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Queensland Resources Council

Analysis of QR User Funding Framework

15 March 2011

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Purpose of the report

We understand that this report is required exclusively for purpose of analysing the QR User Funding Framework as outlined in the signed engagement letter dated January 2011.

Our report will not be used for any purpose, other than those stated above and in our engagement letter, unless written consent has been provided by us. We are not responsible to you, or anyone else, whether for our negligence or otherwise, if the report is used by any other person for any other purpose.

Scope

The scope of our report is in accordance with the engagement letter dated January 2011.

The opinion of Deloitte is based on economic, market and other conditions prevailing at the date of this report. Such conditions can change significantly over relatively short periods of time. This report should be read in conjunction with the declarations outlined in Section 8.

Contents

1 Introduction

The Queensland Competition Authority ("QCA") has advised that despite being a monopoly owner of regulated infrastructure, QR National Limited ("QRN") cannot be forced to invest in expansions and/or extensions of the Central Queensland Rail network (the "Network"). QRN has advised members of the Queensland Resources Council (QRC) that it is seeking a rate of return in excess of the regulated weighted average cost of capital in all but limited circumstances.

The QCA has proposed that users should have the right (but not the obligation) to fund expansions or extensions of the regulated Network at their option at any time. In addition, the potential exists for any expansion to be jointly user and QRN funded.

Consistent with the intent of the QCA Act, the QCA aims to promote efficient investment in the network, link revenues to efficient costs and requires QRN to negotiate in good faith with all access seekers. In addition, the QCA has agreed that to the extent that QRN wants to earn returns in excess of the regulated Weighted Average Cost of Capital, QRN needs to justify any excess return on the basis of incremental costs or risks incurred directly associated with any deviation from its normal course of operations.

The QRC on behalf of the coal mining sector in Queensland has asked Deloitte to assess the proposed bankability of the QR Investment Framework and consider the potential to develop a workable commercial and financing framework. This model would need to operate will either collectively (through a single vehicle), individually as a single user, or through a combination of funding sources, thereby enabling coal producers to implement a credible, cost-efficient and competitive user funding alternative (User Funding Framework).

This interim report details the findings associated with assessing the bankability of the proposed QRN Investment Framework. This report does not seek to summarise the legal or other issues associated with the various agreements but rather present at a high level the key features associated with the bankability or otherwise of the proposed QRN Funding Framework from a user and third party funder point of view.

2 Our Approach

Under the proposed QRN Investment Framework, QRN's intent was to provide a sufficient and credible alternative for users when assessing the reasonableness of the proposed terms and conditions.

In order to promote an efficient, comparable and credible alternative to QRN funded infrastructure projects, users or third party funding providers need to ensure that the playing field is kept level and that the risks of an investment is as far as is practical, relatively similar to an investment made by QRN for the same infrastructure on the basis of a returns derived using a regulatory cost of capital. In other words, whether the proposed framework, assuming that returns are limited to the regulatory cost of capital, is sufficient to compensate potential third party investors commensurate with the risk that they are being asked to assume.

In order to determine whether the proposed QRN Investment Framework meets their stated goals, we have assessed the proposed framework to determine whether or not it leaves users in similar position as QRN if seeking to fund the same asset.

Critically, the key test was whether the proposed framework could deliver a financeable (in terms of both debt and equity) alternative to QRN funded projects.

3 Market Demand

In order to assess whether there is a viable alternative funding option, consideration was given as to whether there is demand for investment in regulated below rail infrastructure assets within the confines of the current regulatory return benchmarks applied by the QCA.

Infrastructure is an attractive asset class in Australia from a debt and equity perspective as evidenced by numerous direct investments in respect of Public Private Partnerships (PPP's) in sub-sectors including social infrastructure, roads, ports, airports, power, water, and rail. Infrastructure assets are generally viewed as being low risk due to their long lives, stable and growing cash flows and monopoly-like features, with low sensitivity to economic cycles and low correlation to other asset classes. Their high operating margins and stability also make them attractive assets to lend against. Investments in infrastructure are attractive to superannuation and international pension funds seeking a regular and predictable inflation-linked income streams (yield) with potential capital growth whilst also matching their liability profiles. Many of these assets have a regulatory framework in respect of their revenues and asset values.

