

## **Introduction**

BHP Billiton Mitsubishi (BMA) welcomes the opportunity to provide its views on the key issues fundamental to delivering a robust and workable investment framework for the coal industry in Queensland.

The submission has been developed recognising the following steps have occurred:

- in October 2010, QRNN's third Access Undertaking (2010 AU) was approved by the QCA, including amendments to Part 7 and the establishment of Investment Framework Principles (Schedule J) which QR was required to fully implement within three months of the 2010 AU approval date;
- in December 2010, QR National Network (QRNN) submitted to the Queensland Competition Authority (QCA) a draft amending access undertaking (the 2011 DAAU) under section 142(1) of the *Queensland Competition Authority Act 1997* and proposed Standard User Funding Agreement (comprised of a construction agreement and a participation agreement) (SUFA); and
- on 3 March 2011, the QCA advised QRNN that the 2011 DAAU and SUFA did not comply with clause 7.6(a) of the 2010 AU and that it would exercise its powers to develop the investment framework amendments and SUFA for incorporation into the 2010 AU. Notwithstanding this, BMA understands that the QCA is still obliged to make a decision on the 2011 DAAU in accordance with section 142(2) of the *Queensland Competition Authority Act 1997*.

BMA has participated in the development of the Queensland Resources Council (QRC) submission to the QCA and endorses the submission as reflective of industry's position on the preferred user funding investment framework and associated agreements required to give effect to a viable user funding model. BMA acknowledges that further industry consultation may be required to refine the details, particularly the form of the suite of standard user funding agreements.

BMA is making this submission to the QCA in order to:

- confirm its support for the QRC's submission;
- outline major areas of concern with the 2011 DAAU, SUFA and QRNN's model for user funding which should be addressed by the QCA in its decision on the 2011 DAAU and SUFA; and
- explain the reasons why the QCA should not approve QRNN's 2011 DAAU and SUFA.

## ***The importance of the investment framework and user funding***

The QCA's decision in relation to QRNN's 2011 DAAU and SUFA is very important for the future growth of the coal industry in Queensland. In a recent address to Australian Business in Europe, Glenn Stevens, Governor of the Reserve Bank of Australia made the following points<sup>1</sup>:

"The current rise in demand for energy and resources is expansionary for the Australian economy";

"A very large increase in investment in the [Australian] resources sector is currently under way";

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<sup>1</sup> Glenn Stevens, Governor of the Reserve Bank of Australia, Address to Australian Business in Europe – United Kingdom, Robert Walters Boardroom Series – Australialive Business Lunch, London - 9 March 2011

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“Historically, Australia has not managed global trends terribly well”;

“Australia has to do better to capitalise effectively on some very powerful trends in the global economy to which we are, almost uniquely, positively exposed”;

“We are now engaged in a national discussion about how to stretch the benefits of the resources boom over a long period, and how to manage the risks that it will bring. These are complex matters that involve a wide range of policy areas – macroeconomic, microeconomic, taxation, industrial and so on. But if that discussion can be conducted in a mature fashion, and followed up with sensible policies, then we have a good chance of leaving to the next generation a wealthier, more secure and more stable Australian economy.

The Australian economy is not in a position to obtain the full benefit of the global resources boom without a viable rail infrastructure funding model which enables competitive, timely and transparent negotiation with QRNN for the development, construction and delivery of rail expansion projects to complement the Queensland coal industry’s future growth pipeline of mine projects in a timely manner. Competitive discipline in industry negotiations with QRNN is fundamentally reliant on an alternative investment pathway whereby industry can self-fund, manage and control the risks associated with the relevant rail investment projects which underpin coal mine expansions.

It is very important for the Australian economy that an alternative investment pathway is established in the form of an effective user funding regime. An effective user funding regime will promote economically efficient investment in the rail network and competition in the related coal markets.

As the QCA acknowledged when approving the 2010 AU, the effectiveness of any investment framework depends on the effectiveness of a user funding model as both a deterrent for the misuse of market power and as an alternative funding mechanism if QR is unable or reluctant to fund an expansion. The QCA has also recognised that adherence to timelines is particularly important for user funded expansions to ensure that user funding remains a credible constraint on the exercise of monopoly power by QRNN.

