

Position Paper

Aurizon Network's 2013 Standard User Funding Agreement Draft Amending Access Undertaking

May 2014

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SUBMISSIONS

Closing date for submissions: 27 June 2014

Public involvement is an important element of the decision-making processes of the Queensland Competition Authority (QCA). Therefore submissions are invited from interested parties concerning its assessment of Aurizon Network's 2013 SUFA Draft Amending Access Undertaking (DAAU). The QCA will take account of all submissions received.

Written submissions should be sent to the address below. While the QCA does not necessarily require submissions in any particular format, it would be appreciated if two printed copies are provided together with an electronic version on disk (Microsoft Word format) or by email. Submissions, comments or inquiries regarding this paper should be directed to:

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In the interests of transparency and to promote informed discussion, the QCA would prefer submissions to be made publicly available wherever this is reasonable. However, if a person making a submission does not want that submission to be public, that person should claim confidentiality in respect of the document (or any part of the document). Claims for confidentiality should be clearly noted on the front page of the submission and the relevant sections of the submission should be marked as confidential, so that the remainder of the document can be made publicly available. It would also be appreciated if two copies of each version of these submissions (i.e. the complete version and another excising confidential information) could be provided. Again, it would be appreciated if each version could be provided on disk. Where it is unclear why a submission has been marked 'confidential', the status of the submission will be discussed with the person making the submission.

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Public access to submissions

Subject to any confidentiality constraints, submissions will be available for public inspection at the Brisbane office, or on the website at www.qca.org.au. If you experience any difficulty gaining access to documents please contact us on (07) 3222 0555.

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EXECUTIVE SUMMARY

The Central Queensland Coal Network (CQCN) is the largest coal rail network in Australia.

The CQCN has seen significant expansion over recent years to meet demand for increased railings for coal exports. Aurizon Network suggests that by 2016-17 the CQCN will have a built capacity of around 310 million tonnes, compared to 187 million tonnes in 2009-10¹.

While Aurizon Network has made significant investments in expanding the network, it has also said that, as a commercially listed company, it should not be obliged to expand the network. It has noted it has an obligation to meet its shareholders' legitimate expectations of achieving appropriate returns for infrastructure investments.

The *Queensland Competition Authority Act 1997* (QCA Act), stipulates that under an access regime, a regulator cannot require an access provider, such as Aurizon Network, to pay some or all of the costs of extending its network². Nonetheless, the QCA Act also allows the regulator to require an access provider to extend its network.

Standard User Funding Agreements (SUFA) in Context

In our final decision on the 2010 access undertaking (UT3), we required QR Network (now Aurizon Network) to provide us with a proposed Standard User Funding Agreement (SUFA) and related amendments to UT3 to fully implement the investment framework amendments (Schedule J). SUFA is a suite of standard pro-forma agreements designed to facilitate alternative options to Aurizon Network funding rail infrastructure expansions on the CQCN.

The need for SUFA stems from what Aurizon Network's stakeholders described during its UT3 review as an unwillingness to fund expansions on its network at the regulated rate of return. At that time, coal project proponents wanted access to what was described by Aurizon Network as 'a capacity constrained network in need of expansion'.

Stakeholders were very concerned about protracted access negotiations and Aurizon Network's requests for higher than regulated returns, for what Aurizon Network perceived as higher risks for constructing expansions. Access seekers wanted us to require Aurizon Network to construct expansions at Aurizon Network's cost.

Progress to date

The first generation SUFA, developed late in 2010, consisted of a participation agreement and a construction agreement. The agreements were simple and straightforward focussing on Aurizon Network as the constructor and users of the system making monthly payments to Aurizon Network during construction. Unfortunately, this model did not work so was eventually rejected, due to tax implications, and replaced with the second generation SUFA.

The second generation SUFA developed by Aurizon Network during 2011-2013³, was based upon a trust model where preference unit holders in a Trust commit the funds required to develop an infrastructure

¹ Aurizon Network, 2013 Draft Access Undertaking, Volume 3, p. 13

² Unless the access provider has voluntarily agreed to do so within its access undertaking.

³ The second generation SUFA broadly comprises the following submissions: the 2012 Standard User Draft Amending Access Undertaking (2012 SUFA DAAU) and the subsequent updated 2013 SUFA Standard User Funding Agreement Draft Access Amending Undertaking (2013 SUFA DAAU).

project in return for rights to a future rental cash flow. Preference unit holders do not have ownership rights over the infrastructure constructed under the Trust once completed.

Under this framework, it was anticipated that primarily larger mining companies would be able to fund a SUFA project off balance sheet. It was acknowledged that smaller mining companies may lack sufficient funding or reserves to do so.

Considerable progress has been made on the back of the second generation SUFA, including reaching agreement on there being an independent trustee and preference units not being stapled in the operational phase.

We recognise both Aurizon Network and the Queensland Resources Council (QRC) have made significant investments in developing the framework to this point and this has involved compromises being made by both sides. However, it is clear from submissions we have received on the 2013 SUFA DAAU that Aurizon Network and its stakeholders have collectively not been able to develop a workable SUFA framework. Notably, in August 2013, the QRC indicated that:

The SUFA Document structure is complex and difficult. If the SUFA Documents are amended as proposed by the QRC in this submission and the QRC Mark-up, it will provide, at best:

- *a barely workable framework through which mining companies may invest their own capital...⁴.*

In its December 2013 submission, the QRC noted two core areas of Aurizon Network's SUFA proposal that required significant amendment. The first core area was funders bearing construction risks with respect to cost overruns, late completion and abandoned projects. The second was lack of revenue certainty because of issues regarding the rental methodology, payment processes, security interest and the risk of Aurizon Network default⁵.

The QCA view is that after a lengthy negotiation period, including extensive drafting and re-drafting of the SUFA agreements, substantial key issues regarding the workability and bankability of the SUFA framework have yet to be resolved. More importantly, at this stage we question whether the key issues can be resolved by another round of re-drafting the agreements.

Given the importance of SUFA, particularly in the context of UT4 and Aurizon Network's proposed approach to expansions, we felt it prudent to undertake a further considered review of the existing SUFA framework, with a view to determining what changes are necessary, or even possible, to produce a workable, bankable and credible SUFA.

We engaged Grant Samuel, as financial advisor, to provide us commercial advice on the 2013 SUFA DAAU. Grant Samuel said that the 2013 SUFA DAAU was not workable or bankable. It was not a financing structure which could be attractive to third party financing, and as a result, not credible in its current form. They also noted that it was evident from submissions and the discussion held with Aurizon Network and stakeholders that there remained a significant gap between the positions of the parties, particularly with respect to construction. This gap was unlikely to be bridged within the 2013 SUFA DAAU as it stood.

Despite this, Grant Samuel, working with our legal advisors (Clayton Utz), considered the 2013 SUFA DAAU could be amended to achieve a workable, bankable and credible SUFA. This would require change and a compromise to be achieved between Aurizon Network and stakeholders. It would also need us to change aspects of our processes.

⁴ QRC 2013b, p. 5

⁵ QRC 2013m, p.2

QCA Proposed Changes

The changes we are proposing to the SUFA framework are not wholesale changes. They serve to transform it into a more conventional and attractive financing structure that allows as many financing options for, and potential participants to, a SUFA as possible. In our view, this forms the basis for a competitive process for the financing of expansions in the CQCN as it minimises barriers to participation.

Our proposal represents a package of measures that work together dynamically and are aimed at:

- simplifying the SUFA documents
- ensuring roles and responsibilities are clearly defined
- ensuring that existing processes are fit-for-purpose in an environment with SUFA.

The proposals cover four main areas comprising security and certainty over cash flows, the overall construction process (construction, the expansion process and preapproval), the maintenance of SUFA assets and, third party financing and risk assessment. These are outlined below.

Our proposal assumes the concerns surrounding tax have been resolved. If those concerns prove intractable, SUFA will not be effective⁶.

Security and certainty over cash flows

In our view the 2013 SUFA DAAU does not provide sufficient security and certainty over rental cash flows. This is also true for rent-equivalent cash flows in the event of the termination of the SUFA agreements whilst the SUFA assets continue to generate revenue. Without security and certainty over cash flows third party financing is not viable and SUFA cannot function effectively.

In order to provide certainty and security over cash flows our proposals are:

- clarification of the rent calculation methodology and its implications
- ensuring that the distribution of rental cash flows is mandatory
- limiting set-off to non-material fluctuations in the rental stream
- providing SUFA funders with security over rental cash flows
- providing SUFA funders with security over rent-equivalent compensation cash flows

Of critical importance is these proposals do not require security over the SUFA assets. This is a requirement of QTH so that the CQCN remains whole in the event of the termination of the Aurizon Network and/or SUFA leases.

The main implication for the SUFA documentation is the introduction of a security agreement. Various clauses will also need to be amended to ensure the relevant conditions apply for set off and mandatory distributions. The rental calculation methodologies will be re-drafted to make them more transparent. Examples of how the rent is calculated in various circumstances will also be developed and provided with SUFA documentation.

⁶ An appropriate form of statutory severance is required for SUFA projects to be commercially viable. This requires legislative change. Concerns regarding the processes and responsibilities for obtaining Administratively Binding Advice (ABA) and Private Binding Rules (PBRs) have to be resolved and the tax indemnities have to be clarified.

Construction, the expansion process and preapproval

The expansion process will estimate the costs of construction for a capital project. The proportion of this expenditure that goes into the regulatory asset base (RAB) defines the rental stream if the project is undertaken via a SUFA. Consequently clarity and certainty surrounding the outcome of the expansion process is critical to users and potential third party funders.

The construction process within UT3 and the Project Management Agreement of the 2013 SUFA DAAU needs to be refined with the objective of:

- ensuring that risk is allocated to the parties best able to manage it
- providing greater certainty over what is delivered via a capital project
- providing greater certainty of the treatment of capital costs.

In order to achieve this, clarity over the control of construction, the provision of upfront commitments, an effective expansion process and a preapproval process all need to work effectively together.

Clarity over the control of construction and upfront commitments

Aurizon Network should have control of the construction of a SUFA project. It should also:

- provide transparent upfront commitments to construct the infrastructure as efficiently as possible across the dimensions of scope, standard, cost and time to complete after a proposal has gone through the expansion process
- as infrastructure planner, asset constructor and operator of the rail network, build a SUFA project to an agreed range of capacity outcomes and be accountable for delivering on these commitments.

We believe that this can apply for all capital projects that result in a material capacity change, irrespective of the source of funding.

Expansion process

Major capital projects should be subject to an expansion process capable of delivering feasibility studies to a level of accuracy required to provide credible upfront commitments that satisfy the needs of Aurizon Network as infrastructure provider, third party financiers and user funders. An expansion process is already being developed as part of the UT4 arrangements and Aurizon Network and the QRC have made considerable progress on resolving previous differences. We are of the view that, as far as practicable, this expansion process should be included in UT3.

From the perspective of user funders and third party financiers, the upfront commitments for each capital project that come out of this process can be regarded as a “package of measures” that define a clear product offering which they can finance. This product offering can either be financed on Aurizon Network’s terms or an alternative arrangement via a SUFA.

Preapproval process

To remove optimisation risk for users and financiers, we are proposing a preapproval process. We believe that preapproval will provide greater certainty to all relevant parties that the prudent and efficient capital expenditure will be included in the RAB prior to construction starting.

We also consider that for the benefits of preapproval to be realised it needs to be incentive-compatible with a well-functioning expansion process. Consequently, we consider that preapproval should only apply once the expansion process has been completed and a set of upfront commitments agreed. This strengthens the incentives to engage in the expansion process appropriately. It also means decisions regarding the trade-offs when making a decision to expand are not transferred to the QCA.

This overall process allows SUFA to be viewed as a financing tool. It allows a clearly defined product offering to be developed that can be subject to differing financing options from Aurizon Network, or user funders and third party financiers based on their perception of the risks.

This should have the additional benefits of:

- allowing a SUFA trustee to act in a passive manner and focus on administrative tasks
- aligning interests in the construction phase of a SUFA, thereby mitigating any perceived need to significantly constrain ownership of preference units in a SUFA
- using a simplified construction contract in SUFA which reduces the complexity associated with a number of the SUFA documents.

Our proposal, however, does require an acceptance across stakeholders that Aurizon Network is best placed to control the construction of SUFA infrastructure. Aurizon Network also has to accept that if it is acting as infrastructure planner, constructor and operator of the rail infrastructure, it needs to make a range of upfront commitments. We also have to change our practices and develop a preapproval process with stakeholders.

Maintenance of SUFA Assets

Any participant in a SUFA has the right to expect that the infrastructure that they have invested in is appropriately maintained and not treated unfavourably. We consider this can be achieved by broadening the existing condition-based assessment process in UT3, rather than defining a separate process.

Third party financing and risk assessment

We are of the view that a structure has to be put in place that allows potential SUFA funders to assess any termination risks associated Aurizon Network's Infrastructure Lease with QTH, which is confidential.

Summary of QCA Proposal

We consider that the proposals outlined above can result in a SUFA framework that provides a competitive market for financing infrastructure expansions in the CQCN whilst accounting for the interests of Aurizon Network, its present and future customers and QTH. We consider our proposal will simplify the SUFA documents and allow a clearer document structure to be developed.

Next Steps

The main aim of this position paper is to inform interested parties of our current thinking. The views expressed in this paper are not intended, nor do they, constitute a decision (whether preliminary or not) with respect to the 2013 SUFA DAAU and proposed amendments to UT3.

We want to gauge stakeholder's views on our proposed package of measures and whether the resulting SUFA will be workable, bankable and credible. It is our preference to have parties discuss and focus their responses on the issues outlined, rather than the detailed drafting of the documents and the term sheets provided with this paper. If agreement can be reached on potential resolutions to the key issues, it is only at that time will we consider redrafting the standardised set of SUFA agreements.

1 WHAT IS SUFA AND WHY IS IT NEEDED?

1.1 What is SUFA?

The Standard User Funding Agreement (SUFA) is a suite of pro-forma agreements designed to facilitate user funding of rail infrastructure on the central Queensland coal network (CQCN).

The SUFA framework has been developed by Aurizon Network to give access seekers the option of financing the costs of railway extensions to accommodate their capacity requirements and timeframes.

Aurizon Network made it clear that SUFA is not the only funding option available and its existence does not preclude negotiation of alternative funding arrangements⁷.

1.2 What it seeks to achieve?

SUFA has its origins in Schedule J - Investment Framework principles of Aurizon Network's 2010 Access Undertaking (UT3). In 2009 we proposed that an investment framework be included in UT3 in response to concerns from Aurizon Network's customers that it was under no legislative obligation to fund extension/expansion infrastructure on its own network.

Whilst we have the power to determine access disputes in respect of declared services that are referred to us, under section 119(2) of the QCA Act, we must not make an access determination that would result in any of the following outcomes:

- reduction in the amount of the service able to be obtained by an access provider
- an access seeker, or someone else, becoming the owner, or one of the owners, of the facility, without the existing owner's agreement
- an access provider being required to pay some or all of the costs⁸ of extending the facility.

The investment framework (Schedule J) is based on foundation principles reflecting specific clauses of the QCA Act related to network expansion, specifically:

- Aurizon Network cannot be forced to fund an extension other than in accordance with an approved undertaking or the provisions of the QCA Act regarding determination of access disputes
- to the extent that Aurizon Network does invest in rail transport infrastructure used in the provision of declared services, including Significant Investments⁹, the QCA can determine the rate of return that is commensurate with the risk of investment
- Aurizon Network should not be able to exploit its monopoly power
- users should have the right to fund extensions (other than replacement capital expenditure) at their option.

⁷ Aurizon Network 2013b, p. 4

⁸ Of note, there is no definition of 'cost' in the QCA Act.

⁹ Aurizon Network's 2010 undertaking defines a Significant Investment as an investment in a major extension project to cost in excess of \$300 million.

1.3 Linkages with the expansion process

Aurizon Network has not included a revised expansion process¹⁰ as part of its 2013 SUFA submission. Aurizon Network noted the development of the expansion process, which was originally considered as a part of the SUFA discussions with the Customer Working Group (CWG), was deferred to enable SUFA to be prioritised¹¹.

The UT3 model for capacity expansion was formed out of a process identified in our draft decision on Aurizon Network's 2009 DAAU to develop a more detailed framework for the development of 'major projects'. Aurizon Network proposed new arrangements for major projects as it said it needed to gain some prior knowledge of the likely future demand for capacity in order to ensure the future infrastructure project was appropriately sized.

Major projects in UT3 are defined as projects which would create additional capacity, relating to the expansion or construction of a new loading or unloading facility and cost in excess of \$300 million¹².

The expansion process in UT3 is based on Aurizon Network performing the planning and studies for a project and entering into access agreements for the anticipated capacity to be generated from a project. Each of these steps is required to either trigger the SUFA process or 'fill in' schedules to the SUFA agreements, namely:

- determining that a significant investment is required
- requesting interested stakeholders to express interest in: the access rights generated by the anticipated capacity and whether they wish to enter into a user funding agreement should Aurizon Network choose not to fund the extension
- releasing a request for proposal to interested parties noting the expected costs and timing of the project and whether it was willing to fund the project
- performing the necessary scoping and planning studies¹³.

Industry stakeholders have been concerned the expansion process in UT3 (and Aurizon Network's 2011 DAAU) was not sufficient to guard against Aurizon Network's ability to delay planning and development of expansion projects¹⁴.

