Submission to Queensland Competition Authority

Submission on the 2013 Standard User Funding Agreement DAAU

Anglo American Metallurgical Coal Pty Ltd

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1 Introduction

Anglo American Metallurgical Coal Pty Ltd (***Anglo American***) welcomes this opportunity to present its views to the Queensland Competition Authority (***QCA***) on Aurizon Network Pty Ltd's (***Aurizon Network***) 2013 Standard User Funding Agreement DAAU (***SUFA***). SUFA is comprised of the following agreements:

(a) Umbrella Agreement (***UA***);

(b) Trust Deed (***TD)***;

(c) Subscription and Unit Holders Deed (***SUHD***);

(d) Project Management Agreement (***PMA***);

(e) Rail Corridor Agreement (***RCA***);

(f) Extension Infrastructure Head-Lease (***EIHL***);

(g) Extension Infrastructure Sub-Lease (***EISL***); and

(h) Integrated Network Deed (***IND***).

In Anglo American's view, SUFA remains an important development in the 2010 Aurizon Network Access Undertaking (***UT3***). It was designed to constrain the market power of Aurizon Network to refuse to expand the network until the coal producers agreed to a return higher than the regulated return, by allowing the coal industry to 'by-pass' Aurizon Network and fund expansions itself.

As preliminary matter, it should be noted that SUFA is not a substitute for mandatory expansion in the specific circumstances contained in UT3.

As the discussions between Aurizon Network and industry show, the SUFA process is inherently complex and raises difficult issues. Neither of the parties to the SUFA process (being Aurizon Network and industry), or the QCA as regulator, will know for certain whether SUFA will be successful until an actual transaction, including construction and commissioning of the expansion works, has been successfully undertaken. Further, at this point in time Anglo American has strong doubts that a SUFA will be successful for various reasons outlined below. More specifically, there is a real concern about the 'bankability' of the package given its complexity and the lack of control the participants have in the process.

In light of that, Anglo American wishes to strongly reiterate its position that the QCA should not allow Aurizon Network to remove (or even dilute) the Access Conditions regime that is present in UT3 (currently Part 7 of UT3). Although not at issue in this submission, Anglo American notes that Aurizon Network proposes to remove the Access Conditions regime from the 2013 Access Undertaking (***UT4***) (evidenced by Part 8 of its 2013 Draft Access Undertaking submission) and Anglo American is concerned that Aurizon Network will argue that the Access Conditions regime is not necessary because of the SUFA.

Anglo American also notes that Aurizon Network proposes in its draft UT4 submission that even if users are willing to fund an expansion under SUFA, Aurizon Network still has significant discretion regarding whether to approve the SUFA and how it will progress (see clause 8.2.1(a) and (b) of UT4). In particular, clause 8.2.1(b)(ii) of UT4 clearly introduces an economic discretion for Aurizon Network – this is entirely inappropriate. Where the alternative to a SUFA expansion is around 15% return on the capital, which is significantly above the regulated rate of return (as Aurizon Network sought with the Goonyella to Abbot Point Expansion (***GAPE***) and the Wiggins Island Rail Project(***WIRP***)), it will *always* be in Aurizon Network's legitimate business interests to refuse a SUFA. Further, there are no objective circumstances or tests outlined to determine when an expansion will be economically feasible (and no explanation as to why Aurizon Network should determine whether the project is economically feasible when the entire capital outlay is being

provided by users). This gives Aurizon Network clear discretion over what should be objective factors leading to the approval of a SUFA and undermines the premise of the entire project. Combined with the removal of all mandatory funding obligations (other than replacement capital), this discretion creates further cause for concern for users willing to invest in extensive expansions to the network.

Aurizon Network also proposes in its draft UT4 submission to have the ability to determine the order in which expansions proceed (if at all). User-funded or not, being part of a vertically-integrated business with interests in above and below rail assets and ports means Aurizon Holdings would have complete control of the supply chain (including how and when it is expanded), creating clear conflicts contrary to interests of rail access users and seekers, and potentially in breach of ringfencing obligations.