It is BMA’s submission that QRNN’s proposed 2011 DAAU and SUFA is not workable in its current form, and therefore does not constitute an effective investment framework. To be effective, the user funding regime needs to have a high degree of detail, clarity and certainty. QRNN’s proposed 2011 DAAU and SUFA does not meet these criteria and will not achieve the object of promoting efficient investment and competition.

### ***Investment Framework Assessment Criteria***

In considering the 2011 DAAU and SUFA, BMA has established the following key assessment criteria:

- Criteria 1 - a competitive, workable and robust alternative funding structure to enable producers to trigger new expansion projects where QRNN is not prepared to invest at the regulated rate of return;
- Criteria 2 - a structured investment tollgate process to provide for clear and transparent pre-execution expansion investment decisions to be made in a timely way to align with industry’s specific growth pipeline;
- Criteria 3 - regulatory certainty to promote investment in the market, including certainty on the:
  - a. treatment of user funded costs and revenue distributions to ensure a level playing field exists between a QRNN funded investment and user funded investment;
  - b. nature of access conditions available to QRNN and user funded projects;
  - c. pricing principles underpinning new rail projects.

These criteria are all in accordance with the Investment Framework Principles set out in Schedule J of the 2010 AU.

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BMA has assessed QRNN's 2011 DAAU and SUFA to determine whether it delivers on the requirements of the Investment Framework Principles set out in Schedule J of the 2010 AU. BMA acknowledges QRNN has gone some way to develop a user funding model that would provide a self funded investment platform for users. However, the difficulty with QRNN's model is that it contains fatal flaws which must be addressed by the QCA if the 2011 DAAU and SUFA are to be effective in delivering a viable and efficient alternative investment pathway.

- Criteria 1 and 2 are not achieved. This is a fatal flaw in the Queensland rail investment market model. Non-achievement of each criterion will effectively create barriers to entry in Queensland's rail infrastructure market and foreshadow the potential for "investment hold ups" in future rail expansions to occur<sup>2</sup> to delay, frustrate and remove industry's ability to expand the coal market in Queensland. Such an outcome would preclude industry and the Australian economy from benefiting from the global resources boom to which Australia is uniquely and positively exposed.
- Criteria 3 is not achieved. QCA direction is required on the regulatory parameters underpinning investment in rail infrastructure in Queensland. Establishing a strong incentive to invest in a market requires certainty around market fundamentals, enabling businesses to undertake optimal investment and mitigate the risks inherent in that investment.

**1. A competitive, workable and robust alternative funding model which will allow producers to trigger new expansion projects where QRNN is not prepared to invest at the regulatory rate of return.**

To be bankable (that is, to be capable of attracting funding from financiers and/or capable of being approved by boards of user funders), the user funding model in the SUFA must (a) minimise tax uncertainties, (b) be of sufficient credit quality and (c) provide an investment return at least equivalent to the relevant regulated Weighted Average Cost of Capital (WACC), as set by the QCA (inclusive of access conditions where appropriate) from time to time.

- **Tax Uncertainties**

QRNN has proposed a "Construction Contract" model for user funded projects where QRNN acts as a construction contractor during the construction phase and pays a distribution to user funders during the operational phase based on the value derived from the asset. Based on tax risks peculiar to this model, QRNN concedes in its submission that the commercial viability of the model relies on acceptance by the Australian Tax Office (ATO) in a tax ruling. Unusually in the circumstances, QRNN additionally seeks a full tax indemnity from the user funders for the life of the investment.

BMA Comment

The Construction Contract model raises unnecessary complications including tax risks such that QRNN, in addition to obtaining a binding ruling from the ATO, seeks for the user funders to provide an indemnity for QRNN's own tax position. In these circumstances, a tax indemnity would unreasonably place the burden of all tax risk for a project on the user.

A simpler and more effective model, both commercially and with regard to tax, is the Direct Construction Contract Model (DCCM) where users directly engage third party contractors and then separately engage QRNN to manage the contractors.

BMA fully supports the QRC's submission regarding the DCCM. The DCCM does not raise the tax uncertainties of the QRNN model and provides an effective platform from which the user funders can manage and control the construction contract directly with the contractors. Another benefit of the DCCM is that, by removing the necessity of the ATO ruling process, it allows more timely investment by funding users than the QRNN model. This is because the existence and scope of the proposed indemnity in the QRNN model may act to delay execution of the Construction Agreement by a user until such time as QR obtains the ATO ruling for the project. This risk is mitigated by the DCCM.