Aurizon Network has included a draft expansion process in its UT4 process. The QRC has been of the view that the expansion process in UT4 is flawed and requires substantial work. Specifically, the QRC considers a prescriptive expansion process (which does not rely on commercial negotiation, and does not provide Aurizon Network with a level of discretion to 'pick winners' of new capacity) is needed¹⁵. We understand Aurizon Network and the QRC have recently been engaged in extensive consultation and they are close to agreeing the major aspects of the expansion process.

QCA view

Consideration of Aurizon Network's proposed SUFA is as a draft amending access undertaking (DAAU) to UT3. This means the extension policy relevant to this review is the extension policy

¹⁰ Formerly called the extension process.

¹¹ Aurizon Network 2013b, p.8

¹² QCA 2009 Draft Decision p. 116

¹³ Aurizon Network 2010 AU, p.75-76

¹⁴ QRC 2011, p.11

¹⁵ QRC, 2013b, p. 9

contained in UT3 - an extension policy we understand both industry and Aurizon Network have agreed to move away from for UT4.

Our consideration of the 2013 SUFA DAAU includes both the SUFA agreements and related amendments to UT3 to enable use of the SUFA agreements.

2 AIMS AND OBJECTIVES

2.1 Aims and objectives of the position paper

Considerable progress has been made in developing the 2013 SUFA DAAU. Unfortunately significant differences exist between stakeholders and Aurizon Network regarding the 2013 SUFA DAAU. The overriding observation of stakeholders is the SUFA, in its current form, will not provide a competitive financing alternative to an Aurizon Network financing proposal for an expansion. We consider this is the fundamental purpose of SUFA.

Given this, this paper does not attempt to assess all the detailed issues surrounding the evolution of Aurizon Network's 2013 SUFA DAAU. We are of the view this would not be productive. Rather, it provides our view on where the discussions on SUFA have got to date. Thereafter, it provides a number of high-level proposals we consider have the cumulative effect of producing a SUFA framework that provides a competitive financing alternative for the financing of expansions for the CQCN. Our proposals represent a "package" of measures that work together, rather than discreet options.

In addition to this section, this paper comprises the following sections:

- **Section 3:** The 2013 SUFA DAAU
- **Section 4:** Overarching assessment of the 2013 SUFA DAAU
- **Section 5:** Alternative options
- **Section 6:** Rental method
- **Section 7:** Construction of SUFA infrastructure
- **Section 8:** Security and financeability
- **Section 9:** Termination
- **Section 10:** Discrimination
- **Section 11:** Preference unit transfers
- **Section 12:** Third party finance
- **Section 13:** Taxation
- **Section 14:** Access undertaking amendments.

The main aim of this position paper is to inform interested parties and stakeholders of our current thinking on the issues raised by the SUFA and DAAU which have been submitted by Aurizon Network. The views expressed in this paper are not intended, nor do they, constitute a decision (whether preliminary or not) with respect to the submitted 2013 SUFA DAAU.

We have worked intensively with our commercial and legal advisors. This position paper is the culmination of a collaborative effort to produce a practical, commercially viable and legally robust outcome. This paper is accompanied by a set of high-level term sheets and a briefing note outlining the preliminary recommendations of our commercial advisors (Grant Samuel), who have been supported in their assessment of the 2013 SUFA DAAU by our legal advisors (Clayton Utz).

This paper and associated term sheets reflect our thinking at the time of writing and does not account for discussions we have had with stakeholders of late.

2.2 Process going forward

This document provides a discussion of our view respecting outstanding SUFA framework issues.

Stakeholder submissions in response to this position paper should focus on resolving issues.

It is our preference to have parties discuss and focus their respective responses on the issues, rather than the detailed drafting of the documents and term sheets. If agreement can be reached on potential resolutions, it is only at that time that we will consider redrafting of the standardised set of SUFA agreements.

3 THE 2013 SUFA DAAU

3.1 Summary of the 2013 SUFA DAAU

The concept of a trust

The initial SUFA model proposed by Aurizon Network included two agreements - a participation agreement and a construction agreement. The original concept behind SUFA was that an access seeker could fund an expansion project by making monthly payments to Aurizon Network during construction under the construction agreement. This model was eventually rejected due to tax implications and was replaced with a trust model. Under the trust model, a project is funded by way of a trust in order to achieve an efficient tax treatment¹⁶.

Under Aurizon Network's 2013 SUFA DAAU, a trust is formed (the Trust) and a trustee appointed (the Trustee). Money is introduced into the Trust by access seekers purchasing preference units in the Trust. The preference unit holders are to provide all Trust funding; however, Aurizon Network may be a preference unit holder where it chooses to jointly fund the SUFA asset (referred to as hybrid funding). There is one ordinary unit holder in the Trust, Aurizon Network.

The Trust finances the construction of SUFA infrastructure assets to be integrated into the relevant railway system. The infrastructure assets are owned by QTH, leased to the Trust and sub-leased to Aurizon Network for it to operate as part of its network. In other words, the SUFA framework is designed so that preference unit holders commit the funds required to develop an infrastructure project in return for a rental stream from the SUFA infrastructure, rather than outright ownership of the SUFA infrastructure. It is this cash flow rather than the physical assets themselves which is the principal asset of the Trust.

SUFA Agreements and parties involved

Aurizon Network's SUFA framework is comprised of nine interconnected template agreements covering funding, legal structures, lease tenures and supporting matters. The SUFA suite of agreements as well as the primary purpose of each agreement is contained in Table 1.

Aurizon Network's proposed SUFA agreements contemplate the involvement of six parties:

- **Access seekers:** fund the construction of infrastructure by purchasing preference units in the Trust and secure access rights by executing access agreement (as contemplated in an Umbrella Agreement).
- **State of Queensland:** approval is required from the State of Queensland for Aurizon Network to enter into a SUFA arrangement. As such, the State of Queensland is signatory to the Integrated Network Deed (IND).
- **Queensland Treasury Holdings (QTH):** is the ultimate owner of all infrastructure assets developed under a SUFA arrangement. QTH, as the lessee, will agree to a SUFA on a transaction-by-transaction basis. Where assets are on the North Coast Line, the ultimate owner of the infrastructure assets is Queensland Rail.
- **Aurizon Network** performs the following roles in the context of SUFA:

¹⁶ Tax is discussed in Section 13 of this position paper.

- land owner
- funder/preference unit holder (where it chooses to partially fund a SUFA (hybrid funding option))
- ordinary unit holder of the Trust
- sublessee of SUFA infrastructure
- project manager
- access provider
- network operator
- **Aurizon Holdings:** Aurizon Holdings, Aurizon Network's parent company is the guarantor to QTH of the performance of Aurizon Network and the Trust.

Each party's involvement in the respective agreements is summarised in Table 1

The lifecycle of a SUFA asset

The life-cycle of a SUFA investment can be characterised in the following stages¹⁷:

Stage 1: Pre-closure phase - Aurizon Network initiates its commercial and technical engagement with access seekers who are potentially preference unit holders. This includes discussions on project scope, procurement methodology, and target cost and budget. A specified methodology will be used to determine each preference unit holder's percentage interest in a SUFA according to their respective capital costs. The level of available capacity from the completed SUFA infrastructure is not guaranteed. The aggregate amount of all upfront payments by preference unit holders will be 130%¹⁸ of the total project cost.

Indicative time duration: approximately 12 months to complete¹⁹.

Stage 2: Project delivery phase - execution of all SUFA documents is completed and initial funds are paid into the Trust.

Indicative time duration: approximately two months to complete, provided all documents are executed on a timely basis.

Stage 3: Project delivery phase - the project delivery phase starts when all agreements are executed and ends when the last segment²⁰ constructed becomes available.

The Trust engages Aurizon Network to be the project manager under the Project Management Agreement (PMA)²¹. Key features of this stage include:

- scope, cost, procurement and timeframe schedules agreed and specified in the PMA. Any voluntary changes are to be agreed by Aurizon Network and the Trustee.

¹⁷ This represents a simplified version of the lifecycle. It is possible for the phases to overlap.

¹⁸ We understand that the upfront payment was reduced from 150% to 130% after discussions with the CWG. We understand that the upfront payment amount above 100% is to cover off potential cost overruns.

¹⁹ The time frames outlined for each stage in the SUFA asset lifecycle are based on discussions with Aurizon Network and should only be viewed as a guideline if the process and construction runs smoothly.

²⁰ A segment is defined in part 1.1 of the Subscription and Units Holders Deed (SUHD). It is a contiguous portion of the Railway Network in respect of which capacity is required by preference unit holders and works are required to provide the capacity.

²¹ It is possible for a replacement project manager to be appointed in certain circumstances. Aurizon Network, however, still maintains various rights over decisions associated with the construction of the SUFA asset.

- the costs of the project manager will be paid by the Trust. The project manager will receive a project management fee subject to time and cost performance. As the Trust's agent, the project manager may engage contractors, to be directly paid by the Trust.
- preference unit holders, through the Trust, will bear risk on the scope and procurement methodology, to the extent that preference unit holders agree to or specify the scope and procurement methodology. Aurizon Network will take scope, standard and cost prudence risk over SUFA project elements within its discretion.
- preference unit holders, through the Trust, may veto Aurizon Network's proposed actions at defined milestones under the works contracts in response to non-compliance with scope or the procurement methodology schedules.
- the Trustee may call funds from preference unit holders during this phase according to a pre-agreed formula. The Trust will not raise funds itself.
- Aurizon Network will consult and report to the Trustee and preference unit holders throughout this phase.

Indicative time duration: Approximately 2 to 3 years.

Stage 4: Project delivery consolidation phase - this stage commences when the last segment becomes available and ends when all outstanding construction issues have been addressed.

Indicative time duration: Approximately 3 to 5 years.

Stage 5: Revenue phase - the revenue phase generally starts when rent is first due from Aurizon Network and ends when there is no further obligation to pay rent. This will generally overlap with stage 4.

The Trust leases the extension infrastructure from QTH, and then subleases to Aurizon Network. Aurizon Network operates the entire network and is responsible for all operations and management of the network, including SUFA infrastructure. Aurizon Network is responsible and/or liable for the following:

- to QTH for loss
- to provide all necessary insurance
- making rental payments to the Trust
- entering into a linked access agreement (being an access agreement entered into under the Umbrella Agreement) with each preference unit holder (or their nominee)
- each linked access agreement entered into having a direction to pay instruction to the Trust, with the intention that aggregate amount of access charges payable under those access agreements is at least equal to the rent due in any given month.

Indicative time duration: Asset dependent, but could be up to 40 years.

Stage 6: End of life phase - this phase begins when the SUFA assets have a zero value in the RAB (Zero Value Date). The Extension Infrastructure Sub Lease (EISL) automatically terminates 12 months after the Zero Value Date, which in turn terminates the SUFA agreements save for the Trust Deed and Subscription and Unit Holders Deed. Further, from the Zero Value Date, Aurizon Network, as ordinary unit holder, can direct the Trustee to redeem the preference units. After all preference units have been redeemed, the Trust can be wound up by Aurizon Network acting as the ordinary unit holder.

Indicative time duration: at least 1 year.

Table 1: Summary of parties involved and applicable agreements

		Queensland Treasury Holdings	State of Queensland	Aurizon Holdings	Aurizon Network	SUFA Trustee	User Funders
The Trust							
Trust Deed (TD)	Establishes the Trust with Aurizon Network as ordinary unit holder, permits the issue of preference units and appoints the Trustee				Yes	Yes	
Subscription and Unit Holders Deed (SUHD)	- Imposes obligations on access seekers to subscribe for preference units - Establishes the operational rules of the Trust whilst there are unredeemed preference units - Prevails over the Trust Deed if there is a conflict				Yes	Yes	Yes
Project Delivery and Land Access							
Project Management Agreement (PMA)	- Engages Aurizon Network as Project Manager - Identifies the terms and governance requirements under which this role is undertaken				Yes	Yes	
Rail Corridor Agreement (RCA)	- Provides a licence to the Trustee so that it can access Aurizon Network land and modify infrastructure - Identifies the terms and conditions associated with this right				Yes	Yes	
Leasing, Ownership and Rent							
Extension Infrastructure Head-lease (EIHL)	- Establishes the ownership and leasing terms and conditions for the SUFA asset between QTH, the Trust and Aurizon Network	Yes			Yes	Yes	
Extension Infrastructure Sub-lease (EISL)	- Establishes the sub-leasing terms and conditions for the SUFA asset between the Trust and Aurizon Network - Contractually defines the rental terms and conditions for Aurizon Network to pay rent to the Trust				Yes	Yes	
Access Rights and Tax Indemnity							
Umbrella Agreement (UA)	- Establishes that each preference unit holder or nominee will enter into an access agreement - Establishes that each preference unit holder will provide various tax indemnities				Yes	Yes	Yes
Agreement Termination and SUFA Asset Disposal							
Integrated Network Deed (IND)	- Governs the circumstances and process by which the QTH may dispose of SUFA assets following termination of the EIHL - Governs the disposition of any disposal proceeds if a disposal occurs	Yes	Yes		Yes	Yes	
Performance Standards							
Deed Poll Guarantee (DPG)	- Guarantees to QTH, Aurizon Network and the Trustee's performance of their obligations under the EIHL and IND - Indemnifies QTH against any losses it may incur due to a default of delay in the performance of these obligations			Yes			

3.2 SUFA documents yet to be completed

The SUFA documents are being designed as a standard form of agreement, and as such, it is accepted that parties may wish to negotiate variations to the standard set of arrangements ultimately approved by us. The standardised set of agreements has been described by Aurizon Network as a 'safety net' to be used where negotiations are not successful.

In its reply submission to us in December 2013, Aurizon Network notes that following its submission in December 2012, it worked with QTH and Queensland Rail on the Extension Infrastructure Head Lease (EIHL) and the Integrated Network Deed (IND). It is our understanding that negotiations on these agreements are ongoing and, at the time of writing, these agreements are still incomplete²².

²² Aurizon Network 2013a, p. 1.

4 OVERARCHING ASSESSMENT OF THE 2013 SUFA DAAU

4.1 Overarching summary of Aurizon Network's view

Aurizon Network says that due to its ownership by an ASX listed company and the large scale investments required for infrastructure extensions, it must maintain commercial flexibility over the funding of capital projects. When Aurizon Network decides not to fund an extension, access seekers require options to enable ongoing enhancements to the CQCN.

Aurizon Network notes that its guiding objective in developing SUFA has been simple - enabling new arrangements and choices for access seekers in funding extensions and growth of the CQCN. Further, it says that its SUFA framework is intended to facilitate network extensions for capacity growth by providing a mechanism to fund infrastructure enhancements and provide cash flows to funders²³.

Aurizon Network's proposed SUFA framework is not designed to do the following:

- impact on the ownership or operation of the CQCN
- create secondary markets for the cash flows generated by the CQCN
- enable access seekers to control or own parts of the CQCN
- enable access seekers to fund directly and take security and recourse over parts of the CQCN
- enable third party investment in network extensions (which could conflict with the wider coal supply chain coordination, network continuity and coordinated network investment).

Aurizon Network says five principles have been implemented throughout the development of the SUFA, namely: system integrity, workability, efficiency, non-prejudicial and flexibility. These principles are summarised in Table 2.

²³ Aurizon Network 2013b, p. 3

Table 2: Aurizon Network's SUFA Principles

<i>Principle</i>	<i>Implication</i>	<i>Proposed structure</i>
System integrity	Aurizon Network holds a fundamental concern that its network augmented by a SUFA project may fail to provide the level of access provision (e.g. capacity, reliability, efficiency and resilience) that would have been provided had Aurizon Network funded the project and determined that project scope and its delivery.	To minimise "system integrity risk", Aurizon Network has imposed substantially all responsibility for the development, operation and maintenance of the infrastructure to itself and has granted information and governance rights in respect of Aurizon Network's activities to the preference unit holders.
Workability	Access seekers must have a workable mechanism to enable them to fund the delivery of the extension project. The framework must also satisfy the State's requirements respecting system integrity under the infrastructure leases held with Aurizon Network.	The SUFA framework has been developed to allow for projects of varying sizes and timeframes. Preference unit holders commit funds required in return for rights to future cash flows, rather than owning infrastructure.
Efficiency	The SUFA framework must be structurally efficient for all parties, enabling transactions to occur in a timely, low cost and tax effective manner.	There is generally a clean allocation of responsibilities between Aurizon Network, the Trustee administering the SUFA transaction and the participating access seekers (as preference unit holders).
Non-prejudicial	The SUFA framework should not compromise Aurizon Network's legitimate business interests or prejudice future extension projects - whether funded by Aurizon Network or not.	SUFA has been structured so that it does not disadvantage: <ul style="list-style-type: none"> • access holders • the wider supply chain • subsequent SUFA projects • Aurizon Network's existing and future business activities and legitimate business interests.
Flexibility	The SUFA framework must enable flexibility on a project-by-project basis.	The framework allows for: <ul style="list-style-type: none"> • commercial negotiation of compensation for additional risk Aurizon Network takes on • hybrid funding, where Aurizon Network can fund part of the cost of a SUFA project.

Aurizon Network says it has developed SUFA template documentation as a package to address most (but not all) of the commercial positions required for a SUFA transaction. It notes that, as is the case for any template documentation, the treatment of certain commercial positions is best determined at the time of the transaction²⁴.