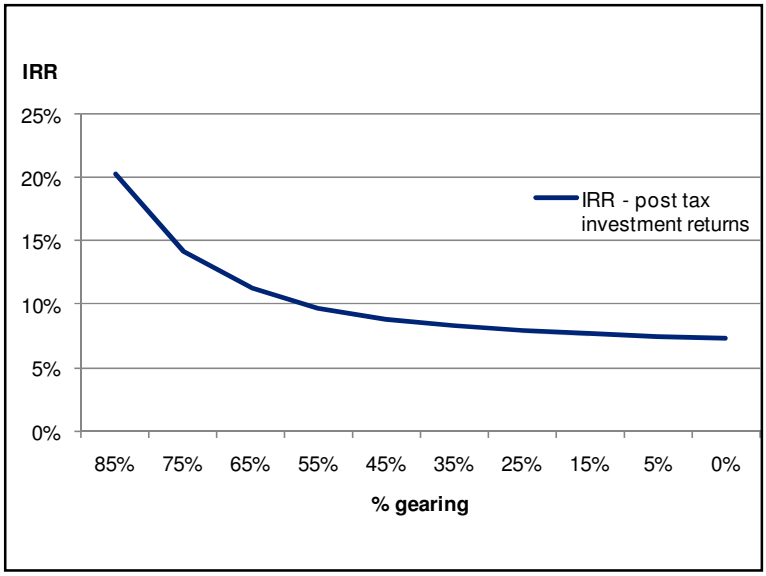
A critical element underpinning demand in the context of a viable alternative funding model for users and/or third parties is that the actual risks of the user funding framework are similar to those risks traditionally associated with this type of infrastructure including:

- Construction risk – The ability to ensure that the assets are constructed on budget, on time and to agreed specification.
- Counterparty risk –Most infrastructure investments have direct counterparty exposure to a single strong investment grade party such as government, or the monopoly-like nature of the asset results in strong demand for the asset, irrespective of counterparty risk of an individual party.
- Security over the underlying asset – Most infrastructure investments provide a notional (eg. leasehold) or actual (i.e. physical) interest in the asset being created. This interest underpins the value of the investment created by the future cash generating potential of the asset.
- Security and certainty of cash flow – The ability to ensure that future cash flows from the user assets are secure (separately identifiable and protected from operator insolvency) and predictable. These are long term assets and security over the future income of the asset needs to be considered in the context of 30 year plus contractual commitments and the risks that the environment may change in the future.
- Financing Risk – Senior debt financing is available at appropriate cost and leverage levels and that debt servicing can be managed within the available project cash flows.

- Refinance risk – Due to the tenor of debt available in the Australian market being less than the asset life, both debt and equity holders take refinancing risk. The refinancing of debt (quantum and pricing variations) needs to be manageable within a project's future cash flows.
- Liquidity Risk – The risk that equity holders are unable to exit the investment in a timely and efficient manner. Returns and risks need to be acceptable to the market and reflective of the underlying investment irrespective of the strategic value to users, particularly if any individual user would like an option to dispose of their investment in the future prior to the end of the asset's remaining life.
- Price Risk – Returns from an infrastructure investment must be commensurate with the risk assumed by the investor/financier. To make it a viable alternative to QRN funded investment. The investment must have a risk profile consistent with the parameters of the regulatory return setting process.

In addition, there are numerous project specific and execution risks that would be considered in determining final investor return expectations (an example of which would be the likelihood of the asset becoming stranded).

Availability of debt financing will also be a key factor as to the investor demand in the context of the user funding framework. The analysis below indicates the relationship between gearing, and potential equity return at the regulatory WACC[1]. This analysis would also change based on total cost of debt, assuming that the WACC remains unchanged.



[1] Assuming a regulatory WACC of 9.96%, Tax Rate of 30% and Cost of Debt of 8.5%.

