual volumes. Vale suggests the only way to clearly show an increase in train paths is via a Master Train Plan that shows the current contract train paths including maintenance allocations, and the additional paths that could be created.

3.2 Integrate Planning Framework

Aurizon has stated that Network Operations has been developing an integrated planning framework to address a number of issues which were negatively affecting network availability and reliability. Vale supports any improvement process being presented by Aurizon that would improve the network performance above the historical underperformance, however, it believes this initiative appears to focus on maintaining and achieving Aurizon's contractual obligations. The activity appears to involve improved communication with other parts of the coal chain to ensure better co-ordination which Vale believes would not be considered as either outperforming or innovating but rather the operation of a prudent process that is already compensated for as part of the Revenue Cap.

3.3 Multiple Consist Stowage

The third item claimed is the Multiple Consist Stowage trial to assist in the efficiency of deployment of train crew and rollingstock maintenance staff, and provides more options to plan maintenance, and avoidance of new holding lines. Aurizon has not quantified an equivalent number of train paths resulting from this initiative as this activity involves better utilisation of the infrastructure during network shut downs. Vale believes this activity is not an outperformance or innovation but

rather the prudent operation of the network which is already compensated under the Revenue Cap.

3.4 Ultrasonic Testing

Aurizon has included a claim for improvements to its ultrasonic testing methods to detect rail defects within the rail to reduce the number of derailments and cancellations associated with rail failures. Vale believes that improved maintenance methods are influenced by the requirement under the Undertaking to maintain the network to an appropriate standard, reduce exposure to network cause cancellations, and managing the maintenance cost allowance. Vale believes Aurizon is incentivised to improve maintenance methods due to these regulated incentives and to provide an additional incentive would not be appropriate.

3.5 Non-Destructive Testing

Aurizon has also included as part of its Increments claim the benefit of moving to Ground Penetrating Radar (GPR) testing as the primary means of planning the location for the ballast cleaning machine operations. Aurizon claim this process utilises less track time hours than the previous destructive testing method and increases the network availability. Vale believes network availability can only be assessed against the contractual position of Aurizon as theoretically the same amount of the network should be available every year. Due to the historical inability of the network to achieve its contractual capacity it is unclear if this change is providing above contract availability or releasing the capacity that is already compensated under the Revenue Cap. Aurizon is incentivised to improve its maintenance methods as it can also keep any underspend of the maintenance cost allowance and it reduces their exposure to any impairment of the network due to the poor condition of the track.

Aurizon's claim for the GPR relates to the reduced track time required to assess and plan the ballast cleaning maintenance tasks, however, Vale does not believe this can be viewed in isolation as this is only one part of the total ballast cleaning maintenance activity of Aurizon. The level required, and efficiency of ballast cleaning maintenance has been the subject of much debate over a long period of time. Significant time and money has been spent on assessments of the standard of the rail network and the performance to scope of Aurizon's ballast cleaning activities in UT3 and the proposed activities in UT4. Vale is concerned that after all this analysis it is still not clear what or how much ballast cleaning activity needs to be completed on the network and therefore the value of using GPR or the potential savings this provides to the network. Similar to the ultrasonic testing, Vale believes Aurizon has other incentives that encourage them to improve their efficiency as it will reduce their exposure to network cause train cancellations and impairments of the infrastructure due to poor quality.

4. Capital Projects

Aurizon has claimed an Increment due to the capital projects completed for overhead asset renewals, overheight detectors, and the Gracemere overpass. Aurizon notes that they "*will only earn a regulated return on the value of these projects....yet substantial benefits have accrued to other supply chain participants*". The QCA has determined that the WACC is the appropriate return for these investments. Earning "only" a regulated return does not indicate that an additional payment is required, as the QCA has determined that the providers of debt and equity should find the regulated WACC an acceptable return. It is to be expected that "*substantial benefits have accrued to other supply chain participants*" because it is other supply chain participants (coal producers) who service the full cost of these investments. The purpose of the Increment is to reward Aurizon Network when its activities and initiatives result in more efficient use of assets and this causes throughput to increase, not to provide an additional margin on capital expenditure

simply because that expenditure increases capacity. Vale also notes the following on each of the capital items.

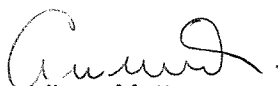
Asset renewals by nature are provided to maintain the existing capacity rather than increasing capacity. Vale does not support any additional incentive for asset renewals as it believes the QCA already has made an allowance for an incentive within the WACC to ensure Aurizon continues to invest in the network. Aurizon are also incentivised to complete the overhead line equipment asset renewals as it will reduce its exposure to traction faults, and therefore train cancellations, due to network cause.

Aurizon's claim for an Incentive also includes the construction of the Gracemere overpass. Aurizon states that it assisted the Department of Transport and Main Roads (TMR) in terms of logistical and planning support as the construction was concurrent with the duplication of the Blackwater mainline. Vale believes ensuring construction activities are managed and planned between the parties would be considered good project management to ensure efficiency of capital costs and minimisation of project risks. Vale does not believe the activities it completed were at a level that outperformed a prudent operation or was innovative to justify any further incentive about that allowed in the WACC.

Aurizon has installed over-height detectors at two level crossings due the real and increasing threat of damage to the overhead lines and relating impact on coal services. Aurizon state that this is required as vehicles are not complying with the road rules and signage, and if a collision event occurs, the vehicle may leave the scene and this provides Aurizon with limited ability to recover the costs of the damage. Vale supports initiatives to improve road safety and reduced damage to the overhead wires, but it sees this as part of a prudent operation of a rail network that interacts with road users. Vale also believes that Aurizon are incentivised to install the detectors as it reduces their maintenance costs, reduces their exposure to train cancellations due to network cause, reduces any the safety risk to their personnel, and reduces Aurizon's exposure to financial loss as it is likely the cost of repair would not exceed Aurizon's self-insurance limits

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

Yours sincerely,



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