QRC

submission

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QRC submission to the QCA in response to QR Network's Draft Amending Access Undertaking (2011 DAAU)

Queensland Competition Authority

18 March 2011

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List of Attachments (to be read as part of QRC's submission)

Attachment 1. Report by Deloitte Touche Tohmatsu Limited.

Attachment 2. Expert tax advice from Greenwoods and Freehills (Tax).

Attachment 3. Assessment of Schedule J compliance (Legal Review).

Attachment 4. Standard Study Agreement – Term sheet.

Attachment 5. Comments on Construction Agreement.

Attachment 6. Comments on Participation Agreement.

1. Introduction

The Queensland Resources Council (**QRC**) is a non-government organisation representing companies that have an interest in exploration, mining, minerals processing, gas and energy production. It is the resource industry's key policy-making body in Queensland, working with all levels of Government, interest groups and the community.

The Council's membership is comprised of all Queensland coal producer companies, and represents a number of emerging companies that are on the cusp of commencing production with advanced coal mine developments. The expansion plans of QRC's coal members in the central Queensland coal region are heavily reliant on successful negotiations with respect to rail access and investment.

QRC's coal industry members have been active participants in the development of this submission and support its content. However given the critical importance of implementing a workable Investment Framework, a number of QRC member companies have indicated an intention to lodge individual submissions for the Authority's consideration to complement QRC's submission. QRC encourages Queensland Competition Authority (QCA) to consider these submissions as part of industry's response to this consultation phase of the process.

2. Background

The QCA approved QR Network's 2010 Access Undertaking (the "2010 AU") on 1 October 2010. The 2010 AU contains provisions which provide for the development, consultation and approval of:

- Proposed Standard User Funding Agreements ("SUFA"); and
- A draft amending access undertaking incorporating amendments to the 2010 AU necessary to implement the principles set out in Schedule J.

QR Network submitted a Draft Amending Access Undertaking (2011 DAAU) and SUFA (together referred to as "the proposed Investment Framework") to the QCA on 24 December 2010. QRC provides this submission to the QCA in order to assist in the assessment of the proposed Investment Framework. The submission outlines the major issues and the absence of direct comments by QRC regarding QR Network's proposals should not be taken to represent acceptance.

QRC notes that QR Network was unable to undertake meaningful consultation with industry prior to submission of the 2011 DAAU. Consultation since this time has also been limited due to the complexity of issues to be considered within the permitted timeframes. However, QRC is hopeful that this submission, and the detailed consideration which lies behind it, will facilitate more effective consultation over the weeks ahead.

QRC supports the QCA's past practice of providing a Draft Decision for consultation ahead of any Final Decision on the Investment Framework. A Draft Decision will provide QRC's members (key stakeholders in this process) a greater opportunity for detailed input than has been practically possible in the permitted timeframes.

In light of the industry's concerns identified throughout this submission and supporting documentation, QRC recommends that the QCA:

- Provide a Draft Decision to not approve QR Network's proposed Investment Framework.
- Consider the amendments to the Investment Framework proposed by QRC. These will be outlined in this submission, while suggested drafting will be provided in the near future.
- Engage with QRC and QR Network to enable the timely implementation of an amended Investment Framework.

QRC would welcome the opportunity to discuss in greater detail in the weeks ahead the rationale and benefits of the proposed amendments and to further develop these proposals. Industry remains committed to implementing a workable approach to this watershed framework.

3. Overview

3.1 Purpose

The purpose of this submission is to:

- Respond to matters of importance to industry with respect to QR Network's proposed Investment Framework; and
- Outline the issues which QRC considers must be addressed in order for an effective Investment Framework to be fully implemented.

Ultimately, industry is seeking an approved Investment Framework that provides an efficient process to achieve the timely expansion of QR Network's central Queensland below-rail network. The Investment Framework will largely define the effectiveness of the regulatory regime, well beyond the current regulatory period.

This submission includes the attachments referred to in this document.

3.2 Importance of User Funding within the Investment Framework

A fundamental element of the Investment Framework principles is the right for Users to fund extensions (which incorporates expansions) of the network. The right to User-Fund is essential given that QR Network has only committed to invest in a limited range of circumstances, and has a stated view that current regulatory settings do not provide an adequate incentive to invest. QR Network has no obligation to fully fund Significant Investments, while the voluntary investment commitments that are included within UT3 may not be present in UT4. The User-Funding model is therefore critical.

An effective User-Funding alternative must provide:

- Competition in the market for financing network projects.
  - QRC members hope that this competition will constrain the returns sought by QR Network to a competitive level associated with such regulated investments.
- A timely pathway through which network projects can be financed and constructed in the event that QR Network decides not invest.