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<sup>2</sup> Throughout the 2010 AU negotiation process, QRNN repeatedly identified to the QCA and industry that it was not willing to invest its own capital in its business at the regulatory rate of return.

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- **Credit Quality**

User funded rail projects are likely to involve investments by coal companies running into the hundreds of millions of dollars. The return on this investment (being a share in the access revenues generated by the project) will be received by the funding users over many years (average regulatory asset life is approximately 35 years), long after the original funds have been provided. As such, funding users are subject to many risks, including the credit risk of both users of the infrastructure and of QRNN itself.

While funding users must accept the same credit risks which QRNN already takes in respect of access revenues, the user funding model put forward by QRNN creates unacceptable credit risks for funding users in respect of QRNN. Recognising the potential for this risk to arise in user funded projects, one of the principles set out in schedule J of the 2010 AU relates to security for user funders as follows:

“In relation to any User Funded Extension, each Funding User (or Funding User’s financier where debt financed) may take security over the contracts, including the User Funding Agreement, and associated cash flows and QRNN’s creditors may take security over its cash flows and the resulting Rail Infrastructure.”

BMA Comment

The user funding model proposed by QRNN does not comply with the principle contained in the 2010 AU set out above. The only security permitted under QRNN’s model is security over the participation agreement, and not the cash flows associated with the user funded investment. These cash flows comprise of:

- the access revenue already collected by QRNN; and
- future revenue accruing under access agreements.

Under QRNN’s model, the access revenues earned on the user funded expansion will be collected and commingled with other revenues earned by QRNN. This means in the event QRNN became insolvent then the funding users would be unsecured creditors of QRNN and would have no direct rights in respect of the revenue already collected from the user funded investment and no direct rights to the sources of that revenue (being the relevant access agreements) in the future.

At a minimum the investment framework must permit user funders to have:

- direct access to the revenues that have already been collected, ideally through a trust account structure such as that proposed by the QRC;
- security over the participation agreement;
- security over the relevant access agreements; and
- appropriate tripartite arrangements in respect of such security.

These requirements are all in accordance with the principles set out in schedule J of the 2010 AU.

BMA reiterates that satisfactory arrangements to manage the credit risks associated with the user funding model are critical to ensuring that the users can undertake such an investment.

- **Investment Return**

QR has structured the cash flow return (referred to as a revenue distribution) of user funders to provide them with the equivalent revenue risk profile which QR faces under the regulatory framework. Conceptually, the return is directly proportional to the percentage share of the annual maximum allowable revenue that is generated by the assets funded by the user within each coal system and benefits from the annual revenue cap and end of regulatory period true up mechanisms so that the rate of return is guaranteed over the regulatory life of the asset in an NPV neutral way.

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## BMA Comment

QRC's financial modelling demonstrates that QRNN's proposed revenue distribution model (subject to tax indemnity and credit quality issues being addressed) could deliver the required revenue outcome. Specifically, a producer can fund its own rail infrastructure and leave itself in roughly the same revenue position as it would have been had QRNN funded the project at the regulatory Weighted Average Cost of Capital (WACC). This distribution mechanism means user funders have a competitive choice over funding mechanisms to deliver rail projects to align with future demand requirements.

This financial modelling is based on the assumptions that the operational and performance risk allowance is nil. It is unclear what operational and performance risks are currently funded through the asset related component of the revenues (return of and return on capital). BMA notes that operational and performance risks are normally captured in QRNN's system-wide cost allocation. To the extent that these costs are increased by the addition of user funded assets it is expected that the system wide and regional allowance will also increase and be incorporated into reference tariffs, payable by all users on the network.

A QCA review of the actual modelling mechanism to be used by QRNN will need to be undertaken to ensure that this intent is translated into a workable revenue distribution process.

### ***2. A structured investment tollgate process to provide clear and transparent pre-execution expansion investment decisions to be made in a timely way to align with industry's growth pipeline.***

The 2011 DAAU provides no guidance on the pre-execution investment processes to be undertaken by QRNN to bring a significant rail investment to the decision point where users can elect between a QRNN funded or user funded project.

## BMA Comment

A major concern in BMA's consideration of the proposed investment framework is the lack of clarity in the pre-execution process QRNN must follow to develop future rail projects to a design, engineering and cost standard capable of being executed by QRNN under either a QRNN funded or user funded model.

