VALE

29 August 2014

Mr Matthew Schroder
General Manager
Fuel, Transport and Prices Oversight Branch
ACCC
GPO Box 520
Melbourne VIC 3001

By Email : transport@accc.gov.au

Dear Mr Schroder,

Discussion Paper ARTC's Hunter Valley Rail Network Access Undertaking – Revenue allocation review

I refer to the ACCC's invitation to provide submissions regarding the discussion paper on Australian Rail Track Corporation's (**ARTC**) revenue allocation methodology in the Hunter Valley Rail Network Access Undertaking (**HVAU**) dated 29 May 2014 (**Report**). Vale appreciates the opportunity to provide this submission as part of the consultation process on the revenue allocation review.

Summary of Paper

The ACCC position paper provides further transparency to stakeholders about how ARTC applies the pricing principles contained in section 4 of the HVAU. Specifically, the issue being raised is the allocation of revenue to determine the annual revenue shortfall or surplus, for each pricing zone. ARTC derives revenue from the Hunter Valley by charging each producer based on the number of gross tonne kilometres used as they traverse each segment which forms part of their journey. This charge is based on a non-TOP portion which recovers the direct costs that a producer imposes on a particular segment, and a TOP portion which is based on indirect costs, or common costs, that a producer imposes on a particular segment within a particular pricing zone. The direct costs reflect the variable costs of the network and the indirect costs reflect the fixed components and new capital components of the network.

The ACCC has highlighted that 3 pricing zones are used in the determination of pricing for the Hunter Valley Coal Network. All producers traverse pricing zone 1 and the producers in pricing zone 2 and 3 only use their respective parts of the network to connect to pricing zone 1 segments. ARTC receives revenue from producers and allocates this to each segment based on the direct costs and a share of common costs imposed by producers on that segment. The exception to this allocation methodology is the revenue received for pricing zone 1 common costs paid by pricing zone 3 users. This revenue is reallocated from pricing zone 1 and applied to pricing zone 3 before determining the revenue shortfall or surplus in the constrained network of pricing zone 1 and 2. The revenue shortfall or surplus is then recovered or returned to those producers in pricing zone 1 and 2. For example, ARTC sought an under recovery of revenue in calculating the 2012 annual compliance process from pricing zone 1 and 2 producers which would not have been required if the pricing zone 1 common costs incurred by pricing zone 3 producers were not reallocated to pricing zone 3 revenue.

Comments on Discussion Paper

Pricing zone 3 is considered to be an unconstrained part of the network due to the lower volumes of coal, so a loss capitalisation mechanism was established to encourage new volumes and ensure the future recovery of the economic cost by ARTC. Under loss capitalisation, the revenue received is compared to the economic cost of the pricing zone 3 part of the network and any shortfall is capitalised in the RAB to be recovered at a future date when volumes increase. The paper outlines that ARTC's current revenue reconciliation approach is to reallocate the pricing zone 1 common costs, paid by pricing zone 3 producers, by applying them to pricing zone 3 revenue before determining the loss to be capitalised in the RAB. This generally has the effect of increasing revenue and reducing risk for ARTC as it reduces the loss to be capitalised in the RAB and increases the revenue recovered in pricing zone 1 due to the shortfall created by the revenue reallocation. Vale does not believe this mechanism is appropriate as it is not cost reflective of producers' use of the Hunter Valley coal network.

Vale does not believe this level of pricing detail has been previously presented in the 2012 or the recently submitted 2013 ARTC annual compliance assessment. Vale believes it is difficult to assess this level of detail as much of the financial information that is provided to the ACCC, as part of ARTC's annual compliance, is not publicly available to stakeholders due to ARTC's request for confidentiality. Vale believes this restricts stakeholder access to information that could provide greater transparency of how the pricing principles are being applied by ARTC under the Hunter Valley Access Undertaking.

Vale understands that due to the high initial capital costs of establishing rail infrastructure in pricing zone 3, the loss capitalisation mechanism was introduced to provide a long term pricing profile. This allows the recovery of the initial capital costs over future pricing zone 3 volumes, to avoid the initial pricing zone 3 volumes paying inflated charges in the early years, due to low volumes Vale believes the market adjustment, within pricing zone 3, was established to encourage further economic growth and fairness of pricing between existing and future producers in the pricing zone while also maintaining a cost reflective approach as the costs remain within pricing zone 3 and do not impact on other pricing zones in the network.

Vale believes ARTC's revenue allocation approach to pricing zone 1 is not cost reflective or provides pricing fairness to pricing zone 1 and 2 producers as the revenue allocated to pricing zone 1 does not reflect the cost impact of pricing zone 3 producers. Under a revenue shortfall situation, pricing zone 1 and 2 producers are required to pay their share of the common costs via the TOP charge, but then contribute further revenue for pricing zone 1 through the unders and overs adjustment due to the reallocation of revenue from pricing zone 1 to pricing zone 3. Vale believes it is highly likely that because of the revenue reallocation, pricing zone 1 and 2 producers will consistently incur a revenue shortfall which effectively provides ARTC with an earlier recovery of revenue than would otherwise form part of the loss capitalised in the RAB for pricing zone 3.