3.3 QRC's Position on QR Network's proposed Investment Framework

Based on industry's assessment, QR Network's proposed framework:

- Is not consistent with the Schedule J Principles.
- Will not provide for a competitive market for the financing of projects – and a level playing field in that market.
- Will not promote an appropriate regime to ensure that track expansions are built at an efficient cost and in a reasonable timeframe (and, when targets are determined, on budget and on time).
- Does not sufficiently address a number of QR Network controls, discretions and powers that could allow QR Network (if it chooses to do so) to disadvantage User-Funded projects. For example, if QR Network is able to significantly delay a User-Funded project, including through protracted dispute resolution processes, then this risk alone (regardless of QR Network's actual intentions) will discourage User Funding.

QRC Position

QRC suggests that the **QCA does not approve** QR Network's proposed Investment Framework.

Key changes required to the Investment Framework are set out in detail within this submission and its attachments.

4. Industry's criteria

QRC's two key requirements for an effective Investment Framework, and the essential elements of these requirements, are set out in this section.

A competitive market for the financing of projects (which requires a level playing field in that market and no barriers to User Funding).

- Essential element: Minimises monopoly power
  - Investment Framework should not allow scope for QR Network to disadvantage a User-Funded project, including through delay.
- Essential element: Promotes Competitive Financing
  - Investment Framework should not unnecessarily increase the cost or risk of capital for user funded projects.
- Essential element: Facilitates Efficient Structures
  - User-Funded projects should be structured based on the most efficient structure from time to time, taking into account contemporary tax, financing and other considerations.

An appropriate framework to ensure that track expansions are built at an efficient cost and in a reasonable timeframe (and, when targets are determined, on budget and on time).

- Essential element: Minimises monopoly power
- Essential element: Promotes Efficient Costs
  - User-Funded projects should be able to implement efficient costs, procurement strategies, construction and project delivery.
- Essential element: Supports Timely Project Delivery
  - User-Funded projects should be completed within a timeframe which meets the needs of Users (generally to meet port expansion timetables).

5. Assessment against criteria

QRC's assessment of QR Network's proposed Investment Framework is provided in this section. This includes a high-level assessment of QR Network's proposed Investment Framework against industry's key criteria.

QRC has proposed improvements to QR Network's proposed Investment Framework in order to achieve industry's key criteria and compliance with the Schedule J Principles. These suggested improvements are outlined in Sections 8.1 (Proposed Standard Study Agreement), 8.2 (Construction Agreement) and 8.3 (Participation Agreement). Proposed detailed drafting to give effect to the suggested improvements will be provided in the near future, including specific Access Undertaking amendments.

5.1 Assessment against Criteria 1

Criteria 1: A competitive market for the financing of projects (which requires a level playing field in that market and no barriers to User Funding)

- **Key concern: Cashflow Security:** QRC's assessment is that QR Network's proposed Investment Framework is not bankable in its current form, thereby making 'funding competition' illusory. The central issue is the absence of any effective security over the cashflows from the user funded investment.

  User-Funders are proposed by QR Network to rank as unsecured creditors, while the risk position of QR National's lenders is improved as a larger pool of assets will be available to secure the commitments of the QR Group (therefore a commercial benefit will be gained from User-Funded projects).

  QRC's financial advisors advise that third party financing is unlikely to be available under QR Network's proposed arrangements and, to the limited extent this is available, will come at a high cost. Meanwhile financing a User-Funded project on the balance sheets of coal producers will only be possible to the extent that coal producers are prepared to accept a risk profile which is unacceptable to third parties.

  Returns to User-Funders will be based on the approved regulatory settings, however, User Funders will face a higher risk profile than QR Network in regard to similar investments. Section 6 explains the security issues and proposed solutions in detail.

> **Industry response:** User Funders require meaningful security over the cashflows arising from their investments. A range of proposed solutions are discussed in Section 6.
>
> These proposals have been developed taking into account the expert report by Deloitte Touche Tohmatsu Limited (Attachment 1.)

– **Key concern: Control Over Projects:** Under the proposed Investment Framework, QR Network retains a number of controls, discretions and powers which:

- Allow QR Network (if it chooses to do so) to disadvantage User-Funded projects, for example through delay.
- Result in User-Funders facing significant risks while not having sufficient ability to control these risks.
- Result in User-Funders being fully liable for the costs of the Extension, without having any opportunity to reasonably control those costs.

QRC's financial advisors advise that third-party financing is unlikely to be available under QR Network's proposed arrangements and, to the limited extent this is available, it will come at a high cost due to the lack of control over the construction of the project.

Industry response: User-Funders require a level of control over projects which reflect the allocation of risk. Amendments should be made to the proposed Construction Agreement and 2010 AU to reflect this. Further, it is suggested that a new Standard Study Agreement be developed.

These proposals have been developed taking into account the expert report by Deloitte Touche Tohmatsu Limited (Attachment 1.)

– **Key concern: Contracting Model:** QRC does not consider the proposed model (QR as contractor) to be reasonable. The model proposed by QR Network creates an unusual and significant tax-related risk for Funding-Users in that Funding-Users may have to compensate QR Network as a result of QR Network not being able to obtain a specific income tax treatment of its construction costs (through an indemnity contained in the Construction Agreement).