Potential investors seeking to provide funding to support these assets would require a higher gearing ratio than that stipulated by the QCA (i.e. 55% D/EV) in their regulatory rate setting process to enable sufficient return to make these viable investments.

In summary, despite the impact of the global financial crisis, infrastructure as an investment remains attractive to a number of parties provided that the risk profile of the investment remains commensurate with its associated returns.

An appropriately structured framework could allow access to new capital which could avoid QRN needing to fund investments that do not meet its business objectives.

4 Summary or the QRN Proposed Investment Framework

The proposed QRN investment framework proposed 3 possible scenarios for any below rail investment:

1. QRN funds the investment entirely
2. Users fund the investment entirely
3. Some combination of the above.

Each of these scenarios was assessed in the context of the relative risks imposed on each investor given the proposed QRN investment structure, contractual framework and regulatory conditions imposed under Schedule J. Option 3 was only assessed to the extent that the Option 2 structure was a viable alternative to protect any partial investment made.

QRN Funds the Investment

Historically, QRN has funded all Network investments through its QR National Network subsidiary ('QRNN') with the exception of some user funding for single mine spurs. This has seen QRN seek to utilise its own balance sheet and sources of funds to invest in below rail infrastructure with its revenue sources being underpinned by long term take or pay contracts.

Diagram 1 illustrates the basic transaction framework that this approach would follow. Equity investors in QRN enjoy a direct ownership of the economic benefits derived from the asset's creation which, whilst legal ownership may reside with the State of Queensland, QRN enjoys the head lessee relationship (land and infrastructure leases) and is able to offer its lenders direct security against the lease.

QRN's secured debt providers have either fixed and/or floating charges[2] over the assets of the company which provides direct recourse against assets, including the lease in the event of insolvency provided that the State does not exercise its rights to terminate the infrastructure and land leases. It would appear based on disclosures contained in the QR prospectus[3] that the State does not have to give approval for such security to be granted in relation to the Central Queensland Coal Network (CQCN).

[2] This security is also likely to encompass negative pledges and other detailed terms which are not specified in QR's midyear 31 December 2010 financial statements.
[3] QR National Share Offer Document, section 7

