Submission to the Queensland Competition Authority

QR Network – Standard User Funding Agreement

Anglo American Metallurgical Coal Pty Ltd

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1. Executive Summary

Anglo American Metallurgical Coal Pty Ltd (**AAMC**) welcomes the opportunity to make submissions to the Queensland Competition Authority (**QCA**) in respect of the Draft Amending Access Undertaking (**DAAU**) and Standard User Funding Agreement (**SUFA**) submitted by QR Network to the QCA on 24 December 2010.

It is understood that the QCA is undertaking two separate processes, being:

(a) drafting amendments to the Access Undertaking 2010 (**UT3**) to incorporate the investment framework and the SUFA; and

(b) considering whether to approve or refuse to approve other amendments contained in the DAAU.

AAMC recommends that the QCA, in drafting the amendments to UT3, take into account the amendments suggested in this submission in respect of the incorporation of the investment framework and, otherwise, refuse to approve the amendments contained in the DAAU. AAMC believes that the SUFA requires extensive amendments before it would represent a user funding model which is bankable and workable. It is essential that the user funding model which is both bankable and workable to ensure that it operates, as it was intended, to constrain the market power of QR Network. Although AAMC does not believe that the QR Network draft DAAU and SUFA are an appropriate starting point for the user funding model, it has suggested amendments below to illustrate particular points.

In general terms, AAMC supports the submissions of the Queensland Resource Council (**QRC**) and has attempted not to repeat submissions made by the QRC in this submission. The purpose of this submission is to provide additional submissions or alternative proposals. There is some cross-over and repetition due to the short period of time in which submissions have needed to address very complex issues.

Phrases which are capitalised but not defined in this submission are a reference to the definition of that phrase as used in the SUFA or the DAAU, as the context requires.

2. General Comments – Risk Allocation described in the Explanatory Notes

By way of preliminary observation, AAMC wishes to comment upon the risk allocation issues raised in the Explanatory Notes to the "24 December 2010 Draft Amending Access Undertaking", circulated on 27 January 2011.

QR Network states that under a User Funding Model there are a number of risks which will be assumed by QR Network and which will not be compensated under the User Funding Model and that compensation for these risks should be incorporated[1]. Those risks include:

(a) regulatory error;

(b) forecast and scope error;

(c) derailment and weather related impacts;

(d) asset stranding risk[2]; and

(e) performance risk.

Each of these risks is addressed separately below.

2.1 Regulatory Error

The Explanatory Notes state that the predominant source of risk relates to the consequences of regulatory error in the approval of maintenance costs on the basis that there are no readily comparable railway networks which provide an effective benchmarking maintenance cost.

There are no regulatory precedents of compensation being factored into a regulatory decision for the risk of regulatory error relating to pricing decisions of economic regulators.

In another context, the Australian Competition Tribunal has found that "it is doubtful that the Tribunal is entitled to assume that the decision-makers regulating Part IIIA will make errors"[3]. Regulators have also expressed the opinion that regulators are "well aware of the scope of regulatory error" and as a consequence tend to be "conservative in their selection of parameter values for the key costs of capital components"[4]. Therefore, there is no regulatory precedent and no compelling reason for the compensation of regulatory error.

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[1] Page 21 of the Explanatory Notes and the attached report by Synergies Economic Consulting, "Compensations for Operation and Maintenance of User Funded Assets", January 2011 (**Synergies Report**).

[2] Page 21 of the Explanatory Notes states that QR Network is not compensated for asset stranding risk. However, we note that the Synergies Report states that asset stranding risk under the User Funding Model has been shifted to funding users in respect of the portion of the assets funded by users, see page 8.

[3] *Re Fortescue Metals Group Ltd* [2010] A Comp T 2 at [823].

[4] Ed Willet, "A Regulatory Framework for the 21st Century", Vector Policy Forum, New Zealand, 23 March 2007.

In any event, as the coal producers pay for operation and maintenance costs through the Reference Tariff, any risk of regulatory error is currently symmetrical. That is, if the QCA makes a regulatory error in the approval of maintenance costs by under-valuing those costs, then QR Network bares the risk of not being able to recover costs incurred from the users, whereas, if the QCA makes an error by over-valuing the maintenance costs then the coal producers bare the risk of paying for the over-valuation.

