



30 September 2010

Mr Paul Bilyk  
Director  
Queensland Competition Authority  
Level 19 12 Creek Street  
Brisbane QLD 4000

Dear Paul

### **Final Decision QR Network's 2010 Draft Access Undertaking**

We thank you for the opportunity for Xstrata Coal Queensland ("Xstrata") to comment on the QCA's Final Decision in relation to the 2010 DAU. Xstrata recognises that the QCA has taken considerable account of the concerns expressed by stakeholders in coming to its final decision. However, there are a number of issues where Xstrata has positive suggestions in order to ensure that the QCA's objectives are able to be implemented properly in the practical commercial environment in which the 2010 DAU will operate.

#### **1. Measurement of Capacity**

It is essential that the definition of Capacity requires QR Network to take into account realistic assumptions in regard to the functioning of other parts of the entire supply chain. However, Xstrata is concerned that the definition of "Supply Chain Operating Assumptions" refers to QR Network's assumptions without qualifying that the assumptions must be based on any consultation with any Supply Chain Group, or that the assumptions have to reflect the current operational reality of any coal supply chain. There would clearly be no benefit in having reference to Supply Chain Operating Assumptions which do not realistically reflect the actual functioning of the coal supply chain.

Xstrata recognises that clause 11 of the DAU moves QR Network a considerable way towards addressing these concerns, since it requires QR Network to participate in Supply Chain Groups and to engage in discussion of the Supply Chain Operating Assumptions. However, Xstrata also considers that some small adjustments to the Access Undertaking would have considerable benefits in relation to the certainty of these provisions.

Xstrata proposes that:

- (a) The Access Undertaking should ***explicitly recognise the desirability of agreeing a common set of Supply Chain Operating Assumptions which will be utilised by all of the participants in a coal supply chain.*** Xstrata recognises that it may not be possible ultimately to agree a shared set of assumptions, but does consider it likely that these could be developed, as has been done through the Hunter Valley Coal Chain Logistics Team in the Hunter Valley Coal Chain. There is already work being done to bring this about in the Dalrymple Bay Coal Chain through the Integrated Logistics Company.

- (b) Whether or not shared Supply Chain Operating Assumptions are agreed, there should be a general requirement in the definition of Supply Chain Operating Assumptions that the assumptions should be reasonable, given the actual functioning of the relevant coal supply chain. While clause 11.1.3(a) requires QR Network to develop Supply Chain Operating Assumptions, and clause 11.1.3(c) (ii) requires QR Network to consider whether variations may be required, the Access Undertaking does not explicitly reference the benchmark against which the Supply Chain Operating Assumptions must be judged (including by the QCA where the matter is referred to it in accordance with clause 11.1.3(d)). Xstrata considers that it would be of benefit to the operation of the Access Undertaking to **explicitly state that the assumptions should be reasonable, given the actual functioning of the relevant coal supply chain.**
- (c) **QR Network should be obliged to publish its Supply Chain Operating Assumptions.** At present, clause 11.1.3(b) (ii) requires QR Network to notify any Supply Chain Operating Group of the Supply Chain Operating Assumptions. However, it would be in the interests of all participants in the coal supply chain for the QR Network Supply Chain Operating Assumptions to be published on the QR Network website, whether or not a Supply Chain Operating Group has been formed in relation to any particular coal supply chain.

## 2. Extension Process and triggering feasibility studies

Xstrata welcomes the proposed Extension Process set out in paragraphs 47 to 51 of Appendix 1 to the QCA's Final Decision (included as Schedule J to the Access Undertaking) (the "**Investment Framework Principles**"). This proposed process could be improved through the clarification of exactly how the process is to be undertaken and by recognising that the QR Network feasibility studies do not and cannot occur in isolation of the feasibility studies for the remainder of the coal chain (i.e. mine and port).

Paragraph 47 of the Investment Framework Principles envisages that QR Network would be obliged to initiate the Extension Process where it receives requests in relation to 70% of the Planned Capacity of the smallest efficient Extension of the Rail Infrastructure (or less than 70% where the Users requesting the Extension are prepared to meet 70% of the cost associated with the development of the Extension).

However, the Planned Capacity of the smallest efficient Extension of the Rail Infrastructure will not be known until after the completion of pre-feasibility and feasibility study process, which is envisaged to occur in accordance with paragraph 49 of the Investment Framework Principles as part of the Extension Process. The feasibility study establishes the required Extension to meet demand, the Planned Capacity which will be added by the Extension through engineering and planning work and the efficiency of the Extension options, the smallest efficient Extension and its Planned Capacity are not known in advance of the completion of the feasibility study. Additionally, a User should not be expected to commit to meet 70% of the cost of development of the Extension when the scope, timing and eventual cost of the Extension are unknown at that point.

