

GRANT SAMUEL



Standard User Funding Agreement  
for  
Aurizon Network Pty Ltd

**High Level Discussion Paper for  
the Queensland Competition Authority**

**4 March 2014**

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# 1. Background

Aurizon Network Pty Ltd (“Aurizon Network”) controls, manages, operates and maintains the “below-rail” infrastructure of the Central Queensland Coal Network (“CQCN”). As a monopoly provider of access to this infrastructure, Aurizon Network is regulated by the Queensland Competition Authority (“QCA”) under the Queensland Competition Authority Act 1997 (Qld) (“QCA Act”). Aurizon Network’s activities are primarily governed through a network access undertaking which is approved by the QCA. The current undertaking, QR/Aurizon Network’s 2010 Access Undertaking (“UT3”), expired on 30 June 2013 but has been extended to 31 December 2014. The QCA and Aurizon Network are currently in the process of developing the next undertaking (“UT4”) which is intended to apply from 1 January 2015.

Under UT3, Aurizon Network is required to develop a Standard User Funding Agreement (“SUFA”). The purpose of the SUFA is to provide an alternative to Aurizon Network funding expansion/enhancement projects. The process of developing the SUFA began in 2010 and, as part of that process, Aurizon Network has undertaken extensive consultation with users of the CQCN (“Users”) and other stakeholders.

The current iteration of the SUFA Draft Amending Access Undertaking was submitted to the QCA in July 2013 (“the 2013 SUFA DAAU”) and we understand that it reflects the agreement reached on various issues between Aurizon Network and the Queensland Resources Council (“QRC”) (as the representative body of the Users). The QCA has invited submissions from interested parties on the 2013 SUFA DAAU. These responses have included submissions from the QRC, individual Users (including Anglo American Metallurgical Coal Pty Limited, Glencore Coal Assets Australia Pty Limited, BHP Billiton Mitsubishi Alliance and Vale) and Asciano.

From the nature of the submissions received from the various parties it is apparent to the QCA that, despite the extensive consultation since 2010, Aurizon Network and the other stakeholders have not been able to reach a mutually acceptable SUFA proposal.

The QCA has engaged Grant Samuel Debt Structuring & Advisory Pty Limited (“Grant Samuel”), as commercial advisers, to provide advice on the 2013 SUFA DAAU.

The key questions asked by the QCA were:

- is the SUFA workable, bankable and credible for both Users and third-party financiers (equity or debt)? and
- if not, what amendments should be made to the 2013 SUFA DAAU to make it workable, bankable and credible?

Grant Samuel has formed the view that the 2013 SUFA DAAU is not workable or bankable and, as a result, is not credible. From the submissions and discussions with Aurizon Network and the QRC, it was also evident that there remains a significant gap between the positions of Aurizon Network and Users and that it is unlikely that this will be bridged within the 2013 SUFA DAAU as it stands.

Accordingly, we have, with legal input from Clayton Utz (the QCA’s legal advisors regarding SUFA), considered alternative approaches to certain elements of the 2013 SUFA DAAU. We are of the view that this may help in achieving the objective of a workable, bankable and credible SUFA. It does, however, require a compromise to be achieved between Aurizon Network and stakeholders, as well as the QCA changing processes it has adopted to date.

This paper provides an outline of our views on the key changes that are required to the 2013 SUFA DAAU to ensure that it is workable, bankable and credible.

## 2. Basis of Approach

### 2.1 QCA BRIEF

The QCA is tasked with approving or developing a SUFA that:

- has regard to the promotion of the economically efficient operation of, use of and investment in, the CQCN, with the result of promoting effective competition in upstream and downstream markets. In this context, QCA believes the goals for any expansion project framework are to:
  - ensure that infrastructure and capacity necessary to meet market demand is built;
  - deliver infrastructure that meets the objectives of the project; and
  - deliver projects at an efficient cost in the minimum practical time frame; and
- has regard to a number of factors, including the public interest (which includes the public interest in having competition in markets), the legitimate business interests of Aurizon Network and of access seekers to, and existing Users of, the CQCN.