There is economic literature to support the fact that it is unconscionable to have a regulatory framework where either the users or the service provider are solely exposed to the risk of regulatory error[5].

If the User Funding Model was to be re-designed to attempt to compensate both coal producers and QR Network for regulatory error there would be significant difficulties encountered in attempting to value any such compensation.

In light of the above, there is no justification for the compensation of regulatory error in the User Funding Model.

It is for this reason that AAMC strongly objects to the amendments put forward by QR Network to clause 7.5.5(l) of UT3.

2.2 Forecast and Scope Error

QR Network states that the forecasting of maintenance costs and the scope of maintenance activities is subject to the risk that the required maintenance scope is materially different from that originally assumed to the dynamic operation of the rail network[6].

UT3 provides two important protections for QR Network in respect of maintenance costs, being:

(a) each year during the Revenue Cap adjustment process, maintenance costs are increased in accordance with the Maintenance Cost Index (**MCI**) which, importantly, protects QR Network from significant variations in maintenance costs due to issues such as the fluctuation of fuel and labour costs; and

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[5] A Kahn, "Competition and stranded costs re-revisited" (1997) 37 Nat. Resources. 29,34; J McArthur, "Cost responsibility or regulatory indulgence for electricity's stranded costs?" (1998) 47 Am. U. L. Rev. 755,889; J Poff, "Determination of the allowable rate of return by the Texas Public Utilities Commission" (1979) 57 Tex. L. Rev. 289,293.

[6] Page 23 of the Explanatory Notes.

(b) the ability of QR Network to amend the Reference Tariff where maintenance costs, which have been prudently and efficiently incurred, exceed the forecast cost by 2.5% as a Review Event under Schedule F of UT3.

These are more than adequate protections for QR Network for any error it may make in forecasting the maintenance costs or the scope of maintenance activities.

There is sufficient regulatory precedent to show that these protections adequately protect QR Network. In 2007, QR Network sought approval from the QCA to increase its reference tariffs in the central Queensland coal region (**CQCN**) on the basis that it had "grossly underestimated its maintenance expenditures observed to date and expected in the future"[7]. QCA recognised that maintenance costs had increased since the development of QR Network's maintenance forecasts and, accordingly, approved the increased reference tariffs based on the revised maintenance costs of $98.2 million in 2007 - 2008 and $102.5 million in 2008 - 2009, providing QR Network with an additional $38.6 million[8]. QR Network is currently seeking approval of its adjusted maintenance cost allowance for 2009 - 2010 which is $1.5 million greater than its original forecast[9].

2.3 Derailment and weather related impacts

In respect of derailments, such liabilities are an operational risk addressed through the insurance (including self-insurance) allowance which is currently provided for in UT3. At the time that QR Network made its submissions in respect of the allowance for self-insurance[10], QR Network and the QCA were both aware of the fact that significant capital expenditure was to be made in respect of the network resulting in a number of extensions and expansions. For example, the Coal Rail Infrastructure Master Plan (**Master Plan**)[11] set out a number of projects or either expansion or extensions of the network, most of which have the approval of users. The User Funding Model is most likely to be used for the funding of projects which have already been identified through the Master Plan. It would seem unlikely in the near future that users will choose to fund an expansion or extension which has not currently been identified as an appropriate project. Therefore, it should be assumed that

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[7] *Decision on QR's Draft Amending Access Undertaking: Coal System Maintenance Costs* (November 2007)

[8] *Ibid.*

[9] *QR Network Access Undertaking (2008): Revenue Adjustment Amounts (2009/10 Revenue Cap)* (November 2010).

[10] *Submission on QR Network Access Undertaking (2009): Western System Coal Tariff Development* (September 2008).

[11] *Coal Rail Infrastructure Master Plan* (2008).

the submissions in respect of self-insurance were made on the basis of the current expected projects. It is irrelevant whether these projects are funded by QR Network or users.