As a result, the User-Funder will effectively bear the tax risk twice in respect of a single payment:

- First, the User-Funder will bear the tax risk regarding the treatment of their own payments made to QR Network;
- Second, the User-Funder will bear the tax risk regarding the treatment of subsequent payments made by QR Network to the constructors.

Industry response: QRC proposes changes to the Standard Construction Agreement and 2010 AU to address these concerns.

The proposed changes have been developed taking into account expert advice from Greenwoods and Freehills (Attachment 2) and from Deloitte Touche Tohmatsu Limited (Attachment 1).

– **Key concern: Flexibility of Structure:** QRC considers that the arrangements for User-Funding may need to be amended over time taking into account tax, financing and other issues and based on learnings from actual projects. QRC is concerned that a 'locked in' standard framework may become ineffective over time and that the proposed Undertaking does not oblige QR Network to implement reasonable changes to ensure that User-Funding remains an effective option.

Industry response: QRC proposes that the Access Undertaking include an obligation for QR Network to implement reasonable changes to User-Funding arrangements over time, subject to appropriate protection of QR Network's interests.

QRC intends to provide proposed drafting in the near future.

5.2 Assessment against Criteria 2

Criteria 2: An appropriate framework to ensure that track expansions are built at an efficient cost and in a reasonable timeframe (and, when targets are determined, on budget and on time).

- **Key concern: Construction Incentive Payment:** Under the proposed arrangements, Users are exposed to time and cost risks for example during the construction phase, without having adequate control over the management of these risks. A solution involving appropriate levels of User-Funder control is discussed in the preceding section.

  QR Network proposes to address the issue of incentives through a Constructive Incentive Payment ("CIP"). The CIP is proposed to be applied to User-Funded projects in order to provide an incentive for QR Network to meet time and cost targets. The CIP is notionally up to 8% but is to be negotiated with QR Network for each project.

  QRC's concerns with the CIP include:

  - The CIP is proposed without QR Network taking on any additional risk.
  - Assuming that QR Network is diligent in constructing both User-Funded and QR funded projects, User-Funded projects will have a construction cost disadvantage of approximately 8%. QRC suggests that such a systematic cost disadvantage for User-Funded projects is inappropriate.
  - User funders must negotiate the CIP with QR Network for each project, but will have no alternative in this negotiation (that is, User-Funders are not free, under the proposed arrangements, to choose an alternative contractor in the event that agreement cannot be reached with QR Network). Putting potential User-Funders in a position where they must "negotiate", but without an alternative, means that User-Funding cannot provide genuine competition to QR Network funding: the User-Funding option will only be as competitive as QR Network agrees (case-by-case) to let it be.
  - Initiating a dispute in regard to the CIP is unlikely to be a satisfactory solution in the absence of guidelines to assist in this process.
  - Setting an appropriate CIP by reference to industry benchmarks requires an understanding of matters such as the level of risks accepted by QR Network relative to the benchmarks and the basis of performance targets.
  - There is a risk that the addition of the CIP may result in part of the cost of a project being considered imprudent (and being excluded from the RAB). To the extent that QR Network subcontracts construction to other parties, the CIP will be paid in addition to, rather than instead of, the margin charged by other contractors (a margin on a margin). QR Network suggests that the 8% is below industry benchmarks, but this does not acknowledge the fact that QR Network is not taking on any genuine risk for the margin (that is, a margin of 8% is very generous where no risk is taken). QRC notes that QR Network views the 8% margin as being a "risk", because it is "at risk", which then justifies the fee itself. This is an unhelpful characterization of the proposed margin: if the margin was reduced to 0%, then QR Network would be taking no risk and the margin and risk would again be aligned. The same would be true for any higher level of margin. Clearly the appropriate margin needs to reflect genuine risks and rewards for performance.

Industry response: QRC suggests that, in the absence of alternative agreement on a project-specific basis, the default CIP should be zero. Processes are also required for pre-approval of any agreed CIP to ensure that the resulting target cost is considered prudent.

Alternatively, the undertaking should contain a specific default CIP above zero and should set out the risk allocations on which this CIP is based. If this approach is preferred by the QCA, the issue of User-Funded projects having a systematic cost disadvantage compared to QR Network funded projects must also be addressed.

- **Key concern: Timeframes and Processes:** User-funders require timely cost estimates and project scope information to provide the level of certainty appropriate to each stage of the investment decision. Clear timeframes and processes are critical to ensure that below-rail expansion projects are completed in alignment with port expansions.

  QR Network's proposal does not provide a formal mechanism to ensure project planning phases (concept to feasibility) and the Investment Framework process (feasibility to construction) can be aligned to ensure timely project delivery (between mine, rail and port developments). The Extension Process (as foreshadowed in Schedule J) could easily become captive to unnecessary QR Network approval delays, or unnecessary arguments between different supply chain participants which then impact on timing and cost.