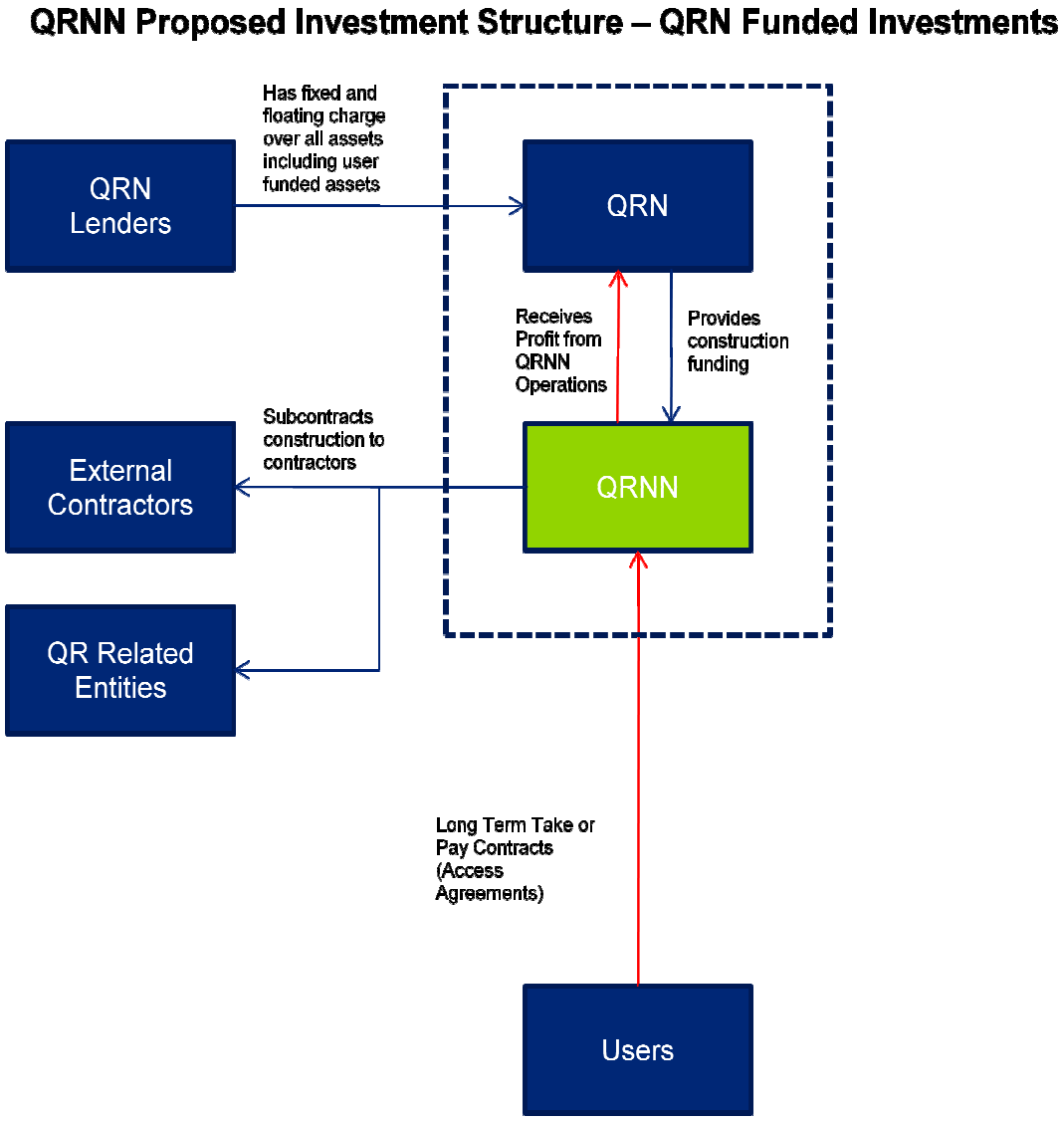
QRN takes on the construction project management and delivery risk and potentially any risk that revenue could be delayed. However, QRN is protected from any cost blow out to the extent that any overrun is able to be incorporated into the regulated asset base and is recovered through the access charges.

QRN has control over the timing, delivery and expenditure associated with the asset's creation giving it direct control over the likely amount of capital to be invested and the risk of the asset being completed. Both of these risks are critical in assessing the size of any financial commitment and the return expectations for equity holders and timing of any debt repayment, or refinancing requirement.

In addition, upon completion of the asset, QRN retains control over the maintenance process which impacts on the life of the asset. This cost is recovered through the regulatory access pricing arrangements. Likewise, any revaluation of the asset created benefits QRN directly as all capital upside resides with QRN.

Underpinning the recovery of the capital investment are take or pay contracts that govern the future earnings of the asset which are in turn supported by either the user's balance sheets or their banks through the use of bank guarantees or other types of security. This effectively underwrites the value of the investment making it relatively low risk for lenders considering risks such as stranding and/or demand risk. If there is not sufficient demand for the infrastructure (i.e. that users are not prepared to enter take or pay contracts to meet minimum investment requirements), QRN has no obligation to build it. In addition, QRN's lenders also lend to the whole QRN group and not a specific asset (i.e. full recourse financing) which spreads their risk across the whole business group and does not limit the cash flow to repay their debt to single asset or group of assets (or notional assets).

