



Issues Paper

**2012 Standard User Funding
Agreement Draft Amending Access
Undertaking**

(2012 SUFA DAAU)

February 2013

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SUBMISSIONS

Public involvement is an important element of the decision-making processes of the Queensland Competition Authority (the Authority). Therefore submissions are invited from interested parties concerning its assessment of Aurizon Network's 2012 Standard User Funding Agreement Draft Amending Access Undertaking (the 2012 SUFA DAAU). The Authority will take account of all submissions received.

Written submissions should be sent to the address below. While the Authority does not necessarily require submissions in any particular format, it would be appreciated if two printed copies are provided together with an electronic version on disk (Microsoft Word format) or by e-mail. Submissions, comments or inquiries regarding this paper should be directed to:

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The **closing date** for submissions is **29 March 2013**.

Confidentiality

In the interests of transparency and to promote informed discussion, the Authority would prefer submissions to be made publicly available wherever this is reasonable. However, if a person making a submission does not want that submission to be public, that person should claim confidentiality in respect of the document (or any part of the document). Claims for confidentiality should be clearly noted on the front page of the submission and the relevant sections of the submission should be marked as confidential, so that the remainder of the document can be made publicly available. It would also be appreciated if two copies of each version of these submissions (i.e. the complete version and another excising confidential information) could be provided. Again, it would be appreciated if each version could be provided on disk. Where it is unclear why a submission has been marked "confidential", the status of the submission will be discussed with the person making the submission.

While the Authority will endeavour to identify and protect material claimed as confidential as well as exempt information and information disclosure of which would be contrary to the public interest (within the meaning of the *Right to Information Act 2009 (RTI)*), it cannot guarantee that submissions will not be made publicly available. As stated in s187 of the *Queensland Competition Authority Act 1997* (the QCA Act), the Authority must take all reasonable steps to ensure the information is not disclosed without the person's consent, provided the Authority is satisfied that the person's belief is justified and that the disclosure of the information would not be in the public interest. Notwithstanding this, there is a possibility that the Authority may be required to reveal confidential information as a result of a RTI request.

Public access to submissions

Subject to any confidentiality constraints, submissions will be available for public inspection at the Brisbane office of the Authority, or on its website at www.qca.org.au. If you experience any difficulty gaining access to documents please contact the office on (07) 3222 0555.

Information about the role and current activities of the Authority, including copies of reports, papers and submissions can also be found on the Authority's website.

PREAMBLE

Aurizon Network¹ has proposed amendments to its approved 2010 access undertaking to give effect to a user funding mechanism for network expansions. These amendments are contained in Aurizon Network's 2012 Standard User Funding Agreement Draft Amending Access Undertaking (the 2012 SUFA DAAU) that was submitted to the Authority for approval on 20 December 2012.

The purpose of this document is to assist stakeholders in preparing submissions on the 2012 SUFA DAAU. This paper highlights some of the overarching issues relevant to the 2012 SUFA DAAU. It does not seek to comprehensively address all issues raised or amendments proposed by Aurizon Network. Hence, interested parties should rely on their own analysis to determine whether there are additional matters and specific points of detail on which they wish to comment.

The Authority encourages interested parties to consider the criteria in the *Queensland Competition Authority Act 1997* (the QCA Act) for the approval of draft access undertakings when preparing submissions. Interested parties may also wish to comment on the degree of consistency between Aurizon Network's 2012 SUFA DAAU and other access regimes in Australia.

The closing date for submissions is 29 March 2013.

¹ Aurizon Network (formerly QR Network Pty Ltd) is the below-rail subsidiary of Aurizon Holdings Limited (formerly QR National Limited). Aurizon Holdings was privatised on 22 November 2010, prior to this it was a State-owned business.

THE DEVELOPMENT OF THE 2012 SUFA DAAU

The need for developing the Standard User Funding Agreement (SUFA) was born out of the process of finalising the 2010 access undertaking. Aurizon Network's position throughout the 2010 access undertaking approval process was that it would only undertake significant extension/expansion investments in central Queensland if it considered it to be commercially viable to do so. Aurizon Network's position is partially based on section 119(2)(c) of the *Queensland Competition Authority Act 1997* (QCA Act), which prevents the Authority from making an access determination that 'require[s] an access provider to pay some or all of the costs of extending the facility'. The SUFA aims to give effect to this principle by providing an option whereby parties other than Aurizon Network can fund network extensions/expansions. In doing so, SUFA can also offer the prospect of providing for greater competition in financing significant extension/expansion investments, leading to efficiency and innovation benefits and a reduced need for regulatory oversight.