BMA supports the development of an investment process with clearly defined timeframes and trigger points (tollgates) for the delivery of projects from concept stage through to execution. Whilst the 2010 AU imposes obligations on QRNN to undertake and facilitate expansion studies<sup>3</sup> the lack of clarity in process provides significant opportunities for delay and frustration in the development and completion of rail projects. Similarly an efficient and effective dispute resolution process must be developed to allow project timeframes to be met within the investment process<sup>4</sup>. This enables rail projects to move between each stage of the project with minimum delay and frustration.

In this regard, BMA supports the submission of the QRC on pre-execution processes, particularly the need for a study funding agreement. Complementary amendments are also required to the 2010 AU to:

- clearly define the trigger points for QRNN or a user to initiate the investment process,
- ensure QRNN complies with its obligations in implementing this investment process, including delivery of services within defined timeframes;
- timely resolution of disputes; and

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<sup>3</sup> The 2010 AU allows QRNN to recover all costs from expansion studies even where those studies do not proceed past the study phase.

<sup>4</sup> The 2011 DAAU relies on the existing dispute resolution process in the 2010 AU to apply to the investment framework. Whilst acceptable for the statutory processes in the 2010 AU, this framework is not acceptable for the investment process as any investment delay will significantly and adversely impact on individual producer's global marketing strategies. At a time when entry into the global market attracts a premium, it is essential the QCA ensures a timeframe driven investment model is delivered.

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- step in rights for users to take over an investment study process which is being unreasonably delayed<sup>5</sup>.

In managing the timeframes associated with the investment process, it is important that expanding users of a new or existing coal terminal are allowed to deliver to their relevant growth pipeline without risk of delay to fit to the timeframes of another coal terminal's growth pipeline. In this context, it is appropriate for participation eligibility in a project EOI process to be constrained to the users who are participating in the same coal terminal expansion project which triggered the EOI. Without this constraint, the EOI process could be slowed down as different users from different coal terminals seek to fit an EOI process into the timeframes of other terminal expansions. For example, there are two coal terminals at the Port of Hay Point and plans to construct another two coal terminals nearby at Dudgeon Point. It would not be reasonable to constrain each of these terminals into a hierarchy of expansion options and timeframes within one EOI process. The rail projects and EOI process required to complement all terminal expansions will need to be conducted separately and on a stand-alone basis<sup>6</sup>.

### **3. Regulatory Certainty and Incentive to Invest**

Funding users and third parties who invest in rail infrastructure are effectively investing in the regulatory return of QRNN's Central Queensland Coal Network. The return on investment in a rail infrastructure project will be determined by the regulatory parameters set by the QCA, specifically setting the:

- value of the rail project for inclusion in the Regulatory Asset Base (RAB) and future optimisation conditions, subject to the regulatory protections in Schedule A of the 2010 AU;
- annual allowable costs, including annual maintenance and operational costs, and the depreciation schedule and the WACC (with any access conditions) which would apply to the assets; and
- annual maximum allowable revenue, including the WACC and any access conditions which would apply to the assets; and
- reference tariffs to determine the allocation of network costs (including expansions) amongst existing and new users of the network, subject to the pricing principles in Part 6 of the 2010 AU.

Understanding how such regulatory issues may be treated by the QCA will also be critical to delivering investment certainty over the life of the project.

- ***treatment of costs incurred in a user funded project will determine whether a level playing field exists between a QRNN and user funded investment;***

QRNN has identified the extension costs and expenses which would be incorporated into the costs of a user funded project (Schedules 7 and 11 of the SUFA). These costs include specific reference to costs incurred due to the project being user funded, including managing QRNN's tax position, organising forums and meetings in relation to the SUFA, dispute resolution, stamp duty payable on transfer of ownership, administrative and overhead costs and pre-commencement extension costs. A construction incentive payment is also proposed under the SUFA to provide an incentive for QRNN to deliver a user funded project within budget and on time.

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<sup>5</sup> Strict timeframes must be contained within the investment process to enable an independent assessment of whether QRNN has unreasonably delayed the progress of the relevant stage of the investment process.