In addition, the QCA considers that, under Section 138(2)(h) of the QCA Act, for a SUFA to be acceptable to the QCA, it must be:

- **workable** - the documents must achieve the intended outcome and be able to be executed by all parties without negotiation if necessary (i.e. they are sufficiently clear and certain and provide an appropriate allocation of risk);
- **bankable** - third-party financing (that has recourse only to the SUFA assets and rights) can be obtained to fund a SUFA. This will require that there is a high level of confidence that the expected returns will be delivered and that the asset will be appropriately operated and maintained over its lifecycle. If the SUFA is not financeable through third-party debt and equity markets, its utility is limited to those Users with the financial capacity to absorb the risks associated with the SUFA; and
- **credible** - the SUFA structure does not create such risks and uncertainties for Users and potential financiers or overlay such unnecessarily high transaction, tax or finance costs on an expansion project that the SUFA can never be a credible alternative to Aurizon Network undertaking the expansion itself.

### 2.2 APPROACH ADOPTED

In putting forward our recommendations, in the context of the QCA's brief, we have sought to:

- recognise and balance the legitimate business interests of Aurizon Network and the interests of Users. However, it must be recognised that, in view of the significant differences between the parties, compromises (within the constraints of UT3 and the QCA Act) will be required on both sides to achieve a workable, bankable and credible SUFA;
- utilise the 2013 SUFA DAAU framework and agreements proposed by Aurizon Network to the maximum extent possible, rather than create new structures or frameworks (except where necessary); and
- develop a proposal that does not require any legislative changes (other than those necessary for a tax effective proposal, such as legislating statutory severance) and can be accommodated within QCA's existing legislative authority (albeit that it may involve changes to QCA's practices and operational requirements).

## 3. Key Recommendations

We have split our recommendations into the following areas:

- construction phase;
- operating phase;
- financing efficiency;
- tax efficiency; and
- documentation efficiency.

### 3.1 CONSTRUCTION PHASE

In reviewing the 2013 SUFA DAAU and the submissions, it is apparent that major differences between the parties arise in respect of the initial development of a SUFA project, particularly with respect to the control, management and risk sharing during the construction phase. In our view, there is unlikely to be a resolution satisfactory to all parties using the existing model. Accordingly, we have, in conjunction with the QCA, developed a set of principles which we believe has merit and could, with sufficient goodwill on both sides, be developed into a workable framework.

The following principles underpin our thinking:

- (i) We recognise Aurizon Network is probably best placed to design and construct the expansion. At the same time, Aurizon Network is the party best placed (and most appropriate) to bear the risks associated with this element of an expansion project;
- (ii) From a User's perspective, for the SUFA to fulfil its purpose, it has to be something that they can "make happen" (assuming the project is economically and technically possible) if Aurizon Network is not otherwise willing to undertake the project itself on reasonable financing terms.

SUFA Users also need to have a process through which they are not exposed to failure by Aurizon Network to deliver against key project criteria (except where this is caused by factors beyond Aurizon Network's control).

Further, Users have a legitimate expectation that capacity (not just infrastructure) will be delivered as a result of an expansion and that they should not bear the cost of capacity shortfalls following an expansion (except where such shortfalls are due to factors beyond Aurizon Network's control);

- (iii) Given Aurizon Network's control over the existing network, Users have limited ability to supervise rail network construction or effectively monitor expansion costs and, following construction, monitor maintenance and/or replacement of the expansion assets;
- (iv) The QCA has historically reviewed Aurizon Network capital expenditure on an ex-post basis but could move to a pre-approval regime for the scope, standard, cost, time-to-complete and capacity delivered for all capital projects;
- (v) Third-party funders (whether equity or debt) of a SUFA project will have a different perspective to Users. Their primary (but not only) concern will be that capital expenditure on a SUFA project:
  - either goes into the regulated asset base ("RAB") on which it will earn (in simple terms) the regulated WACC return plus depreciation (the "capital components" of access charges) or the cost

- is borne by a party other than the SUFA Trust (that is, they are less concerned with cost overruns or delays as long as those cost overruns are recognised in the RAB); and
- in aggregate terms the capital expenditure on the project remains within reasonable limits (that is, the size of their funding requirement does not change materially);

The use of a pre-approval process provides third-party funders with greater certainty with respect to these concerns:

- (vi) There is merit in a uniform expansion project development process that applies irrespective of whether such a project is funded internally by Aurizon Network or by Users through a SUFA. This may require changes to the expansion project development process currently under discussion between Aurizon Network and other stakeholders; and
- (vii) The funding decision should be dealt with after the completion of the project feasibility stage, when the details and economics of the project itself have been determined. This approach will facilitate greater transparency of costs and ensure that the SUFA is a funding mechanism, rather than an expansion mechanism.