The process of developing SUFA commenced upon the approval of Aurizon Network's 2010 access undertaking (i.e. 1 October 2010). Clause 7.6(a) of the 2010 access undertaking required that, within three months from the approval date, and following consultation with stakeholders, Aurizon Network would submit to the Authority:

- (a) a proposed SUFA; and
- (b) a DAAU incorporating amendments to the 2010 access undertaking it considered reasonably necessary to fully implement the principles set out in schedule J of the undertaking (i.e. the 'Investment Framework Amendments').

On 24 December 2010, Aurizon Network submitted a draft amending access undertaking (the 2011 DAAU) and a proposed SUFA to the Authority for its approval. The Authority conducted public consultation regarding this proposal, and stakeholders generally agreed that the proposal was not workable in the form submitted by Aurizon Network. Aurizon Network subsequently accepted this view and later withdrew the 2011 DAAU.

Aurizon Network then committed to undertake a more consultative approach with its stakeholders, in order to develop a new model for the SUFA. On 20 December 2012, Aurizon Network submitted the 2012 SUFA DAAU for consideration by the Authority. This submission comprises approximately 1,090 pages, the majority of which is devoted to a suite of nine legal agreements that together comprise the SUFA².

It is apparent that the 2012 SUFA DAAU is not an agreed position between Aurizon Network and industry stakeholders, although Aurizon Network has indicated that it does reflect compromises on both sides. Aurizon Network's submission lists a number of substantive issues that remain unresolved (p.26, vol 1). These broadly relate to the control-reward-risk balance between the parties of a SUFA. Volumes 1 and 3 of the 2012 SUFA DAAU provide an explanation and some justification/evidence of Aurizon Network's position. However, it is not clear to what extent, if any, the outstanding issues constrain Aurizon Network's proposed SUFA from being 'workable and credible'. This Issues Paper focuses on widening the discussion of various substantive high-level issues. The issues are outlined in the following section, along with questions for comment. They comprise:

- 1 Overall allocation of risk and liability
- 2 Complexity and the trust concept
- 3 Identity of the Trustee

² The agreements comprise: The Trust Deed, the Subscription and Unit Holders Deed, the Project Management Agreement, the Rail Corridor Agreement, the Umbrella Agreement, the Extension Infrastructure Lease, the Extension Infrastructure Agreement, the Integrated Network Deed and the Deed Poll Guarantee.

- 4 Construction and project management
- 5 Performance incentives and timely completion of projects
- 6 Stapling, preference unit transactions and third party financing
- 7 Non-discrimination, SUFA and the Extension Process

HIGH-LEVEL ISSUES AND QUESTIONS FOR COMMENT

1: Overall allocation of risk and liability

Aurizon Network (p. 9, vol. 1) says that the SUFA framework achieves an acceptable balance between itself and preference unit holders for a “base case” SUFA transaction and that if the framework is changed, significant restructuring may be required to retain the commercial balance.

Aurizon Network (p. 30, vol. 1) also says that it has structured the SUFA framework such that Aurizon Network is not liable for any loss arising from its performance, except to the extent that the loss is a result of Aurizon Network’s fraud, gross negligence or wilful default. With respect to the Project Management Agreement, Aurizon Network is liable to the Trustee (a subsidiary of Aurizon Network) for loss arising from Aurizon Network’s breach or negligence. The extent of the liability, however, is limited to the total project management fee where the project management fee is in addition to the construction costs of a SUFA project.

As Aurizon Network also wishes to have overall control of the construction and operation of SUFA projects, this means it has considerable control over the risk allocation associated with its performance in this regard. For instance, Aurizon Network notes (p. 6, vol. 1) that SUFA must allow for flexibility to allow for the negotiation of compensation for additional risk. Aurizon Network may assume risks that, under a base-case scenario, are allocated to preference unit holders (e.g. project delivery cost overrun risk) in return for commercially negotiated returns.

The 2012 SUFA DAAU indicates that issues surrounding liability and the implications this has for risk allocation have yet to be agreed through consultation with stakeholders.

Question 1: How do the risk and liability proposals in the 2012 SUFA DAAU compare with your experience of commercial project financing agreements, particularly in the rail, construction or mining markets?

Question 2: Would stakeholders be willing to enter into a SUFA project based on the proposed allocation of liability and risk in the 2012 SUFA DAAU? If not, why not and what changes to the SUFA framework would be needed, in particular given your previous experience of commercial project financing agreements? From most to least important, how would you rank the proposed changes identified.