In respect of weather related incidents, QR Network has the protection from insurance and the further protection that it can seek a variation of the Reference Tariff if a Force Majeure Event (which includes a flood) affects QR Network such that it will incur additional costs of greater than $1 million. This is adequate protection against the risk of weather related impacts. It is inappropriate for QR Network to seek to remove all risk relating to weather and therefore the $1 million threshold is appropriate. In fact, it is arguable that the threshold is too low as it requires the users to bare a significant proportion of the risk in respect of any serious weather related incident.

Although it is not entirely clear what is meant by "performance risk" in the amendments to clause 7.5.5(l), if it is a reference to the types of risks dealt with in this section then AAMC strongly objects to the amendments put forward by QR Network to clause 7.5.5(l) of UT3.

2.4 Asset Stranding Risk

QR Network states that funding users may be prepared to inefficiently expand the rail network as it may be prepared to underwrite the stranding risk through the resource rent accruing to the mining project. QR Network goes on to state that where assets become stranded the funding users may recover the economic cost of the infrastructure enhancement through the mining project and transfer a portion of that risk to QR Network's existing assets[12].

It is difficult to see how any asset stranding risk will be transferred to QR Network. The User Funding Model which has been put forward by QR Network ensures that QR Network has no asset stranding risk through the following mechanisms:

(a) QR Network will enter into Access Agreements which contain a 100% take-or-pay commitment; and

(b) volume risk is entirely taken by funding users through the mechanism that QR Network will only make a distribution payment to funding users if there is sufficient access fees collected to cover the operation and maintenance costs.

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[12] Page 24 of the Explanatory Notes.

3. Approach to Risk Allocation in the SUFA

QR Network has stated that it is not willing to take any risk as to user funded infrastructure costing QR Network any amount, for example, QR Network has said that it will take no risk on tax liability and therefore requires a full tax indemnity.

In circumstances where QR Network refuses to take any cost risk then it should also not be entitled to any potential benefit from user funded infrastructure.

The SUFA as originally drafted by QR Network contains the following risk allocation:

(a) The funding users taking the risk on cost over-runs with QR Network having at risk only a portion of its incentive payment (but no part of the costs itself);

(b) The funding users taking the risk on time over-runs with QR Network having at risk only a portion of its incentive payment;

(c) The funding users taking the volume risk; and

(d) To the extent that there is any stranding risk the risk is borne by the users (which is dealt with above).

3.1 Cost Overruns

Under clause 3.3 of the SUFA QR Network only has to use reasonable endeavours to ensure that the costs for each Customer's Segment do not exceed the Target Costs. This does not provide any incentive for QR Network to incur costs on an efficient basis. Historically, QR Network has not operated on an efficient basis. By way of example, QR Network's operation costs have historically included significant wages and immediately upon the Initial Public Offering (**IPO**) QR Network announced that it was able to cut a third of its staff. In circumstances where the users are funding the extension, there would be sufficient protections to ensure that QR Network is only incurring efficient costs.

QR Network may argue that it has an incentive to incur costs efficiently because it has included an incentive payment in the SUFA but the draft SUFA allows for an incentive payment to be made even if the project was over budget by 20%. In fact, the incentive payment structure may provide QR Network with an incentive to over inflate the Target Cost.

AAMC's most significant concern with the obligation on QR Network being limited to using reasonable endeavours to ensure that costs do not exceed the Target Costs is that this issue, in conjunction with the fact that the funding users will have no security over the revenue generated by the user funded Extension, will make any Extension project un-

bankable. That is, third party financiers will not invest money in the project. This is of serious concern to AAMC because without user funded projects being bankable, the Investment Framework will not achieve its stated outcome of limiting monopoly power.

The User Funding Model needs to be workable to ensure that the issues identified in AAMC's submission to the QCA dated 12 February 2010 are addressed. In particular, an unworkable User Funding Model will not address the issue identified on page 18 of that submission of "investment hold-up", whereby QR Network can refuse to build what is considered to be strategically important rail infrastructure until coal producers pay returns higher than the regulated return. Although UT3 has limited the ability of QR Network to impose unreasonable Access Conditions (and, in particular, the ability of QR Network to seek returns above appropriate regulated returns) this does not, by itself, limit the ability of QR Network to engage in "investment hold-up" as QR Network can just refuse to build the infrastructure if it is unhappy with the Access Conditions approved by the QCA. It is for this reason that it is critical that the User Funding Model is a workable, and bankable, model.