  QRC appreciates that it is problematic to stipulate a one-size-fits-all approach. However, the framework, as currently presented, provides too much discretion for QR Network and too much uncertainty regarding the process. QRC considers that:

  - Users should have sufficient control over the development and progression of necessary planning studies and QR Network should be obligated to progress these through its internal processes within efficient timeframes. Timely and accurate planning information is critical for producers looking to User Fund.
  - A standard study agreement should be developed to streamline the delivery of Concept, Pre-Feasibility and Feasibility planning studies.
  - The Access Undertaking should include expedited dispute resolution provisions (providing for an expedited determination by the QCA) where a User and QR Network are not able to agree the terms of a Study Agreement, Construction Agreement or Participation Agreement within a reasonable period of time.
  - Providing greater User involvement within the Construction Agreement ensures that project delivery is aligned to the interests of those with the most incentive to deliver projects on time and on budget.

Industry response: QRC proposes amendments to the Standard Construction Agreement and 2010 AU, as well as the development of a Standard Study Agreement to address these issues.

6. Cashflow security

6.1 Background

Effective security over the cashflows from User-Funded investments is necessary in order to make the User Funded model bankable (third party debt and equity), while in the case of user-funders who fund on balance sheet, it is reasonable to expect that similar requirements will apply. User-funders cannot make a prudent business decision to invest in a case where they will receive the regulated WACC, which is based on a certain risk profile, while facing a higher risk profile due to an inferior security position.

QRC's assessment is that QR Network's proposed Investment Framework is not bankable in its current form. This is based on:

- advice from Deloitte Touche Tohmatsu Limited;
- 'market soundings' of investment banks; and
- discussions with coal producers in regard to their internal investment criteria.

QR Network's proposal is inadequate as Funding-Users are only entitled to charge the Participation Agreement. This section outlines a range of alternatives which seek to provide a competitive market for financing of projects by ensuring appropriate security is provided for user funded investments.

Schedule J acknowledges that funding users and their lenders are entitled to security over the revenue earned from user funded extensions. The form of that security is not specified in Schedule J. This issue is critical given that the relevant projects are:

- Likely to be **<u>very large investments</u>**.
- **<u>Paid</u>** for by users but **<u>Owned</u>** by QR Network.

6.2 QR Network proposal

The effect of QR Network's proposal is that User-Funders would rank as unsecured creditors, while the risk position of QR National's lenders would be improved as a larger pool of assets will be available to secure the commitments of the QR Group (therefore a commercial benefit will be gained from User-Funded projects).

QR Network have proposed that Funding-Users be entitled to charge the Participation Agreement. This would allow a user who has obtained third party finance to grant a mortgage over the Participation Agreement in favour of its lender. Essentially this provides a third party lender with an interest in the revenues that are <u>received</u> under this agreement. The approach does not in any way assist in:

- Ensuring that amounts payable by QR Network under the Participation Agreement are actually paid.
- Providing User-Funders with any security or protection in the circumstance that QR Network were to become insolvent or QR Network defaults on its Participation Agreement obligations.

Under the QR Network proposal, User-Funders will have no security over the cashflows which QR Network receives from the User-Funded assets, and QR Network's obligation to pay amounts under the Participation Agreement are not secured.

Unless these matters are addressed, there will not be a competitive market for finance, and expanding coal producers will have no alternative but to support the terms requested by QR Network for QR Network funding.

6.3 Consideration of the requirements for a competitive financing

QRC commissioned Deloitte Touche Tohmatsu Limited (**Deloitte**) to assess the bankability of the proposed Investment Framework and to develop a workable commercial and financing framework. A copy of the Deloitte Report is at Attachment 1. The proposed Investment Framework was assessed to determine whether or not it provided for a level-playing field in the market for financing of rail projects (that is, were Users in a similar position to QR Network if seeking to fund the same asset).

In terms of the market appetite for third-party User-Funded investments, key findings were:

- Despite the impact of the global financial crisis, infrastructure as an investment remains attractive to a number of investors – provided the risk profile of the investment remains commensurate with its associated returns. The QCA regulated return was not identified as a barrier to third-party investment.

- An appropriately structured investment framework could attract sources of capital which would avoid QR Network needing to fund investments that do not meet its business objectives.

While market demand existed, Deloitte identified that a fundamental deficiency of the proposed Investment Framework involved circumstances where Funding-Users are required to fund the costs of an extension over which it has no interest or title, although this investment was exposed to insolvency/default risk of the wider QR National corporate group. While the risk of QR National insolvency/default is considered low, the risk is not immaterial as it is not limited to the low risk regulatory environment of the below-rail operations of QR Network.

In light of the proposed ranking of User-Funders as unsecured creditors, Deloitte found that third party financing is unlikely to be available under QR Network's proposed arrangements and, to the limited extent this is available, would come at a high cost which could not be justified for an investment earning the regulated WACC. Moreover, even financing User-Funded projects on the balance sheets of coal producers would only be possible to the extent that coal producers are prepared to accept a risk profile which in unacceptable to third parties.