Diagram1

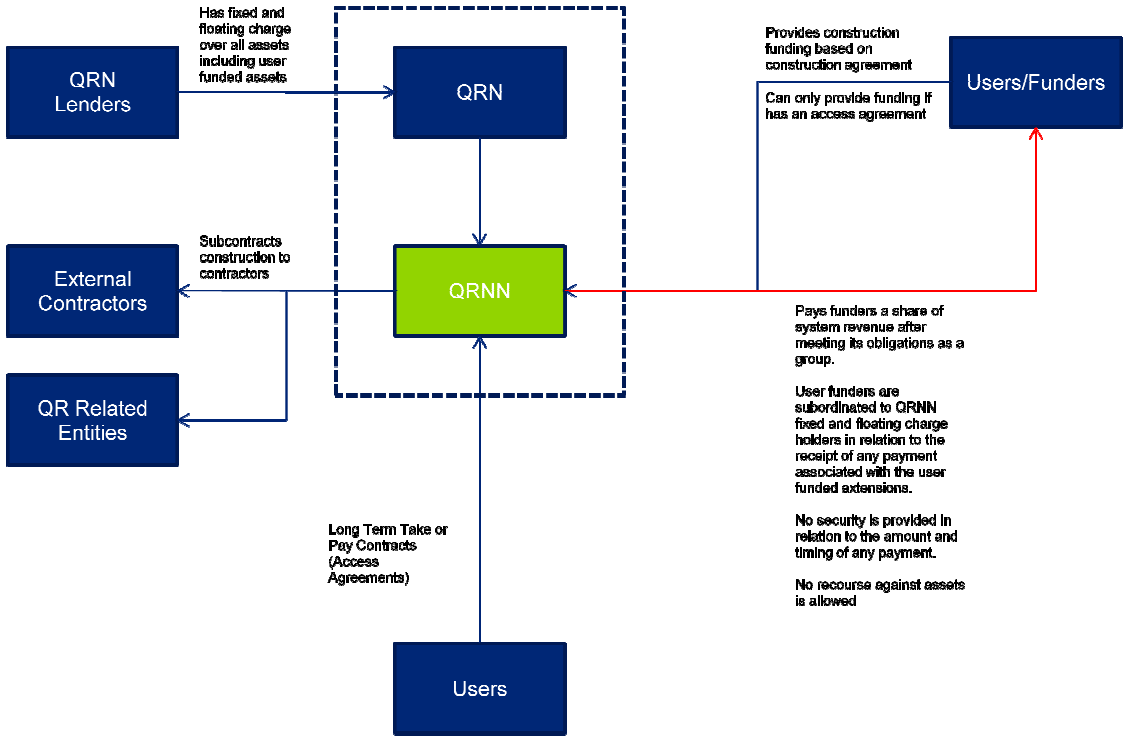

QRNN Proposed Investment Structure – QRN Funded Investments
QRN Lenders
Has fixed and floating charge over all assets including user funded assets
QRN
Receives Profit from QRNN Operations
Provides construction funding
External Contractors
Subcontracts construction to contractors
QRNN
QR Related Entities
Long Term Take or Pay Contracts (Access Agreements)
Users

Users Funds the Investment

The following diagram illustrates the underlying transaction framework that would occur under the structure proposed by QRN. It has three key features:

1) User funders enter into construction finance contracts to fund the construction cost of the investment
2) Users commit to a certain volume of coal under long term take or pay contracts.
3) QRN agrees to rebate to a user funder their share of system revenue that is generated by their investment in the network

QRNN Proposed Investment Structure – User Funded Investments



The proposed structure creates a number of risks for potential user funder investors. These risks can be broadly split into two categories:

1) Construction risks, and
2) Cash flow security risks.

Construction Risks

The construction risks are material and stem from QRN's attempt to pass on any risks that it would ordinarily bear during the construction phase to users without providing any control over the management of these risks to the user funders. While these risks are material, it is anticipated that these risks can be addressed through the re-drafting of the key sections of the construction agreement, specifically the inclusion of:

- step in provisions to ensure asset completion in the event of non-performance;
- tighter controls over costs and cost overruns;
- cost to complete tests applied during each stage of construction; and
- access to liquidated damages for failure to complete on time including loss of income etc.

Security Risks

The security risks are also material because QRN's proposed user funding investment framework does not provide sufficient security over the user funded assets or the cash flow generated by those assets.

Under the User Funded Investment Framework, the underlying agreements that give rise to the cash flow stream are the User Funded Access Agreements. These agreements would exist between QRNN and each individual user or an SPV comprising multiple users. They are the only form of security that is available to users to seek third party investment and are the only basis to guarantee access to the underlying asset for future use. However, the QRNN liability to pay the share of revenue is not secured against the assets created, or any other form of security and there is no visibility as to the cross-guarantee position of the QRNN with the rest of the QRN group.