Aurizon Network concludes that although some matters may not have been fully agreed with the CWG, its proposed framework achieves an acceptable balance between the interests of Aurizon Network (as the railway manager with pre-existing network-wide obligations) and preference unit holders for a "base-case" SUFA transaction. It cautions that if subsequent

²⁴ Aurizon Network 2013b, pp. 5-6

modifications are made to the SUFA framework, significant restructuring may be required to retain the commercial balance between the various competing interests²⁵.

4.2 Summary of stakeholder views

QRC

In its 2011 submission on Aurizon Network's 2011 DAAU, the QRC noted the fundamental element of the investment framework principles is the right for users to fund extensions of the network. The QRC said the right to user fund is essential given Aurizon Network only committed to invest in a limited range of circumstances, and had a stated view that regulatory settings did not provide it with an adequate incentive to invest. Further, the QRC said:

- Aurizon Network does not have an obligation to fund significant investments
- Aurizon Network's voluntary commitment to fund infrastructure up to \$300 million per regulatory period may not be present in UT4.

At the time, the QRC said an effective user funding alternative must provide for competition in the market for financing network projects as competition would act to constrain the returns sought by Aurizon Network to a competitive level associated with such regulated investments. The QRC also said it was necessary to have a timely pathway through which network projects can be financed and constructed in the event that Aurizon Network decides not to invest.

In its August 2013 submission, the QRC said the structural issues and complexity of the SUFA documents meant:

- it will only be suitable for large projects
- third party funding for projects will be difficult to obtain - and where obtainable, will be at a premium to the Weighted Average Cost of Capital (WACC)
- the cost of pursuing user funding via a SUFA will be on par with, or more expensive than Aurizon Network funding (noting that Aurizon Network seeks a substantial premium above WACC for \$300 million plus projects).

The QRC concluded Aurizon Network's proposed SUFA was not a genuine alternative to Aurizon Network funding and as such, does not achieve a significant purpose - which is to create genuine competition for expansion capital²⁶.

The QRC said in its December 2013 reply submission that Aurizon Network's submitted SUFA could not be used by mining companies, as a structure to invest, as it simply presents too much complexity, uncertainty and risk for any prudent person to accept.

Further, the QRC said if mining companies could not tolerate the complexity, uncertainty and risks of Aurizon Network's SUFA, there is little prospect of a third party equity or debt funder doing so. The QRC explains this is because mining companies are likely to have a higher risk appetite for such an investment given the degree of knowledge and familiarity with the rail access regime²⁷.

According to the QRC's December 2013 reply submission, two core areas of Aurizon Network's SUFA require significant amendment, namely:

²⁵ Aurizon Network 2013b, p. 22

²⁶ QRC, 2013b, p. 6

²⁷ QRC 2013m, p.1

- Construction - user funders bear the risk of cost overruns, late completion and abandoned projects without there being the typical mechanisms for them to manage these risks
- Revenue Certainty - this issue involves the rental calculation, payment processes, security interests and the risk of an Aurizon Network default²⁸.

Other stakeholders

BMA/BMC said it was essential for the QCA to establish an alternative competitive investment pathway whereby industry can fund, manage and control the risks associated with rail investment underpinning coal mine expansions. At a minimum, they recommend the SUFA framework must:

- promote an effective competitive alternative to Aurizon Network's current monopoly status in the provision of multi-user rail infrastructure in Queensland
- result in economically efficient investment decisions being made in the Queensland rail infrastructure market
- facilitate competition in all related markets (e.g. financing, engineering design, construction, haulage and coal exploration markets)²⁹.

Glencore noted its concern that even if we adopted all of the changes proposed by the QRC, the complexity and lack of commercial balance in the SUFA agreements will mean it will not be attractive to third party funders (or if it is, only at significant rates of return or with guarantees from miners). Glencore states that the practical effect of this is Aurizon Network will be free to require rates of return equivalent to those required by mining companies. Further:

Mining return requirements reflect the substantial risks attending mine investments (many of which are immediately apparent in the current economic environment). It can only be regarded as a market failure when a regulated monopoly infrastructure owner can extract mining returns while taking little or no risk (as is reflected in regulated access terms and the typical other risk transfers to miners that arise where access conditions are sought)³⁰.

Glencore added that given the risks posed to future investment in mines in Queensland by Aurizon Network's own approach to investment in the network, we should adopt the changes proposed by the QRC and preserve the ability to require further amendments once a live transaction has been attempted or concluded.

Asciano notes it was not involved in the discussions that have resulted in the development of the current SUFA proposal, and as such, is seeking confirmation on a number of issues, namely:

- can an above-rail operator (including itself or Aurizon above-rail operations) hold a preference unit in the Trust?
- will the voting process, with respect to whether the SUFA asset is included in the RAB, be inclusive of all potentially impacted users of the system?
- will the SUFA extensions be subject to the same ring-fencing and confidentiality provisions as extensions funded by Aurizon Network

²⁸ QRC 2013m, p.2

²⁹ BMA/BMC 2013, p. 2

³⁰ Glencore 2013, p. 2

- whether SUFA related dispute resolution processes have the flexibility to allow operators to be involved (for example in respect of track quality)³¹.

Vale considered the development of a credible and efficient investment framework to be one of the most critical objectives for the future competitiveness of the Queensland coal industry. The SUFA must provide a credible solution that cannot be easily discriminated against and provide a real funding alternative to access seekers to provide a competitive market for the funding of extensions. Other concerns include:

- Aurizon Network only views SUFA as an option if it does not wish to fund, rather than a competitive option
- the resolution of tax options with the model are subject to several private tax rulings
- the links between the SUFA documents and the expansion process is not clear³².

4.3 QCA view

Aurizon Network's 2013 SUFA DAAU included nine agreements (over 700 pages). In its submission letter, Aurizon Network noted it had worked with the CWG on a list of key issues. As a result of that consultation, Aurizon Network reported that agreed positions had been reached on each of the key issues. In one instance, there was agreement in principle, but disagreement on drafting³³.

In response to Aurizon Network's 2013 SUFA DAAU, the QRC provided a cover submission and marked-up copies of the SUFA agreements. The QRC notes in its cover submission that its mark-up of Aurizon Network's agreements would at best provide:

- a barely workable framework through which mining companies might invest their own capital
- some prospect of transferring the investment to a third party
- no possibility of third party equity during the construction phase
- no possibility of third party debt financing at any stage, other than through corporate debt held by the individual user funders.

The QRC identified a number of challenges which exist with Aurizon Network's proposed structure. Further, it said that almost all of the amendments were necessary to get the SUFA documents anywhere close to being usable³⁴.

We are of the view that after a lengthy negotiation period, including extensive drafting and re-drafting of the SUFA agreements, substantial key issues in respect of the workability and bankability of the SUFA framework has yet to be resolved. More importantly, we question whether key issues can be resolved by another round of re-drafting the agreements.

Given this background, it is our view that a broader approach must be taken in consideration of the SUFA framework. Key issues as to the workability and bankability of the structure must be resolved before detailed drafting of the agreements is revisited.

³¹ Asciano 2013, pp. 7-9

³² Vale 2012, p. 2

³³ Aurizon Network 2013a, p. 1

³⁴ QRC 2013b, p. 5

The remainder of this position paper addresses what we consider to be the key outstanding issues to be resolved to obtain a workable, credible and bankable SUFA. With these issues resolved, we consider there is a reasonable prospect of having an effective SUFA arrangement developed. If these cannot be resolved we are of the view that there is little value in re-drafting the existing suite of SUFA agreements.

We would welcome stakeholder's comments and views on each of the issues outlined in the subsequent sections of the position paper. In particular we would welcome comments:

- on whether as a package of measures our proposal would meet the objective of a workable, credible and bankable SUFA
- any suggestions stakeholders have on how it could be improved to meet this objective.

5 ALTERNATIVE OPTIONS

As discussed in the previous chapters, the 2013 SUFA DAAU is not complete and a number of critical issues remain unresolved. The general view of stakeholders is that it could only be used by large mining companies funding off balance sheet. Consequently the 2013 SUFA DAAU, or a variant thereof, is unlikely to facilitate alternative sources of financing that can effectively compete with an Aurizon Network financing proposal.

Against this background, we are of the view that it is worth considering whether a modified SUFA can be developed. The subsequent sections of this paper outline our current thinking on this. The term sheets provide a summary of the structure and content of the SUFA agreements based on our view. Our view assumes that the issues surrounding tax can be resolved.

5.1 Alternative SUFA proposal

Overarching objective

The objective of SUFA is to provide a credible choice of competitive financing options for funding an expansion in the CQCN. In our view this means an effective SUFA has to ensure that potential investors can access third party finance via the debt market and ideally the equity market. In order to achieve this, the SUFA needs to be perceived as credible, workable and bankable by third party financiers. Grant Samuel considers that having security over rental cash flows, not SUFA assets, is critical to this.

SUFA also needs to appropriately account for the interests of Aurizon Network, its present and future customers and the ultimate owner of the assets which is QTH. In order to accommodate SUFA we may have to change aspects of the regulatory regime as well.

Summary of alternative approach

Aurizon Network and its stakeholders have invested considerable effort in developing SUFA. Notwithstanding the concerns expressed by stakeholders in respect of the workability of the 2013 SUFA DAAU, we consider the work to date provides a solid base for further refinement to achieve an effective SUFA arrangement.

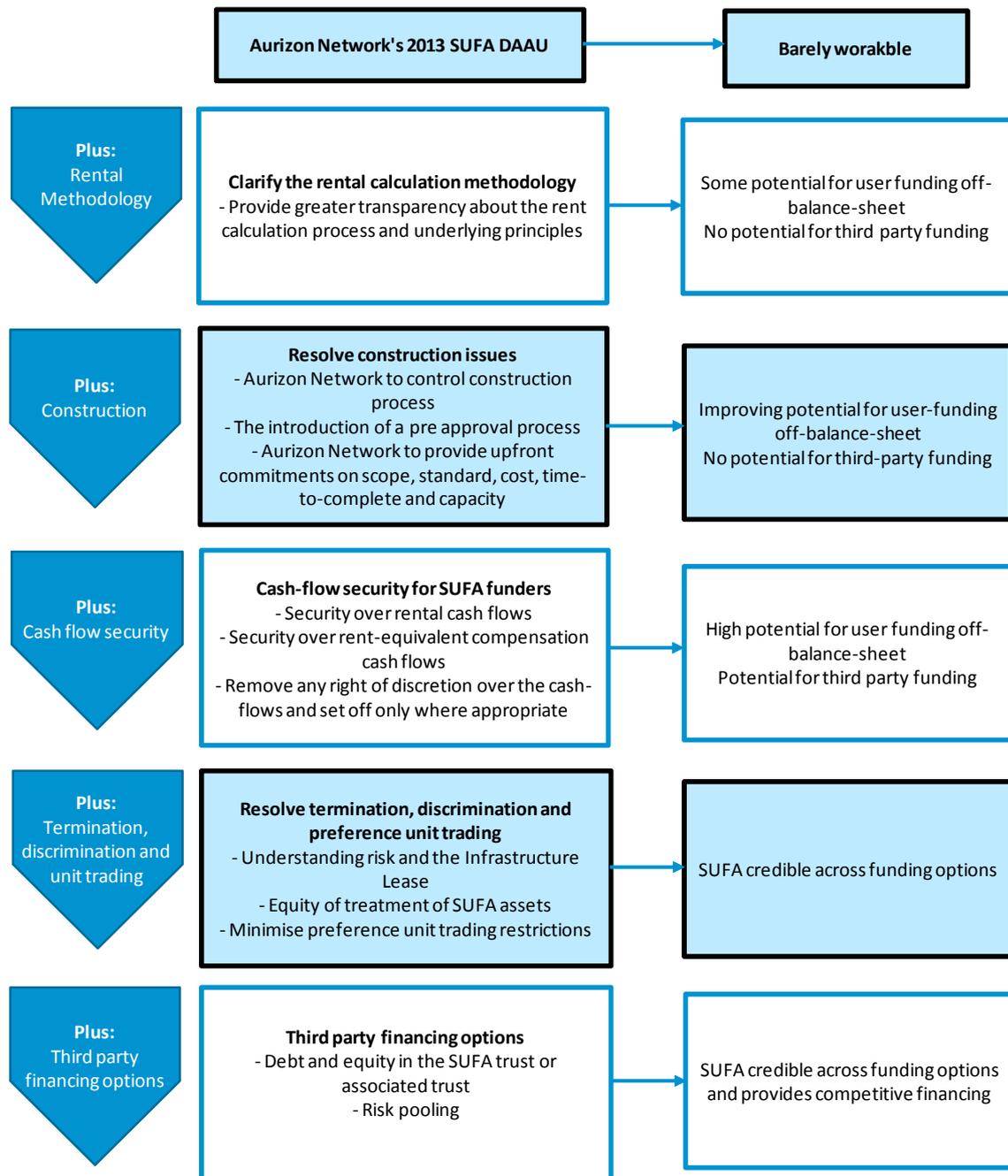
Against this background, in developing our modified SUFA we have maintained the Trust structure used in Aurizon Network's 2013 SUFA DAAU and the majority of Aurizon Network's proposed existing agreements. We have considered from a high-level perspective what issues require resolution, how this can be achieved and what would be the cumulative impact of resolving them in the manner proposed.

Issues surrounding the rent calculation methodology, construction, security over rental cash flows, termination, discrimination, preference unit trading, the securitisation of the SUFA trust and taxation are considered in more detail in the subsequent chapters of this paper. We consider that the most pivotal issues are construction and revenue certainty.

The diagram on the subsequent page provides a stylised summary of our current thinking. It seeks to illustrate how resolution of the issues ultimately results in a SUFA that provides for competitive user and third party financing for infrastructure expansions in the CQCN.

We are of the view the proposals outlined in this paper account of the interests of Aurizon Network, its present and future customers, and QTH.

Figure 1: QCA view of the steps required to obtain a workable bankable and credible SUFA framework



6 RENTAL METHOD

The right to receive rent from Aurizon Network for its use of the SUFA infrastructure is a key asset of the Trustee. Grant Samuel is of the view that to attract third party financing it is critical there is clear and transparent information about the rental arrangements and how the rent is calculated. This is also important to users considering funding a SUFA project off balance sheet.

Overall, we are of the view the suite of SUFA documents should:

- provide potential SUFA funders with transparency over the calculation of rent
- allow potential SUFA funders to clearly understand the risks associated with the rental stream.

How the rent is calculated and paid is outlined in the Extension Infrastructure Sub-Lease (EISL).

6.1 Aurizon Network's position and stakeholder comments

Aurizon Network's rent calculation methodology involves a number of steps and provisions about how the funds will flow from Aurizon Network to the Trust.

This position paper does not seek to discuss all these arrangements; instead it provides a high-level discussion on certain key issues we consider would assist the decision-making process on the SUFA framework at this stage.

This chapter provides an overview of:

- Aurizon Network's proposed rent calculation methodology
- the proposed post-regulatory arrangement
- the associated comments from stakeholders on those matters.

The general consensus of the stakeholders has been the proposed rent calculation methodology is intricate and needs amendments to be understood more easily, this is particularly true for parties not familiar with regulated pricing arrangements.

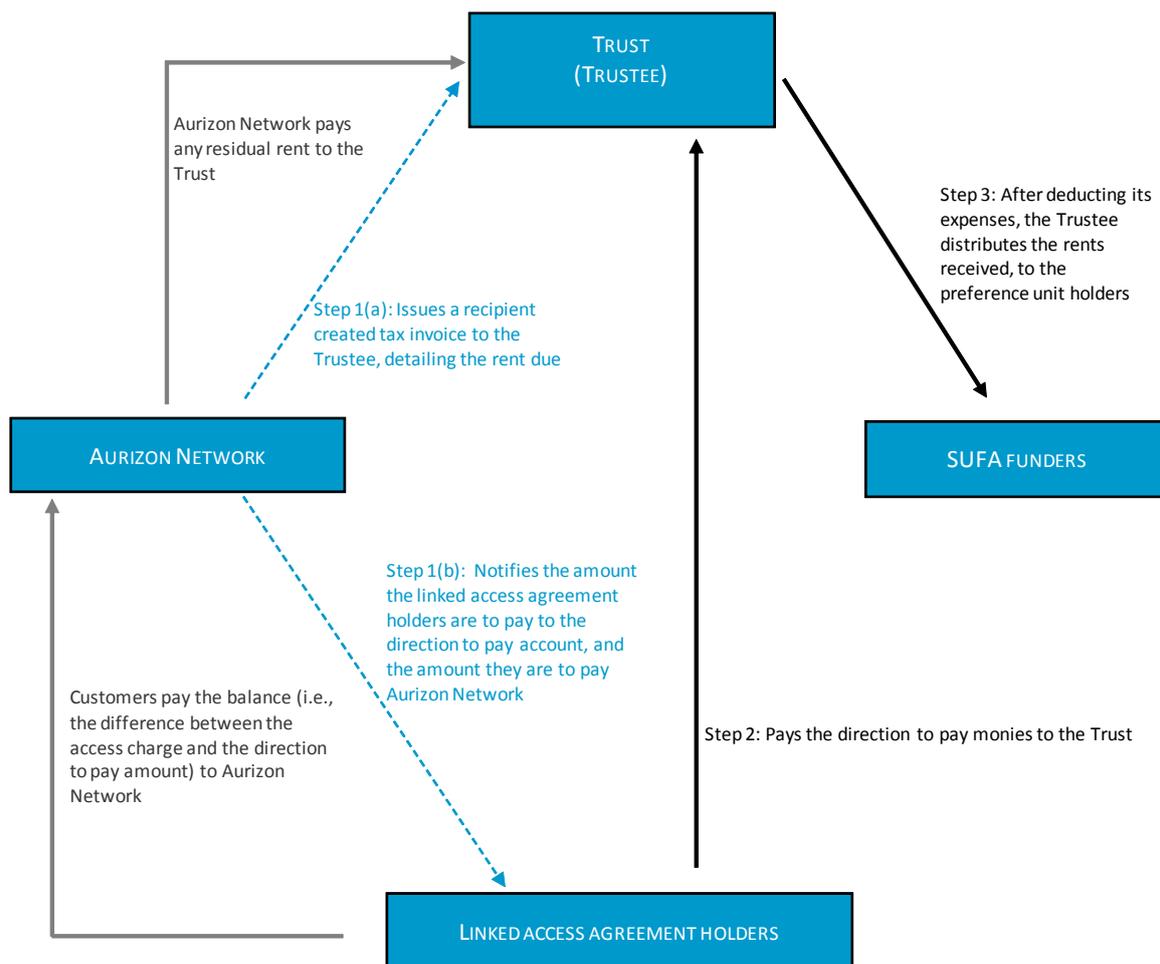
The underlying principles of the proposed rent calculation method

The underlying principles behind the rent calculation in a regulated environment are based on the concept of the system allowable revenue (SAR). This is the same as applied in computing the reference tariffs under UT3. The principles underpinning the rental methodology are outlined in Schedule 2 of the EISL. Schedule 3 of the EISL explains the methodological approach based on the regulatory principles in place at this time.

