

18 March 2011

QRC's commentary on Construction Agreement

Purpose

This document sets out the QRC’s comments on the Construction Agreement (including changes which should be made to the Construction Agreement). The comments set out below are not exhaustive. Where a provision is not commented on it is not to be taken as accepted by the QRC.

In addition to the comments set out below the QRC proposes to provide a mark-up of the Construction Agreement.

References to clause numbers in the table below are references to clauses of the Construction Agreement.

Definitions

Construction Agreement means the draft construction agreement submitted by QR Network to the QCA for approval.

Funding User means a ‘Customer’ under the Construction Agreement.

Participation Agreement means the participation agreement submitted by QR Network to the QCA for approval.

QR Network means QR Network Pty Ltd.

Item	Clause	Issue	Comment
Tax risk and QR Network as a construction contractor			
1	3, 23	<p>QR Network has proposed that it engage the contractors that will supply equipment and construct the Extension.</p> <p>Under this arrangement, QR Network will act as the construction contractor to the funding users.</p> <p>QR Network has assumed that it would be entitled to an immediate tax deduction for all costs incurred in constructing a user funded Extension.</p> <p>There is some uncertainty as to whether this is a valid assumption, as evidenced by QR Network’s intention to seek a private ruling on the matter from the Australian Taxation Office.</p>	<p>Tax risks</p> <p>The model proposed by QR Network creates an unusual and significant tax-related risk for Funding Users in that the Funding Users may have to compensate QR Network as a result of QR Network not being able to obtain a specific income tax treatment of its construction costs (through the indemnity referred to).</p> <p>As a result, the Funding Users will effectively bear the tax risk twice in respect of a single payment – first, the Funding Users will bear the tax risk regarding the treatment of their own payments made to QR Network; second, the Funding Users will bear the tax risk regarding the treatment of subsequent payments made by QR Network to the constructors.</p> <p>How the tax risk can be mitigated</p> <p>The tax risks noted above can be mitigated if the Funding Users engage the construction contractors directly or if QR Network engages the construction</p>

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		<p>To protect itself against that tax risk QR Network has proposed a full form indemnity that transfers any tax risk to the funding users.</p>	<p>contractors as agent for the Funding Users.</p> <p>Under this model (referred to as the ‘direct contractor model’) QR Network does not carry any tax risk.</p> <p>Please refer to the advice of Greenwoods and Freehills for more details.</p> <p>Proposed QRC model – ‘direct contractor model’</p> <p>The QRC propose that QR Network should:</p> <ul style="list-style-type: none"> • be engaged by the Funding Users as project manager for the whole Extension; and • engage construction contractors and other contractors as undisclosed agent for the Funding Users. <p>Under this direct contractor model, QR Network would maintain day to day responsibility for the project. QR Network would solely undertake all of the interface with contractors (including tendering, tender assessment, negotiation, preparation of contracts, award of contracts and contract administration). Funding Users would not have any interface with contractors (other than step-in rights). As undisclosed agent, contractors would not be aware that QR Network acted on behalf of the Funding Users. Therefore, on a day to day basis, QR Network’s roles and responsibilities would not in practice change from that which QR Network contemplated under its draft.</p> <p>The agency arrangement would however require the Construction Agreement to deal with the following issues:</p> <ul style="list-style-type: none"> • the agency arrangement would create a legal liability between the contractor and Funding User. Provisions would need to be inserted into the Construction Agreement which acknowledged that a Funding User’s liability for costs in relation to the Extension were capped at its proportional share of the “Extension Costs”. Consistent with the current draft of the Construction Agreement, Funding Users should not bear the risk of another Funding User’s payment defaults – this risk should be accommodated with QR Network because it is the only party that can assess the creditworthiness of its counter-party and mitigate against this risk through a bank guarantee, parent company guarantee or other form of security (including access to cash on account of the user-funder or a letter of credit). • Funding Users would acknowledge that they cannot exercise their rights as

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			<p>principal (through the agency arrangement) other than as described in the Construction Agreement (in other words, through the User Committee). It would not be practicable for Funding Users to be unilaterally making decisions and directing the contractors. Funding Users would need to act through a committee (please see our comments at Item 4) and then the implementation of that committee's decision would be through QR Network only (the only exception being the Funding Users' step-in rights). QR Network would essentially act as the arms and legs of the User Committee. This is akin to an EPCM contracting model which is very common in construction projects.</p> <p>It can be seen from the above that the direct contractor model is in practice not all that different from the QR contractor model. It carries the significant benefit that it removes any tax risk for QR Network and any does not create a 'doubling-up' of the tax risk for Funding Users.</p> <p>On the basis of the above, the whole of clause 23 (and corresponding definitions such as cost allocation principles) should be deleted from the Construction Agreement.</p>