With a completely untested SUFA, if users lose the protection afforded by the Access Conditions regime there will be no ability to force Aurizon Network to complete an expansion on a user's behalf at reasonable expense. Rather, as has already happened to users in negotiations over the GAPE and WIRP, users will be subject to 'economic hold-up' at the hands of Aurizon Network. Anglo American supports the submissions of the Queensland Resources Council (***QRC***), including the suggested drafting. In particular, Anglo American supports the QRC in stating that:

(a) SUFA is unnecessarily complex and, as such, unlikely to operate effectively (if at all);

(b) there is no commercial balance or reasonableness between Aurizon Network's position and that of users;

(c) that SUFA is not a real alternative to Aurizon Network Funding;

(d) the expansion process provides Aurizon Network with too much discretion, reinforcing its monopolistic position; and

(e) all of the QRC's subsequent suggested drafting amendments for the eight SUFA documents.

It should be kept in mind that the Target Trust Capital Costs (***TTCC***) are to be based upon a significant amount of study works, which will also generally have been funded by the users.

2 Protecting against 'economic hold-up'

Anglo American agrees with Aurizon Network's position that commercially negotiated agreements are preferable to prescriptive regulation, however, it believes that there is a case for a prescriptive regime in light of the outcomes in GAPE and WIRP. In negotiating capacity expansions, the parties' interests are not completely aligned, and in these circumstances relying on voluntary commercial agreements only causes conflict and delay. There is an incentive for the owner to engage in tactical delays to expansions in order to force more favourable access conditions, including prices significantly higher than the market or regulated prices; sometimes even in excess of monopolistic prices. Users are forced to accept these prices due to inevitable time constraints, in particular in mine expansion situations where commitments have already been made to mine expansion projects and ports (including specific capacity long-term Ship or Pay agreements). Further, giving producers no choice but to accept these high long-term fixed costs erodes the competitiveness of Queensland coal in the seaborne market, which is exacerbated in a downturn particularly when foreign exchange rates are unfavourable, or simply makes projects uneconomic thereby encouraging investment elsewhere.

The benefit of SUFA is that it agrees the vast majority of the numerous issues that will arise between the parties and minimises the negotiation time that will be required to form a commercial agreement. As already discussed, however, Anglo American is not assured that the amended

SUFA is workable, in the sense that it is not clear that the terms sufficiently protect the interests of users to allow users to raise the capital needed to execute a SUFA.

As such, the QCA should not allow the removal of the Access Conditions regime while any SUFA process remains untested as it exposes users (and as such the market) to the extreme possibility of 'economic hold-up' and inefficient pricing. Maintaining the prescriptive Access Conditions regime ensures that the QCA can be pro-active in Queensland coal market processes and demands rather than relying on the uncertain outcome of commercial negotiations under a SUFA that may not work.

3 Non-discrimination between assets

Anglo American notes that there is no general provision in any of the agreements preventing Aurizon Network from discriminating between its existing assets and the user-funded assets created by the relevant SUFA. This does not offer any protection for the assets that users have been required to fund in order to achieve the expansion of the network.

An example of weak non-discrimination restrictions can be found in the RCA where Aurizon Network (as Landholder) must not require the Trustee to comply with any requirements which are 'materially more onerous' than it would require where it is constructing the project itself in the same or similar circumstances (see clause 3.7(b)). The same attempt at a non-discrimination requirement is contained in clause 6.1(e) of the RCA in relation to determining Interface Risk Management Plan. First, the restriction that a requirement must not be *materially more onerous* is inherently unclear, as there is no materiality threshold considered within the RCA and, therefore, no yardstick with which to measure Aurizon Network's compliance with these provisions. Second, as each extension or expansion is a new development in order to deal with specific circumstances and conditions relating to particular users on particular systems and lines it is immensely difficult to determine what Aurizon Network would require as Landholder if the project was being run as the hypothetical Reference Project. Anglo American submits that these provisions lack clarity and, therefore, the ability to be properly enforced by the Trustee on behalf of unit holders.