A fundamental point to note is the existing regulatory environment utilises a revenue cap. If this was removed or the SUFA operated in an unregulated environment (i.e. in the event the CQCN, or parts, cease to be declared under the QCA Act) the Trust and Aurizon Network would be exposed to volume risks.

Rent and its relationship to direction to pay

Under the EISL, Aurizon Network sub-leases the extension infrastructure from the Trustee and is required to pay rent to the Trustee in respect of the sub-lease. Based on submissions and meetings with Aurizon Network, our understanding is the rental methodology involves a number of steps as shown in Figure 2.

Figure 2: Flow of rent to the SUFA funders

The figure shows the various links that lead to the payment of rent to the SUFA funders.

The process starts with Aurizon Network sending invoices to all the access holders, where the invoice to the linked access holders is accompanied by the direction to pay notice (step 1b), as discussed shortly. The linked access agreement holders are initially those access seekers who are the first investors in a SUFA.

Once the Trustee receives the funds (step 2) from the linked access agreement holders (and any residual rent from Aurizon Network), it distributes those to the SUFA funders, minus its expenses (step 3).

The following steps discuss the rent payment mechanism and its link to the direction to pay:

- **Step 1(a)** - Aurizon Network to the Trustee³⁵:
 - Aurizon Network sends a monthly recipient created tax invoice to the Trustee, indicating the amount (expected rent) payable to the Trustee³⁶. This amount is equal to:

³⁵ For simplicity, the explanation and example provided here excludes operating and performance risk allowance (OPRA). Aurizon Network proposed it should receive this allowance to compensate it for any risk involving the maintenance and operation of the SUFA assets. If OPRA is greater than zero it reduces the lease rental stream payable to the SUFA funders.

Equation (1)

Expected rent = Distribution pool × Proportion of that pool attributable to the Trust

Where the,

Equation (2)

Distribution pool = capital components (return on and return of the existing infrastructure plus the SUFA asset) of all invoiced access revenues

Rent is the portion of this applicable to the Trust. This portion is based on the capital component of the revenue that relates to the SUFA infrastructure.

- **Step 1(b)** - Aurizon Network to the linked access agreement holders:
 - Aurizon Network sends a monthly invoice to the linked access agreement holders. This states the portion of their access charge payable to the Trustee. The sum of such portions in that month is the direction to pay amount, which is equal to the:

$$\frac{\text{Expected rent}}{\text{Linked access charge invoiced for the month}}$$

The linked access agreement holders are also notified of the amount they are to pay Aurizon Network, which is the difference between the direction to pay amount and the access charge.

- **Step 2**
 - The direction to pay is determined once the expected rent is calculated. This means it is based on invoiced amounts, rather than actual amounts. The rental payment process includes a number of 'set offs' to account for discrepancies that may actually occur. Set offs are the 'adjustment' mechanisms for the over- or under- recoveries/payments of rents with respect to the direction to pay. A simple example of how the above steps set off works is provided in Box 1:

³⁶ Aurizon Network 2013c, clause 8.1(a)

Box 1: Example of Under-Recovery**Example of under-recovery**

- In January, the distribution pool (the capital components of the access charges) is \$4 million, and the proportion of this attributable to the Trust is 5%. According to Equation 1, the 'expected rent' payable by Aurizon Network to the Trust is \$200,000.
- The invoice value (i.e., total value for the linked access agreement holders) is \$320,000 in January. The direction-to-pay based on this is, 62.5% (i.e., \$200,000/\$320,000). This relates to the proportion of the linked access agreement charges to be paid to the Trust from the linked access holders.
- However, in January the Trust only receives \$180,000 through the direction to pay. This leaves a rent shortfall of \$20,000, as against the expected rent.
- This is equivalent to a shortfall in aggregate access revenues of \$20,000 for January. However, as the shortfall relates to a direction to pay not being paid, the Trust bears the shortfall for three months if it is not rectified.
- After the three month period, if the direction to pay shortfall has not been paid to the Trust, the shortfall is "socialised". This occurs because it becomes classified as a system-wide debt as it is deemed to reflect a bad debt associated with access holder(s) not paying their access charges in full in January. This results in the Trust only bearing its share of the \$20,000 debt, instead of the full amount of \$20,000.
- In this example the Trust's share of the shortfall is straightforward to calculate as it is the Trust's share of the distribution pool, which is 5%. So the SUFA trust's share of the \$20,000 shortfall is \$1,000.
- Aurizon Network provides the Trust with an additional \$19,000 in rent in April/May through adjusting the direction to pay for April or May, depending on the precise timings of the billing cycle.
- So the expected rent for January was \$200,000 but the actual rent eventually received for January is \$199,000 (\$200,000-\$20,000 +\$19,000). The actual rent then reflects the Trust's share of the \$20,000 bad-debt.

This example shows how an adjustment works in case of an imbalance between the actual versus the invoiced payment. It also shows the Trust's actual rental stream is subject to the actual flow of access charge revenues and the associated under and over-payments that occur through time. If revenue in a particular year is below the SAR for that year, this will be adjusted via the revenue cap process.

The QRC said the rent calculation methodology is complex and may lead to difficulty in raising funds for the SUFA project. Although we understand that the QRC accepts the process of deriving SAR and access charges, it considers the rental mechanisms are complex. It is of the view that the proposed rent calculations and provisions within the SUFA framework could be modified in order to increase transparency and mitigate complexity.

The QRC proposed a number of amendments, including prohibition of set offs, clarifications on the distribution pool calculation and flexibility in the calculation of adjustment charges.³⁷

Post regulatory arrangement

Aurizon Network has proposed various principles for rent calculation in an unregulated environment in Schedule 2 of the EISL.

These principles include pricing of access and revenue sharing.³⁸ For access pricing, the SUFA funders would bear the risk in the event the access charge is lower than that in the regulated environment. On the revenue front, if the access revenue is higher than that allowed in a regulated environment, the SUFA funders are excluded from enjoying that benefit.

The QRC said given SUFA funders and Aurizon Network share a similar risk and return profile under the regulatory regime, it does not seem reasonable that the funders are placed in an unfavourable situation in an unregulated environment.³⁹

The QRC also noted that there was the potential for discriminatory treatment. The QRC said:

As an example of the absurd results which Aurizon Network's methodology could provide, if access charges were to double post-regulation, and there were two access holders, one of which was a third party and the other a related body corporate of Aurizon Network, the rent would double in respect of the third party's use, and not increase at all in respect of the related body corporate's use (given that the related body corporate would be heavily incentivised to provide the service under a CITS^{40,41}).

6.2 QCA view

Regulatory arrangement

We consider the method of rent calculation proposed by Aurizon Network to be unclear and assume a high degree of specialist knowledge of the specific regulatory environment. Although the underlying philosophy of the rent calculation process appears reasonable, we consider the calculation methodology needs to be clarified and simplified in order to provide assurance for all potential SUFA funders that this is the case.

We are currently in the process of addressing this with Aurizon Network. This includes developing spreadsheet examples and reviewing the schedules underpinning the rent calculation methodology. This comprises looking at the rent calculation process under different scenarios such as over- and under-payments relative to the direction to pay, and the role that revenue cap adjustments and volume forecast re-sets play with respect to calculating rent. The objective is to make these arrangements available to interested parties in the near future and to include them as part of the SUFA documentation.

³⁷ QRC 2013b, pp.17-19

³⁸ Aurizon Network 2013c, Schedule 2, Objective 2.3

³⁹ QRC 2013b, p.20

⁴⁰ A CITS is defined in Schedule 2 part 2 of the EISL. This relates to the rental objectives in an unregulated environment. CITS means a commercially integrated transportation service for which the provider incurs both below rail costs and other transportation costs, and charges its customer an integrated fee for transportation services rendered to it. Aurizon Network is defined as a CITS provider.

⁴¹ QRC 2013b, p. 20

Unregulated arrangement

The SUFA funders should be provided with a level of certainty that, in the event there is a change in the regulatory environment, their rental stream is still protected.

Subdivision 4A, and Subdivision 5 of, Part 5; Division 2, of the QCA Act provides for two circumstances where declared infrastructure may no longer be declared.⁴² In both circumstances, the CQCN (or part thereof) would only become unregulated if we were satisfied that it no longer meets the declaration criteria, and our recommendation to revoke or not re-declare was accepted by the QCA's Ministers.

A key determinant for the infrastructure not to be declared would be the presence of effective competition in markets that are dependent on the market for the regulated service. In a competitive environment, the SUFA funders and Aurizon Network would need to negotiate among themselves the contracts, terms and conditions, and sharing of risks.

In this context, Section 95 of the QCA Act allows the existing contractual rights and obligations of the access holders to continue even if the infrastructure ceases to operate in a regulated environment. We consider that these provisions in the QCA Act and the SUFA documents should be aligned so that the SUFA funders are provided with a degree of certainty over the rental stream in the event a change in the regulatory environment has to occur.

Where our views are reflected in the term sheets

6.1 Amendments to the Extension Infrastructure Sub-lease:

Tidy up of rent calculation and methodology found in section 7.4(c)(iii)

⁴² QCA Act, 1997

7 CONSTRUCTION OF SUFA INFRASTRUCTURE

The Project Management Agreement (the PMA) and aspects of the Rail Corridor Agreement (the RCA) define the construction process for SUFA assets within the 2013 SUFA DAAU. The PMA and RCA are not in an industry recognised form and numerous issues of detail remain.

This chapter does not intend to discuss each of these issues separately. It focuses on our understanding of the overarching concerns and whether an approach can be developed to alleviate these and provide the necessary environment to encourage third party financing. In this regard Grant Samuel has advised us that the more certainty there is surrounding construction and capacity delivered, the more attractive SUFA will become to third party financiers. This also applies to users funding off balance sheet.

7.1 The construction process

Aurizon Network's position

Aurizon Network considers it should have control over the construction of a SUFA project. Based on submissions and discussions with Aurizon Network, our understanding is that Aurizon Network⁴³:

- considers it is best placed to manage construction risk for assets on its own network
- has obligations to the State to ensure system integrity over the whole of the network including SUFA assets
- is responsible for health and safety management of the network, including the SUFA assets.

However, from a legal perspective, control of the construction process technically lies with the Trustee. In order to manage this separation, Aurizon Network's 2013 SUFA DAAU included a complex agency structure that allows it to 'claw back' control of the construction process.

Thereafter, the subsequent interaction of various aspects of the PMA⁴⁴ means that the more control SUFA funders require over Aurizon Network's actions in the construction phase, the greater the level of risk SUFA funders are expected to bear. This occurs regardless of whether Aurizon Network is better placed to control and manage the risks.

Arguably, this provides a disincentive to be involved in the construction process.

Stakeholder views

Aurizon Network's position contrasts sharply with that expressed by the QRC. The QRC's view is broadly supported by industry participants.

⁴³ Our understanding of Aurizon Network's position has been informed through discussions and reviewing Aurizon Network's SUFA submissions. Volume 3 of Aurizon Network's 2012 SUFA DAAU provided in December 2012 provides the most comprehensive written explanation of Aurizon Network's underlying position. It provides a summary of Aurizon Network's position regarding risk management (page 8, section 2.2.2.2), business interruption and damage (page 9, section 2.2.3.1), system integrity and asset management (page 9, section 2.2.3.2) and safety assurance (page 10, section 2.2.3.3). With respect to construction, the 2013 SUFA DAAU focuses on changes to the SUFA documents as a result of negotiations with stakeholders.

⁴⁴ These include the provision of: the provisions relating to the procurement method, the controls over construction and the capital cost optimisation process.

Based on submissions and discussion with the QRC, our understanding is the QRC did not support the agency structure in the 2013 SUFA DAAU and was of the view SUFA funders should have an a high degree of input into the construction process because they⁴⁵:

- primarily bear the economic cost of delivery uncertainty and capacity risk
- provide the funding for the project.

Some stakeholders have also alluded to previous instances of dealing and negotiating with Aurizon Network regarding significant expansions such as the Goonyella to Abbot Point Expansion (GAPE) and the Wiggins Island Rail Project (WIRP). These experiences appear to have resulted in a desire to have greater influence over the timing of the end-to-end expansion process comprising design, construction and operation⁴⁶.

7.2 QCA View

We recognise Aurizon Network and the QRC have put considerable effort into seeking to reach an agreed compromise for the PMA.

Unfortunately the output from this process is a complex construction agreement we consider is difficult for potential SUFA funders to use practically. We also consider it will be challenging to find independent corporate trustees to undertake the role of SUFA trustees at a reasonable cost. This is because the PMA requires that the Trustee undertake tasks beyond its administrative abilities (i.e. effectively becoming a construction manager).

Given this, we believe there is benefit in developing a simpler approach. Our proposed approach re-focuses SUFA to be a financing tool as it was originally intended.

Our proposed approach will require various changes to SUFA, the undertaking and our own approval arrangements. The changes proposed seek to:

- ensure that risk is allocated to the parties best able to manage it
- provide greater certainty over what is delivered via a capital project
- provide greater certainty of the treatment of capital costs
- ensure the role of the Trustee is passive and limited to administrative activities.

Our proposed approach can broadly be split into the following sections:

- control over construction and upfront commitments
- expansion process
- preapproval process.

⁴⁵ Our understanding of stakeholder's views has been informed through reviewing submissions and discussions with the QRC. The QRC's covering submission on the 2013 SUFA DAAU provided in August 2013 outlines a number of overarching concerns with the PMA and RCA (sections 7 and 5 respectively). Additionally the QRC proposed a significant number of detailed amendments to the PMA and RCA documents. The QRC's covering submission also noted that SUFA needs to be considered in the context of a robust expansion process (section 3.3 and Annexure B). Submissions from BHP Billiton Mitsubishi Alliance, Glencore, and Anglo America on the 2013 SUFA DAAU in August/September 2013 broadly supported the QRC's position. Further submissions provided by stakeholders in December 2013 did not change this.

⁴⁶ In its August and December submissions Anglo American referred to GAPE and WIRP and the need to protect against 'economic hold up' (page 2 in both submissions).

It is our view the expansion and preapproval processes would form part of the undertaking and encompass up front commitments. The expansion process is already being developed as part of UT4. Control over construction would impact directly upon the SUFA agreements.

Control over construction and up front commitments

Our proposed approach is based on Aurizon Network having control of the construction of SUFA projects.

We are of the view this is necessary as Aurizon Network must operate and maintain the CQCN. Allowing Aurizon Network control significantly reduces the complexity of the construction process and the suite of SUFA agreements. It also re-focuses SUFA as a financing tool.

While Aurizon Network should have control over the construction of SUFA assets, Aurizon Network will need to provide delivery commitments to SUFA participants, as would be the case in any standard arrangement. Our proposal requires Aurizon Network to provide transparent, up front commitments to construct SUFA infrastructure as efficiently as possible across the dimensions of scope, standard, cost and time-to-complete.

Aurizon Network, as infrastructure planner, constructor of the asset and operator of the rail network, is also required to build a SUFA project to an agreed range of capacity outcomes on the basis that capacity is the product demanded by users, not infrastructure. This capacity outcome should be agreed as part of the expansion process.

Expansion process

In order for our proposed approach to operate effectively, UT3 will need to be amended to include an expansion process. This process will need to be capable of delivering feasibility studies to a level of accuracy required to provide credible up front commitments that satisfy the needs of Aurizon Network as infrastructure provider, third party financiers and users funding off balance sheet.

An expansion process is already being developed as part of the UT4 arrangements. We are of the view that, as far as is practicable, this should be included in UT3. This requires that the expansion process is developed to account for the needs of the SUFA framework, noting the intention is for the SUFA framework to roll into UT4.

Introducing an effective expansion process and providing Aurizon Network with control over the construction of SUFA projects allows the risk associated with construction and capacity delivery to be allocated to Aurizon Network.

In our view, up front commitments should provide greater certainty over the infrastructure and capacity to be delivered. They also provide a set of measurable benchmarks from which construction performance and capacity delivery can be objectively assessed. These measures will allow the Trustee to act in a passive manner and focus on administrative tasks. This should also increase the pool of potential SUFA trustees and reduce the cost of employing them.