User-Funders would be entitled to returns that reflected the approved regulatory parameters; however they would be forced to face a higher risk profile than QR Network with respect to similar investments. In summary, the proposed framework is not bankable.

6.4 Options for fully addressing the security issue

Deloitte identified three main options to provide a competitively-neutral cashflow security outcome:

Option 1 – User-Funded assets held within a QR National SPV with protection of sublease through a Tripartite Agreement with the State Government.

Option 2 – QR National provides Corporate Level Secured Facility.

Option 3 – QR National provides shared ownership of the new user funded investments.

These are outlined in detail within Deloitte report at Attachment 1.

QRC understands the challenges involved in implementing these options, each of which would require a significant level of cooperation from QR Network and some of which may require participation (or at least approval) by the State Government. Importantly, any options to address the security issue can only be designed with full knowledge of the leases between the State Government and QR National and any limitations imposed by the existing security arrangements between QR National and its secured lenders. Given the limited information available to QRC, the options are necessarily presented at a high level.

6.5 Possible option for partially addressing the security issue

Based on the advice from Deloitte, it is clear that the minimum requirement for the user funding model to be bankable involves some meaningful form of security over the cashflows, and that this security must provide some rights (beyond those of an unsecured creditor) in the case of QR Network insolvency.

QRC is keen to explore each of the options discussed above with QR Network and the QCA. In addition, QRC are currently seeking further advice on the viability of an alternative solution involving:

- Revenue from the User-Funded Extension (less operation and maintenance charges) being paid into a trust account. This serves to limit the exposure to QR Network defaults and the exposure of QR Network co-mingling user funded Extension funds and general revenue;

  AND

- Registered security over the User-Funded Extension infrastructure securing the revenue payable under the Participation Agreement. If properly structured, this would assist in protecting against a receiver or administrator simply dishonouring the Participation Agreement. This could be implemented without significantly affecting QR Network's existing or future finance arrangements;

  AND

- QR Network granting security to the Funding-Users (or their lenders) over amounts payable to QR Network under access agreements entered into in respect of the Extension (the rights under that security could only be triggered in the case of a default by QR Network under the Participation Agreement or insolvency by QR Network);

  AND

- QR Network entering into a tripartite agreement with a Funding-Users' third party lender which addresses the usual requirements of lenders of such agreements (these requirements would be set out in the Participation Agreement).

The arrangement described above is not optimal but **may** (subject to further assessment and advice) provide the minimum level of security required to ensure that User-Funding is viable and may be considered in the event that the more effective options discussed in Section 6.3 cannot be implemented.

7. Assement against Schedule J Principles

QRC considers that QR Network's proposed Investment Framework does not adequately implement the principles set out in Schedule J.

A "Foundation Premise" of Schedule J is that "QR Network should not be able to exploit its monopoly power" (Schedule J, Item 3). QRC considers that QR Network will be in a position to exploit its monopoly power unless the Investment Framework provides for a User-Funding alternative which meets the criteria set out in section 4 of this submission. As these criteria have not been met, the Investment Framework Amendments have not addressed this Foundation Premise.

QRC engaged Freehills to undertake a detailed legal assessment of QR Network's proposals compared to the Schedule J Principles. A complete copy of this analysis is at Attachment 3, while a selection of the inconsistencies are discussed below (all item references are to Schedule J). Note that this selection is not an exhaustive list of the inconsistencies identified, rather, it is a selection of items which require additional discussion (beyond the level of detail provided in Attachment 3).

Schedule J notes that User-Funding should be available to Users at their option and should reflect the same risks as QR Network funding (see for example item 29, item 3 and item 11). If User-Funding is not on a level footing with QR Network funding it ceases to become a practical alternative and QR Network is able to exploit its monopoly position. A number of aspects of QR Network's proposals place User-Funding in an inferior position:

- ***Process and timelines*** (Item 48): The Schedule J Principles note the importance of clear processes and timelines for Extensions. These processes and timelines are crucial in avoiding delay and ensuring that QR Network is not able to leverage its monopoly position.

  The amended Access Undertaking proposed by QR Network does not include any timelines or clear processes for the development of Extensions. The proposed Construction Agreement submitted by QR Network is dependent on a scope of work, target cost and target schedule being developed <u>prior to</u> execution of this agreement. The development of the scope, timeline and budget for an Extension are significant undertakings in themselves, yet processes for determining these critical items are not set out in the Undertaking or in any of the agreements.

  The Access Undertaking should be amended to include clear Expansion timelines and processes. As a part of those amendments the Access Undertaking should also include a standard agreement for studies (concept, pre-feasibility and feasibility). That agreement could provide for the Funding-User to:

  - Pay the costs of the studies; <u>or</u>
  - Underwrite the costs of the studies such that if the costs of the study are not incorporated into the regulated asset base, the funding users will compensate QR Network.

  Such a study funding agreement is a key means of reducing the time taken to develop a User Funded Extension and clarifying the processes which must precede the execution of the Construction and Participation Agreements.