Further, a similarly broad approach has been taken to non-discrimination under the EISL. Clause 6.1(a) provides that Aurizon Network is only restricted from discriminating against SUFA-funded assets where that 'action is for the sole purpose (and no other purpose of reducing the Rent payable' by Aurizon Network under the EISL. There is no mention of a proportionality threshold, so even if Aurizon Network has a 99% purpose of reducing its own rent by discriminating against SUFA-funded assets, this action is not prevented by the so-called 'non-discrimination' provisions of the EISL. Anglo American submits that this is unacceptable.

The result of allowing such weak non-discrimination restrictions could be that Aurizon Network can discriminate against SUFA-funded assets for its own commercial gain. An example of this would be where Aurizon Network made the strategic decision to allocate its maintenance allowance to Aurizon Network created assets rather than the SUFA-funded assets. This causes disrepair and potential capacity degradation issues on the SUFA-funded assets (which users would undoubtedly be required to pay extra to repair) but does not have any measurable impact on the rent that Aurizon Network is required to pay under the SUFA. Further, Aurizon Network can then degrade the SUFA-funded assets at a much greater rate than its own assets and in some circumstances may have an incentive to optimise the asset out of the RAB as the consequence is that Aurizon will no longer be required to pay rent.

One of the fundamental purposes of third party access regimes is to promote competition in markets other than the market for the facility. Over the last 15 years of the operation of third party access regimes it has become clear that a 'service' provided by the owner of natural monopoly

infrastructure is the provision of capital to expand the facility. As has been evident in Queensland this service can be provided on monopolistic terms without recourse under third party access regimes. SUFA has the effect of bringing competition into the market by providing capital for expansions of the CQCN and infrastructure necessary to connect new basins. To allow this competition to be effective it is necessary that Aurizon Network does not discriminate against assets funded by third parties.

Anglo American understands that Aurizon Network is reluctant to negotiate on this point as it believes that protections against discrimination of assets might lead to numerous potential claims over minor differences in price. Anglo American does not believe that this is a valid concern, as SUFA-funded assets are supposed to operate as part of the CQCN and when they become operational they should be treated as such. Further, as long as Aurizon Network does not intend to discriminate against SUFA-funded assets for its own commercial gain, it need not be concerned about the operation of non-discrimination provisions.

As such, Anglo American believes that the EISL and the RCA should contain strong provisions against Aurizon Network discriminating between assets, as well as dispute processes that enable users to apply to the QCA for consideration where they feel that discrimination is occurring. In this regard, Anglo American supports the comments and suggested drafting of QRC in respect of clause 18.2 of the RCA.

In addition, Anglo American agrees with the specific proposals by the QRC that:

(a) the materiality qualification should be removed from any of the non-discrimination provisions as there is a lack of clarity around the concept of materiality and no discrimination should be acceptable;

(b) where it has been established that there is breach of a non-discrimination provision then the limitation of liability provision should not apply; and

(c) the concept of a 'Reference Project' should be removed as the essential concept is that the SUFA-funded asset should not be discriminated against in respect of assets owned by Aurizon Network.

4 No cap on a user's commitment

Under the transaction commitment process contained in Part 4 of the SUHD, there is no true cap on the costs of the expansion nor sufficient ability for users to control costs. Each Preference Unit Holder's maximum liability should be limited to the call amount in clause 5.9 of the SUHD. There is then a process in clause 10.1 of the SUHD to agree to additional funding. Clause 10.2 provides that the consequence of the parties failing to agree additional funds is to permanently cease the works and may continue to make calls for cost relating to the cessation of the works.