The essence of these principles is that any expansion project (whether funded by Aurizon Network or through a SUFA) is subject to a “pre-approval” process by the QCA. The approval will encompass scope, standard, cost, time-to-complete and capacity as well as the basis for acceptable variations.

We believe that this approach will be of considerable benefit to Aurizon Network, Users and third-party financiers through increased transparency, uniformity of process (applicable whether an expansion is funded by a SUFA or Aurizon Network), reduction of risks, greater assurance of outcome and clarity as to roles and responsibilities.

As a result of this approach, Aurizon Network will have exposure to cost overruns or delays on a SUFA project (where they are not due to factors beyond Aurizon Network’s control) but:

- Aurizon Network will have full control over the construction of the project and the nature of the risk exposure will not be any different to that faced by Aurizon Network if it constructed the project within a competitive market environment for construction services;
- Aurizon Network may be able to capture the benefits of delivering a project early or at below estimated cost (assuming no change in scope or standard) if the regulatory framework permits this; and
- variations will be monitored as the project progresses, giving Aurizon Network the opportunity to take mitigating actions.

Although SUFA funders will not have control of the construction process, the introduction of the pre-approval and defined, uniform expansion project development processes allows credible upfront commitments to be made by Aurizon Network as to scope, standard, time-to-complete and cost. It also means Aurizon Network can provide assurances as to the capacity delivered, from which only defined variations will be permitted. We consider this to be a reasonable requirement (notwithstanding the practical measurement issues) and would generally be expected by the parties providing the funds for the expansion.

In addition, the process should lead to greater discipline around project planning.



## 3.2 OPERATING PHASE

In reviewing the operating phase of a SUFA, we identified a number of aspects that require amendment in order to provide a structure that is capable of attracting third-party financing (equity or debt). The primary issues relate to:

- calculation of rental income;
- certainty of rental cash flows;
- maintenance of asset quality and discrimination; and
- termination.

### (i) Calculation of rental income

The current drafting of the rental calculation clauses is complex and unclear. We recommend simplifying the language and including relevant examples to provide clarity, especially for the benefit of third parties.

Further, we view the post regulatory tariff regime as inappropriate insofar as it provides revenue that is effectively the lower of actual revenue or the notional regulated revenue that would have applied.

In any event, the SUFA raises the question of whether and when, as a practical matter, the regulatory regime can be eliminated (or materially altered), given the need to provide third-party financiers with a high level of certainty as to the level of income earned by the SUFA Trust.

### (ii) Certainty of rental cash flows

Certainty of access to rental cash flows will be fundamental to any third-party financier. Without this certainty third-party financing is unlikely to be viable. The “Direction-to-Pay” regime is an important component of providing this certainty but, in our view, needs to be augmented by other arrangements to achieve a commercially acceptable outcome.

These include:

- removal of Aurizon Network’s right to order the trustee not to distribute income. It is of paramount importance to external lenders that income flows through to meet interest and principal repayments; and
- extending the arrangements to grant the SUFA Trust security over the capital component of the access charge payments of linked access agreements (for instance an assignment (by way of security) which can be perfected on the occurrence of certain events). The reason for this requirement is to provide certainty that the SUFA Trust will still be entitled to receive payments even if the “Direction to Pay” is disputed or is no longer effective, which could be the case in an insolvency or termination event.

### (iii) Maintenance of asset quality and discrimination

Aurizon Network, Users and third-party financiers all have a legitimate interest in the maintenance of the extension infrastructure. We accept that Aurizon Network should be permitted to maintain the extension infrastructure in the same way as it does for the remainder of the CQCN. The Users and financiers, however, should be able to objectively measure the standard of maintenance of the extension infrastructure to ensure Aurizon Network does not discriminate between SUFA assets and non-SUFA assets in its maintenance regime.

We consider it reasonable for Aurizon Network to be required to include in its condition based assessment reports of the network specific reference to SUFA infrastructure. We also consider it reasonable for Aurizon



Network to provide that report to the SUFA Trustee, together with a certificate confirming the extension assets are in no worse a condition than the rest of the system (or network, if the assets are a system).

If, in the SUFA Trustee's view, the assessment report indicates that there has been discrimination against the extension infrastructure then the SUFA Trustee may seek a determination by the QCA as to whether there has been discrimination.