- ***Control over the performance of the Works (Item 24)*:** Schedule J notes that QR Network are to construct the Extensions because of "*operational/safety concerns*".

Under the proposed Construction Agreement QR Network reserves to itself control over the construction of the works beyond operational and safety matters. In light of the fact that Funding-User bear all of the costs of the Extension and that under QR Network's formulation of the Construction Agreement it effectively bears no risk, it is reasonable to expect that Funding-User should have a greater say over the way in which the works are performed.

This is an issue which goes to the bankability of User-Funding.

- ***Security over the cash flows generated by a user funded Extension (Item 23)*:** Security over the cashflows generated by a user-funded asset is critical to User-Funding. For such a security to be effective, it must include a link to the User-Funded assets and the revenue. Without this, Funding-Users face an unreasonable exposure to the insolvency of QR Network, which will affect funding by balance sheet and third party financing. This is discussed in Section 6 and is explained in detail in the advice provided by Deloitte Touche Tohmatsu Limited (Attachment 1).

- ***Retention of revenue generated by user funded extensions and mark-ups on Extension Costs (Items 42, 43 and 45)*:** Item 45 notes that QR Network should not charge additional fees or on-costs unless it agrees to take on additional risk. QR Network's Construction Agreement provides for it to be paid an incentive payment on all costs incurred in addition to margins which QR Network related entities earn on subcontracts (and without taking on any additional risk).

  QR Network's proposed Participation Agreement also provides that QR Network can (in addition to operation and maintenance charges) retain a portion of the user funded Extension revenue for "regulatory and performance risk".

8. Amendments required to Investment Framework

This section outlines specific concerns with the agreements which underpin QR Network's proposed Investment Framework. This section should be read in conjunction with the corresponding attachments referred to in each sub-section.

Importantly, QRC intends to provide formal mark-ups of QR Network's proposed agreements and additional proposals in the near future as means of accelerating the development of a workable User-Funding regime.

8.1 Proposed Standard Study Agreement

QRC proposes the development of a Standard Study Agreement. A term sheet outlining the key components is provided at Attachment 4.

8.2 Standard Construction Agreement

Attachment 5 provides detailed comments on the Standard Construction Agreement. A selection of key issues is outlined below.

Reliance on preparatory documents being completed: The Construction Agreement contemplates a scope of work, target cost and target schedule being agreed and attached to the agreement. Each of those documents is crucial to the administration of the Construction Agreement.

The amendments to the Access Undertaking proposed by QR Network do not contain any process or timelines for those documents to be prepared. Without clear processes and timelines there is a high risk of delay and disputation. Such risks undermine the utility of User-Funding (when compared to QR Network funding).

Control: The Construction Agreement does not provide Funding-Users with sufficient control over the performance of the works. It is considered that such control is justified in light of the fact that QR Network effectively bears no risk in relation to the construction works.

Further, to the extent that finance is provided from a third party a third party financier will require some element of control in order to mitigate the risk of delays and cost blowouts on the project.

Amendments should be made to the Construction Agreement to provide funding users with control, subject to appropriate protections needed to ensure that QR Network is not exposed to safety and operational risks.

Flexibility in models: The Construction Agreement only contemplates a single Customer as a counter-party to the Construction Agreement. The Construction Agreement should provide flexibility for other models, including:

- Where funding users have formed an SPV; or
- Other models requested by the funding users.

Decisions by funding users: The Construction Agreement is drafted as though separate construction contracts would be let for each funder's segment. This does not reflect the reality that procurement and construction contracts are likely to be let for the whole Extension (or at least parts that go outside the bounds of segments). Decisions of one funder therefore have the potential to impact another funder. The Construction Agreement should therefore include practicable mechanisms (such as a committee) for the funding users to make decisions that QR Network are to act on.

Liability of QR Network: QR Network only have a liability where it willfully breaches the agreement or acts dishonestly. That should be broadened to include gross negligence.

Definition of Extension Costs: Funding-Users are liable to pay for the "Extension Costs". The Construction Agreement definition of "Extension Costs" is unreasonably broad. It is drafted to include all costs and expenses "in connection" with the Extension. The definition is so broad that a funding user would be liable to pay QR Network for shortfalls in operation and maintenance costs and for costs caused by QR Network's breach. The definition of Extension Costs should be amended to exclude:

- Any amounts covered or intended to be covered by access charges (including operation and maintenance costs); and
- Costs and expenses caused by QR Network's breach of any agreement.

Tax risks: QR Network have stated that they are unwilling to bear the risk of adverse tax consequences as a result of user funding. QR Network have proposed a full form tax indemnity that passes all tax risk on to User-Funders. The tax indemnity goes beyond the bounds of what is reasonable in the circumstances. In order for a Funding-User to gain sufficient comfort around the tax risk allocated to it by the indemnity it would be necessary on a project-by-project basis to obtain a tax ruling. This is a slow and uncertain process. The risk of an adverse tax outcome can be removed if construction contracts are let by QR Network acting as undisclosed agent for the funding users (Please refer to the expert tax advice from Greenwoods and Freehills – Attachment 2).