Under the Corporations Act, creditors are prioritised in relation to the relative security interest they hold in the assets of a company. Generally speaking, secured creditors rank first with all other creditors ranking behind (See Table on the following page). As a result it is likely that user funders will be treated as unsecured creditors in the event of a QRN default. Under the proposed user funding framework if an administrator and/or receiver were appointed, they would have the right to repudiate contractual agreements if they believe that the agreements are not in the commercial interests of the company.

Security Priority[4]

1. Fixed Charge: a security over a particular asset or assets as guarantee for debt – generally land, plant and equipment, generally property for which there is a register which can record encumbrances – includes leases, aircraft, ships, motor vehicles etc.

2. Creditors holding a floating charge concede ranking to these priority creditors:

    i. Expenses incurred in realising assets/carrying on the company's business
    ii. Taxed costs of the applicant of the winding up
    iii. Other expenses of the liquidator (not including deferred expenses)
    iv. Remuneration & Expenses of the liquidator (deferred expenses)
    v. Wages & Superannuation contributions payable for services rendered before winding-up
    vi. Employee leave entitlements
    vii. Retrenchment payments to employees

3. Floating charge creditors

4. Unsecured creditors; including any shortfall to the fixed and floating charge holders and excluded employees

Schedule J attempts to address this issue by allowing user funders to take security over the take or pay agreements, however, this requires guarantees by either QRN or users signing access agreements. However, neither of these options fully address the QRN default issue.

The supply of a guarantee by users is problematic in the sense that the underlying access agreement, which gives rise to the cash flow, could be set aside during an insolvency event. This could result in users having to meet any guarantee to funding providers whilst potentially having to renegotiate access arrangements with a party looking to acquire the asset lease from either the receiver/administrator or the State Government.

The supply guarantee by QRN creates an additional credit risk for the user funding investor based on QRN's ability to pay that income. The lack of transparency from QRN on the timing and quantum of cash flow to be paid across to user funders under the proposed investment framework compounds this problem by adding timing uncertainty to the cash flows available to meet any debt or equity obligation.

[4] Summary of the priorities contained in the Corporations Act (Cth) 2001

This lack of enforceability in the event of default makes the investment risky from a user or third party equity point of view and unattractive to third party debt funding providers who will effectively rank equal to unsecured trade creditors in the event of a QRN default.

Whilst the likelihood of a QRN insolvency is low, it is a fundamental risk which would require a substantial equity investment in order to effectively remove it from any unsecured debt provider. This would reduce return and as a result in investment returns that would not be in an acceptable range to potential third party investors. Users as a result would be required to leverage their own balance sheets to promote any project. This would only occur to the extent that users themselves are willing to take the risk that their investment may rank equally with unsecured trade creditors in the event of default and also to provide full recourse debt financing to their corporate balance sheets. In other words, users must be willing to accept the risk that they could lose their entire investment in the event of a QRN insolvency and utilise their pre-existing asset base to support any borrowings used to fund the investment in order to make the QRN framework financeable.

Overall, the lack of asset security significantly reduces the prospect of it becoming a financeable investment alternative in a highly competitive investment funding environment. In summary, the proposed QRN structure is unlikely to be financeable in the context of non-recourse debt financing for users and when combined with the proposed contractual risk allocation implies that the investment could also not be fully debt financed unless users were willing to provide direct recourse against their own balance sheets.

Importantly, it is probable that debt financing will not be available under the proposed structure unless some form of security arrangement is entered into between QRN and users and/or their financiers.

Joint Investment Funding

The final funding structure that is proposed by QRN is a joint funding approach. This approach does not actually affect the fundamental problems identified under the user funded option. Rather, it highlights more clearly the disadvantage that user funders have vis a vis QRN. Importantly, this approach is not impinged in any form under the solutions considered.