Scope of works, target cost, target schedule and procurement methodology

2	Schedules 3, 4, 5 and 6	The Construction Agreement contemplates the Extension being constructed in accordance with a scope of works, procurement methodology, target cost and target schedule.	<p>A significant amount of work is required to develop the scope of work, procurement methodology, target cost and target price.</p> <p>For the Construction Agreement to be effective the scope, targets and procurement methodology need to be well developed and well thought out. If, for example, the scope of works is too high level, the variation mechanism will become meaningless.</p> <p>In other places in the QRC's submission it has been noted that the Access Undertaking should be amended to include clear processes and timelines for the development of a scope, target and procurement methodology. Those things are best developed as part of a feasibility study. For this purpose, the QRC considers it crucial that the Access Undertaking include a standard funding agreement for study work.</p>
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Item	Clause	Issue	Comment
Control over the performance of the works and decision making			
3	General	<p>Schedule J notes that QR Network should have sufficient controls over the performance of the construction work for operational and safety reasons.</p> <p>The Construction Agreement goes much further. The Construction Agreement reserves to QR Network total control over the performance of the Works, with very limited exceptions.</p> <p>The limited exception is that if QR Network wishes to vary the target cost or target schedule, the approval of the Funding User is required (although approval is not required for adjustments required by force majeure, latent conditions and the like).</p>	<p>Defects in the drafting</p> <p>Clause 4 of the Construction Agreement purports to be a variation mechanism. It requires QR Network to obtain the Funding Users' consent if QR Network wishes to amend the target cost or target schedule.</p> <p>The clause is deficient in that it does not prohibit QR Network from changing the works, schedule or otherwise incurring additional costs (without the Funding Users' prior consent). The clause should be re-drafted so that it is consistent with a usual variation clause whereby there cannot be any variation to the Works, any additional costs incurred or any delay suffered or any changes to schedules without the prior written agreement of the Funding Users.</p> <p>Funding Users should have greater control over the way in which the works are performed</p> <p>The Construction Agreement provides for QR Network to be paid all of the costs of the Extension. It limits QR Network's liability to \$1. QR Network does not bear any risk if it is late in completing the project (i.e. there aren't any LDs or the like).</p> <p>In a circumstance where Funding Users bear total cost, schedule and performance risk they should be given greater control over the way in which the Works are performed.</p> <p>QR Network should be required to seek the approval or direction of the Funding Users over material things relating to the performance of the Works, including:</p> <ul style="list-style-type: none"> • tender lists for contractors; • terms and conditions of construction and supply contracts; • selection of successful tenderer; • all variations other than variations lower than a specified threshold; • decisions to extend time under a contract; and • decisions in relation to disputes and settlement of claims. <p>The Funding Users should also have the right to require changes, variations and acceleration. The Construction Agreement should expressly note that QR</p>

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4	4.5 among other	Where consent of a Funding User is required under the Construction Agreement, the Construction Agreement provides that QR Network must seek the consent of the Funding User and each 'Other Funding User' relevant to a segment.	<p>Network could not be required to comply with any direction which required it to breach a law, undertake an unsafe act or breach an Access Agreement.</p> <hr/> <p>QRC's concerns</p> <p>The QRC have two primary concerns with QR Network's formulation of decision making by Funding Users:</p> <ol style="list-style-type: none"> 1 Decisions are required to be unanimous. This is unlikely to be practicable. 2 Decisions are to be made on a segment by segment basis. Only those Funding Users that are relevant to a segment are to be consulted. The QRC does not agree that only Funding Users relevant to a segment should be consulted. In most cases, construction and supply agreements will be let on a basis that overlaps different segments. Further, delays to the construction of one segment may impact the construction of another segment. For these reasons, the QRC considers that where the consent or approval of a Funding User is required it is more appropriate that all Funding Users be consulted, rather than just those Funding Users relevant to a segment. <p>Modifications to Construction Agreement</p> <p>The QRC consider that the Construction Agreement should be modified in the following ways:</p> <ul style="list-style-type: none"> • A User Committee should be developed. The User Committee should be a committee in which each Funding User appoints representatives. It would be separate from the Extension Committee (contemplated in the Construction Agreement) which has QR Network as a member and serves to allow the distribution of information. • The User Committee would be the body that would make decisions and give consents and approvals of Funding Users to QR Network. • The Construction Agreement should oblige QR Network to initiate the User Committee and have all Funding Users agree to its rules. This is necessary because there is no privity of contract among the Funding Users. <p>The Construction Agreement should set out the key rules of the User Committee namely, appointment of a chair, notice provisions for calling meetings, quorums and decision making thresholds. The Construction Agreement should be flexible</p>