2: Complexity and the trust concept

The SUFA framework proposed by Aurizon Network involves creating a trust for each SUFA project undertaken. The SUFA framework incorporates an indemnity for any tax liability that may be faced by Aurizon Network. User funding also seems to raise balance sheet issues as it is possible that SUFA funding could be categorised as Aurizon debt. Aurizon Network says that this has the potential to impact unfavourably on the perception of Aurizon’s financial health within financial markets. Aurizon Network is of the view that its proposed trust arrangements mitigate these concerns. The trust structure is, however, relatively complex and it is important that it does not create any additional unnecessary constraints, either actual or perceived, within corporate decision making bodies of potential SUFA participants or the financial community.

Question 3: Would stakeholders have any concerns with adopting a trust-type structure for the SUFA framework? If so, why and what changes to the SUFA framework would you propose? From the most to the least important, how would you rank the proposed changes identified?

Question 4: Can stakeholders provide an example(s) of an alternative framework that provides Aurizon Network with appropriate tax liability and balance sheet protection within the context of

SUFA? What are their advantages and disadvantages relative to Aurizon Network's proposed trust approach and would they alleviate any concerns identified with adopting a trust-type approach?

3: Identity of Trustee

Aurizon Network's proposed SUFA framework requires that an Aurizon Network subsidiary be the Trustee. Aurizon Network also proposes that it controls the construction process and subsequent operation of any SUFA asset. The framework also provides that the ordinary unit holder (Aurizon Network) has discretion over the life-time income/rental distributions to those parties that have funded a SUFA project, subject to the consequences of withholding these distributions; such as bearing the interest costs and any associated tax implications. Moreover, in relation to Trustee remuneration, Aurizon Network adopts a full cost-recovery approach, rather than a full efficient cost-recovery approach.

Aurizon Network considers these positions to be reasonable, primarily for the following reasons. Firstly, it is argued that this structure is needed to maintain the level of balance sheet and tax protection afforded by the trust. In particular, Aurizon Network states that having an Aurizon Network entity as Trustee is important in ensuring that SUFA funding is treated as equity on Aurizon Network's balance sheet. Secondly, it ensures that Aurizon Network adheres to the performance guarantees that it has had to commit to as part of the SUFA agreements with the State, and which Aurizon Network and the Trustee must meet. Aurizon Network states that the performance guarantees associated with SUFA agreements are consistent with the existing lease agreements between Aurizon Holdings and the State. Aurizon Network also notes that the Reserve Decisions and Powers, outlined in Schedule 4 'Reserve Decisions' and Schedule 5 'Reserve Powers' of the 'Subscribers and Unit Holders Deed', should provide sufficient comfort to companies financing the trust and holding preference units, particularly when account is also taken of the Trustee's fiduciary obligations and the ability to replace the Trustee.

Although the above reasons provided by Aurizon Network may be valid, it is not clear from Aurizon Network's submission precisely how issues surrounding balance sheet protection and performance would be compromised if the Trustee was not an Aurizon Network subsidiary, and the extent to which this could be mitigated or addressed in an alternative manner. It is also unclear whether the Reserve Decisions and Powers provide comfort to trust participants, particularly with respect to their interaction with other conditions across the legal agreements.

The 2012 SUFA DAAU indicates issues surrounding the identity and remuneration of the Trustee have yet to be agreed with stakeholders.

Question 5: Do stakeholders consider there to be a legitimate need for an Aurizon Network subsidiary to be Trustee of a SUFA trust? If not, why not?

Question 6: Do stakeholders consider there to be a conflict of interest if a company related to Aurizon Network acts as Trustee of a SUFA trust? If so, why? Why is this not mitigated by the Trustee's fiduciary obligations, the ability to replace the Trustee, the proposed Reserve Decisions and Powers and their associated voting structures?

Question 7: What Reserve Decisions and Powers, as well as associated voting structures, do stakeholders consider appropriate to mitigate any actual or perceived conflict of interest? If this would not be sufficient to mitigate all concerns regarding Aurizon Network's proposed approach to the Trustee, what other measures might be required?

Question 8: Do stakeholders agree that the ordinary unit holder (Aurizon Network) should have discretion over income/rental distributions attributable to those parties that finance a SUFA project, given the disincentives from withholding these distributions; such as bearing the interest costs and any associated tax implications? If not, why not?

Question 9: What alternative options are there for the role of Trustee? How do they alleviate any legitimate concerns Aurizon Network may have? What are their advantages and disadvantages?