However, this approach is unacceptable as it places users in the position of being forced to agree to additional funds because by the time clause 10.1 is practically enlivened:

(a) the Project Manager has spent or committed the TTCC (that is, the total estimate capital costs of the extension, including trust administration costs); and

(b) a 20% cost overrun buffer. It should be noted that Aurizon Network is claiming 30%. 20% cost-over has been accepted by industry as a comprise but is a very significant 'buffer'.

Anglo American believes that if Aurizon Network cannot complete the expansion within budget plus a 20% cost overrun allowance, then it should be forced to fund the remaining capital costs and roll any prudent capital costs into the RAB. In essence, this is merely an incentive mechanism. Third party access regimes often contain incentive mechanisms with financial penalties which apply if particular incentive matrices have not been met.

5 Risk allocation generally

Under the various agreements Aurizon Network is entitled to be paid various fees, expenses and costs and has significant control over various issues. In particular, a fundamental aspect of the SUFA framework is the right of the Trustee to receive Rent from Aurizon Network. Aurizon Network has also included provisions (for example, clause 3.2 of the PMA) whereby the Trustee appoints Aurizon Network as the disclosed agent of the Trustee in circumstances where the Trustee cannot continue to act unless under very narrow exceptions.

Anglo American suggests that the risk allocation contained in the SUFA framework is fundamentally wrong. Aurizon Network has adopted a zero risk approach (for example, see its approach to the tax indemnity) and all the risks lie with coal producers, even though they are not necessarily able to control or mitigate the extent of their risks.

In this regard, clause 3.6 is entirely unacceptable. In essence, clause 3.6 has aggregated the fiduciary duties that the Aurizon Network as Project Manager has to the Trustee as disclosed agent. Under clause 3.2 Aurizon Network is appointed as the disclosed agent of the Trustee for the purposes of performing the Services (in essence, the project management of the extension or expansion works) and, in particular, as disclosed agent of the Trustee for the purposes of:

(a) procuring, negotiating, entering into, varying and administering Works Contracts;

(b) liaising with the Authorities in relation to the Works for the Extension; and

(c) applying for and obtaining any Authority Approvals or variations to any Authority Approvals.

These matters are extremely important and clause 3.4 provides that the Trustee must not, other than through Aurizon Network do anything for which Aurizon Network is appointed as disclosed agent unless required by law, authorised in writing by Aurizon Network or expressly required or permitted under the PMA.

Clause 3.6 then provides that 'despite any fiduciary obligations which would, for the operation of this Agreement, arise as a consequence of the Project Manager acting as disclosed agent for the Trustee' under the PMA or the RCA the Trustee:

(a) irrevocably consents to Aurizon Network, when acting as disclosed agent, doing acts and making omissions which may:

  (i) be in the interests of, or to the advantage of, the Project Manager or its related Bodies Corporate;

  (ii) not be in the interests of, or disadvantage, the Trustee; and

(b) agrees the Project Manager will have no obligation to fully disclose to it the interest or disadvantage prior to the relevant act or omission.

There are then some exclusions, however, they are extremely narrow.

The QRC submission outlines numerous risks which have been placed on the coal producers and circumstances where the coal producers are not in a situation where they are able to control or mitigate those risks.

The situation is exacerbated by the unreasonable position being adopted by Aurizon Network in respect of the limitation of liability provisions throughout the SUFA framework. For example, under the EISL it is currently proposed that Aurizon Network's liability be limited to $1 (other than for fraud, gross negligence and wilful default).

Fundamentally, there would be two approaches to executing a SUFA, being:

(a) the coal producers are entirely responsible for the SUFA works subject to complying with standards of infrastructure required by Aurizon Network and any directions relating to the safe operation of the network – in which circumstances it is appropriate that the users take all the risk and Aurizon Network subsequently obtains no benefit from the SUFA asset and carries no risk; or

(b) a SUFA framework whereby Aurizon Network is appointed as the Project Manager and appropriate risk allocation is adopted between the parties in accordance with the usual allocation of risks, being that the risk is borne by the person best able to control or address the risk.