In the context of the proposed QRN investment framework, the key element which needs to be addressed is the lack of underlying security (both cash flow and investment protection) provided to potential investors that could be attracted to this type of investment. Unless this fundamental issue is addressed and the contractual framework better reflects traditional market expectations for these types of investments, the proposed framework is unlikely to be attractive to the investment market.

5 Options to Address Security Issues

There are number of possible solutions that could address some or all of the issues relating to security protection. They all however require either the State or QRN to demonstrate a willingness to address these issues by allowing a sufficient level of protection for both the asset and cash flows associated with the investment.

Option 1 – QRN SPV with protection of sublease through a Tripartite Agreement with the State Government)

QRN establishes a SPV that enters into a sublease under QRN's head lease agreement with the State. QRN allows user funders to take a floating charge over the SPV, provides user funders with a share mortgage over its equity interests in the SPV and grants a negative pledge in respect of the SPV. QRN Group's secured lenders consent to the SPV being carved out of their security package and to QRN granting the security to the user funders (and their debt financiers). QRN, user funders (and their debt financiers) and the State enter into a tripartite agreement in respect to the sublease. The tripartite agreement with the State allows for the sublease not to be terminated in the event of a QRN insolvency and the user funders to have step in rights in respect of the sublease to enable them to protect their interests as a secured creditor and in respect of any renegotiation of access agreements in circumstances where a receiver or administrator has been appointed to QRN. This ensures continuation of the service (either construction or operation) in the event of a QRN insolvency event. This could also be used to isolate any tax or other implications of the investment and avoid any grouping issues that QRN is seeking indemnities for. Obviously, any administration costs associated with compliance and operation would become part of the regulatory operating and maintenance allowance.

This recourse does not change the ownership structure of the underlying asset but rather creates a notional security interest in the underlying asset (either by way of value or by way of schedule of construction elements undertaken as part of the project). It provides recognition of the value of the asset rather than a specific asset itself. This would reflect a similar profile to a syndicate investment in a building which cannot be separated but does however require all parties with an interest to agree on the course of action in any disposal or treatment of the leases.

It is important to recognise that under this model, QRN has a structural incentive to fund 'critical' infrastructure as opposed to allowing user funding to dominate the funding structure of QRN's below rail assets. This commercial pressure could assist in fast tracking negotiations between users and QRN in determining the appropriate funding mix. Similarly, users would have an incentive to fund more and the greater proportion of funding supplied, the greater level of protection that will have in terms of controlling any default event. To provide certainty to the future volume of user funding we would also recommend that QRN secured lender consent is obtained for a preapproved dollar value of user funding so that there is no requirement to seek additional approvals and users rank equally with the secured lenders in the event that the security needs to be enforced.

Other requirements of this option are the existence of take or pay contracts or contractual rights to a fixed proportion of system revenues and a reduction of any cash flow uncertainty arising from any system wide revenue cap. This provides the required certainty to future cash flows. There may still be some residual timing risk associated with the revenue cap true up process but the relative risk is minimised. In addition, the cash flows associated with this recurring revenue stream needs to be clearly identifiable and separated from other QRN revenues. This can be achieved by separate invoicing of these amounts or via clear identification on invoices of these specific amounts. Such invoicing arrangements would also make it clear that these receivables are collected on trust for the SPV user funders and QRN would deposit the cash flow associated with these receivables into a trust account. This would provide protection to the cash flow stream in circumstances of a QRN insolvency.

Option 2 – QRN provides Corporate Level Secured Facility

A variation of the first option is for user funders to provide asset financing via a direct funding arrangements with QRN at a corporate level on a secured basis. Under this approach, the lending agreement would be ranked equally (i.e. pari passu) with existing QRN lenders. This would obviate the need to have a tripartite agreement with the State but would require approval from both QRN and its secured lenders.
This security arrangement could be linked to the access agreements which would require consent before any termination could occur or notionally if the access agreements were to be terminated without user funding consent (i.e. if no consent is given, the termination of the access agreements could be a default event).

A notional debt balance would need to be derived over time to establish a baseline for inter-creditor purposes. Similarly to Option 1, we would recommend that QRN secured lender consent be sought for a defined facility amount in order to give certainty to user funders in terms of future funding opportunities and existing QRN lenders in terms of the likely impact of any consent provided (rather than on a project by project basis).