QR Network circulated a second draft of the SUFA which included clause 7.15 which provides for a limited refund of imprudent costs. AAMC believe that this provision is too narrow. Clause 7.15 seeks to differentiate between costs which are:

(a) not reasonable having regard to the scope and standard of work, in which case a refund is given; and

(b) not accepted by the QCA on the basis of prudency of scope and/or prudency of standard of work, in which case no refund is given.

This approach does not provide any incentive for QR Network to ensure that the scope, standard of work nor actual costs incurred are efficient. In fact, it will give QR Network an incentive to over-inflate the scope and standard of works (on the basis that if the scope and standard of works are over-inflated then it is harder to argue that costs are not reasonable having regard to that scope and standard of work). If the QCA does not accept capital expenditure into the Regulatory Asset Base (**RAB**) on the basis that the scope or standard of work are imprudent, then under clause 7.15 this risk is entirely with the funding users because:

(a) under clause 7.15(d)(i) the costs are not refunded to the funding users; and

(b) the exclusion of the costs will result in lower revenue (on the basis that the Reference Tariffs will be lower) and therefore there will be less revenue to return to the funding users under the Participation Agreement.

The approach suggested by QR Network is inconsistent with principle 25 of Schedule J which requires that QR Network absorb all cost overruns which are not prudent.

In developing a balanced approach to the refund of imprudent capital expenditure it is desirable that the approach is consistent with the principles currently contained in UT3.

Under UT3, the QCA must accept the scope of a capital expenditure project if it has been approved by a Customer Group in accordance with clause 3.2.2 of Schedule A of UT3. A Customer Group does not approve either the standard of works or the costs. These are assessed by the QCA in accordance with the terms of Schedule A.

Therefore, the most appropriate approach to the refund of imprudent capital expenditure would be as follows:

(a) the QCA is obliged under the Access Undertaking to accept the scope of the capital expenditure (on the basis that the funding users have agreed to the scope as part of the negotiation of the SUFA and this is analogous to Customer Group acceptance under clause 3.2 of Schedule A of UT3); and

(b) if the QCA finds that standard of works or costs are imprudent then these are refunded to the funding users.

In AAMC's view, the appropriate scope of clause 7.15 of the SUFA is as follows:

7.15 Exclusion of imprudent costs

(a) QR Network must seek to include the Extension Costs for each Customer's Segment ~~and the Final CIP Adjustment Amount for each Customer's Segment~~ into the Regulatory Asset Base ~~when required under~~ in accordance with the Access Undertaking.

(b) ~~Subject to clause 7.15(c), i~~If the QCA makes a decision not to accept part of the Extension Costs for a Customer's Segment into the Regulatory Assets Base on the basis of prudency of ~~that the~~ standard of work or costs ~~Extension Costs for the Customer's Segment were not reasonable having regard to the scope and standard of work done~~ (Not Prudent), including and Extension Costs which were Not Prudent because of the procurement methodology adopted by QR Network, QR Network must pay the refund Amount for the Customer's Segment to the Customer by the refund Date for the Customer's Segment.

~~(c)Clause 7.15(b) does not apply, and QR Network will have no obligation to pay any amount to the Customer, in respect of a Customer's Segment if the Extension Costs for the Customer's Segment are less than or equal to the Target Costs for the Customer's Segment.~~

~~(c)For the avoidance of doubt, QR network will have no obligation to pay any amount to the Customer under this clause 7015 or otherwise, in the event~~

~~that the QCA does no accept the whole or part of:~~

~~(i)the Extension Costs for a Customer's Segment into the regulatory Asset Base on the basis of prudency of scope and/or prudency of standard of work; or~~

~~(ii)the Final CIP Adjustment Amount for a Customer's Segment into the Regulatory asset Base on the basis of prudency of costs.~~

In circumstances where QR Network has expressed the view that it will not accept any risk or costs then it should equally take no benefit. It is for this reason that AAMC believes that clause 7.15(c) of SUFA should be removed altogether.

