

Submission to the Queensland Competition Authority

**Submission in respect of the QCA Position Paper
on the Standard User Funding Agreement**

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1. Executive summary

Anglo American Metallurgical Coal Pty Ltd (**Anglo American**) welcomes this further opportunity to present its views to the Queensland Competition Authority (**QCA**) in respect of the Position Paper on Aurizon Network Pty Limited's (**Aurizon Network**) 2013 Standard User Funding Agreement (**SUFA**).

Anglo American considers SUFA to be critical to the future operation of the Queensland coal network and the global competitiveness of its users. This is because, as recognised by the QCA, it is the only viable mechanism which is available to address the issue of economic "hold-up" by monopoly service providers: in this case, Aurizon Network.

As recognised by the QCA, as well as the Queensland Resources Council (**QRC**) in its most recent submission, SUFA is considered to be critical because, in the absence of any mandatory obligations to invest, it is the only mechanism available to address the economic "hold-up" issue. SUFA was envisaged to constrain the market power held by Aurizon Network in instances where Aurizon Network refuses to expand the Central Queensland Coal Network (**CQCN**) without agreements for returns higher than the approved regulatory return on the CQCN. Anglo American is keen to see SUFA achieve this goal.

As Anglo American has always maintained, however, SUFA is not a substitute for mandatory expansion requirements in the specific circumstances outlined in the 2010 Access Undertaking (**UT3**). Anglo American notes that this view has also been expressed by the QRC in its most recent submission, and Anglo American strongly supports the submissions of the QRC in this regard.

Anglo American supports the majority of the QCA's findings outlined in the Position Paper. In particular, Anglo American agrees that, as it is currently drafted, the Aurizon Network SUFA:

- (a) is unlikely to be bankable - as such, Anglo American supports the majority of the structural changes proposed by the QCA;
- (b) does not appropriately allocate risk and control - ie, Aurizon Network independently controls the majority of the design and construct process with little input from funding users or the Trust, however, liability for time delays or design and scoping errors rests almost solely with funding users;
- (c) in numerous occasions throughout SUFA, decision criteria should be broadened to condition-based assessment in order to ensure objectivity in decision-making. This will both assist Aurizon Network with ease of reporting and providing reasons, and also lessen the likelihood of disputes arising because of subjective decision-making; and
- (d) permits discrimination between SUFA-funded and Aurizon Network-funded assets, even if only for the purposes of Aurizon Network's legitimate commercial interests. Anglo American agrees that a similar condition-based assessment approach could assist with this concern, coupled with increased reporting requirements for Aurizon Network to show the treatment of Aurizon Network-funded assets to SUFA-assets, as well as SUFA-assets to SUFA-assets (coupled with appropriate penalties if discrimination is shown).

Anglo American also notes that the current draft of the Aurizon Network SUFA allows for certain tax benefits which are not necessarily covered by the QCA redraft. Anglo American submits that the QCA redraft should ensure that it does not remove some of the important tax

benefits available to unit holders while attempting to redefine other elements of the Aurizon Network draft.

However, Anglo American notes that the QCA has inserted the concept of stakeholders and Aurizon Network being able to agree the "range of capacity outcomes". Anglo American believes that this concept is fundamentally flawed to the extent that the baseline of capacity for each individual system within the QCN is not known to stakeholders. This has been an ongoing concern with UT3, and Anglo American notes that Aurizon Network has proposed even less transparency regarding system capacity in its 2013 Draft Access Undertaking (UT4). Therefore, if stakeholders and Aurizon Network are to agree the range of capacity outcomes, stakeholders have no foresight regarding what capacity is available and truly required in a system (eg, an agreement that Aurizon Network will produce 15mtpa of capacity for a cost to funding stakeholders of \$600 million is flawed where it is not known what capacity the system is able to deliver without the expansion). Anglo American believes that such a requirement will only result in users agreeing to SUFAs in order to obtain much-needed capacity without knowing what is truly required. Therefore, this would not only make scoping of SUFA projects difficult, but also result in inefficient or uneconomic investment, undermining the economic competitiveness of the Queensland coal network.