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			so that the Funding Users can agree the thresholds for decision making (eg, 50%, 75% or unanimous). Funding Users' voting entitlement would be determined by reference to their proportion of the capacity increment which will be developed from the Extension.
5	See for eg, 17.10	In a number of places QR Network has included a warranty to the effect that it will ensure that in respect of a clause that clause is included in all Construction Agreements.	While QR Network and a Funding User should always be free to agree differently, the Construction Agreement should include a clause in which QR Network acknowledges that all 'funding user' agreements for an Extension will be on the same terms.
6	5.7 and definition of "Adjustment Event"	QR Network are entitled to a variation and adjustment to the targets, where certain neutral events (such as force majeure) occur (defined as "Adjustment Events").	<p>If an "Adjustment Event" occurs, clause 5.7 provides that QR Network will be entitled to an adjustment for the period "QR Network considers" appropriate. It is not reasonable that QR Network decides its own adjustments.</p> <p>The agreement should be amended so that the Independent Engineer determines adjustments resulting from "Adjustment Events".</p> <p>Paragraph (d) of the definition of "Adjustment Event" should be amended so that disputes caused by QR Network are excluded.</p>
7	5.8	Clause 5.8 sets out the details for a "Reference Program" to be developed.	<p>Clause 5.8 should be amended so that:</p> <ul style="list-style-type: none"> the reference program is a level 3 program, which is updated regularly (not less than monthly) to reflect the actual progress of the works; the reference program is provided to Funding Users and the Independent Engineer in hard copy, and native file prima vera; and QR Network are to give Funding Users notice if at any time it becomes aware or believes that there will be a delay to the progress of the works.

Costs which are reimbursable by Funding Users and QR Network's obligations in relation to cost and schedule

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Clause 1.1
and
Schedule 7

Funding Users are required to pay their share of the 'Extension Costs'.

'Extension Costs' is defined in clause 1.1. It is defined on a non-exhaustive basis. Schedule 7 sets out a long list of items which are deemed to be 'Extension Costs'. The list in Schedule 7 are examples of costs that are "Extension Costs".

Definition of 'Extension Costs' and Schedule 7

"Extension Costs" is defined as any costs 'in connection with the Extension'. This is far too broad. We assume it was not intended, but the definition is so broad that it would allow QR Network to recover its operation and maintenance costs in relation to the Extension.

Further, "Extension Costs" is defined in such a way that it continues and infinitum (rather than for a period).

There should be a long stop date by which Extension Costs cannot be recovered. The QRC believes that the appropriate time for Extension Costs to be cut-off is a short period after practical completion (defined in the agreement as 'Available') of the Extension.

The definition of 'Extension Costs' should be amended as follows:

- the definition should only apply to the costs of 'designing, supplying, constructing, commissioning and project managing the Extension' as opposed to any costs 'in connection' with an Extension;
- other than as noted below, Extension Costs shouldn't include costs incurred before the commencement of the Construction Agreement;
- the definition should expressly acknowledge that QR Network may not claim the following costs under the Construction Agreement:
 - costs which are intended to be compensated by any regulatory charge (e.g. operation and maintenance charge);
 - costs which are incurred as a result of breach or negligence on the part of QR Network; and
 - costs which are covered by a study funding agreement.

Schedule 7 should also be amended in a corresponding way, including deleting (a)(ii) and (vi).

Paragraph (b) and (c) of Schedule 7 should also be deleted. Administrative and overhead amounts (as contemplated in paragraph (b)) is far too broad.

Paragraph (c) of Schedule 7 should be deleted because there should be a prohibition on QR Network subcontracting without the prior written approval of

the User Committee. Costs of subcontracts to QR Network related bodies corporate should only be reimbursable to the extent that those subcontracts are approved by the User Committee. Without this caveat, QR Network could deliberately subcontract to QR Network related bodies corporate and recover under those subcontracts margins and profits that are not otherwise contemplated to be recovered by the Construction Agreement.

Pre-Commencement Extension Costs

The Construction Agreement provides for Funding Users to reimburse pre-commencement Extension Costs. These costs are defined as any costs incurred before commencement.

The QRC proposes that this definition should be amended so that it reflects an actual sum, to provide Funding Users with certainty.