Vale believes the revenue allocation approach being adopted by ARTC is likely to lead to a market failure in capital expansions of the Hunter Valley coal rail network. Due to the revenue reallocation, pricing zone 3 producers would have a long run pricing improvement for capital expansions as the contribution to pricing zone 1 common costs, relating to any expansions, are being offset against any loss capitalisation. Vale believes that this is likely to lead to inefficient capital decisions in pricing zone 1 as pricing zone 1 and 2 producers will pay higher charges due to increased common costs yet pricing zone 3 producers can reduce their future long run pricing by offsetting this increase in pricing zone 1 common costs against any loss capitalisation in pricing zone 3. This situation is likely to have greater impact in the future as pricing zone 3 is expected to contribute significantly to future volume increases which will trigger capital expansions of the pricing zone 1 segments of the network.

Vale believes the revenue allocation approach being adopted by ARTC is likely to lead to inefficient capital expansion decisions by ARTC. ARTC will be incentivised to find a capacity expansion solution in pricing zone 1 rather than pricing zone 3 as the revenue reallocation will allow them to recover the revenue earlier. The revenue reallocation approach would mean that a capital expansion in pricing zone 1 is likely to result in a revenue shortfall which would allow ARTC to claim further revenue from pricing zone 1 and 2 producers while offsetting more of the loss capitalisation value in pricing zone 3. Conversely, a capital expansion in pricing zone 3 would increase the economic cost in the zone and result in a higher loss to be capitalised within the RAB. Vale believes this market failure would lead to inefficient capital expansion decision which could impact on the network's ability to achieve the contractual throughput required.

Vale believes that the revenue allocation approach will also impact the pricing of future tenements in the Hunter Valley. The value of a tenement will include some consideration of the distance that a tenement is located from the port. Tenements closer to the port are likely to include a higher premium to reflect the lower cost of logistics to move the coal to the port. Vale believes the current mechanism introduces an inefficient market signal as pricing zone 1 and 2 users are paying a greater share of the common costs for pricing zone 1. Conversely, pricing zone 3 producers are reducing their loss capitalisation liability by offsetting any contribution to pricing zone 1 common costs. Vale does not believe this reflects the true cost of a tenement that is required to traverse both pricing zones 1 and 3 to access the port.

ARTC Submission

On the 19 August, ARTC released a submission to the ACCC and stakeholders to provide a response and further context to the ACCC Report. Vale would like to provide some comments on the information that has been presented in the ARTC response.

ARTC argue that pricing zone 1 users do not provide any revenue to cover the cost of pricing zone 3. Vale believes this is appropriate as pricing zone 1 producers do not impact on pricing zone 3 users as they do not operate on the pricing zone 3 infrastructure. Vale does not believe this would be cost reflective or encourage economically efficient decisions in pricing zone 3 if this was the case. However, pricing zone 3 users do operate on, and require expansions of, pricing zone 1 infrastructure to operate on the network. Therefore, Vale believes revenue raised in pricing zone 1 should reflect both the direct and indirect costs of operating in these segments.

ARTC argue that in the long run all cost users will pay a fair share for Hunter Valley network investments as and when they can. The example given is the contribution of pricing zone 2 producers that were previously considered part of an unconstrained network and are now part of the constrained network. The numbers presented by ARTC suggest that pricing zone 2 producers contributed approximately 25% of both the tonnage and revenue to pricing zone 1 for the compliance year. Vale would question when or how pricing zone 2 producers pay their fair share of costs in the long run if they are only contributing revenue in pricing zone 1 equivalent to their usage. Vale believes that to truly provide a fair share of long run pricing there would need to be additional revenue recovery to reimburse pricing zone 1 producers for paying all the revenue in pricing zone 1 when pricing zone 2 was unconstrained and not contributing revenue to pricing zone 1. ARTC's submission advises that based on the current approach, by 2020, the combined recovery of pricing zone 1 fixed costs from pricing zone 2 and 3 producers is forecast to be around 40-45%. Based on the numbers presented in the ARTC submission, it appears to Vale that this reflects the utilisation of pricing zone 1 infrastructure but does not show any long term increased contribution to pricing zone 1 fixed costs to compensate for the sunk costs that have already been contributed by pricing zone 1 users during the periods when the other pricing zone were unconstrained. Vale does not believe this approach leads to all producers contributing their fair share of costs in the long run as suggested by ARTC,

Vale believes that efficient economic decisions are closely linked to the risks that each stakeholder is subject to and their willingness, or ability, to accept these risks. Pricing zone 1 and 2 producers have no ability to influence or control the risks in pricing zone 3 as they do not provide, or influence, access to the network in pricing zone 3 and do not have an RCG vote on any pricing zone 3 infrastructure expansions. The only stakeholders that can influence these outcomes, and therefore influence the risks, are ARTC and pricing zone 3 stakeholders. Vale believes that by reallocating the revenue, ARTC is moving part of the risk of revenue recovery from themselves to pricing zone 1 and 2 producers and is not matching the revenue allocation with the cost allocation.

Vale believes ARTC's revenue allocation approach is driven by a desire to reduce their risk of recovery of the loss capitalisation as ARTC are effectively recovering part of the loss capitalisation from pricing zone 1 and 2 producers via the unders and overs assessment. Vale does not believe this approach is cost reflective and is not likely to promote economically efficient capital decisions or create long run pricing fairness between producers.

Vale appreciates the opportunity to provide its views on this topic and would be happy to discuss this further if you need any clarification.

Yours sincerely,

Anneliese Mattos
Manager Logistics Development
Vale Australia Pty Ltd