#### **(iv) Termination**

Financiers of the SUFA Trust (equity or debt) are exposed to the risk of a default by Aurizon Network resulting in the termination of the Infrastructure Lease under which Aurizon Network leases the CQCN from Queensland Treasury Holdings Pty Limited ("QTH") ("Infrastructure Lease"). Although the right to share in any compensation paid by QTH for the sale of the CQCN following a termination of the Infrastructure Lease will be of some comfort, it is our view that, in these circumstances, Aurizon Network should be obliged to repay the net present value of the then future cash flows of the extension infrastructure as the SUFA Trustee has no ability to prevent the termination. Alternatively, the SUFA Trustee should be entitled to claim damages on behalf of the SUFA Trust.

### **3.3 FINANCING EFFICIENCY**

The following amendments are required to meet the expected minimum requirements of financiers, to maximise flexibility or to minimise the costs to be incurred (whether interest or other costs). The primary issues relate to:

- financing structure;
- destapling in the construction phase;
- right-of-first refusal; and
- funding commitments.

#### **(i) Financing Structure**

Ideally, external debt funding for a SUFA would be incorporated within the SUFA Trust, in order to provide maximum funding efficiency and reduce unnecessary transaction costs.

We understand that direct financing in the SUFA Trust may create problems for Aurizon Network and we would like to understand the basis of the problem. If direct financing is not practical, the issue could be overcome by placing a "Financing Trust" over the top of the SUFA Trust. The Financing Trust would hold all the preference units in the SUFA Trust with Users holding ordinary units in the Financing Trust in the same ratios as they would have held in the SUFA Trust. The Financing Trust would also carry all the debt funding. This arrangement will require amendments to the drafting of some documents.

#### **(ii) Destapling in the construction phase**

We are aware that the QRC has agreed to Aurizon Network's requirement that preference units be stapled to a User through the construction phase (although we understand there are still outstanding issues in relation to definitions).

In our view, stapling is suboptimal as it prevents non-access seekers (including investors) from investing in an expansion from the start, thereby restricting funding choice. Moreover, we believe that the restriction is unnecessary under the proposed pre-approval regime because the parties will have certainty as to scope, standard, cost, time-to-complete, capacity and the variations process. Consequently, any potentially different interests of non-access will have little influence on decision making during the construction process.





### **(iii) Right of First Refusal**

The 2013 SUFA DAAU requires a holder who wishes to sell Preference Units to provide Aurizon Network an opportunity to acquire the Preference Units and not sell to a third-party if the sale price is less favourable than Aurizon Network's offer.

In the event of a default (by the SUFA Trustee or a SUFA User), an external lender would expect to have recourse to the Preference Units and will wish to realise the maximum price for them in any sale process. Any first or last right (or other form of pre-emptive right) restricts the ability to freely sell the securities and ultimately impacts on price as it deters other bidders. This issue is also of concern to equity investors. Accordingly, this provision should be removed.

If absolutely necessary, a veto right would arguably be more acceptable to third-party lenders, as long as it was exercisable only when Aurizon Network could objectively demonstrate that the new owner would harm the interests of the SUFA Trust (and its unit holders).

### **(iv) Funding Commitments**

So long as the Trustee can demonstrate to Aurizon Network's satisfaction that there is sufficient funding in place for the construction of the extension and its rights as ordinary unit holder are protected, Aurizon Network should not be concerned with how the SUFA Trust is funded. The documents will need to be amended to leave open the choice of funding type to the Users and third-party financiers

## **3.4 TAX EFFICIENCY**

The 2013 SUFA documents are, on their face, not tax effective (and, therefore, not bankable). We propose that the following steps be spelt out clearly in the SUFA:

- obtain statutory severance of any infrastructure built under a SUFA as soon as possible and, in any event, have this as a condition precedent for a SUFA arrangement; and
- obtain a private binding ruling from the ATO for the SUFA as a condition precedent for a SUFA arrangement and, in any event, seek an administratively binding advice on the SUFA package as soon as possible.

## **3.5 DOCUMENTATION EFFICIENCY**

To remove duplication of drafting across the SUFA documentation and to avoid inadvertent mismatches across the documents, we are of the view that certain of the common terms and conditions be rationalised into one document. Examples of terms and conditions which we believe are suitable for rationalisation are the confidentiality provisions, interpretative requirements, limitations on liability and notice provisions.

In addition, we propose that the roles of the parties in each document be clarified and, where a party has multiple roles in a document, it be made clear in what capacity the party is acting in each part of the document. We consider that clarification will remove apparent duplication across the document suite.



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