Anglo American once again supports the previous comments from industry participants and the QRC (including its most recent submission on this issue), that:

- (a) SUFA is unnecessarily complex, impacting its functionality;
- (b) Aurizon Network's position is focused on its own commercial interests and does not reflect the balance that needs to be struck in a monopoly market;
- (c) SUFA is not an alternative to Aurizon Network Funding, and while SUFA remains essential because it creates parity between third party funding and Aurizon Network Funding, it is only one element of the expansion process and does not replace the need for Aurizon Network to fund expansions with certain characteristics at the regulated WACC;
- (d) expert or QCA determination of scope should not result in funding users bearing the entire risk of that scope;
- (e) expert or QCA determination of scope should be binding on all users, otherwise Aurizon Network will have a clear incentive to dispute elements of the determination in order to shift risk back to users; and
- (f) SUFA provides Aurizon Network with too much discretion and should be amended to include clear objective criteria for decision-making processes.

As such, Anglo American welcomes the drafting amendments and restructuring proposed by the QCA.

2. Requirement for Aurizon Network to construct expansions

The QCA states that Access Seekers wanted the QCA to require Aurizon Network to construct expansions at its own cost. Anglo American supports this view to the extent that it is done in a timely and efficient manner at the appropriate WACC.

However, Anglo American agrees that where a SUFA is concluded between Aurizon Network and various funding users, the entire purpose of the agreement is to conclude funding for an expansion not at Aurizon Network's cost.

In saying that, Anglo American does believe that the final SUFA approved by the QCA is no substitute for the mandatory expansion regime that currently exists in Part 7 of UT3. While Anglo American understands that this is still a matter for discussion in relation to Part 8 of UT4, it reiterates its previous submissions that due to the complexity and uncertainty currently surrounding SUFA, it is essential that the mandatory expansion regime remain strong and functional. This is particularly true for the provisions relating to minor expansions (up to the cap of \$300 million, or another value determined by the QCA as the \$300 million cap has been effective for a number of years already), replacement capital expenditure and the various other expansions that Aurizon Network is otherwise required to complete under UT3. It is fundamental that the owner / operator of any regulated asset should expand its asset base provided it is done under the regulatory regime at the appropriate risk parameters.

3. Bankability of a SUFA

Anglo American strongly supports the views expressed by the QCA and its independent expert Grant Samuel that, as it is currently drafted, a SUFA would simply not be bankable. Anglo American and numerous other industry participants, including the QRC, have made this point in previous submissions to the QCA.

In particular, Anglo American agrees with the QCA's position (also supported by the QRC) that as it is drafted SUFA does not provide sufficient security and certainty over rental cash flows, nor does it allocate construction risks to the party best able to control those risks: Aurizon Network. Rather, funding users are required to bear all those risks without any ability to influence or mitigate those risks on their own behalf.

Anglo American strongly supports the majority of the QCA's proposed amendments in respect of this aspect of SUFA.

One concern that Anglo American does have with the QCA's suggestions relates to the commitments that funding users will be able to extract from Aurizon Network in relation to its control over construction and rental costs. Specifically, the QCA proposal "requires Aurizon Network to provide transparent, up front commitments to construct SUFA infrastructure as efficiently as possible across the dimensions of scope, standard, cost and time-to-complete".¹ Anglo American fears that this incentivises Aurizon Network to over-scope or over-estimate project costs in order to ensure that it is not required to bear excess costs toward the conclusion of the expansion. Anglo American believes that the only way to avoid this is to ensure that funding users, most appropriately through information provided to the Trust, have enough insight into the construction and project management processes to determine whether efficiency objectives, scopes and time constraints are being followed. Again, this provides objectivity to the process, rather than the subjective and opaque options provided in the Aurizon Network-drafted SUFA. In any event, an effective dispute resolution process is necessary to ensure this potential behaviour is able to be objectively determined.

On this point, Anglo American strongly supports the submission of the QRC that funding users (or potential funding users) must have complete transparency of information available to Aurizon Network or any dispute or expert determination provisions included in a SUFA will be hampered or completely ineffective.

¹ Queensland Competition Authority, *Position Paper: Aurizon Network's 2013 Standard User Funding Agreement Draft Amending Access Undertaking* (May 2014) 27.