There would need to be consequential changes to the following:

(a) clause 3.1.1(a)(ii) of Schedule A of UT3 would need to be amended to so that the QCA will accept the scope of a capital expenditure project as prudent if the scope of the capital expenditure has been accepted by a Customers Group in accordance with clause 3.2.2(f) "or by Funding Users of a User Funded Extension"; and

(b) the definition of "Excluded Amount for a Customer's Segment" would need to be amended as follows:

> **Excluded Amount** for a Customer's Segment means~~:~~
>
> ~~(a)~~ the amount of the Extension Costs for the Customer's Segment which the QCA does not accept into the Regulatory Asset Base on the basis that the Extension Costs for the Customer's Segment were Not Prudent~~; less~~
>
> ~~(b)any Procurement Methodology Excluded Amount for the Customer's Segment.~~

This amendment might not be necessary if the QCA approves a Procurement Methodology for User Funded Extensions. However, QR Network has not proposed a methodology (that is, Schedule 6 is blank). In circumstances where the Procurement Methodology is not approved by the QCA, it should be open to the QCA to refuse to accept costs incurred under the procurement methodology adopted by QR Network as Not Prudent.

It is usual in construction contracts for the construction costs to be fixed but subject to an increase which has been agreed by the parties, or failing agreement, by an independent expert. AAMC accepts that there may be particular issues (for example latent defects in geology) which may increase the costs beyond the agreed costs. However, in

circumstances where QR Network is taking no risk on costs and has no direct incentive to efficiently incur costs the appropriate balance is:

(a) QR Network and the Funding Users agree costs at the beginning of the project; and

(b) those "Agreed Costs" can be increased where:

(i) the Funding Users and QR Network agree to the increase; or

(ii) where there is not unanimous agreement, an independent expert considers the increase is necessary and reasonable.

The SUFA therefore should remove the "reasonable endeavours" requirements and references to "Target Costs" to "Target Available Date" and impose an obligation to deliver the project in accordance with the "Agreed Costs" and before the "Agreed Available Date". There should then be an ability for the "Agreed Costs" and "Agreed Available Date" to be varied by agreement or, failing agreement, by an independent expert. The independent expert should have the ability to increase the "Agreed Costs" or extend the "Agreed Available Date" where the variation is both necessary and reasonable.

The SUFA should remove the distinction between "Scope Change Event" and "Adjustment Event" (because where there is a true Scope Change Event the independent expert will adjust the costs and there is no justification for unilateral variation of any costs) and allowed for the independent expert to increase the costs where the increase is necessary and reasonable.

The QRC submission has recommended that the payments to contractors be made directly from the funding users to contractors. In those circumstances it will still be necessary to have a regime of "Agreed Costs" as QR Network will still have some costs of interacting with the contractors.

3.2 Time Risk

The SUFA also imposes all time risk on the funding users. Clause 3.4 of SUFA provides that QR Network's only obligation is to use its reasonable endeavours to ensure that each Customer's Segment becomes Available by the Target Available Date for the Customer's Segment. Clause 3.5 of SUFA provides that QR Network has no liability for late delivery except for a reduction in the incentive payment. Schedule 11 of SUFA provides that QR Network can still receive an incentive payment if it is 180 days late (ie 6 months).

Construction contracts (as opposed to Alliance Contracts) would usually have a fixed date and late delivery would result in liquidated damages. An Alliance Contract is not an

appropriate analogy to the SUFA because under an Alliance Contract QR Network would have to take some risk. In circumstances where QR Network refuses to take any risk on cost or time an Alliance Contract model is not appropriate.

AAMC accepts that there may be particular issues (for example latent defects in geology) which may increase the construction time beyond the agreed timeframe. However, in circumstances where QR Network is taking no risk on time and has no direct incentive to deliver the project on time the appropriate balance is:

(a) QR Network and the Funding Users agree the timeframe at the beginning of the project;

(b) The "Agreed Availability Date" can be extended where:

  (i) the Funding Users and QR Network agree to the extension; or

  (ii) where there is not unanimous agreement, an independent expert considers the extension is necessary and reasonable.

The approach adopted in the marked-up SUFA attached to this submission amends "Target Available Date" to "Agreed Available Date" and includes the ability for an independent expert to extend the timeframe if it is necessary and reasonable.