It appears that it is intended that paragraph 49 of the Investment Framework Principles should operate whether or not an Extension Process has been commenced in accordance with paragraph 47 of the Investment Framework Principles. However, given that paragraph 49 is part of the Extension Process triggered under paragraph 47 of the Investment Framework Principles (and is defined as such) this is not clear.

Xstrata therefore proposes that paragraph 49 of the Investment Framework Principles should be amended to state that where increased Capacity is required by any Access Holder or Access Seeker (or their customers), QR Network must carry out pre-feasibility and feasibility studies with a view to determining the smallest efficient Extension of the Rail Infrastructure, but still subject to the costs of the studies (as opposed to the development of the Extension at that point) being met in accordance with paragraph 49 of the Investment Framework Principles. Where the person seeking the Capacity **may** intend to finance the Extension through the entry into of a User Funding Agreement, then the studies carried out should be in accordance with the reasonable requirements of that person or their financier, so as to ensure that this option would be practically available to them.

This drafting should also be reflected in clause 7.5.2(d) of the Access Undertaking to ensure that QR Network is obliged to undertake these studies as set out in the Investment Framework Principles.

### **3. User funding options**

Xstrata acknowledges the steps that have been taken to provide a workable right for users to provide funding for Extensions in accordance with clause 7.5.5. Xstrata has some further suggestions to ensure that the right is as workable as possible, so that all Access Seekers and coal producers are able to utilise the right to user fund Extensions.

Xstrata is concerned that the funding process is insufficiently flexible as to the identity of the funder, which may present practical obstacles to the usage of the procedure. For example, a producer may wish to seek third party finance. It is understood QR Network objects to having to enter in to third party finance arrangements, however access to third party finance and a User Funding model which facilitates this will greatly alleviate the concerns the QCA has identified in respect of Users unable to directly fund Extensions.

Xstrata is concerned that it is unclear at what point in the user funding process the user will be committed to proceed with funding the Extension in accordance with the User Funding Agreement. A user should not be committed to proceed to fund one stage of an Extension until the previous stage has been completed to its satisfaction. For example, construction should not proceed unless the funder is satisfied with the feasibility study - a funder should not be obliged to fund an Extension which is not feasible. This highlights the need for the imposition of strict timelines on QR Network for the conduct of the feasibility studies and presentation of any Access Conditions sought by QR Network at least 6 months prior to the proposed final commitment date for the relevant Extensions.

Xstrata is concerned that there is insufficient recognition of the risks that funders face through the interaction of the funding regime and the other financing arrangements which may be entered into by QR Network. In particular, Xstrata is concerned that rights to the revenue generated through the user funded assets should be secured and that, in addition, the funders should have the right to enter into a tripartite arrangement with QR Network and any other secured financiers to ensure that the rights of the funders will be treated with equal priority to those of any other secured financier where a receiver is appointed or the other secured financiers otherwise assume control of the QR Network business. Similar concerns arise in respect of the initial contributions of finance to fund an Extension. If these arrangements are not put in place then the returns under the User Funding Agreement will represent a highly risky investment which it will be difficult to justify, particularly for smaller coal companies. Additionally, it will potentially erode any benefit of User Funding relative to any Access Conditions QR Network may be seeking. The investment would be exposed to the risk that QR Network does not generate a sufficient return to cover the rebates as well as the operating and maintenance costs, but would also be exposed to the risk that the financier of other unrelated operations of QR Network (or possibly of the QR Group as a whole given that cross charges may be in place) may take steps which threaten QR Network's ability to repay these amounts. This would place any investment through the User Funding Agreement in the same risk class as an equity investment, except without the protections

which a shareholder would generally be entitled to, through voting and other entitlements and through the provisions of the Corporations Act 2001 (Cwth).

Xstrata proposes that:

- (a) The Access Seeker or Customer may choose to seek third party financing of the Extension. The third party may be an independent financier or it may be a related body corporate of the Access Seeker (or where the Access Seeker is a mine which operates through an unincorporated joint venture of one of the joint venturers or the operator of the mine).
- (b) The Access Undertaking should clarify that the funder's obligation to advance funds for each stage of the development (concept, pre-feasibility, feasibility and construction) is contingent on the funder being satisfied that the previous stage has been completed satisfactorily and that the proposed investment it may undertake through the User Funding Agreement remains satisfactory to it. As noted above, QR Network should be obliged to complete these studies in accordance with the reasonable requirements of the funder so as to ensure that finance will be able to be advanced in accordance with these arrangements.
- (c) The cash flows from the Access Agreements of other users who have contracted to use the user funded Capacity should be secured in favour of the funder of that Capacity under the User Funding Agreement. This should also apply to the cash flows from the Access Agreements of the User Funder. The User Funder Agreement should provide that such cash flows are not subject to any security in favour of any other provider of finance to QR Network or the QR Group, and that the cash flows should be segregated into a separate account which is only utilised for the collection of such sums, and the payment to QR Network of its operating and maintenance charges and to the funder of rebate payments under the User Funding Agreement.
- (d) QR Network should be obliged to ensure that any other person which holds any security over the part of the Network which is used to provide the Capacity funded under the User Funding Agreement should enter into an agreement with the funder to regulate what would occur upon the enforcement of any such security, including provisions that:
  - (i) the User Funding Agreement will survive any receivership of QR National and if the Network is sold by a receiver then the User Funding Agreement will be novated to the new owner of the Network assets (along with the tripartite arrangements with the new financiers of the Network assets);
  - (ii) the Capacity which is funded under the User Funding Agreement must continue to be operated and made available to Access Holders on the same basis as Capacity which is not funded in that way, to ensure that payments from the Access Holders who utilise that infrastructure continue to be made for the benefit of the funder under the User Funding Agreement; and
  - (iii) the rights to a rebate under the User Funding Agreement will take priority to any other security over any payments made in respect of the Capacity to which the User Funding Agreement applies.

#### **4. Returns on user funded capacity**

Paragraph 43 of the Investment Framework Principles provides that Funding Users will be entitled to a return on capital equal to the Regulated or Varied WACC. The Regulated WACC is in accordance with the usual provisions of the Access Undertaking and the Varied WACC is any amended WACC which the QCA may have approved for QR Network in accordance with paragraph 32 of the Investment Framework Principles, where QR Network considers that its cost of funds for a Significant Investment is inconsistent with the Regulated WACC.

Xstrata considers that it would be appropriate to allow the Funding User also to seek approval for a Varied WACC based on the Funding User's cost of funds. Logically, if QR Network is entitled to seek a Varied WACC based on its own cost of funds then, if it is the Funding User which is providing the funding for the relevant Significant Investment, the Funding User should have a similar right to seek a Varied WACC based on its own cost of funds (or the cost of funds provided by a third party financier). This would of course be subject to the QCA's approval in the same way as an application by QR Network in accordance with paragraph 32 of the Investment Framework Principles.

However, the process that the QCA goes through should be slightly different for a Funding User as opposed to QR Network. In the case of QR Network, the QCA has already carried out an examination of QR Network's cost of funds, which has been used to establish the Regulatory WACC. It is therefore appropriate to follow the process set out in paragraph 32 of the Investment Framework Principles to determine whether a Varied WACC is appropriate through testing if the relevant Significant Investment will have an impact on the gearing ratio or credit rating of QR Network, and thus on the assumptions which were used to calculate the Regulatory WACC. In the case of Funding Users, the initial work has not been done to establish what their cost of capital is (since there is no Regulatory WACC established on the basis of the Funding User's cost of funds).

In addition, the Regulatory WACC has been calculated on the basis of the risk profile associated with investment in Rail Infrastructure which is both owned and managed by QR Network and has the benefit of being operated as an entire network with a wide range of users. QR Network therefore has a much lower risk profile than a Funding User, which is investing in Rail Infrastructure which will be owned and operated by another party, which is geographically less extensive and is therefore more vulnerable to stranding risk and the risk of major adverse events and is also likely to have a narrower range of customers and therefore to be more exposed to the credit risk of those customers.

Therefore, Xstrata would propose that a Funding User should have a right to seek a Varied WACC for a Significant Investment which it is funding, based on the Funding User's cost of funds and the risks which are being assumed by the relevant Funding User in relation to the funding of the relevant Significant Investment.

Xstrata understands the concern, that this may result in other users of the Network paying higher Access Charges in order to fund the Varied WACC which has been approved by the QCA. However, other users would also have had the right to fund the Significant Investment and avoid the exposure to the higher Access Charges. In addition, the Funding Users will only be funding an amount of spare Capacity equal to the difference between the Access sought by them and 70% of the minimum efficient Extension size established as part of the Extension Process. There is no right for Funding Users to fund excessive amounts of Capacity in order to seek returns at the approved Varied WACC from future users; the only amounts of Capacity which may be funded in accordance with these provisions is the minimum amount necessary for the Funding Users to realise their Capacity requirements through the construction of the minimum efficient Extension size (as approved by the QCA in the event of any dispute).