9 Clause 3.5 and Schedule 11 QR Network proposes that it be entitled to an incentive payment on top of the reimbursement of all costs (and overheads). The incentive payment is not connected to QR Network taking on additional risk. The incentive payment is still proposed to be payable in circumstances where the Extension is completed over-budget and late (for example, QR's proposed table shows a CIP being payable in the case of a project being 180 days (**nearly six months**) late provided that the project is less than 5% **over budget**).

The provision for the incentive payment should be deleted.

Funding Users and QR Network should be free to agree to an incentive arrangement on an Extension by Extension basis. An incentive should not however be a feature of the pro forma Construction Agreement – particularly in circumstances where QR Network does not accept any risk for such incentive.

References throughout the Construction Agreement to the 'CIP Adjustment' should be deleted (including Schedule 11).

10 Clauses 3.3 and 3.4 Clauses 3.3 and 3.4 of the Construction Agreement provide that QR Network will use its reasonable endeavours to complete an Extension by the target date and within the target cost.

A reasonable endeavours (and best endeavours) obligation allows a party to have regard to its own commercial interests. That right should be expressly excluded (perhaps by an acknowledgement in the interpretation provision that a party may not have regard to its own commercial interests).

Further the reasonable endeavours obligation should be replaced with a best endeavours obligation. That reflects a slightly higher standard than reasonable, but still falls well short of an absolute obligation.

The Construction Agreement should also oblige QR Network to:

- act expeditiously; and

- avoid unreasonable or unnecessary delay.

11	n/a	n/a	The Construction Agreement should oblige QR Network to ensure that the scope of works for the Extension will be sufficient to deliver the capacity nominated in the Construction Agreement.
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Consultation, reporting and independent engineer

12	Clause 6	<p>Clause 6 establishes the Extension Committee (which is intended to be a committee at which QR Network consult with the Funding Users).</p> <p>It also provides for QR Network to provide monthly reports to Funding Users during the construction period</p>	<p>Funding Users should be entitled to bring an observer to Extension Committee meetings, as well as the independent engineer (discussed below).</p> <p>QR Network should be obliged to provide the independent engineer with all information reasonably requested by the independent engineer.</p>
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13	4.6, 5.6	In a number of places where a Funding User and QR Network can not agree, the disagreement is to be referred to an expert.	<p>The QRC propose that the parties agree upon an independent engineer and that disputes that would otherwise be referred to an expert be referred instead to the independent engineer.</p> <p>That has the benefit of having the one 'expert' (i.e. the independent engineer) involved throughout the project and would facilitate a quicker resolution of disputes (because the independent engineer will be familiar with the issues facing the parties).</p> <p>The QRC also propose that the independent engineer make a number of the key determinations and certifications which QR Network propose to undertake. For example, the determination as to whether "Availability" has occurred under clause 4.3 and the Final Certificate process should be determined and issued by the independent engineer (and not QR Network). It is not appropriate for QR Network to make these determinations.</p>
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Payment

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Clause 7 sets out the Funding Users' payment obligations, as well as related matters.

Set-off

Clause 7.11 acknowledges that QR Network has a right to set-off amounts payable by QR Network against amounts payable by the Funding User. The clause only permits set-off by QR Network. It should be made mutual.

Clause 7.13 acknowledges that QR Network may set-off amounts payable by QR Network under the Participation Agreement against amounts payable by the Funding User under the Construction Agreement.

Clause 7.13 should be deleted. The right of set-off should be confined to amounts payable under the Construction Agreement. Third party lenders will not accept any right of set-off against payments under the Participation Agreement.

Imprudent expenditure – ambiguity in the clause

Clause 7.15(b) provides that QR Network must refund all Funding Users their proportion of any costs found by the QCA not to be prudent having regard to the scope and standard of work.

Clauses 7.15(c) and (d) heavily limit the operation of clause 7.15(b). Clause 7.15(c) states that costs are deemed to be prudent if the costs are equal to or less than the Target Cost. Clause 7.15(d) provides that QR Network will not have any obligation to refund monies under clause 7.15 if the QCA does not accept Extension Costs into the regulated asset base on the basis of prudence of scope or standard of work.

Clauses 7.15(d) and 7.15(b) conflict and are ambiguous. We understand that what is intended by clause 7.15(d) is that QR Network only bears the risk of imprudent management by QR Network.

Amendments to the prudence clause

Clause 7.15 should be amended as follows:

- The clause should apply to any imprudent expenditure and not just imprudent scope and standards of work. Clause 7.15(b) should be amended to reflect this.
- Clause 7.15(c) should be deleted. If a cost is not prudent it is irrelevant whether it is within or outside of budget.