One way of mitigating the time risk to funding users is an appropriate "step-in" clause. The approach of QR Network in clause 24 of the SUFA of engaging a managing contractor to finish the project is one appropriate solution. However, it contains elements which are not appropriate, including:

(a) the trigger of 6 months is too long, but the time the trigger has been satisfied the delay is likely to be more than 1 year (6 months to trigger the step-in and 6 months for the contractor to finish the project) and therefore AAMC believes the trigger should be three months; and

(b) QR Network should not engage the managing contractor but the managing contractor should be jointly engaged by the funding users (and therefore report to, and be responsible to, the funding users).

QR Network's commercial interests are adequately protected by the requirement that the project continue to be built to QR Network's standards as specified by QR Network.

However, funding users should have the option of appointing a managing contractor or exercising the step-in rights themselves.

3.3 Volume Risk

QR Network has no volume risk under the SUFA for the following reasons:

(a) QR Network will require 100% take or pay contracts for the expansion capacity;

(b) even if it did not, the fundamental structure involves funding users paying full system Reference Tariffs and receiving a separate revenue stream so that if volume is lower than expected the revenue stream will be lower; and

(c) QR Network will not be exposed to outstanding operation and maintenance cost risk as these are variable costs so that if the volume is lower then the operation and maintenance costs are lower and, in any event, any risk of shortfall in operation and maintenance expenditure will be mitigated by the operation of the revenue cap model.

AAMC accepts that the funding users must take the volume risk. To manage this risk, QR Network should require all funding users to enter into 100% take or pay contracts for a period of at least 10 years.

3.4 Incentive Payments

The incentive payment model incorporated into the SUFA does not have the benefit of ensuring that QR Network will be efficient in terms of costs or delivery of the project. In fact, it gives QR Network an incentive to over-inflate the “Target Costs” and “Target Availability Date”.

The incorporation of an incentive payment (which must be negotiated on a case-by-case basis) allows QR Network scope to choose an incentive payment which makes the User Funding Model uncompetitive, such that the User Funding Model is unworkable. The coal producers will have no leverage in the negotiation of the incentive payment.

If QR Network takes no cost, time, volume or taxation risk under the SUFA then it should not be entitled to take any benefits. Therefore, AAMC believes that the question of an incentive payment should be removed from the SUFA entirely. It would remain possible for QR Network and funding users to negotiate an incentive payment on a particular project (for example, where QR Network agrees to take some risk on the project) but there should not be a default position in the SUFA where QR Network takes no cost, time, volume or taxation risk and is entitled to any form of incentive payment.

For the same reasons the SUFA should not contain the 4% fee in clauses 7.2(a)(ii) and 7.2(b)(ii). This fee has not been explained by QR Network and therefore should not be allowed.

Any form of incentive payment or other fee is inconsistent with principle 25 of Schedule J.

3.5 Varied WACC

In circumstances where QR Network does not retain the Weighted Average Cost of Capital (**WACC**) component of the Reference Tariffs but returns any revenue earned to the funding users, it has no incentive to seek a Varied WACC from the QCA in circumstances where that is appropriate.

Therefore, either the DAAU or the SUFA should impose an obligation upon QR Network to seek a Varied WACC if requested to by the funding users. Funding users should have the ability to provide submissions directly to the QCA on the appropriateness and level of the Varied WACC.

3.6 Under-delivery of Capacity

The fundamental concept of the SUFA is that the funding users agree to pay a certain amount of capacity expenditure for a certain amount of capacity. It is a significant risk to the funding users that they agree to pay but the amount of capacity is not delivered.

Consistently with principle 14 of Schedule J of UT3, QR Network must fund any Infrastructure Enhancements necessary to catch-up the under-delivered capacity up to $300 million. Clause 7.5.4(a)(ii) provide that QR Network will undertake and fund all Extensions that are needed to provide sufficient capacity where a compression of capacity has occurred under clause 11.3 of UT3. Clause 7.5.4(a)(ii) does not contain a $300 million cap, however, it only applies in circumstances where there are conditional access agreements. The DAAU should:

(a) clarify that there is no cap where conditional access agreements have been entered into between QR Network and the funding users. This is appropriate because otherwise funding users would have entered into access agreements which contain a 100% take or pay clause and their capacity is compressed but there is no obligation on QR Network to catch-up the capacity. This could leave the funding users with less capacity then they required (and had paid for) and exposed to pay the take or pay charges; and

(b) there is a $300 million cap where conditional access agreements have not been entered into (which might occur if QR Network does not sign the access agreements

until it knows what capacity has been delivered) which may be appropriate because whilst the funding users have not obtained the capacity they required they, at least, are not exposed to take or pay obligations.