<sup>6</sup> This may initially serve to increase QRNN's administrative costs by bringing forward the timeframe of studies, but it will avoid QRNN's current practice of lumping future expansions in the same coal system (eg Blackwater or Goonyella) under the one umbrella study and advising of an inability to drill down into design, engineering and costs due to a lack of knowledge on where the tonnes would ultimately be coming from on the system. QRNN's 'just in time' approach to studies currently pushes industry negotiation to the 11<sup>th</sup> hour of any investment decision. Given industry is funding or underwriting the studies undertaken by QRNN, any increased study costs are considered efficient as it allows industry to assess mine viability in terms of the transport coal chain interface costs at the same time it is prepared to sanction its mine project and coal terminal expansion.

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## BMA Comment

Significant regulatory risk surrounds the relationship between the costs incurred by producers in funding a rail project and the value of the subsequent asset that the QCA will roll into the RAB. To the extent that there is a negative cost difference between the costs incurred by the producers and the costs accepted by the QCA in the valuation of the asset, it will place user funding at a competitive disadvantage to a QRNN funded model (akin to an asset write down so the asset generates a lower than regulated WACC over the life of the project).

Accordingly, BMA seeks QCA confirmation that the costs, expenses and construction incentive payment identified by QRNN in the SUFA would be acceptable to the QCA for incorporation into the RAB so the regulatory WACC would be earned on the full investment. BMA notes that QRNN has accepted the prudence of cost risk associated with the QCA review of the project costs, but has mitigated this risk with reference to any project costs which have been specifically agreed to by the funding producers. To address the regulatory risk associated with a user funded project, BMA recommends appropriate regulatory clearances be obtained prior to executing a SUFA, including regulatory pre-approval of scope, standard (where appropriate) and procurement strategy.

BMA supports the development of a construction incentive mechanism to drive appropriate incentives within QRNN to deliver user funded rail projects on time and within budget. BMA recognises that such mechanisms are common under EPC and EPCM/alliance style contracting arrangements and recommends QRNN's proposed incentive mechanism be market tested by the QCA to ensure it is competitive with similar incentive mechanisms used in the construction industry<sup>7</sup>. Subject to this market testing, BMA recommends the QCA support the inclusion of a competitively developed construction incentive mechanism into the costs recognised by the QCA when valuing a project for incorporation into QRNN's RAB<sup>8</sup>.

It is understood that under the terms of the State Lease Agreement, certain QRNN projects may be opted to be or, required to be, transferred to the Queensland Government. BMA recommends that the QCA consider the terms of the State Lease Agreement to determine whether transfer duty may arise on the transfer of completed user funded projects from QRNN to the State and whether such duty would be payable for comparable QRNN funded projects.

Users should not be liable to pay duty on the transfer of user funded rail assets to the Queensland Government in circumstances where the transfer is either required or facilitated by the State Lease Agreement, which the users are not party to. However without access to the State Lease Agreement, users cannot assess the likelihood of this risk. Further, it remains inappropriate to indemnify QRNN for any risk of transfer duty. In this context BMA notes the position put by the QCA on page 67 of the QCA's Final Decision – QRNN's 2010 DAAU – September 2010<sup>9</sup>.

- ***access conditions available to user funded projects (whether 100% user funded or co-funded with users and QRNN)***

The 2011 DAAU allows QRNN to seek QCA approval for access conditions or other risk adjustments from access seekers for significant infrastructure investments. Where the QCA approves access conditions to apply to a rail project, then funding users of that project are similarly entitled to benefit from those access conditions. However, where QRNN does not seek access conditions to apply to a project or rejects the access conditions agreed to by the QCA, then a funding user is not able to approach the QCA and obtain access conditions which address a different risk profile from that faced by QRNN.

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<sup>7</sup> BMA questions whether an incentive mechanism already forms part of QRNN's costs under QRNN funded projects in situations where QRNN use an Alliance contracting arrangement to implement and construct a rail expansion project (with the incentive margin being captured as a project cost in the Alliance contract).

<sup>8</sup> This could be achieved by allowing for regulatory pre- approval of a construction incentive payment to be sought as a component of the QCA's pre-approval process for the Procurement Strategy on a project by project basis.

<sup>9</sup> The Authority accepts that QRNN's regulatory asset base should reflect the DORC valuation of the assets transferred. However, it does not accept that the access seeker should pay, or that QRNN should be compensated for, the transaction costs associated with the transfer of the assets. The intention is that QRNN should be a stand-alone provider of access to the declared facilities. The QR corporate group should not be compensated for remedying its failure to have arranged itself in a way that is compatible with this intention... It does not seem appropriate that a QR Ltd entity should be compensated for any transactions costs (including taxes and duties) associated with the transfer of rail transport.