We consider the expansion process should apply to all capital projects undertaken that result in a material capacity change. We consider this threshold should account for both the expected cost and incremental capacity delivered.

This means that for each project that goes through the expansion process, a set of up front commitments regarding scope, standard, cost, time to complete and capacity delivered will be developed. This represents a 'package' of commitments for a particular project. This could be financed based on Aurizon Network's proposed financing terms or an alternative financing arrangement via a SUFA.

Preapproval process

The final element of our proposal is the use of a preapproval mechanism, as opposed to an exclusively ex-post assessment for including capital expenditure in the RAB.

We consider a preapproval process will provide greater certainty to all relevant parties that the prudent and efficient capital expenditure associated with the expansion will be included in the RAB prior to the project commencing. We note while the option of preapproval has existed since UT2, it has not been used.

Our preliminary thinking regarding a preapproval process is outlined below and can be split into three distinct areas comprising:

- preapproval
- project variations post preapproval
- capacity assessment.

Preapproval

In our view, a well functioning expansion process, with robust timely dispute resolution provisions,⁴⁷ provides an appropriate framework for the parties considering an expansion to reach an agreement and complete a feasibility study. This can be used to define a set of up front commitments for preapproval.

We consider the preapproval process should apply once the expansion process has been completed, and all parties to the feasibility study have agreed on a set of up front commitments and the preapproval submission. From this perspective we do not consider the preapproval process should allow parties to re-open aspects of what should be an agreed package. In our view this strengthens the incentives to engage in the expansion process appropriately. It ensures the risk associated with technical decision making remains with those appropriately qualified. This means decisions regarding the trade-offs when making a decision to expand are not transferred to the QCA.

Figure 3 outlines our preliminary thinking about how the preapproval process could work. This is undertaken in the following steps:

- **Step 1:** Aurizon Network would submit a preapproval submission providing the required information. A report from an independent engineer/expert advisor engaged by Aurizon Network but responsible solely to the QCA, would also be provided.
- **Step 2:** We would choose to either approve or reject the project based on the recommendation of the independent engineer/expert advisor.
- **Step 3:** When the project is completed, the lesser of the actual capital cost to build the asset and the approved capital costs, net of the contingency funds identified, will be included in the RAB if the project is approved. The precise timing of this will depend on when the project is completed and operational.

Our expectation is that an agreed capital cost proposal submitted for preapproval would generally be accepted unless it fails the system test. We are of the view that the system test for preapproval should include assessments of whether the expansion reduces the existing capacity entitlements of users and/or increases the tariffs of existing users if the incremental costs of the

⁴⁷ These relate to the expansion process and are distinct from the overarching access dispute mechanism.

Project variations post preapproval

We acknowledge that given the nature of rail infrastructure and the construction risks involved, it is likely that a preapproval will need to include the provision of contingency funding and the identification of 'specified variation events' for which this funding can be used.

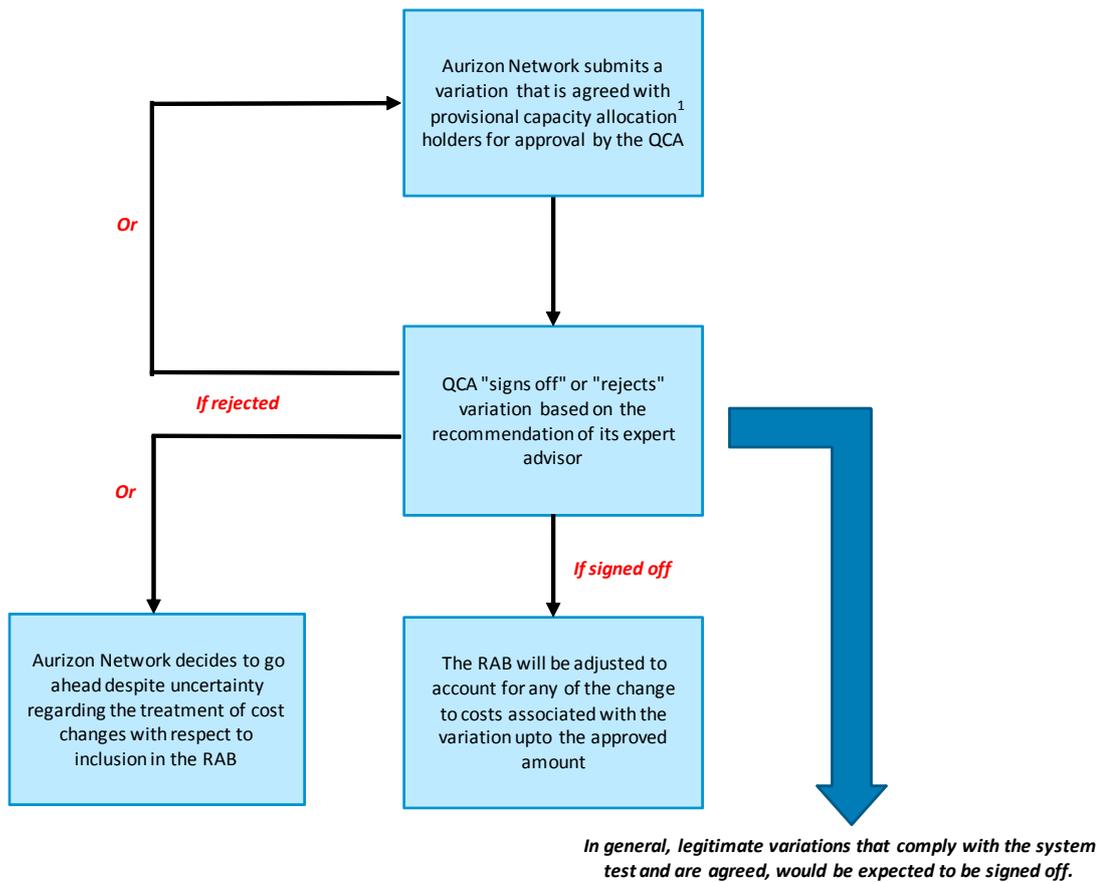
We consider as a matter of good practice, these issues should be considered as part of the expansion process and agreed upon by parties prior to seeking preapproval. This reflects that each capital project will have a unique set of construction risks to deal with. It also provides third party funders and users funding off balance sheet with a level of assurance as to the maximum expenditure the project is perceived to face.

In order to ensure there are appropriate incentives to 'size' the contingency correctly and use it efficiently, variations outside of the agreed contingency funding level or not within the specified variation events would not be part of the preapproval process. They will be subject to a separate assessment upon completion of the project. This will assess whether the incremental costs associated with these events should be included in the RAB. This also applies for any variations Aurizon Network decides to undertake on its own initiative.

Our expectation is legitimate variation proposals that are agreed, and submitted for approval, would generally be accepted. The exception would be if the variation resulted in a failure of the system test⁴⁸ or the contingency fund being used up. Overall, if a variation is signed off, the lesser of the actual capital cost associated with the variation and the approved capital cost for the variation will be included in the RAB. Figure 4 below outlines our proposed variation process.

⁴⁸ We consider that contingency funding should be included as a cost in the system test. This should limit the possibility of a legitimate variation proposal failing the system test.

Figure 4: Variation Process



A variation submission by Aurizon Network to include details of:

- why it is needed and whether it is considered a legitimate variation
- implications for scope and standard
- implications for cost ("barebones" construction cost, overhead allocations, fees (if any), contingency for agreed variations)
- implications for time-to-complete
- implications for capacity to be delivered by the project
- implications for the system test applied (tariff test and baseline capacity test) including any stakeholder consultation undertaken
- a report from an independent engineer (engaged by Aurizon Network but responsible solely to the QCA)

Once the contingency fund has been used, any subsequent variations will require additional funding to be made available for

- non-SUFA projects: this has to be agreed with provisional capacity allocation² holders
- SUFA projects: the process adopted will be governed by the terms of the user funding agreement executed

^{1,2}Provisional Capacity Allocation refers to terminology in UT4. It is being used in this diagram on the assumption that the UT4 expansion process will be included in UT3.

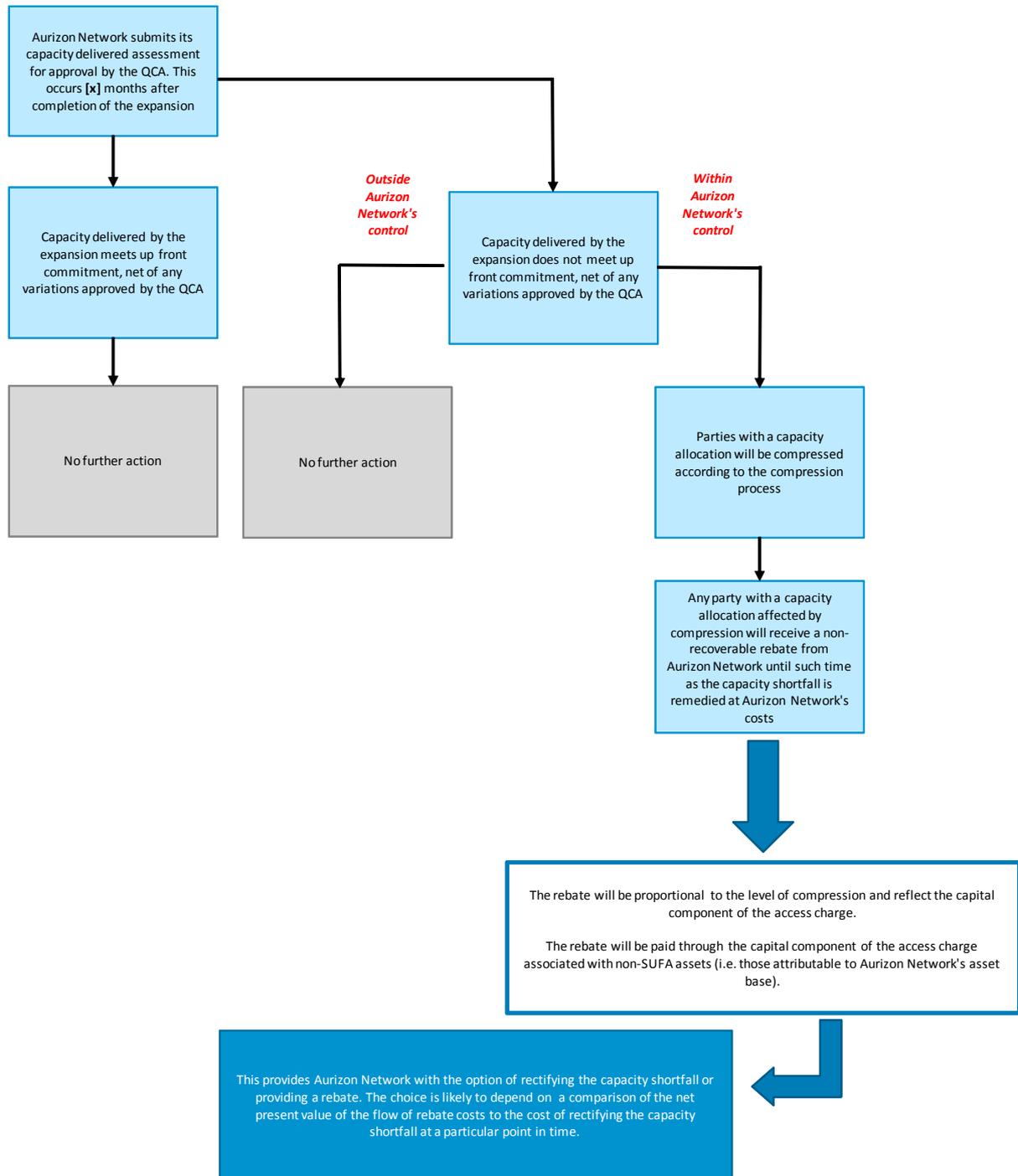
Capacity assessment

Our proposed approach to assessing the capacity delivered by an expansion is provided in Figure 5. The objective of this process is to ensure there is an incentive for Aurizon Network, as infrastructure planner, constructor and operator, to meet its up front capacity delivery commitments for an expansion.

If Aurizon Network does not meet up front commitments, net of any approved variations, and this could have been mitigated, then a non-recoverable rebate should be provided to each affected party until such time as the capacity shortfall is remedied. This provides Aurizon Network with the option of rectifying the capacity shortfall or paying a rebate. The decision will depend on the circumstances prevailing at the time.

Our preliminary thinking is the rebate for each affected party should be in proportion to the level of compression and paid via the capital components of access charges attributable to non-SUFA assets.

Figure 5: Capacity assessment



Summary

We consider that our proposed approach of providing Aurizon Network with control of the construction process allows risk to be allocated appropriately. It also allows the suite of SUFA documents to be simplified. It means the PMA can be replaced with a more standard construction agreement. The RCA and, potentially, aspects of the lease agreements can also be simplified. This makes the documents more usable for third party financiers and users funding off balance sheet.

The provision of up front commitments regarding scope, standard, cost, time-to-complete and capacity delivered by Aurizon Network provides greater transparency and certainty. This is complemented by the inclusion of an expansion and preapproval process within UT3. Preapproval can be structured to provide incentives for the relevant parties to reach an agreement on the upfront commitments and thereby obtain greater certainty over the inclusion of the capital costs into the RAB.

We consider that together these changes allow SUFA to be viewed as a financing tool. Every project that goes through the expansion process will culminate in a defined set of up front commitments. This allows Aurizon Network to propose financing terms for each project based on these commitments. It also allows existing users and prospective investors to assess whether they can construct a SUFA on more competitive terms than those proposed by Aurizon Network.

Where our views are reflected in the term sheets:

7.1 Amendments to the project management agreement (PMA)

The PMA is replaced by the Construction Contract (CC). Our preliminary thinking about the CC is provided in section 5 of the term sheets. It reflects Aurizon Network having control of the construction process.

7.2 Amendments to the Rail Corridor Agreement (RCA)

Aspects of the RCA relating to construction and providing the Trustee and its representatives with access to land have generally been removed. Our preliminary thinking about the amended RCA is outlined in section 8 of the term sheets.

7.3 Amendments to 2010 Access Undertaking

The 2010 Access Undertaking to be modified to include the expansion and preapproval process. Our preliminary thinking about this has been outlined in this chapter.

8 SECURITY AND FINANCEABILITY

A key to the success of the SUFA agreements is ensuring the framework allows for third party financing. Third party financiers will require security over the Trust's cash flows and contractual rights. Third party financiers also require a cash flow that is stable and predictable.

Aurizon Network's SUFA agreements do not contemplate security over cash flows and prohibit the granting over contractual rights. Rather, the agreements focus on:

- users providing financing - whether by way of their own equity or debt facilities
- Aurizon Network partially funding a SUFA project

The following actions have been raised as impediments to third party financing as each may reduce the certainty and stability of the cash flows back to the user funders:

- direction to pay - it is not clear that this contractual mechanism is strong enough to survive an Aurizon Network insolvency
- lock-up of distributions - under the Subscription and Unit Holders Deed (SUHD), Aurizon Network may (acting as the ordinary unit holder) direct the Trustee not to make distributions to the preference unit holders
- set off - under the Extension Infrastructure Sub-lease (EISL), Aurizon Network may set off any amounts which are due to it by the Trustee against amounts payable to the Trustee.

8.1 Direction to pay

Under the EISL, Aurizon Network is required to pay rent to the Trustee. We understand that, as a form of protection against Aurizon Network not paying the rent, Aurizon Network is to direct nominated access holders to pay a matching amount of access agreement revenue directly to the Trustee. This mechanism operates through a contractual obligation called a direction to pay.

In the operational phase, each access agreement entered into by an access seeker funding the SUFA (or its nominee) (the linked access agreements) is to include an ability for Aurizon Network to give a direction to that access holder to pay up to 100 percent of its access charges to the Trustee (specifically, to a bank account held by the Trustee). Aurizon Network has advised, in normal circumstances, the aggregate of the access charges which Aurizon Network directs be paid to the Trustee will be sufficient to meet its obligation to pay the rent due from Aurizon Network to the Trustee.

We understand should the aggregate of the access charges due under the linked access agreements be less than the rent due, then access holders under other (non-linked) access agreements (where those agreements have included a direction to pay arrangement)⁴⁹ may also be called upon to pay their access charge to the Trustee.

The QRC also sought further security over the rental payments in addition to the direction to pay mechanism outlined above. The QRC proposed that if Aurizon Network materially breaches its obligations under the EISL by not paying rent, the Trustee should have the right to terminate

⁴⁹ Aurizon Network is expected to amend the Standard Access Agreements in UT3 to include the direction to pay.

or suspend the performance of all rights and obligations under the EISL until the breach is remedied. This would effectively allow the Trustee to stop-the-trains if rent was not received and not remedied within a specified time period. Under this suspension, Aurizon Network would bear any costs it incurred as a result of the suspension⁵⁰.

8.2 Distribution of cash flows

If Aurizon Network chooses to partly fund a SUFA project, it can purchase preference units in the Trust - resulting in a 'hybrid funding arrangement'.

We understand where Aurizon Network chooses to partly fund a SUFA; it prefers that distributions from the Trustee to the preference unit holders be considered 'non-mandatory', as mandatory distributions will result in preference units being classified as debt, rather than equity on Aurizon Network's balance sheet.