4. Above rail advantage

Anglo American supports the submissions made by Asciano in relation to the potential for cross-shifting of costs and subsidies within the Aurizon group of companies.²

As it is currently structured, the proposed SUFA gives the Aurizon Group the ability to move costs into entities that will recover that expenditure from funding users, rather than commercially absorbing that cost. Simple examples of where Anglo American believes cost shifting could occur are:

- (a) between Aurizon Network and its related entities for provision of back-end office services;
- (b) between Aurizon Network and its related above-rail operator, Aurizon Operations for the provision of maintenance and operating services (including electrification) when the completed SUFA-asset requires these aspects; and
- (c) between Aurizon Network and its related port entity, Aurizon Terminal, for any instance where a SUFA involves connection to port facilities and costs can be shifted to the Aurizon entity holding port rights.

The outcome of this possible cost-shifting is a potential competitive disadvantage for other above-rail operators, in particular Pacific National. Any competitive disadvantage to operators in competitive markets undermines the purpose of regulating Aurizon Network and should not be permitted.

Anglo American notes that the QCA considered this point in its Position Paper. Anglo American supports the QCA's recommendation to broaden the scope of SUFA in order to enable condition-based assessment. This would allow the QCA to approve a range of specific objective criteria that can be applied in a number of scenarios, including (but not limited to) above rail, funding user and asset discrimination. Further, condition-based assessment allows for ease of activity and decision reporting by Aurizon Network, allowing it to present reports clearly stating the criteria applied rather than having to draft extensive reasons for subjective decisions.

As such, Anglo American recommends that any discriminatory advantage is countered with clear, objective criteria approved by the QCA, so that such cost shifting potential cannot have an adverse impact on upstream or downstream competitive markets, or the overall bankability of a SUFA.

5. Discrimination between SUFA and non-SUFA assets

Anglo American agrees with Asciano, the QRC and the QCA that the current drafting of SUFA allows for discrimination between Aurizon-funded assets and SUFA-funded assets. Anglo American has previously made extensive submissions on this point.³ Anglo American strongly reiterates its previous comments, as well as supporting the points made by the QRC in its most recent submission on SUFA.

The current drafting will continue to create issues for funding users attempting to secure finance for SUFAs, as there would be no certainty regarding the treatment of the asset during or post-construction. As Anglo American has previously noted, discrimination for Aurizon Network's commercial gain is possible in a number of instances, for example where Aurizon Network makes the strategic decision to allocate its maintenance allowance to Aurizon

² In particular, see Asciano, *Asciano Submission to the Queensland Competition Authority in relation to the Aurizon Network Proposed Standard User Funding Agreement* (August 2013) 5.

³ See Anglo American, *Submission on the 2013 Standard User Funding Agreement DAAU* (August 2013) section 3.

Network - created assets rather than SUFA-funded assets. This causes disrepair and potential capacity degradation issues on SUFA-funded assets (which users would undoubtedly be required to pay extra to repair) but does not have any measureable impact on the rent that Aurizon Network would be required to pay under the SUFA. Further, Aurizon Network can then degrade the SUFA-funded assets at a much greater rate than its own assets, and in some circumstances may have an incentive to optimise the asset out of the RAB as the consequence is that Aurizon Network will no longer be required to pay rent.

Anglo American understands that this is an inherent concern with the SUFA model, however, agrees with the QCA that there are a number of steps that can be taken to reduce the risk of unfair discrimination between assets.

In particular, as stated above Anglo American supports the idea of applying condition-based assessment wherever possible in order to reduce the subjective control that Aurizon Network has over these assets. By reducing Aurizon Network's subjective control through strict and fair objective criteria, there is limited scope for any funding user to suggest that Aurizon Network has had opportunity to secure a competitive advantage for its related entities.

Further, Anglo American agrees with the QCA that this condition-based assessment should consist of both an initial assessment and an end of period assessment to allow for a determination of asset deterioration across the period, including a comparison of the condition of SUFA-funded assets and Aurizon Network-funded assets. Anglo American submits that this comparison should also include an individual breakdown of deterioration between each separate SUFA-asset, preventing possible discrimination between the various SUFA-assets (for example, in situations where one SUFA-asset yields a maintenance return if left degraded while other SUFA-assets are maintained).