The use of an SPV would be beneficial in separately identifying the value of assets created and revenue share or take or pay contracts underpinning that value as well as compartmentalising the risk issues to a specific entity that could form the basis for security (eg. asset plus equity interest in SPV) but is not a requirement under this option.

Option 3 – QRN provides shared ownership of the new user funded investments

The final option would be to allow user funders to take a direct notional ownership interest in the assets created. This would in effect create the same effect as a security covenant. However, the structural issues discussed in Option 1 would still apply in respect of the requirement for a sublease, a tripartite agreement with the State and the security protection of the associated user funded asset cash flows.

This model also creates a number of complications with respect to Schedule J and potentially under the existing State lease structure.

6 Conclusion

Based on the assessment of the funding framework proposed by QRN for user funded investments there appears to be strong evidence that in its current form, the investment will not be financeable unless users are willing to absorb QRN's operational credit risk as a group and provide guarantees for completion and income security or facilitates financing through recourse entirely to their own balance sheets.

This outcome is primarily driven by the fact that QRN has not afforded users the same level of protection that would be customary for an investment or debt financing of this magnitude on a non-recourse basis. In particular, the inability to provide a level of security that survives an insolvency event by QRN.

The concept of ranking a 35 year infrastructure investment equal to a general unsecured creditor is inconsistent with the quantum of dollars invested and the nature of the underlying asset and the risks associated with funding regulated infrastructure assets.

This fundamental design flaw coupled with other issues surrounding uncertainty during the construction period, possible variations in the quantum and timing of receipts and limited recourse and incentives would make a user funded investment unattractive to third party investors and their debt financiers due to its risk profile and importantly, uncompetitive relative to the same investment that would be funded by QRN. Access to debt funding without additional balance sheet support is unlikely or prohibitively expensive at best. This would force a less than optimal capital structure and impose a higher cost of funds on the investment.

Whilst the majority of construction issues and operational investment issues could be addressed through a better contracting framework, the security issue persists irrespective of whether users fund the assets alone or whether funding is being sought by third parties.

Importantly, whilst some larger users may overcome this through internal funding, the structure of the investment could make funding access by smaller users prohibitively expensive and could also prevent exiting of the investment post construction.

Finally, whilst there are number of possible structural options to address the security issue, any solution can only be designed with full knowledge of the underlying head lease between the State and QRN and any limitations imposed by the existing security arrangements between QRN and its secured lenders.

In order to finalise an appropriate and functional user funded model that provides a genuinely competitive option to QRN, both QRN and the State must be willing to recognise the intrinsic rights that would normally accrue to debt financiers and investors in these types of assets. This recognition does not necessarily mean a

transfer of ownership but rather recognition that a notional interest in the combined asset is formed when a funding provider (irrespective of the source) supplies funds to create or enhance an asset. This notional interest is fundamental and provides the basis for ensuring that their rights are maintained in circumstances where non-performance occurs and in particular, a QRN insolvency event occurs. These rights should rank equally with the equivalent source of funds if QRN was funding the asset alone and would also apply when shared funding is provided by users and QRN.

7 Limitations of our work

This interim report is prepared solely for the use of QRC. This report is not intended to and should not be used or relied upon by anyone else and we accept no duty of care to any other person or entity. The report has been prepared for the purpose set out in our engagement letter dated January 2011. You should not refer to or use our name or the advice for any other purpose.

The work contained in this interim report is work in progress and is designed to facilitate discussion and comment on the matters contained herein. It should not be used by any other party and is limited by the conditions set out in our engagement letter.

8 Qualifications, declarations and consent

The report has been prepared at the request of QRC to provide analysis of the bankability of the QR User Funding Framework. Accordingly, it has been prepared only for the benefit of QRC management, exclusively for the purpose set out above and should not be used for any other purpose unless written consent has been provided by us. We are not responsible to you, or anyone else, whether for our negligence or otherwise, if the report is used by any other person for any other purpose.

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