The QRC indicated that one of the challenges of the SUFA structure is that the source of cash flows is a number of steps removed from the providers of capital. For instance - the unit holders will receive a distribution only if the Trustee elects to make one (which is decided at the Trustee's discretion).⁵¹ In addition they note that:

Before making an investment decision, boards and investors/lenders will carefully scrutinise the rent provisions. The rent provisions are crucial to making SUFA work, as they go to the heart of a user funder's income stream. The more that can be done to provide greater certainty that the rent will be paid, that rent calculation information is transparent and that the rent calculation method is understandable, the better⁵².

8.3 Set off

Under the EISL, Aurizon Network may set off any amounts which are due to it by the Trustee against amounts, payable to the Trustee. If Aurizon Network wants to deduct any amount from the rent payable, it can reduce the amount that it would otherwise direct a customer to pay into the direction to pay account. Under Aurizon Network's proposal, set off provisions work in one direction only.

We understand the main reason for set off payments is to deal with situations where Aurizon Network has potential difficulty in recovering costs from a Trust. As the Trust will not own assets (other than the right to receive rent and its rights under the SUFA arrangements), Aurizon Network considers it will be difficult to remedy a loss it may suffer should the Trustee not make a payment. For example, there may be an instance where Aurizon Network pays a tax amount covered under the tax indemnity, and the Trustee does not reimburse the amount already expended by Aurizon Network.

The QRC says third party investors and financiers will not accept a right for Aurizon Network to set off payments against the rent as they will require certainty that the rent will be paid. Given this, the QRC has proposed that there be a prohibition against set offs, applying to both parties, not just Aurizon Network⁵³.

⁵⁰ QRC's amended EISL, p. 59.

⁵¹ QRC2013b, pp. 5-6.

⁵² QRC 2013b, pp. 17-18.

⁵³ QRC 2013b, p. 6.

8.4 QCA view

As drafted, the SUFA arrangements do not provide the level of certainty or security required over the rental cash flows to encourage third party funding.

It is our view that SUFA should permit both third party funding, as well as off balance sheet funding provided by users. However, if security cannot be granted over the rental cash flows, third party funding is unlikely to be achievable and off balance sheet funding will be limited. In particular, there must be a mechanism in place allowing for the payment of cash flows to be enforced if certain circumstances occur.

We believe that the following changes will provide a greater level of certainty and security over the cash flows:

- SUFA funders taking security over the cash flows
- distribution of cash flows be mandatory
- set off is available to both parties in specific circumstances.

Direction to pay

We are advised that a contractual mechanism, such as the direction to pay, will not provide sufficient security over the future rental cash flows for third party financiers. Based on advice from Grant Samuel, the direction to pay obligation needs to be augmented by other arrangements.

We also understand the right to terminate or suspend operation of the network (stopping the trains) proposed by the QRC is unlikely to be acceptable from the perspective of Aurizon Network, existing access holders or QTH.

Based on discussions held with stakeholders - security cannot be taken over the infrastructure assets as ownership ultimately rests with the State (through QTH). However, it is not unreasonable (and there should be no impediment to) for there to be a form of security over the right to receive the future rental cash flows. This could be a form of security that does not materially impact on the legitimate business interest of Aurizon Network or create issues for the State.

For instance, security could be granted over the capital component of the access charges of the linked access agreements. This security should be able to be acted upon on the occurrence of certain events, such as Aurizon Network becoming insolvent. This type of security would not reach any further than the rental payment that is to be paid to the Trustee and would provide the additional certainty that the Trust will be entitled to receive payments in the event that the direction to pay is no longer an effective mechanism. Similar issues apply to certain termination events (see Section 9).

Distribution of cash flows

We note Aurizon Network's preference to keep the distribution of cash flows from the Trustee to the preference unit holders as non-mandatory. We understand that where Aurizon Network chooses to partly fund a SUFA, Aurizon Network is concerned as to the likelihood of the entire investment being classified as debt on its balance sheet.

However, we also understand the potential for the investment to be treated as debt, when it is funded by parties other than Aurizon Network, does not raise concerns for Aurizon Network.

Our advice is the Trustee's discretion to distribute cash flows to the preference unit holders should be removed as it is fundamentally important for external lenders to receive a rental payment that meets its interest and capital repayments. By allowing for the potential of a cash flow not to be paid at the discretion of the Trustee, the attractiveness of lending into such a framework is lower as certainty of receiving the cash flow is reduced.

It is our view that to ensure the attractiveness of the cash flows for a financier, the SUFA should require the Trustee to make distributions to preference unit holders, rather than allowing for the Trustee to retain discretion. If Aurizon Network chooses to partly fund a project, parties would be free to negotiate away from the standard agreement to allow for a non-mandatory distribution arrangement.

Set off

We consider set off may be acceptable to third party financiers if the amounts being set off are not material and set off rights flow both directions. For instance, the amounts being set off against, or added to the rent due, are minor true ups, may be considered non-material in terms of the certainty of amount of the rental cash flow. That is, if the distributions made from rent received continue to cover the principal and interest payments for the financier, occasional influxes or outgoings may not be a concern.

Set off becomes a significant issue where its use is contemplated with larger material amounts. An example is a tax liability bill, paid by Aurizon Network for which it is exempt under the tax indemnity. In this circumstance, we consider that use of set off could result in:

- rent being reduced to the point where there are insufficient distributions to cover the principal and interest due to a financier
- no rent being paid.

Neither of these outcomes is desirable where third party financing is to be encouraged. We consider that for low probability, material events, for instance a change in law, which are likely to impact Aurizon Network's investments in the network as well as the SUFA investments, Aurizon Network may seek a change to the regulatory tariff by the amount of the impact. Where the change to the regulatory tariff is not approved, it is only then that Aurizon Network may seek to set off the monetary impact of such a change. We consider this approach better aligns with Aurizon Network's normal business practice to deal with a change in law (or other significant event) for its existing business.

Where our views are reflected in the term sheets

8.1 Specific Security over Access Charges

Direction to pay - Terms and conditions regarding security over the rental cash flows is found in Section 10 Specific Security over Access Charges.

8.2 Amendment to the Subscription and Unit Holders Deed

Distribution of cash flows (withholding distributions from the Trust) - The ordinary unit holder should not be able to make a direction for the Trustee to withhold distributions.

8.3 Amendment to the Extension Infrastructure Sub-lease

Set off (Section 7.4(c)(i)):

- (a) Rent over/under payment is to be dealt with through the rent adjustment provisions**
- (b) Each party is to have a right of set off**
- (c) Aurizon Network to seek that both it and the Trust are kept whole in respect of their tax exposure (following a change in law) by seeking a change to the regulatory tariff from the QCA. Only if the QCA refuses the change will Aurizon Network be able to seek set off.**

9 TERMINATION

The following leases are relevant to a SUFA:

- Aurizon Network's infrastructure leases (Infrastructure Lease) with QTH
- The Extension Infrastructure Head-Lease (EIHL) of a SUFA
- The Extension Infrastructure Sub-Lease (EISL) of a SUFA.

The Infrastructure Lease relates to the existing rail infrastructure operated by Aurizon Network. It is a confidential document and includes conditions that can cause the EIHL and EISL to terminate.

There are numerous ways that the suite of leases can terminate. This chapter does not consider these in detail. In particular it does not deal with a termination event and associated compensation process where the control and ownership of the CQCN reverts to QTH.

This chapter is concerned with the following issues:

- the implications of the Infrastructure Lease being confidential to QTH and not able to be disclosed to the Trustee
- the implications that a termination event has on cash flows when the SUFA assets remain under the control of Aurizon Network.

We are of the view these represent the concerns for financiers with respect to termination. If these issues are not satisfactorily resolved, the SUFA framework is unlikely to attract third party financing and will not be effective.

9.1 Risk assessment and the Infrastructure Lease

Our understanding from discussions with Aurizon Network and stakeholders is that they consider this an issue that needs to be resolved with input from QTH.

9.2 Termination, security of cash flows and the compensation regime

Aurizon Network's position

Our understanding of the 2013 SUFA DAAU is that in the event the EIHL and EISL have been terminated, there are two possible outcomes:

- where the Infrastructure Lease has also been terminated, the Trustee shares in the compensation payable by QTH
- where the Infrastructure Lease has not been terminated (which permits Aurizon Network to continue to use the extension infrastructure), the Trustee is to be paid compensation in lieu of rent net of any detriment payments due.

The compensation payable is to be equivalent to the rent which would have otherwise been payable, as detailed in the EISL⁵⁴. Compensation, however, is technically different from rent. The payment of compensation to the Trustee may not benefit from the same tax treatment as the payment of rent. The applicability of a detriment payment depends on precisely why the

⁵⁴ Aurizon Network 2013c, Clause 3.5(b)(ii)

EIHL and EISL have been terminated, (in particular which party caused it) and whether any detriment has occurred.

Broadly the following termination events trigger the following outcomes:

Table 3: Compensation arrangements for differing types of termination events

<i>Event</i>	<i>Outcome</i>
Infrastructure Lease terminates	Compensation due to the Trustee by QTH under the Integrated Network Deed
EIHL terminates due to Aurizon Network cause	Compensation paid to the Trustee in lieu of rent
EIHL terminates due to Trustee cause	Compensation paid to the Trustee in lieu of rent less any applicable detriment amount

Stakeholder views

The QRC considers a compensation regime for the EIHL terminating inappropriate. It stated⁵⁵:

...that it is unacceptable that notwithstanding the EIHL has been terminated following Aurizon Network's insolvency/payment default, all operative clauses of the EISL continue to operate as if termination had not occurred and the Trustee is required to wait and bear the risk of continued payment default (or in the case of insolvency, non-payment). It would be reasonable for the Trustee to have an option to suspend the EISL, to require an accelerated return of unpaid capital costs or to continue receiving rent.

In addition, the QRC proposes a tightening of the definition of Insolvency Event. The QRC proposes that events, such as minor infringements and threats of stopping payments, among others, should not be considered insolvency events⁵⁶.

9.3 QCA view

The SUFA framework should encourage investment that is efficient and cost effective. However, the leasing and termination regime could impede this.

The SUFA framework needs to ensure that:

- potential SUFA funders can measure the costs of termination risk accurately
- the possibility of Aurizon Network triggering a termination is minimised/mitigated
- security exists over compensation cash flows, as well as rental cash flows.

Significance of the Infrastructure Lease for risk assessment

The triggers for the termination of the Infrastructure Lease constitute a risk to potential SUFA funders. Potential SUFA funders will need to consider the complete risk portfolio before committing to invest in a SUFA project. The confidentiality of Aurizon Network's Infrastructure Lease may act as a disincentive to invest or lead to the inclusion of unnecessary risk premia in the assessment of the commercial viability of a potential SUFA.

To ensure transparency of the termination regime and allow the SUFA funders to assess risk more accurately, we are of the view that:

⁵⁵ QRC 2013b, p. 21.

⁵⁶ QRC 2013b, p. 25.

- potential SUFA funders should have access to the relevant information in the Infrastructure Lease, or
- the provisions relating to the default of obligations in the Infrastructure Lease and EIHL are consistent.

Having the relevant information from the Infrastructure Lease would be the preferred option as the SUFA funders can themselves judge the significance of any risks. The alternative approach to harmonise the default provisions could also be effective. It serves a similar purpose of allowing the SUFA funders to be informed about the risks in the Infrastructure Lease.

Minimising/mitigating Aurizon Network triggering a termination

We consider the circumstances in which the EIHL and EISL terminate due to Aurizon Network's default should be narrowly defined to deal with very particular circumstances. This reduces the risk of default and rental streams being replaced by compensation payments.

We consider the SUFA agreements should adopt the definition of Insolvency Events as suggested by the QRC. This would narrow down the scope of what constitutes Insolvency Events and prevent the possibility of the otherwise insignificant events from triggering a termination of the lease agreements.

Security over compensation cash flows

We consider that, where the Infrastructure Lease has not been terminated but the EIHL and the EISL have been, the Trustee should benefit from security in respect of the compensation payments. Such security should be similar to the proposed arrangement for rent⁵⁷. Moreover the compensation amount should be defined to be the rent-equivalent that would have been paid in the absence of the termination event (i.e. the defaulting party keeps the non-defaulting party whole for any detrimental cost consequences). This mitigates the possibility of any incremental transaction costs or tax burden associated with a compensation arrangement being borne by the Trust.

Where our views are reflected in the term sheets

9.1 Amendments to the Extension Infrastructure Head Lease

- (a) Significance of the Infrastructure Lease for risk assessment - Section 6.4(d)(i)
- (b) Minimising/mitigating Aurizon Network termination - Section 6.4(d)(iv)

9.2 Specific Security over Access Charges

Security over the cash flows - terms and conditions regarding security over the compensation cash flows is found in Section 10 (Specific Security over Access Charges) and obligation to provide security on Section 7.4(i)

⁵⁷ The Security and Financeability chapter provides more detail.

10 DISCRIMINATION

The potential for Aurizon Network to undertake discriminatory behaviour in a SUFA environment has been raised with respect of the following matters:

- Aurizon Network could treat SUFA funded infrastructure in a manner different from Aurizon Network funded asset
- parties who are eligible to fund a SUFA are limited
- Aurizon Network could use the SUFA framework to advantage its above rail operator.

10.1 Differential treatment of infrastructure

Aurizon Network's view

We understand Aurizon Network considers that during the:

- **project delivery phase:** it does not have a commercial incentive to impose overly restrictive landholder requirements as those requirements could reduce the prospect of earning its project management fee
- **operational phase:** it is in its own interests to maintain SUFA infrastructure to a suitable standard so that it can provide access over the rail corridor, as required under the Infrastructure Lease.

However, Aurizon Network says it nonetheless included non-discrimination provisions as a concession for potential preference unit holders⁵⁸. For instance, Aurizon Network included non-discrimination provisions in both the Rail Corridor Agreement (RCA) (as landholder) and the Extension Infrastructure Sub-lease (EISL) (as the lessee) to govern its conduct in certain activities that have the potential to adversely affect the Trust. The non-discrimination provisions require Aurizon Network to not impose more onerous requirements on a SUFA transaction.

If the Trustee claims Aurizon Network is not complying with the non-discrimination provisions, it is subject to a contractual dispute resolution process⁵⁹. Aurizon Network expressed concern that adoption of non-discrimination provisions may result in unnecessary and protracted disputes in respect of any allegations of discrimination by customers⁶⁰.

Aurizon Network also considers the SUFA framework has been designed so it will not disadvantage:

- access holders
- the wider coal supply chain
- subsequent SUFA projects
- Aurizon Network's: existing business activities, future business activities and legitimate business interests⁶¹.

⁵⁸ Aurizon Network 2013b, p. 35

⁵⁹ Aurizon Network 2013b, p. 18

⁶⁰ Aurizon Network 2013o, p. 35

⁶¹ Aurizon Network 2013b, p. 6

Stakeholder views

The QRC notes non-discrimination provisions in the SUFA agreements were proposed by Aurizon Network to preclude it from either acting or imposing requirements that are materially more onerous than for a "project of the same or similar nature and size as the extension" (called a reference project)⁶².

The QRC recommends the concept of a reference project be deleted as it is difficult to use in practice - the test should be whether SUFA assets are being treated in a manner similar to the rest of the network.

The QRC is concerned that, as written, the proposed SUFA agreements could allow Aurizon Network to treat SUFA infrastructure in a different manner than infrastructure funded by Aurizon Network. For instance, the QRC has indicated there should be no ability for Aurizon Network to maintain infrastructure funded by users at a lower standard than Aurizon Network funded infrastructure⁶³.

Anglo American also expressed concern over the use of a reference project as a benchmark against which potential discrimination will be determined. It says that a reference project lacks clarity and restricts the ability of the Trustee to enforce such a provision on behalf of unit holders. Anglo American's concern is that Aurizon Network could 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.

Anglo American said SUFA has the effect of bringing competition into the market by providing capital for expansions; however, in order for this competition to be effective, it is necessary that Aurizon Network does not discriminate against assets that are funded by third parties⁶⁴.

10.2 Eligibility to fund

Aurizon Network proposes that preference subscribers be the only parties eligible to fund a SUFA project. Preference subscribers are defined as parties requiring access, or additional access to Aurizon Network's railway network in order to transport coal from a coal mine to an unloading point⁶⁵.

In its submission, Asciano queries whether an above rail operator can be a preference unit holder. It recognises that the wording in the proposed SUFA indicates that any access seeker can be a preference unit holder⁶⁶.

⁶² QRC 2013b, p. 5

⁶³ Aurizon Network 2013o, p. 34

⁶⁴ Anglo American 2013, pp.3-4

⁶⁵ Aurizon Network 2013j, p. 1

⁶⁶ Asciano 2013, p. 7

10.3 Above rail advantage

Asciano notes general concern about the current ownership and operating structure of the Aurizon group as a vertically integrated rail owner/operator. More specifically, Asciano believes the proposed SUFA provides a potential channel for cost shifting and cross subsidies between Aurizon Network, Aurizon group's above rail business and the SUFA extension to the detriment of other rail users or one set of operators⁶⁷.

10.4 QCA view

We consider the SUFA agreements are drafted in such a manner that could give rise to discrimination concerns respecting:

- treatment of SUFA assets versus Aurizon Network funded assets
- parties eligible to participate in a SUFA

Nonetheless, we also consider these matters could be addressed by broadening the scope of the condition based assessment and expanding the pool of eligible participants.

We do not understand, at this time, how a SUFA arrangement could provide a channel for cost shifting and subsidies between Aurizon Network, its' related above rail business and the SUFA extension. We are, however, open to more discussion should stakeholders wish to provide more information on how this could potentially occur.