Anglo American strongly supports the QCA's suggestion that, if the assessment uncovers unequal treatment of assets, Aurizon Network should be required to provide a plan to the QCA and Trust on how and when it will rectify the condition of the SUFA-assets. Importantly, Anglo American believes that this should be done at Aurizon Network's cost (as the discrimination between assets is under Aurizon Network's control and allowing recovery of these costs would serve to remove the penalty for discriminating between assets) and should be time-limited so that the report and repairs are required within a given time unless express reasons are provided.

6. Tax depreciation of SUFA assets

Anglo American is also concerned about the clarity of the tax provisions contained within the current SUFA proposal. In particular, Anglo American is uncertain of the Trust's ability to claim tax depreciation in respect of the Extension Infrastructure.

Anglo American understands that a primary design requirement of the SUFA Trust structure was the ability to enable depreciation pass through. If structured correctly, SUFA should result in a tax structure akin to the individual unit holders owning the Extension Infrastructure assets themselves, allowing to claim tax depreciation on, and therefore tax deductibility of, funds invested in SUFA assets. This will mean that cash distributions from the Trust to the unit holders will occur on a tax-deferred basis and only the amount after correct tax depreciation will be included in the income of the unit holders, rather than the full value of the Trust distribution. If the Trust is not able to claim depreciation, this primary tax benefit for unit holders investing in and owning SUFA assets for a period of time will be lost.

Anglo American understands that Aurizon Network's drafting of the Rail Corridor Agreement (**RCA**) gives the Trust a licence to access the Extension Land, a right which Anglo American believes should be considered akin to a "quasi-ownership right" for the purposes of the *Income Tax Assessment Act 1997* (Cth) (**ITAA**). The Aurizon Network drafted RCA also

gives the Trust an express right to remove the Extension Infrastructure at any time. Both of these factors lead to the conclusion that the Trust is the "holder" of the Extension Infrastructure for the purposes of the ITAA, and allowing it to operate in the tax deferral method considered above.

Anglo American notes that the QCA's redraft of the RCA potentially impacts on the operation of the inbuilt tax deferral mechanism and, while it supports the majority of the QCA's drafting amendments, Anglo American wishes to ensure that the tax effect of SUFA continues to apply as envisaged. In particular, by significantly reducing the scope of the RCA, the QCA will need to be careful to ensure that the RCA still confers "quasi-ownership rights" and infrastructure removal rights on the Trust (and, therefore, unit holders). Without ensuring that the redrafted RCA retains these rights, the QCA may undermine the intended tax effect of SUFA at great cost to unit holders and the viability of expansions.

7. Ability of Trust to raise debt financing

Anglo American also notes that the QCA redraft of SUFA proposes to allow the Trust to raise debt financing on behalf of the unit holders. While Anglo American broadly agrees with this concept in order to encourage participation in SUFA expansions, it also notes that in certain instances this can result in the Trust generating losses which could have further tax and financing implications for individual unit holders.

Anglo American agrees with the majority of the submissions made by the QRC on this point, and importantly in the QRC's most recent submission that this possibility requires further consideration. Anglo American also submits that unit holders should not be locked into one financing method or another by the standard form drafting of SUFA, but should rather be allowed choice in each expansion as to how they will raise financing for the project. Each individual SUFA will have different characteristics, including different participants, different capital investments and different funding timelines. As such, unit holders with access to financing avenues outside the Trust should also have the ability to explore those options, or to allow the Trust to raise finance on their behalf.

As a further point to note, however, Anglo American believes that in certain instances the Trust's ability to raise debt may invoke the operation of the thin capitalisation provisions for foreign-owned unit holders (which Anglo American assumes could be a large number of SUFA unit holders). This will also impact the Trust as, even where finance is sourced from Australian banks or financiers, there will be an additional level of tax compliance for consideration by the Trustee and incorporation in the overarching Tax Policy of the Trust.

As stated above, Anglo American broadly agrees with the QCA's suggestion to allow the Trust to raise debt, however, believes that all these implications should be considered during the drafting stage of SUFA rather than in haste when the first SUFA is ready to commence.