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## BMA Comment

BMA supports widening the scope of the 2011 DAAU to allow the user funders of a significant investment to similarly seek QCA approval for access conditions or other risk adjustments to apply to the development of reference tariffs where the rail project has a materially different risk profile to the risks currently compensated for in QRNN's regulatory WACC.

BMA suggests one access condition might involve the sharing of the funding responsibilities between different stages of an expansion project (for example between users of a stage 1 and 2 of new coal terminal<sup>10</sup>) such that all users of stage 1 and 2 bear a proportion of the total financing costs, relative to their tonnage throughput in the completed new terminal. Under this scenario, a user funder of a lumpy rail expansion project (e.g. in stage 1) might seek to have an access condition applied to a subsequent lower cost expansion (e.g. in stage 2) to have the option to require the subsequent users of the lumpy expansion to share the financing responsibility originally borne by the first group of funding users. Such an access condition avoids the economic 'free rider' risk where some users may delay their mine expansion to the second stage of a terminal expansion to avoid bearing the cost of the constructing the lumpy large scale investment made by the funding users in stage 1.

This approach recognises producers do not invest in the rail infrastructure as a stand-alone investment decision. Rather, producer investment in rail infrastructure is only undertaken to facilitate a specific mine and terminal expansion (with the costs included in the relevant mine feasibility costs) where QRNN is not prepared to fund the projects at the regulated WACC. Under such circumstances, it is appropriate that all producers share the financing responsibility required to bring forward the rail projects which support their individual mine projects.

- ***pricing principles to apply to all new rail projects to provide certainty on project viability at the point of project sanction;***

The 2011 DAAU proposes development of a default hybrid differential pricing principle which would socialise all infrastructure costs across each system up to 120%. Where a project results in an increase in reference tariffs greater than 20% then the incremental users of that project would bear 100% of the project costs but would not be required to contribute to the common costs of the existing network.

## BMA Comment

BMA supports a hybrid differential pricing principle which incorporates the following two limbs:

- average price (socialise) the costs of an expansion where the expansion results in a reduction in access charges across all users; and
- incrementally price the cost of an expansion where the expansion would otherwise result in access charges exceeding existing access charges .

The underlying principle is that existing users should not have their reference tariffs affected by an expansion for which they receive no benefit by way of increased tonnage throughput. This principle also recognises that those customers who are paying an incremental access charge above the existing tariffs should similarly not have to pay a contribution to common costs normally required in the development of new infrastructure.

BMA recommends the hybrid pricing principle as more efficient and compatible with an expanding rail infrastructure market. It minimises the incentive for non-expanding users to oppose new expansions thereby lessening the potential for expansions to be inefficiently delayed. It provides pricing certainty for expanding users to enable informed decisions on the viability or otherwise of new mine projects. It also ensures efficient investment decisions are made because expanding users must bear the full cost of the capacity instalment being triggered.

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<sup>10</sup> Or alternatively, financing responsibility may be shared between the proposed two new coal terminals to be constructed at Dudgeon Point.

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A corollary to this pricing principle is the need to ensure any expansion in the rail network which results in an incremental pricing outcome is underpinned by a minimum 10 year take-or pay access agreement (similar to the DBCT AU)<sup>11</sup>. Whilst not protecting existing users for the economic life of the expansion asset, it provides a level of commercial discipline on expanding users to not pursue expansions which cannot be justified on economic grounds over the longer term. This approach would also require an amendment to the relinquishment provisions of the 2010 AU so that the provisions would not apply for the first 10 years of an expansion Access Agreement.

### **Other matters**

- **Co-Funding Arrangements**

BMA notes QRNN's SUFA has been drafted on the assumption that it is 100% user funded. Analysis of flexible models which might manage the multiplicity of different industry investment structures has therefore been precluded. The investment framework and the 2010 AU provide that QRNN will have funding obligations where users have difficulty obtaining funding (up to a maximum amount of \$300 million). It is therefore very probable that there will be extensions in the future which will involve a mixture of users that can fund and those that can't, giving rise to a co-funded project (i.e. in part by QRNN and in part by users). BMA believes that in order to be effective, the investment framework must include a form of SUFA (the co-funded SUFA) which can be used in such circumstances. The SUFA and the co-funded SUFA must be capable of being used interchangeably without changing the risk profile for funding users. The QCA has stated that it views the requirement of QRNN to fund certain expansions where users cannot do so as a 'safety net', and accordingly it is QRNN who should bear the additional risks (if any) in a co-funded expansion, not the funding users.