4: Construction and project management

The 2012 SUFA DAAU indicates that various issues surrounding project management have yet to be agreed with stakeholders. Aurizon Network has proposed that, in the first instance, it constructs and project manages SUFA projects based on its Project Management Agreement. This defines who controls project delivery, project management remuneration and incentives, as well as the risk allocation between parties.

It may be the case that Aurizon Network's position results in the best overall outcome. The 2012 SUFA DAAU documents, however, do not appear to provide a great deal of objective evidence to support this. In particular it may be possible, subject to operational and safety issues, for efficient construction and project management services to be successfully provided by an alternative supplier or within a differing commercial structure.

Overall, it would seem necessary for all parties to be able to agree to the proposed approach to the control-reward-risk trade-offs involved in both the pre-construction and construction phases of a SUFA project for it to be viable. Consequently, the design and construction process, the control, rewards and incentives surrounding project delivery, as well as the ability to seamlessly replace the Project Manager in a cost and time efficient manner are all important.

Question 10: How does the proposed Project Management Agreement in the SUFA submission provided by Aurizon Network compare with your experience of similar commercial agreements, particularly in the rail, construction or mining markets?

Question 11: Would stakeholders be willing to enter into a SUFA agreement based on the proposed Project Management Agreement in the SUFA submission provided by Aurizon Network? If not, what changes to the existing agreement might be needed to better reflect the balance of interests across all relevant parties? From the most to the least important, how would you rank the proposed changes identified?

5: Performance incentives and the timely completion of projects

The 2012 SUFA DAAU is heavily concentrated on developing formal legal agreements. Although a legal framework is clearly needed, the SUFA can also provide for negotiation from the standard arrangements on a case-by-case basis for the mutual benefit of the parties. If there is a misalignment of interests across potential SUFA participants, the scope for any such negotiations is unlikely to exist and there is little possibility of coming to an agreement, regardless of the sophistication and detail underpinning the SUFA legal framework.

A core issue regarding any SUFA investment is ensuring that the availability of the additional rail capacity coincides with underlying coal demand growth and any upswing in market conditions. It may be possible to develop 'default' performance incentives for SUFA agreements that take into account both the specific project performance of a SUFA investment, as well as the prevailing market conditions. This could increase the scope for negotiations across potential SUFA participants, while also linking project management to performance incentives in a transparent and formal manner. Such an approach places greater emphasis on collaborative behaviour across parties, with the legal framework aimed at supporting this; rather than being the primary focus. It may well be the case that such mechanisms have already been considered in consultation with stakeholders. However, from the supporting documentation provided with the 2012 SUFA DAAU, the extent of such discussions is not completely clear.

Question 12: Do stakeholders consider that performance incentive structures related to market conditions, as well as pre-construction and construction delivery, could have a positive impact on the number of SUFA projects and their timely delivery? If not, why is such an incentive structure considered inappropriate?

Question 13: If so, is there benefit in exploring how such incentives could be structured?

Question 14: Based on your experience in developing commercial construction contracts, particularly in the rail or mining markets, what types of performance incentives are adopted and how is actual performance assessed against them?

6: Stapling, preference unit transactions and third party financing

As noted previously, in the absence of barriers, the SUFA can provide for greater competition in financing significant extension/expansion investments and may lead to efficiency and innovation benefits. Aurizon Network's SUFA framework, however, requires a commercial link between the parties funding a SUFA project and those entering into the associated access agreement with Aurizon Network. This is referred to as 'Stapling'. Effectively, it constrains the financial pool available for developing SUFA projects and could dampen the potential competitive benefits associated with this.

Aurizon Network's SUFA framework also places restrictions on a SUFA participant's ability to transfer ownership of its share of the SUFA project (which occurs through the transfer of preference units) at both the project delivery and operational phase of a SUFA project. At the project delivery phase, 'stapling' must be adhered to, effectively prohibiting the transfer of preference units across interested parties. Once a SUFA asset is operational, any transfer of preference units requires the consent of Aurizon Network.

This provides Aurizon Network with considerable control over the preference unit transactions of each SUFA participant over the lifetime of the SUFA asset. There may, however, be legitimate reasons for this. If, for instance, changes in preference unit ownership results in certain thresholds being breached this could have knock-on financial implications, such as changing the tax liabilities of all trust participants. Aurizon Network is also of the view that this approach aligns the commercial interests across all parties involved in the SUFA project. This subsequently ensures that Aurizon Network adheres to the performance guarantees it has had to commit to as part of the SUFA agreements with the State, and which Aurizon Network and the Trustee have to deliver.