Differential treatment of SUFA funded infrastructure

Under Aurizon Network's 2010 access undertaking, the condition based assessment is to consist of an initial assessment and an end of period assessment to allow for a determination of asset deterioration across the period. In our view, the assessment criteria can be broadened to include a comparison of the condition of the SUFA assets and the Aurizon Network funded assets. If SUFA assets have been treated differently, it will be captured by the assessment. As part of the assessment, a certificate confirming the SUFA assets are not worse off than the remainder of the system would be provided.

Should the assessment uncover that there has been unequal treatment, Aurizon Network is to provide a plan to the QCA and the Trust on how and when it will rectify the condition of the SUFA assets.

Eligibility to fund

We acknowledge the issues raised by stakeholders regarding the vertically integrated nature of Aurizon's above and below rail operations and the role of other above rail operators within the expansion process and SUFA. In particular it is not clear why above rail operators cannot participate in an expansion or the construction phase of a SUFA, particularly if there is a preapproval process.

In fact, we consider this is a broader issue - that it is not clear why any creditworthy party wanting to invest in a SUFA is not eligible to participate. Given the certainty of scope, cost and timing to be provided with preapproval of SUFA projects, we believe there should be little concern which party is contributing to project funding.

⁶⁷ Asciano 2013, p. 5

Where our views are reflected in the terms sheets

10.1 Amendments to the 2010 Access Undertaking

- (a) Amend clause 2.2 to allow an access seeker or a Trustee to seek an audit of conduct considered to be discriminatory
- (b) Permission for a SUFA user (or its customer) or a Trustee to bring a dispute to the QCA under clause 10.1
- (c) Condition based assessments under clause 5 of schedule A to include an obligation to specifically address SUFA assets and provide a certificate confirming those assets are not worse than the rest of the system (or network, of the assets are a system)
- (d) If the assessment (or a dispute) indicates discrimination, Aurizon Network is to provide a remedial plan to the QCA and the Trust. If approved by the QCA, Aurizon Network must perform the work to be undertaken in the time provided for in the plan.
- (e) The party bringing the discrimination dispute is to bear the costs of the dispute if discrimination has not been found.

11 PREFERENCE UNIT TRANSFERS

SUFA funders subscribe for preference units in proportion to their share of the capital costs of a SUFA project. Preference units provide their holders with various rights and a share of the distributions made by the Trustee in proportion to their preference unit holding.

In the 2013 SUFA DAAU Aurizon Network adopted the concept of stapling. In the context of SUFA, stapling means that a SUFA funder must hold both preference units and access rights, or that the parties holding preference units and access rights have shared ownership. Stapling effectively creates a constraint on who can own preference units.

Based on the 2013 SUFA DAAU framework, Aurizon Network and the QRC have reached a compromise on the rights to transfer preference units⁶⁸. It is different in the construction phase and the operational phase of the SUFA asset. The compromise reached is:

- **construction phase:** in this phase, stapling applies and Aurizon Network has a first right of refusal on any proposed transfer of preference units. Stapling ensures that preference units can only be transferred to a party which wishes to take on the transferring party's access rights.
- **operational phase:** in this phase, Aurizon Network has the first right of refusal, but no stapling applies. This means that preference units may be transferred independently of access rights.

We understand Aurizon Network's requirement for stapling in the construction phase stems from its wish to ensure that all parties' interests are aligned. We consider, however, that a capital expenditure preapproval regime should remove any concerns surrounding alignment of interests during construction. We also consider that Aurizon Network does not need a first right of refusal over the transfer of preference units in either the construction or operational phase of a SUFA asset.

In our view the original arrangements and the compromise could act to constrain the transfer of preference units and are not needed.

11.1 Stapling

Aurizon Network's position

Aurizon Network proposed that preference unit ownership and access rights must be stapled during the construction phase to ensure that parties' interests are aligned and to prevent a party taking a solely financial view of a SUFA project. We understand in Aurizon Network's view, unaligned interests result in delays and obstruction of the delivery of the project⁶⁹.

In the context of the 2013 DAAU, Aurizon Network considers the preference unit holders have been granted significant rights in relation to changes to project scope and delivery control during the construction phase, and the timely exercise of those rights should act to avoid delays and additional costs. These rights for the preference unit holders were included on the basis that their commercial interests and those of Aurizon Network are aligned. Aurizon Network said

⁶⁸ Aurizon Network 2013a, pp.4-5

⁶⁹ Explanatory Notes p. 28.

these rights can only be efficiently exercised by those having an interest in the delivery of the project⁷⁰.

Stakeholder views

In the context of the 2013 SUFA DAAU, the QRC agreed with stapling preference units' ownership to access rights during the construction phase, provided that there is no stapling after that phase⁷¹.

Asciano has not expressed major concerns over Aurizon Network's proposal on stapling or transfer of preference units. However, Asciano considers preference units should align with a preference unit holder's incremental access entitlements, created as a result of the SUFA infrastructure. In the event access rights do not align with funding requirements, Asciano suggested the transfer of preference units should occur to ensure there is an alignment⁷².

11.2 First right of refusal

Aurizon Network's position

Aurizon Network's proposed first right of refusal applies to both the construction and operational phases. Following discussions with the CWG, Aurizon Network concluded that its concerns regarding the misalignment of the ownership of preference units and access rights could be overcome if Aurizon Network had the opportunity to acquire preference units when a preference unit holder wanted to transfer them⁷³.

Aurizon Network proposed the following restrictions:

- Aurizon Network should be given an opportunity to bid for the preference units
- preference units must not be sold to a third party if that party's bid is less favourable than Aurizon Network's bid
- the third party must have a suitable tax status⁷⁴.

Stakeholder views

Aurizon Network notes the QRC Working Group was concerned that the restrictions on the transfer of preference units would limit their holders' ability to finance and sell the preference units freely⁷⁵.

The QRC says as drafted by Aurizon Network, the SUFA agreement will provide, at best, some prospect of transferring the investment to a third party, but most likely at a discount to the investment cost and, in any case, only post construction⁷⁶.

⁷¹ QRC, Annexure B, 2013, p.11.

⁷² Asciano 2013, p.9

⁷³ Aurizon Network 2013a, pp.4-5

⁷⁴ Aurizon Network 2013a, p. 5

⁷⁵ Aurizon Network 2013a, pp.4-5

⁷⁶ QRC, Annexure B, p. 11

11.3 QCA view

For SUFA to be an effective financing arrangement, we consider SUFA should minimise restrictions on who can participate in, and fund, a SUFA. It should also minimise restrictions on transferability, unless there is a clear need to do so.

While we understand it was Aurizon Network's intent to staple preference units in order to 'align' the commercial interests of parties, we consider this alignment can be addressed through the preapproval process. This means stapling should no longer be required.

We agree Aurizon Network should have the opportunity to acquire preference units, however, an Aurizon Network right of first (or last) refusal to acquire the preference units is likely to impact on bids as others may be deterred from bidding. This can impact on the value of the preference units. Our view is the right of first refusal should be removed from the SUFA documents.

Where our views are reflected in the term sheets:

11.1 Amendments to the Subscription and Unit Holders Deed

- (a) **There is to be no requirement for stapling (Section 4.4(c)(v))**
- (b) **Aurizon Network will be permitted to bid in the process for the transfer of preference units, without a first right of refusal (Section 4.4(c)(vii))**

12 THIRD PARTY FINANCE

The design of Aurizon Network's 2013 SUFA DAAU does not easily support third party financing. However, if the changes we have proposed in previous chapters are implemented, our view is that third party financing becomes a viable option.

In particular, securing rental cash flows allows the Trust to consider obtaining and holding third party finance itself (as an alternative to the SUFA investors raising debt themselves to allow them to participate in the SUFA arrangements).

An alternative option has been raised by Grant Samuel for consideration - the option of holding debt and equity directly within the Trust or within a financing trust sitting above the Trust. This allows the underlying credit risk of SUFA funders to be pooled. Grant Samuel considers that this can lead to a lower financing cost for a SUFA project and a widening of the financing choices available to potential SUFA participants.

12.1 Third party finance

Aurizon Network's position

We understand that allowing the Trust to obtain finance itself was considered in October 2011 when it was assumed that the Trust would own the SUFA infrastructure. At this time, Aurizon Network was of the view that the Trust holding debt itself would complicate the tax position of a SUFA project.

Stakeholder's position

Although the QRC has noted that the 2013 SUFA DAAU does not sufficiently support third party financing⁷⁷, no stakeholders have explicitly commented upon the desirability of the Trust being able to obtain finance itself. Stakeholder comments have been based on the structure of the 2013 SUFA DAAU, not an alternative approach.

12.2 Financiers holding units in the Trust

As noted above, Grant Samuel has raised the prospect that financiers may wish to hold units directly in the Trust as an alternative method of the Trust raising funds.

Our understanding from recent discussions with Aurizon Network is that it is concerned this structure could exacerbate the risk of the Trust losing the ability to carry forward losses as a result of change in the beneficial ownership of the Trust. Our understanding is that this risk is borne by the remaining SUFA preference unit holders and is a risk that SUFA investors would need to take into account when considering financing options.

⁷⁷ Section 2.2, page 5, of the QRC's August 2013 covering submission stated that at best SUFA, even accounting for the QRC's proposed changes, would be a barely workable framework through which mining companies could invest their own capital. The QRC was of the view that there would be some prospect of transferring a SUFA investment to a third party post-construction, but this would most likely occur at a discount to the investment cost. The QRC also considered there was no possibility of third party debt in the construction or operational phase, other than through corporate debt held by individual user funders, and there would be no possibility of equity investment during the construction phase.

12.3 QCA view

In order to make a SUFA arrangement attractive to a wide range of potential financiers, we consider the SUFA documents should:

- allow the Trust to obtain finance itself
- not restrict the Trust from issuing units to third party finance entities or permitting a financing trust above the Trust in order to allow credit risk pooling
- allow the Trustee to charge its rights in the SUFA documents to ensure that lenders to the Trust are secured creditors of the Trust.

We consider the SUFA should not place unnecessary restrictions on a SUFA funder's ability to obtain equity and debt as cost efficiently as possible.

We consider any tax risk that may exist as a result of a particular debt structure can be considered on a case-by-case basis by potential SUFA funders.

Grant Samuel have also noted that a securitisation framework can also support the most efficient approach to transitioning from a lower geared construction phase capital structure to a higher geared operational phase capital structure (supporting the release of equity to the users).

Where our views are reflected in the term sheets:

12.1 Amendments to the Trust Deed

Inclusion of an acknowledgement that the SUFA form of the Trust Deed may be amended as required in order to permit third party finance. (Section 3.3(c))

12.2 Amendments to the Subscription and Unit Holders Deed

Inclusion of an acknowledgement that the SUFA form of the Subscription and Unit Holders Deed may be amended as required in order to permit third party finance. (Section 4.4(d))

13 TAXATION

Taxation has been a key issue throughout the many iterations of the SUFA framework.

Aurizon Network has designed its SUFA framework to ensure cost neutrality, so that that infrastructure funded by way of a SUFA can be undertaken at no cost to Aurizon Network. Aurizon Network requires a tax indemnity under SUFA.

The first SUFA model was abandoned for a number of reasons including an unacceptable level of tax risk for SUFA funders. We understand that Aurizon Network identified that the key advantage of moving to the unit trust model was that the model had a lower level of tax risk than other frameworks. The unit trust was also considered to be more tax efficient because:

- there are no tax implications on the issue of ordinary or preference units by the unit trust
- the cost of the extension is distributed to preference unit holders as: income of the unit trust less tax depreciation⁷⁸.

13.1 Tax concerns

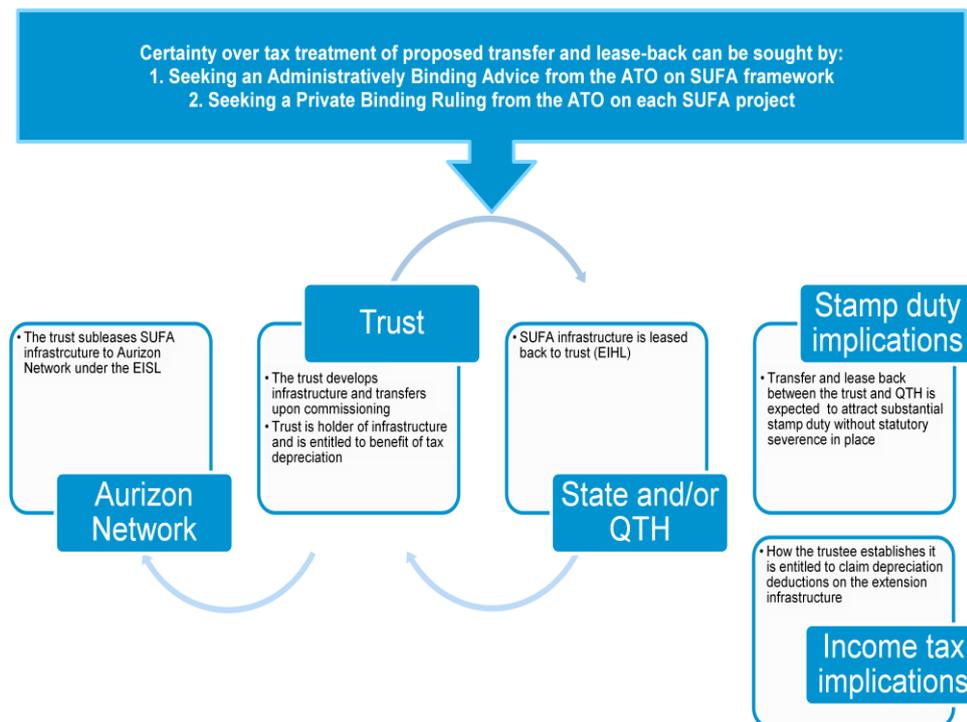
The QRC notes that while progress has been made, and both parties have made compromises, Aurizon Network's proposed SUFA framework still exposes preference unit holders to unacceptable tax risk. The key outstanding issues are detailed in Table 4.

Table 4 QRC's Outstanding Tax Issues

<i>Issue</i>	<i>Description</i>
Lack of certainty of incremental tax risks	<ul style="list-style-type: none"> • Preference unit holders are exposed to stamp duty and income tax risks associated with the transfer to QTH and lease-back of the infrastructure assets. • How the Trustee will establish that it is entitled to claim depreciation deductions of the extension infrastructure.
Scope of tax indemnity	<ul style="list-style-type: none"> • The scope of the indemnity is too broad resulting in preference unit holders being exposed to unacceptably high tax risk. • What is covered under the back-to-back indemnity with QTH.
When and how private binding rulings will be obtained	<ul style="list-style-type: none"> • Parties agree that private binding rulings should be sought from the Australian Tax Office to confirm tax treatment. The process and responsibilities are unclear.

⁷⁸ For example, if the income of the trust is \$100 and tax depreciation is \$30, preference unit holders will receive \$100 cash from the unit trust, but will be subject to tax on \$70 income.

Figure 6: Diagram Outlining Identified Tax Issues



13.1.1 Certainty of incremental tax risks

Two issues have been identified by QRC's tax advisors which have arisen as a result of the proposed SUFA ownership structure:

- preference unit holders will be exposed to potential significant income tax and stamp duty exposure on the transfer and lease-back of the user funded infrastructure
- there is concern about how the Trustee will establish that it is entitled to claim depreciation deductions on the extension infrastructure.

The QRC notes that parties agree that additional certainty respecting the proposed tax treatment is needed, but how, when and which party seeks tax rulings from the Australian Tax Office (ATO) has not yet been agreed (discussed further below)⁷⁹.

According to Aurizon Network, a key attribute of the SUFA framework is that it should be tax effective and allow for the complete pass through of the pre-tax access charges to the infrastructure funder indirectly through the Trust. The intended structure includes the Trust being a holder of the infrastructure for tax purposes for which it is entitled to claim depreciation based upon the costs of construction.

⁷⁹ QRC 2013c, p. 3

13.1.2 Scope of tax indemnity

The QRC's tax advisors note that the QRC does not object to indemnifying liabilities for tax that an "indemnified entity" incurs.

They objected to providing an indemnity to 'another party' (QTH) in what appears to be a back-to-back indemnity. QRC's tax advisors say it is not clear how a back-to-back indemnity between the Trustee, Aurizon Network and QTH will work in practice. Under the proposed SUFA:

- Aurizon Network indemnifies QTH under the Extension Infrastructure Head Lease (EIHL) in respect of any losses
- the Trustee indemnifies Aurizon Network for any amounts paid under the EIHL to the extent that the Trustee has caused the losses.

QRC's tax advisors also formed the view that while QTH is a State body exempt from paying income tax to the Commonwealth, the QTH might be paying tax to the Queensland State Treasurer under the National Tax Equivalent Regime (NTER). It would not be appropriate to indemnify QTH for NTER payments or duty, as taxes paid by QTH would not represent a 'real' loss (but would represent a real cash loss for preference unit holders)⁸⁰.

However, we note this is not an issue, given that we have confirmed QTH is not subject to the NTER.

13.1.3 Private binding rulings

QRC submitted the parties agreed a private binding ruling (PBR) should be sought from the ATO due the complexity of the tax issues involved and the importance of the intended tax outcomes. The benefit of obtaining a PBR is confirmation of tax treatment of various aspects of the SUFA structure prior to SUFA documents being signed on each prospective SUFA project.