If the QCA does not accept this proposal then the Funding Users will be placed in a situation of being forced to fund Capacity effectively at a loss (given that it is being funded at below the risk adjusted cost of capital of the Funding Users) in order to subsidise other users, including in situations where QR Network has refused to construct a Significant Investment and the Funding User has no practical alternative to funding that Extension through the User Funding Agreement process. Xstrata believes this result is inequitable and anti competitive and will not promote efficient economic development.

## 5. "No fetter" clause

Clause 11.4 of the Access Undertaking provides a general right for QR Network not to comply with the provisions of clause 11.3 of the Access Undertaking. Clause 11.3 of the Access Undertaking contains several of the most important provisions in relation to ensuring contract alignment and the proper assessment of Capacity in coal supply chains.

QR Network is entitled to fail to comply with these provisions where either inconsistent with QR Network's commercial objectives, or where exercising any discretion, power, function or right or its obligation to do anything in accordance with the Access Undertaking or any Access Agreement. Xstrata's concern is that the provisions of clause 11.4 are so broad as to effectively remove any certainty that the provisions of clause 11.3 would be enforceable.

Clearly, the preferable course would be for clause 11.4 to be removed, since the issues which it seeks to deal with are already addressed elsewhere to the extent that it is reasonable to do so. QR Network's legitimate business interests are already protected through the application of the principles of Division 5 of Part 5 of the Queensland Competition Authority Act 2007 (Qld) to the QCA's determination of issues arising under the Access Undertaking, given that the QCA would be obliged to take QR Network's legitimate business interests into account in accordance with section 120(1) (b) of the Act. Xstrata considers that any internal conflict between clause 11.3 of the Access Undertaking and other provisions should be resolved through the construction of the Access Undertaking as a whole. Xstrata does not consider that it is appropriate that Access Agreements should have the ability to override or impair the provisions of the Access Undertaking (including clause 11.3), at least in relation to Access Agreements entered into after the date of the Access Undertaking. This principle was recognised by the QCA when it required the amendment of clause 2.4(b) of the Access Undertaking and is already dealt with by that clause.

If the QCA does not support the removal of clause 11.4, Xstrata considers that it would be appropriate to restrict the scope of clause 11.4 through amendments as follows:

- (a) Clause 11.4(a) should be amended to provide that QR Network is obliged to comply with the provisions of clause 11.3 except to the extent that it would otherwise unreasonably interfere with its legitimate business interests. Xstrata considers that this formulation has several advantages:
  - (i) by being expressed as an exception, the probative burden of showing that the exception applies is with QR Network. On the basis of the current construction, it would effectively be for the party seeking to rely on a provision of clause 11.3 to show that the compliance was in accordance with QR Network's commercial objectives, when such a party would not be in a position to provide what those objectives were, nor what the impact of QR Network's compliance with clause 11.3 on those objectives would be;
  - (ii) through using the language of the Act and referring to "legitimate business interests", the proposed formulation uses a known statutory formulation and also reduces the possibility that any illegitimate or undesirable commercial objective of QR Network (for example to reduce

competition, or to maximise revenue through an abuse of its monopoly position) could be taken into account; and

- (iii) the inclusion of a reasonableness requirement means that any consideration of the application of the exception would have to take into account the proportionality of the impact on QR Network's legitimate business interests.
- (b) Clause 11.4(b) should be amended to provide that QR Network is not obliged to do anything which would unreasonably impact QR Network's ability to comply with the Access Undertaking or any Access Agreement entered into prior to the date of the Access Undertaking. Xstrata considers that this formulation is preferable because:
- (i) again, the inclusion of a reasonableness requirement has the benefits set out above;
  - (ii) the inclusion of a consideration of whether the provisions of clause 11.3 impact any discretion, power, function or right under the Access Undertaking or Access Agreement is too broad and uncertain. It is possible to determine with a reasonable degree of certainty what QR Network's obligations are in accordance with the Access Undertaking and Access Agreements. However, QR Network's discretions, powers, functions or rights are far broader and harder to ascertain. Xstrata considers that to allow QR Network to fail to comply with the provisions of clause 11.3 based on adverse impacts on this very broad range of activities introduces too high an element of uncertainty into the enforcement of clause 11.3; and
  - (iii) in accordance with the QCA's position on clause 2.4, by excluding new Access Agreements, QR Network is prevented from "gaming" the system through the entry into of new Access Agreements which would allow it to evade the provisions of clause 11.3. Xstrata considers that QR Network should take into account the requirements of clause 11.3 when entering into future Access Agreements.

## 6. Defined terms

Capitalised terms which are set out in this submission which are not defined in this submission have the meaning given to them in the QCA Final Decision, the Access Undertaking or the Investment Framework Principles (as appropriate).

Please do not hesitate to contact my office in relation to this letter.

Yours sincerely

Reinhold Schmidt  
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Xstrata Coal Queensland Pty Ltd