Hybrid: The Construction Agreement does not deal with hybrid funding (that is, funding provided by both QR Network and Users) – this is identified on the front cover of the Construction Agreement. Similarly, QRC has not yet considered what changes would be required to the Construction Agreement (particularly from a tax perspective) in the event of hybrid funding being undertaken.

8.3 Standard Participation Agreement

Attachment 6 provides detailed comments on the Standard Participation Agreement. A selection of key issues is outlined below.

Security over revenues: The Participation Agreement does not provide Funding-Users with any security over the revenue generated by the User-Funded Extensions.

In order for the agreement to be bankable, and in order for boards to obtain sufficient certainty to lend their balance sheets, some security over the assets developed from the user funded extension is necessary.

This issues and proposed solutions was discussed in Section 6.

No set off: The Participation Agreement allows QR Network to set off amounts owing to QR Network under the Construction Agreement. Such a right of set off will not be acceptable to third party financiers.

QRC questions why QR Network requires this right in a circumstance where funding users' liabilities under the Construction agreement are supported by guarantees.

Retention of monies for "regulatory and performance risk": QR Network has suggested that it can retain a portion of the revenue earned from User-Funded "Extensions" as consideration for "regulatory and performance risk". QRC seeks the QCA's views regarding the extent to which the WACC includes allowances for risks that will be retained by QR Network in the case of a User-Funded project.

Tripartite: The Participation Agreement should require QR Network to execute a tripartite agreement with a funding users' financier. The Participation Agreement should set out the key terms of the tripartite agreement including that the agreement will not be terminated without first providing the financier with notice and a reasonable opportunity to cure.

Force majeure and limitation of liability: The Participation Agreement includes a force majeure provision and full form limitation of liability provision. Neither of these provisions are appropriate as QR Network is not providing a service under the agreement. QR Network's only substantive obligation is the obligation to pay the monthly distribution of revenue to the Funding-User.

8.4 Access Undertaking Amendments

QRC's assessment of Schedule J (Attachment 3) identities a number of amendments that will be required to be made to the Access Undertaking. Proposed amendments, in mark-up form, will be provided in the near future.

9. Pricing matters

9.1 Overview

QR Network has submitted a proposal within the 2011 DAAU which is a significant departure from current Undertaking provisions regarding pricing (refer to 6.4.2(a)(iii) of the 2011 DAAU). This proposal by QR Network was in response to concerns raised by a number of coal producers. Industry has since developed a preferred approach to address industry concerns, which differs from the solution proposed by QR Network. This section provides QRC views of the QR Network proposal and outlines the preferred industry approach to pricing matters.

The establishment of new reference tariffs and the varying of existing reference tariffs have always been important matters for industry. More recently industry has become keenly interested in the establishment of new, clearer principles for setting tariffs, due to:

- The expected large, lumpy incremental costs associated of the next round of track enhancements.
- Concerns that the current undertaking provisions can lead to inefficient and inequitable outcomes.
- A requirement to have a higher degree of certainty (early in the life of a project) regarding the approach being taken to pricing, due to the need to:
  - Complete mine feasibility studies (of which rail costs are a significant input) prior to making binding commitments to rail and port projects;
  - Ensure that pricing approaches are consistent between User-Funded and QR Network funded projects; and
  - Determine which existing mines (if any) will have their tariffs affected by an expansion project for the purpose of determining Reference Tonnes for Master Plan voting processes.

9.2 The existing (2010 Access Undertaking) rules

QRC's understanding of the 2010 AU pricing provisions is that, when a new reference tariff is established, that tariff must be sufficient to cover the incremental costs of the relevant project <u>and</u> provide a minimum common cost contribution. Incremental costs include the additional costs of providing access (including all capital extension/expansion costs) on any spur lines or existing mainline compared to the costs which would be incurred if the service did not operate. Therefore, when a new reference tariff is established, the result for existing Users of a system would be a reduction in tariffs (due to the minimum contribution to common costs).

However, this does not mean that the current rules will always result in expansion projects lowering costs for existing users, because:

- When an existing train service expands, there is no trigger for establishing a new reference tariff. Therefore the project costs are 'socialised' within the relevant system. In this case there may be no contribution to common costs, and incremental costs may not be fully covered.

- For new train services, it is not clear whether the requirement to cover all incremental costs plus a common cost contribution is strictly applied. Part 2 of QR Network's January 2011 Explanatory Notes seems to indicate that incremental mainline capital expenditure costs are incorrectly treated within the minimum contribution common costs, such that the average system price for existing Users may be increased by an expansion project.

9.3 QR Network's proposed amendment

QRC recognises that QR Network's proposal has been developed in response to industry concerns. The proposal suggests a trigger threshold under which a new reference tariff will be developed if the inclusion in the RAB of a Significant Investment would increase the Reference Tariff by more than 20%. As drafted, this amendment would apply only to new Reference Train Services, although this may not be QR Network's intention.