The 2012 SUFA DAAU indicates that issues surrounding 'stapling', preference unit trading constraints and the subsequent implications this has for third party financing through for example superannuation funds and infrastructure trusts, have yet to be resolved.

Question 15: Do stakeholders consider that Aurizon Network's proposed restrictions in relation to preference unit trading and 'stapling' are appropriate? Do stakeholders consider that Aurizon Network's reasons for imposing these restrictions are justifiable? If not, why not?

Question 16: What advantages and disadvantages do stakeholders envisage if third party financing was available for SUFA projects? What elements of Aurizon Network's proposed SUFA framework would you expect to be attractive and unattractive to potential third party financiers?

7: Non-discrimination, SUFA and the Extension Process

The 'Non-discrimination provision' (NDP) within the 2012 SUFA DAAU is aimed at ensuring a SUFA project is treated in the same manner as an Aurizon Network project. Aurizon Network adopts the concept of a 'reference project' which is a notional project comparable in size and nature to the SUFA project but funded by Aurizon Network. This is used as a benchmark from which any concerns regarding discrimination can be assessed.

In principle, the NDP is a valid concept, but whether or not it will be perceived as objective and equitable in practise is the crucial factor. This will depend on whether the ‘reference project’ is considered credible and if there is confidence in the process underpinning NDPs implementation. For example, a reference project may not be considered to be a credible basis for comparison purposes if it is a project where Aurizon Network’s returns have been supplemented by access conditions – in particular, if those access conditions have been agreed in circumstances where user funding has not been a viable alternative.

In relation to this, the first point of interest is Aurizon Network’s proposed remuneration for itself or related companies when providing Trustee services, project management services and operation/maintenance services and the relationship these have to the NDP principle. The second point is how potential issues of discrimination would be identified and dealt with. The NDP principle relates to a set of defined actions (Relevant Actions) and in terms of process the Trustee (a subsidiary of Aurizon Network) initially considers whether Aurizon Network is complying with its NDP obligations and communicates any non-compliance to Aurizon Network. If Aurizon Network considers that it is actually in compliance, the Trustee can refer the dispute to the CEOs of Aurizon Network and the Trustee. If the CEOs, both of whom are affiliated to Aurizon Network, fail to come to an agreement, the dispute is referred to an expert for a binding determination. If the expert determines that Aurizon Network has not complied with the NDP, Aurizon Network has to comply. It is, however, in Aurizon Network’s discretion regarding the remedy it applies.

The 2012 SUFA DAAU indicates that issues surrounding non-discriminatory treatment of SUFA projects have yet to be agreed with stakeholders.

Finally, despite the practical accounting issues associated with SUFA agreements, in reality constructing, operating and maintaining a SUFA asset may be little different from that associated with an asset constructed by Aurizon Network based on its Extension Process. Therefore, in order to minimise the potential for discrimination between SUFA and the Extension Process, and to ensure consistency of treatment in all circumstances, there may be benefit in simultaneously considering the SUFA and Aurizon Network’s proposed amendments to the Extension Process (which are expected to be proposed as part of its next draft access undertaking (UT4)).

Question 17: Would stakeholders be willing to enter into a SUFA project based on the proposed ‘Non-discrimination provision’ (NDP) in the 2012 SUFA DAAU? If not, why not and what changes to the SUFA framework would be needed to better reflect the balance of interests across all relevant parties? From most to least important, how would you rank the proposed changes identified.

Question 18: Are stakeholders of the view that, in order to ensure consistency of terminology and treatment, there might be benefit in considering SUFA and the Extension Process holistically? What would be the advantages and disadvantages of this approach?

Question 19: Do stakeholders consider that Aurizon Network’s proposals for remuneration of itself and/or related companies when providing:

- (a) Trustee services;***
- (b) Project management services; and***
- (c) Operational/maintenance services***

are appropriate, when considered against the criteria of non-discrimination, efficient costing and risk? If not, why not?

WAY FORWARD

The QCA Act provides that the Authority may approve a DAAU only if it has published the undertaking, invited persons to make submissions on it and considered any submissions received within the time stated by the Authority.

The QCA Act (section 147A) requires the Authority to use its best endeavours to make a decision on Aurizon Network's 2012 SUFA DAAU within a six-month period, excluding time allocated for consultation or for a period taken to respond to information requests.

The Authority will offer stakeholders and Aurizon Network a further chance to comment after it has released a draft decision on the 2012 SUFA DAAU.

The Authority invites submissions on any aspects of Aurizon Network's 2012 SUFA DAAU by 29 March 2013.