QRC noted that the parties agree that a PBR must be sought, but that the outstanding issue is how and when it will occur and which party will pursue the PBR.

QRC advised that Aurizon Network had been resistant to being the party responsible for obtaining favourable tax rulings as a formal requirement under the SUFA documents. QRC also said it would prefer that the process of seeking favourable PBR's be included as a condition precedent to the SUFA documents⁸¹.

13.2 QCA view

As drafted, we do not consider the SUFA provides the necessary level of clarity to potential SUFA funders about the overarching tax treatment or the tax indemnities associated with a SUFA transaction.

We consider the suite of SUFA documents and Aurizon Network's undertaking should provide the maximum level of certainty possible regarding the tax position of a SUFA transaction. This includes the following:

- ensuring SUFA is tax effective for all parties, including by obtaining an appropriate form of statutory severance of the SUFA assets from the land

⁸⁰ QRC 2013c, p. 4

⁸¹ QRC 2013c, p. 3

- an upfront commitment from Aurizon Network to obtain an administratively binding advice (ABA) for the suite of finalised pro-forma SUFA documents
- providing transparency regarding the process and the roles/responsibilities of parties for obtaining private binding rulings (PBR)
- clarifying what risk is intended to be covered in the QTH tax indemnity.

13.2.1 Certainty of tax risks

Statutory severance

The transfer and lease-back of infrastructure will attract substantial stamp duty unless the State of Queensland provides a statutory severance mechanism in a form that allows for relevant stamp duty exemptions.

We understand that as a matter of general law, once infrastructure is built, it is considered to be part of the land. Such infrastructure can only be sold or disposed of as property separate from the land if the general law principle is displaced by a statutory provision which "severs" the infrastructure from the land. This allows for transactions where infrastructure can be treated separately from the underlying land.

Statutory severance in the CQCN can be split into three areas, comprising:

- the original CQCN infrastructure
- Aurizon Network funded infrastructure
- SUFA funded infrastructure.

The SUFA has been drafted on an assumption that an appropriate form of statutory severance regime (analogous to that in section 15A of the *Infrastructure Investment (Asset Restructuring & Disposal) Act 2009 (IIARDA)*) will be obtained. With respect to the proposed treatment of user funded infrastructure, Aurizon Network's proposed SUFA presumes there will be an appropriate statutory severance provision that allows for the extension to be owned and leased separately from the land.

Our legal advice confirms that the availability of an appropriate form of statutory severance is essential for the proposed SUFA to work as intended. If statutory severance is not available, the transfers of the asset to QTH would be subject to a transfer duty (at a rate of 5.75 percent). We understand that provided there is statutory severance (modelled closely upon section 15A IIARDA) it would be reasonable to argue that the proposed transfer and lease-back arrangement would not attract stamp duty as the transfer would be a transfer solely of personal property and not of land.

The issue of statutory severance will need to be resolved prior to there being an effective SUFA arrangement implemented. We are working with the Queensland Government in respect of this matter with a view to understanding what changes, if any, might be required to obtain statutory severance for a SUFA project.

Income tax

As indicated above, the primary income tax issue raised by the QRC is whether the Trust could be considered the holder of the infrastructure, and if so, how the cost of the infrastructure would be established for the purposes of tax depreciation. If the Trust is not the holder of the infrastructure for tax purposes, it cannot claim a depreciation deduction. If that occurs, the structure will fail its primary tax design requirement.

The key concern is the SUFA model allows for Aurizon Network to be considered the 'holder', rather than the Trust. This issue arises because under the SUFA documents Aurizon Network is given possession and will ultimately become the 'holder' of the infrastructure (after the zero value date).

Our tax advisors' view is there would be a great reluctance for any party to enter into the SUFA without the benefit of a favourable income tax ruling which confirms that the Trust is the holder of the infrastructure for tax purposes.

13.2.2 Scope of the tax indemnity

We understand the main objection of the tax indemnity is the back-to-back indemnification of QTH. We believe that this issue would likely fall away if an appropriate form of statutory severance was made available. However, the back-to-back indemnity may well be rejected by many third party investors in any event on principle, given the difficulty in understanding and quantifying the real nature of the exposure.

The question of whether the documents indemnify the QTH for income tax payable by it under the NTER was important to stakeholders.

We are advised that QTH is not subject to the NTER.

13.2.3 Private binding rulings

Given the risks outlined above, it becomes clear that the SUFA framework is likely not viable without the benefit of favourable tax rulings from the ATO.

Aurizon Network has been of the view the only means by which rulings can be advanced is through the PBR process where there is a specific transaction underway. The QRC's tax advisors agreed a PBR process cannot be advanced unless there is a specific transaction being contemplated. However, it would likely be feasible to pursue an Administratively Binding Advice (ABA) at an earlier point, at least if Aurizon Network is willing to cooperate in obtaining that ABA. Recent discussions with Aurizon Network have indicated they are not opposed to pursuing an ABA.

Our tax advisors recommend that an attempt should be made to progress an ABA because without an ABA, it would likely be difficult to progress a specific deal to the point at which a PBR can be sought. Given this however, it would be difficult to pursue an ABA without first resolving the statutory severance issue.

We consider Aurizon Network should provide an upfront commitment to obtain an ABA for the suite of SUFA documents. We are also of the view that Aurizon Network is to provide an upfront commitment to pursue a favourable PBR, and that roles and responsibilities for Aurizon Network and SUFA funders in respect to obtaining a PBR are clearly articulated.

Where our views are reflected in the terms sheets

13.1 Amendment to Aurizon Network 2010 Access Undertaking:

- (a) Following agreement of the standard form of SUFA documents, Aurizon Network is to seek statutory severance for the infrastructure assets built under a SUFA**
- (b) Once statutory severance is obtained, Aurizon Network is to obtain an administratively binding advice from the ATO in respect of the SUFA structure**
- (c) Once users agree to fund a SUFA, Aurizon Network is to assist in the application for private binding rulings from the ATO in respect of it.**

13.2 Umbrella agreement to be amended to include Section 2.4(e)(iii).

13.3 Trust deed to be amended to include Section 3.3(a)(iii).

13.4 Subscription and unit holders deed to be amended to include Section 4.4(c)(vi).

14 ACCESS UNDERTAKING AMENDMENTS

Aurizon Network proposed to amend its 2010 Access Undertaking to address the following matters:

- recognition of SUFA assets in the RAB
- implications for user funded capacity shortfalls
- limitations on the application of SUFA and an access seekers ability to user fund
- development of alternate SUFA models
- recovery of the SUFA development costs
- dispute resolution⁸².

14.1 Recognition of SUFA assets in the RAB

Aurizon Network proposes to amend its access undertaking to ensure treatment of SUFA infrastructure assets allows for Aurizon Network to calculate tariffs (and subsequently rental payments) which account for the user funded infrastructure. To accomplish this, Aurizon Network proposes to amend:

- how the capital indicator accounts for SUFA infrastructure
- the capital carryover account and the RAB roll forward report to provide for all for SUFA assets to be separately identified⁸³.

QCA view

We believe that these matters will benefit from further discussion given our proposal to move to preapproval of capital expenditure into the RAB. As noted above, we welcome comments on the preapproval process; including how and when the infrastructure capital costs will be included in the RAB.

14.2 Capacity related shortfalls

Aurizon Network proposes that if the completed enhancement project does not provide the sufficient capacity, the party who funded the project should be the party that funds any necessary complementary enhancements. Aurizon Network considers this is the most appropriate way to account for the following perverse incentives:

- SUFA funders minimise the planned infrastructure enhancements to reduce the funding contribution required and transfer the residual funding obligation through to Aurizon Network
- capacity shortfall may arise due to a particular supply chain operating assumption, which is outside the control of Aurizon Network
- the scope may be the result of dispute resolution where the incentives of access seekers are strongly linked to capital minimisation⁸⁴.

⁸² Aurizon Network 2013o, p. 18

⁸³ Aurizon Network 2013o, p. 19-20

Aurizon Network has also proposed that capacity and capacity shortfall issues for user funded expansions be dealt with in accordance with the terms of the user funding agreement⁸⁵.

QCA view

This matter was discussed in chapter 7 (construction). In summary, it is our view that once Aurizon Network and user funders have received the preapproval of scope, cost and capacity for a project, that Aurizon Network will be responsible for rectifying any capacity shortfall. This includes either paying to rectify the shortfall, or paying a rebate to the users who have not received their capacity for so long as the shortfall exists.

It is our preliminary view that capacity and capacity shortfall issues are a whole-of-network matters which are best dealt with in the access undertaking, rather than individual contractual arrangements. An expansion process, including treatment of capacity shortfalls is being developed as part of UT4.

14.3 Limitations on the application of SUFA and an access seekers ability to fund

Aurizon Network proposes that the SUFA model is only intended to work for significant investments - large scale investments costing in excess of \$300 million. Accordingly, Aurizon Network has proposed:

- access seekers can only fund a significant investment
- Notwithstanding the provisions for negotiation set out under part 4 of the undertaking, Aurizon Network may suspend negotiations (pending the parties agreeing on matters necessary to complete the SUFA documentation).

QCA view

We believe that it would be premature at this point in time to restrict the usage of SUFA for larger investments only. Based on our proposed SUFA framework, we consider that this be a decision that could be left for the potential SUFA funders to make.

We do not consider that Aurizon Network may suspend negotiations in negotiating SUFA arrangements pending agreement by all parties. To do so would place Aurizon Network in the advantageous position of being able to control the progress of negotiations at its sole discretion.

14.4 Development of alternate SUFA models

The SUFA proposed by Aurizon Network does not meet the requirements set out in Schedule J of UT3. Given this, Aurizon Network has removed Schedule J, but notes that the investment framework outlined in Schedule J is reflected in parts 6 and 7 of the DAAU. In addition, it has removed the clause allowing the QCA to develop its own SUFA and Investment Framework Amendments⁸⁶.

QCA view

We are comfortable that Schedule J and the process for us to develop our own SUFA and investment framework amendments can be removed from UT3. This view is however,

⁸⁴ Aurizon Network 2013o, p. 20

⁸⁵ Aurizon Network 2013p, clause 7.5.1(a)

⁸⁶ Aurizon Network 2013o, p. 22

predicated on further progress being made towards what we consider a workable SUFA model. If progress cannot be made, Schedule J and the process allowing for us to develop our own SUFA will have to remain.

14.5 Recovery of SUFA Development Costs

In its 2012 SUFA DAAU, Aurizon Network proposed to include compensation for its development of a SUFA. Aurizon Network considered it reasonable to recover the incremental costs incurred in the development of SUFA. This ensures that prices for access to the service generates expected revenue for the service that is at least enough to meet the efficient costs of providing access, as required under section 168A of the QCA Act⁸⁷.

QCA view

Should Aurizon Network seek to recover these costs we consider that it would be a matter to be discussed at that point in time.

14.6 Dispute resolution

Where an access seeker is in a dispute with Aurizon Network regarding proposed terms of a user funding agreement, then either party may pursue the dispute under section 10 of UT3. Aurizon Network noted its stakeholders suggested there should be specific targeted and expedited dispute resolution procedures.

Aurizon Network said it understood stakeholders' concern to be the potential for a protracted dispute resolution process; however, Aurizon Network considers that UT3 dispute resolution provisions provide sufficient protections for all parties⁸⁸.

QCA view

We are open to discussing ways to potentially improve the dispute resolution process, if stakeholders believe that entering into the dispute resolution process adds unwarranted delays to the development of a project.

14.7 QCA proposed amendments

We are proposing amendments to the following matters in UT3 to account for our proposed changes to the SUFA model, the expansion process and the preapproval process. Each of the matters has been discussed in previous sections as cross referenced:

- expansion process (construction chapter) - we consider that as far as is practicable, the expansion policy that is being developed by Aurizon Network and its stakeholders in the UT4 process should be included in UT3.
- feasibility studies of proposed expansions (construction chapter) - we consider that all up front commitments for a SUFA project (scope, cost, timing, capacity) will be the outputs of a well specified and conducted feasibility study.
- preapproval of expansions (construction chapter) - we propose to approve (or not approve) capital expenditure to be included in the RAB, prior to the project commencing.

⁸⁷ Aurizon Network 2013o, p. 22

⁸⁸ Aurizon Network 2013o, p. 24

- capacity commitment (construction chapter) - we consider that given Aurizon Network has control of construction of SUFA projects, it is not unreasonable for it to commit to providing a project within a narrow range of capacity outcomes.
- non-discrimination (non-discrimination chapter) - we consider that concerns respecting discriminatory treatment of assets can be addressed by amending the condition based assessment process to account for any difference in treatment between SUFA and non-SUFA funded assets. Respecting potential discriminatory treatment of parties eligible to invest, we consider that the pool of funders should not be limited to coal companies.
- statutory severance (tax chapter) - statutory severance is required before a SUFA can be successful. This requires change to Queensland regulations.

Where our views are reflected in the term sheets

- **Part 1 of the term sheets named Draft Amending Access Undertaking (DAAU)**

GLOSSARY

A

2010 access undertaking	Aurizon Network's current Access Undertaking, approved by the QCA on 1 October 2010, together with any subsequent changes made by the QCA.
ABA	Administratively Binding Advice
Aurizon Group	The Group of Companies held by Aurizon Holdings Limited, which includes Aurizon Network
Aurizon Holdings	Aurizon Holdings Ltd
Aurizon Network	Aurizon Network Pty Ltd (formerly known as QR Network Pty Ltd)
ATO	Australian Tax Office

B

BMA	BHP Billiton Mitsubishi Alliance
BMC	BHP Mitsui Coal

C

CITS	CITS means a commercially integrated transportation service for which the provider incurs both below rail costs and other transportation costs, and charges its customers an integrated fee for transportation services rendered to it.
CQCN	Central Queensland Coal Network
CWG	Customer Working Group

D

DAU	Draft Access Undertaking
DAAU	Draft Amending Access Undertaking

E

EIHL	Extension Infrastructure Head-lease
EISL	Extension Infrastructure Sub-lease

G

GAPE	Gooniyella to Abbot Point Expansion
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N

NPV	Net Present Value
NTER	National Tax Equivalent Regime

P

PBR	Private Binding Ruling
PMA	Project Management Agreement

Q

QCA Act	<i>Queensland Competition Authority Act 1997</i>
QRC	Queensland Resources Council
QTC	Queensland Treasury Corporation

QTH Queensland Treasury Holdings

R

RAB Regulatory Asset Base

RCA Rail Corridor Agreement

S

SAR System Allowable Revenue

SUFA Standard User Funding Agreements

SUHD Subscription and Unit Holders Deed

T

TD Trust Deed

TIA Transport Infrastructure Act

U

UT2 The second access undertaking covering the CQCN

UT3 The third access undertaking covering the CQCN

UT4 The fourth access undertaking covering the CQCN

W

WACC Weighted Average Cost of Capital

WICET Wiggins Island Coal Export Terminal

REFERENCES

- Anglo American (2013) re: Submission on the 2013 Standard User Funding Agreement, August
- Asciano (2013) re: Submission to the Queensland Competition Authority in relation to the Aurizon Network Proposed Standard User Funding Agreement, August
- Aurizon Network
- Submission Letter (2013a)
 - Explanatory Notes, 2012 SUFA DAAU as modified by Submission Letter (2013b)
 - SUFA Template Legal Documents
 - Extension Infrastructure Sub-Lease - clean copy (2013c)
 - Extension Infrastructure Sub-Lease - marked-up copy (2013d)
 - Extension Infrastructure Head-Lease (2013e)
 - Integrated Network Deed (2013f)
 - Project Management Agreement - clean copy (2013g)
 - Project Management Agreement - marked-up copy (2013h)
 - Rail Corridor Agreement (2013i)
 - Subscription and Unit Holders Deed - clean copy (2013j)
 - Subscription and Unit Holders Deed - marked-up copy (2013k)
 - Trust Deed - clean copy (2013l)
 - Trust Deed - marked-up copy (2013m)
 - Umbrella Agreement (2013n)
 - Regulatory Notes, 2012 SUFA DAAU (unchanged from 2012) (2013o)
 - Draft Amending Access Undertaking, 2012 SUFA DAAU (unchanged from 2012) (2013p)
- BMA and BMC (2013) re: Standard User Funding Agreement Draft Amending Access Undertaking (2013 SUFA DAAU), August
- Glencore (2013) re: Aurizon 2013 Standard User Funding Agreement (SUFA) Draft Amending Access Undertaking (DAAU), September
- Queensland Resources Council (2011) QRC Submission to the QCA in response to QR Network's Draft Amending Access Undertaking (2011 DAAU)
- Queensland Resources Council (2013) re: Submission on Standard User Funding Agreements, August
- Covering Letter (2013a)
 - Covering Submission and Submission on Standard User Funding Agreements (2013b)
 - Key Outstanding Tax Issues and Drafting Changes (2013c)

Study Funding Agreement (2013d)

Extension Infrastructure Sub-Lease - marked-up copy (2013e)

Umbrella Agreement - marked-up copy (2013f)

Integrated Network Deed - marked-up copy (2013g)

Extension Infrastructure Head Lease - marked-up copy (2013h)

Rail Corridor Agreement - marked-up copy (2013i)

Project Management Agreement - marked-up copy (2013j)

Subscription and Unit Holders Deed - marked-up copy (2013k)

Trust Deed - marked-up copy (2013l)

Reply Submission (2013m)

Vale (2013) re: Aurizon Network's 2013 Standard User Funding Agreement DAAU, August