QRC does not support QR Network's proposed amendment, however, industry recognises that the intention was to respond to industry concerns and QRC welcomes the recognition that this complex issue should be addressed.

9.4 Key concerns with current provisions:

A lack of pricing certainty
Under current arrangements the tariff pricing outcome may be finalised just prior to, or even after, commissioning of an expansion. However, Users need to make binding investment and contractual commitments well ahead of these timeframes. Industry appreciates that approved tariffs are subject to the finalisation of the total cost and therefore some degree of uncertainty will remain until a project is completed. However, the approach to pricing (socialisation, incremental or some form of hybrid) should be clear well before commitments to a project are required. Recent examples highlight the issue:

- The pricing approach for GAPE has not yet been established, although:
    - A number of existing mines which will not be users of GAPE have been asked to vote on this project in the Master Planning Endorsement process, yet are unaware of how their tariff will be affected.
    - Producers were required to enter into underwriting agreements which provided a price structure irrespective of the QCA's approved reference tariff.
- WICET Stage 1 producers are currently considering billion dollar infrastructure investments (rail, port and mine) and have already made significant commitments, all in the absence of certainty as to the ultimate rail pricing approach.

Incentives for Expanding and non-expanding Users
The approach used to determine tariffs has implications on the incentives of Users in regard to Significant Investments. For example, when the incremental costs associated with a rail expansion are above the system tariff:

- Socialisation may encourage existing Users to challenge the underlying need for the project (such as through Master Planning endorsement processes) or to challenge negotiated Access Conditions, both on the basis of possible future impacts on their tariff.
- Socialisation does not provide an appropriate price signal for expansions. This could promote expansions which would not be viable on an incremental cost basis.

On the other hand, incorporating a common cost contribution plus all incremental rail expansion costs results in non-expanding producers receiving a lower tariff and in expanding producers facing an additional cost in what may already be a high-cost project. This could represent an effective cross subsidy in the event that there is no surplus capacity in the existing system.

Current arrangements are inequitable (expanding mines are favoured over new mines)
The cost of expansions accommodating existing load-outs using existing unloading facilities (existing Train Services) are socialised, while a new service must make at least a minimum common cost contribution to the existing system and pay the incremental costs relating to the service.

The current pricing arrangements were developed in an environment where spare capacity existed or additional capacity could be created at a relatively low incremental cost. The arrangements are not suitable in the current environment, where spare capacity does not exist and expansions have a high incremental cost.

9.5 QRC Position

QRC's proposes the following arrangements:

- QR Network should submit a proposed reference tariff if the inclusion into the RAB of the cost of an expansion project would otherwise increase the reference tariffs for that individual coal system. This should apply regardless if the expansion is to accommodate new or existing train services. The new reference tariff for the expansion project should be sufficient to cover the full incremental (including mainline) costs of the expansion.
- In cases where an expansion project has a lower cost than any previous expansion using comparable segments of rail infrastructure, the costs of the expansion should be averaged against the most expensive prior expansion (ie. the cost of the prior expansion is averaged down).
- In a case where an expansion project delivers a clear and measurable benefit to existing users, QR Network should propose (for QCA approval) an allocation of project costs between existing and expanding Users for the purpose of developing reference tariffs. Note however that QRC does not accept that an expansion will necessarily reduce congestion: this will depend on the relative capacity created and contracted.

QRC's approach has the key desirable features:

- Provides consistent rules for New Train Services and expanding existing Train Services.
- Delivers a zero contribution to common costs for expansions that have high incremental costs, rather than requiring a contribution which further increases costs as applies in the current rules.

- Non-expanding producers are no worse off because of an expansion project and therefore have no incentive to oppose expansion projects.
- Provides considerable pricing certainty for expanding and non-expanding producers.
- Enables producers who participate in 'high cost' expansions to obtain benefits from subsequent lower cost expansions.

QRC understands that the above approach generates different tariffs for a number of major expansion phases. In terms of administrative complexity, QRC considers that the current undertaking rules already require reviews of all Incremental Costs for new Train Services and applying this to the expansion needs of existing services would not be unreasonable. Therefore, the key additional task involves tracking investments over future expansion stages when determining the relevant expansion tariff.

QRC considers that the above pricing arrangements would provide greater certainty and result in a fair allocation of expansion costs for all Users.

10. Other DAAU amendments proposed by QR Network

QRC notes that QR Network has proposed a range of amendments which are outside the scope of the Investment Framework. QRC considers that a number of these amendments are constructive, however in the time available QRC has focused this submission on the Investment Framework.

List of Attachments (to be read as part of QRC's submission)

Attachment 1. Report by Deloitte Touche Tohmatsu Limited.

Attachment 2. Expert tax advice from Greenwoods and Freehills (Tax).

Attachment 3. Assessment of Schedule J compliance (Legal Review).

Attachment 4. Standard Study Agreement – Term sheet.

Attachment 5. Comments on Construction Agreement.

Attachment 6. Comments on Participation Agreement.