Moreover, given the nature of the investment market for networked infrastructure, there are significant benefits in enabling different market investment models to co-exist to deliver infrastructure expansions. The QCA should therefore consider including an overarching obligation on QRNN to consider all investment structures available at the time a user funder is contemplating user funding a new rail project and require that funding structures be negotiated with funding users.

- **SUFAs**

BMA confirms its support for QRC's amendments to the SUFAs (user funding – construction agreement, user funding - participation agreement and the study funding term sheet). In particular BMA would like to stress the importance of the following issues arising out of those agreements:

- a. structure – the SUFA must be flexible enough to allow a range of different user funding structures, to be adopted on a project by project basis. This means the funding users should not be required to adopt or participate in any particular form of corporate structure in order to participate in the funding of a rail project (for example, the user must not be required become a shareholder in a special purpose vehicle or a member of an unincorporated joint venture);
- b. risk of cost overruns – the SUFA provides for cost overruns to be borne by the funding users, even if they are incurred due to QRNN's mismanagement of the project. This is contrary to the principles set out in schedule J of the 2010 AU;
- c. inclusion of costs in the Regulated Asset Base – all costs funded by users in respect of expansions should be pre-approved by the QCA for inclusion in the RAB. In addition, QRNN should bear all costs deemed by the QCA to be inefficient, even if they are less than the target costs for the extension (SUFA currently proposes to exempt this outcome);
- d. procurement strategy – there must be greater controls around QRNN's procurement process for the extension, including for all procurement items, not just those above a threshold (requiring

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<sup>11</sup> Another alternative would be to require Expansion Access Agreements to be evergreen 10 year Access Agreements similar to ARTC's proposal for Access Agreements in the Hunter Valley.

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close consultation between QRNN and users on draft tender and contract information, the awarding of tenders and disputes with contractors);

- e. cross default – the SUFA needs to make it clear that funding users do not bear the risk of default by other user funders during the construction phase of a rail project, including that:
  - the expansion will continue notwithstanding the default;
  - the non-defaulting user funders will not be required to provide any additional funding; and
  - to the extent there is a funding shortfall, QRNN will meet that shortfall;
- f. security from QRNN for its construction obligations –QRNN should be required to provide any security to funding users in respect of its obligations to construct the extension;
- g. QRNN's liability – QRNN has proposed a cap of \$1.00 on its liability under or related to its obligations under the agreement (with some limited exceptions) on the basis that QRNN is not, in its view, able to include in its costs for the expansion any 'risk premium' which would allow it to take on any liability in respect of the expansion. The result is that user funders will have no practical ability to be compensated by QRNN for any breach of the agreement. Other approaches include a more realistic cap, liquidated damages for late delivery, and excluding negligence and/or breach of contract from the liability cap (thereby ensuring QRNN has unlimited liability for such items);
- h. dispute resolution – The dispute resolution process provides no allowance for any involvement by the QCA in any such disputes. This is contrary to the principles set out in schedule J of the 2010 AU (see paragraphs 26 and 52);
- i. step-in rights – On the basis of the information released to date, the step-in rights (or 'change in management control') proposed by QRNN are not adequate. They provide for the user funders to require QR National to contract with another 'managing contractor' in place of QRNN. It is very difficult to see how the contractual relationship will work in practice.

### **Conclusion**

BMA agrees with the QCA's approach of considering that the 2011 DAAU does not fully implement the principles set out in Schedule J of the undertaking and developing its own proposed SUFA and investment framework amendments to the 2010 AU. As explained in this submission and in the QRC submission, the 2011 DAAU and SUFA do not provide an effective constraint on QRNN. Accordingly, the 2011 DAAU and SUFA does not promote efficient investment in the rail network or have the effect of promoting competition in the related coal markets. BMA is of the view that the amendments suggested in this submission will help to improve the user funding regime and are designed to assist the QCA as it develops its own proposed SUFA and amendments to the 2010 AU.



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18 March 2011