UT3 should include some administrative requirements around this obligation including a timeframe within which the Infrastructure Enhancements must be delivered.

The SUFA should be amended to ensure that the following are included:

(a) a specific obligation upon QR Network to ensure that the Customer's Segments are capable of delivering the Customer's Capacity, which will give QR Network an incentive to properly plan for the delivery of the capacity contracted for by the funding users;

(b) an obligation to ensure a capacity review prior to commencing construction and within 6 months of finishing construction to assess whether the capacity has been delivered (which could be based upon the "Change in Existing Capacity" process in clause 11.3(c) but must apply to both the circumstances where there are condition access rights and where there are not conditional access rights);

(c) an obligation to commence planning for the Infrastructure Enhancements immediately upon determining that there has been an under-delivery of capacity; and

(d) an obligation to finish the Infrastructure Enhancements within a timeframe agreed between the parties or, if no agreement, by the independent expert.

This will require some flow-on amendments to the DAAU. For example, the insertion of the words "(except where the reductions relate to a User Funded Expansion)" in clause 7.5.4(a)(ii) and the exclusion of "catch-up" capacity more generally in clause 7.5.4(a), is inappropriate.

The clear obligation in the current drafting of clause 7.5.4(a)(ii) of UT3 and principle 14(c) of Schedule J is that QR Network would fund all catch-up capacity where there has been a compression of capacity of conditional access rights. The amendments referred to in the previous paragraph undermine this clear obligation.

4. Tax Considerations

The QRC submission deals with the tax considerations of the most appropriate structure for the SUFA.

In general terms, AAMC supports the QRC submissions in respect of tax considerations. AAMC agrees that further consideration needs to be given to these issues, and that flexibility needs to be retained.

In respect of the tax indemnity AAMC is of the view that if QR Network does not wish to put forward an Alliance Contract model (ie the sharing of risks) then it may be necessary for the SUFA to have a tax indemnity but that the current version of the tax indemnity is not appropriate and should be amended to:

(a) impose a specific obligation upon QR Network to adopt the most efficient tax structure from the perspective of both QR Network and the funding users;

(b) if there is a detrimental impact upon QR Network's position then this should be indemnified by the funding users;

(c) if there is a beneficial impact upon QR Network's position then this should be refunded to the funding users; and

(d) at any time until the completion of construction, if there is a change in tax position which is detrimental to the funding users, they should have the option of abandoning the project and paying all outstanding costs.

5. Security

The requirement contained in clause 9 of the SUFA as drafted by QR Network for bank guarantees for the entire construction costs is unnecessary and expensive.

There are a number of the coal producers who have significant assets and QR Network would be adequately protected if these coal producers were to provide a company guarantee signed by an Australian parent company.

AAMC believes that an approach which would adequately protect QR Network's position without putting all coal producers through the unnecessary expense of a bank guarantee would involve:

(a) amendments to the SUFA so that a parent guarantee is sufficient where the coal producer has an investment grade credit rating or is part of a corporate group (global or Australian) with a market capitalisation of more than $10 billion;

(b) otherwise, a bank guarantee can be required at QR Network's election; and

(c) in any event, the guarantee need only cover outstanding costs (which would allow coal producers to reduce their guarantee payments as the construction proceeds).

6. Socialisation

The DAAU submitted by QR Network provides in clause 6.4.2(a)(iii) that QR Network will submit a proposed Reference Tariff for a new Reference Train Service if the inclusion in the RAB of the asset value for a Significant Investment will increase the Reference Tariff for an Individual Coal System by more than 20%.