6 Limitation of Aurizon Network's liability

Another example of an inappropriate limitation of liability is Aurizon Network's liability under the PMA. As Project Manager, Aurizon Network accepts no liability where there are increased project costs, even if those costs are a result of negligence or fraud. In particular, under clause 22.3 of the PMA, Aurizon Network is not liable for a breach of any obligation under the agreement even if it is caused by negligence or fraud if the QCA accepts the excess cost into the RAB. Even though this means that users are not forced to pay immediately for a breach by Aurizon Network, the RAB is still increased by costs that should not have been incurred and users will be forced to pay Aurizon Network to recover for its own breach through the WACC. This would seem to be a particularly complex analysis for the QCA to undertake where it is determining prudent costs and there is a dispute between the parties as to whether particular costs were incurred as a result of negligence or fraud. Anglo American believes that this is an issue that is best addressed under the SUFA agreements.

A similar exclusion of liability is provided for Aurizon Network in Part 14 of the EISL.

Because of this protection from liability, Aurizon Network may cause users to suffer damage because of its own negligence and provides users with no means of rectifying the situation or receiving a remedy. This risk is purely asymmetric because during the SUFA process Aurizon Network (as Project Manager and infrastructure owner) has control of the matters which may give rise to its own liability while users have no control, even though they are the entities bearing the risk and cost.

7 Lack of repercussions for delivering insufficient capacity

Anglo American believes that this is a significant issue that must be rectified before the approval of the amended SUFA. The current exclusion of Aurizon Network's liability in relation to the insufficient generation of capacity by expansions is contained in clause 9.3 of the UA.

Anglo American foresees a risk that it may fund an expansion expecting a certain delivery of capacity, however, if that capacity is not created users' entitlements would be compressed. This is a significant issue for expanding users who require (and invest because of) expected output capacity from growing mines in order to ensure that these investments are economically viable. Without being able to accurately predict the capacity that they will receive from engaging in the SUFA process, users will be more hesitant to participate in a SUFA process which could be to the detriment of the entire Queensland coal network.

The current complete exclusion of Aurizon Network's liability in instances where an expansion or extension fails to deliver the pre-ordained capacity is thoroughly illogical. In circumstances where there is insufficient capacity available at the conclusion of a major project (which is likely to be strategically important to producers and operators), bearing all liability on a project where users have no control over the risks or liability is totally unacceptable. As discussed above, Aurizon Network has full operational control over how an expansion operates, and also in determining the

studies and feasibility of required construction to deliver the capacity requested by users through the SUFA process.

Anglo American believes that Aurizon Network's acceptance of realistic risk for the provision of insufficient capacity is particularly important in circumstances where users are actually funding the construction of the infrastructure assets being created. The QCA introduced a number of protections in response to the same concern acknowledged by users in UT3, including:

(a) a requirement for Aurizon Network to undertake capacity analyses of each coal system being connected;

(b) limitations on Aurizon Network from over-contracting capacity; and

(c) a specific obligation on Aurizon Network to invest money to ensure that any expansion that under delivers as against the expected capacity is augmented as soon as possible.

As this similar situation was addressed in UT3, Anglo American submits that the amended SUFA is currently inconsistent with the provisions of the existing access undertaking and should be amended to reflect the prevailing approved provisions.

Anglo American is also strongly of the view that the requirement under clause 7.5.4(a)(ii) of UT3 should apply to SUFA-funded assets. That is, Aurizon Network should be required to undertake any extension or expansion that is needed to provide Conditional Access Holders with Additional Access Rights in respect of capacity relating to a SUFA-funded expansion or extension where deductions have occurred because the expansion or extension did not provide sufficient capacity to cover all of the contracted capacity.