It is understood that this was intended to operate so that:

(a) if the inclusion of the Extension in the RAB increases the Reference Tariff by any amount up to 20% then the capital expenditure of that Extension would be included in the RAB and "socialised" across all users of the system (that is, the current Reference Tariff would increase for all customers including those who were existing users and did not obtain any further capacity under the Extension); and

(b) if the inclusion of the Extension in the RAB increases the Reference Tariff by more than 20% then the capital expenditure of that Extension would not be included in the RAB and there would be no "socialisation" but that QR Network would seek a new Reference Tariff which would only apply to the expanding users (ie users obtaining capacity because of the Extension). This would mean that expanding users would pay the full incremental costs of the Extension.

There have been a number of options discussed by coal producers as to the most appropriate approach which have been summarised in the table below.

Option	Description of the Option
1.	No socialisation – every user funds the Extension where they need expansion capacity.
2.	Socialisation across the system up to 20% and if the tariff would be impacted by more than 20% there is no socialisation (this is the option which has been incorporated into the DAAU submitted by QR Network).
3.	Socialisation across the system up to 20% and then expanding users pay a premium beyond the 20% to fund the Extension.
4.	Existing users remain on their current tariff, expanding users pay a premium, socialisation occurs between expanding users on all subsequent Extensions.
5.	Existing users are socialised up to 20%, expanding users pay a premium, socialisation occurs between expanding users on all subsequent Extensions.

AAMC does not support socialisation. This was discussed in details in its submission on UT3 lodged on 12 February 2010.

On the CQCN, socialisation has the effect of existing users cross-subsidising new users. This cross-subsidisation may involve a significant increase in Reference Tariffs for existing users. Existing tariffs are significantly lower than the tariffs which result from a full incremental approach. In part, this is because the existing Reference Tariffs took into account user contributions. In these circumstances it is inequitable to socialise between existing and new users.

This inequality can most clearly be seen when a new coal basin is being connected. An existing user who has no interests in the new coal basin will be paying significantly higher Reference Tariffs in circumstances where it will obtain no benefit from the upgrade.

Another significant issue that AAMC has with socialisation is that it does not protect against the risk of existing users being forced to pay for imprudent future expansions. It is well known that there is a risk that in times of high commodity prices, expansions can occur which do not adequately take into account the fact that commodity markets are cyclical. A recent article in the Australian Financial Review discusses this risk (see Attachment A). Existing users should not have to bear the cost of this risk.

7. Process to Agree a User Funding Agreement

The DAAU does not attempt to set out a process or timelines for the negotiation of a User Funding Agreement.

AAMC's preference is that UT3 should set out such a process (like it does for the negotiation of Access Agreements).

The DAAU needs to address how the process sits with the current processes in UT3. One option would be for potential funding users to trigger the process in clause 7.5.2. This would be consistent with clause 12 of Schedule J which requires that all potential users be given an opportunity to participate. However, in these circumstances the 70% trigger may not be appropriate because funding users may not be sure of what interest there is in funding the Extension in question.

QR Network should also be subject to an obligation in the DAAU to negotiate in good faith. This could be achieved by a section clause 7.5.6 which sets out the process and includes the following clauses:

7.5.6 Process for negotiating a User Funding Agreement

(a) QR Network must negotiate the terms of a User Funding Agreement in good faith.

(b) The Dispute resolution process under clause 10.1 may be initiated if:

(i) at any time during the Negotiation Period, an Access Seeker or Customer who intends to enter into a User Funding Agreement, believes that QR Network is not negotiating in good faith; or

(ii) the Access Seeker or Customer and QR Network do not enter into a User Funding Agreement within 6 months of the commencement date of the Negotiation Period.

Other minor issues relating to the DAAU:

(a) AAMC is unsure of the meaning of the words “as between QR Network and those Access Seekers and Customers” as inserted into clause 7.5.5(b); and

(b) it is unclear why QR Network has removed the qualification on clause 7.5.5(e) which stated “except for any funding which QR Network is obliged to fund in the circumstances set out in paragraph (f). If the qualification is not present then there will be an inconsistency between paragraph (e) (which requires Access Seekers to fund all the projected cost of an Expansion) and paragraph (f) (which requires QR Network to fund some of the costs in certain circumstances).