- Clause 7.15(d) should be deleted. As noted in Schedule J, QR Network should bear the risk of imprudent expenditure in the same way that it does for QR Network funded Extensions.

Payment into trust account

Payments which are made by Funding Users to QR Network under the Construction Agreement should be made into a trust account. QR Network may only use monies in that trust account to pay Extension Costs.

Guarantees

15	9	<p>Clause 9 of the Construction Agreement requires a Funding User to provide a bank guarantee for the full value of its estimated contribution to Extension Costs.</p> <p>This clause also includes a complicated regime to deal with the circumstance in which a Funding User fails to provide its bank guarantee.</p>	<p>The QRC seeks the following changes to clause 9:</p> <ul style="list-style-type: none"> • a Funding User should not be required to provide any security where it satisfies a specified credit rating; • a Funding User should be entitled to provide a company guarantee from an appropriately creditworthy entity in lieu of a bank guarantee; • the provision of guarantees or satisfaction of the credit rating test should be a condition precedent to all agreements. As currently structured the Construction Agreement exposes Funding Users to risk. If a Funding User fails to provide security and the Construction Agreement is cancelled on that basis, the Funding User's proportional responsibility for Extension Costs increases. It is feasible that a Funding User may not wish to proceed on this basis. The Construction Agreement as currently drafted only gives QR Network an entitlement to terminate; and • QR Network should not be able to call on a bank guarantee or any letter of credit without first giving 5 Business Days notice of its intent to do so.
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Access Agreements and Participation Agreement

16	10	<p>Clause 10 provides that the Funding User and QR Network will enter into the Participation Agreement.</p>	<p>Clause 10 should be amended to permit Funding Users to (at the election of the Funding User) have their lenders enter into the Participation Agreement.</p>
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17	11	<p>Clause 11 provides that a Funding User may enter into an access agreement or have its rail haulage operator enter into the access agreement.</p>	<p>Clause 11 should be amended to also permit a related body corporate of a Funding User to enter into the access agreement.</p> <p>Where the Funding Users have established an SPV that is the counter-party to the Construction Agreement, the agreement will nominate the entities that will enter into access agreements with QR Network.</p>
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Step-in

18	24	<p>Clause 24 sets out a process for a Funding User to appoint a contractor to manage the works in certain circumstances.</p> <p>The right to appoint a managing contractor only arises where the Works will be 6 months later than the last planned 'Target Available Date' or 3 months later than the planned completion date of the relevant terminal upgrade/development.</p> <p>In that circumstance the Funding User may give QR Network a notice. QR Network may refer the matter to dispute. After resolution of any dispute process the Funding User (if all Funding Users agree) may appoint a contractor to manage the Works the subject of the Extension.</p>	<p>Right of step-in</p> <p>Clause 24 does not provide a right of step-in. It confines the Funding User's right to the appointment of a contractor to manage the works. That may be an outcome which the Funding User wishes to adopt, but the agreement should give the Funding Users an election as to how it exercises its step in rights (including by directly managing the works or undertaking construction works personally).</p> <p>Triggers for the right of step-in</p> <p>The trigger to the right of step-in is far too narrow. The step-in right should be able to be exercised for any un-remedied default by QR Network – particularly in light of the fact that QR Network has such limited liability.</p> <p>It is unreasonable to expect that a Funding User should suffer a delay of 6 months or more before it can exercise its step-in rights. Further, the right of QR Network to dispute the entitlement to step-in allows QR Network to hold off the exercise of a step-in right by starting a dispute process thereby reducing any value which is gleaned from the step-in at all. The agreement should therefore provide that the Funding Users can exercise their rights of step-in, notwithstanding any dispute process (that would not relieve the Funding Users from liability if the exercise of the step-in rights was wrongful).</p>
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Limitation of liability

19	14	<p>QR Network limit its liability to \$1.</p> <p>The only exception is where QR Network is</p>	<p>The following should be added to the exceptions to QR Network's limitation of liability:</p>
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guilty of fraud, dishonesty or wilful default.

The above amounts to a near total exclusion of liability.

In addition to the limits noted above, QR Network's liability for 'consequential loss' is excluded.

- gross negligence by QR Network or its personnel;
- breaches of law by QR Network.

QR Network should also have a positive obligation to pass on to Funding Users amounts recovered from contractors and subcontractors. If the direct contractor model is not utilised then to perfect the flow of loss, it would be necessary for QR Network to indemnify the Funding Users for breaches by contractors and subcontractors, capped at the amount that QR Network recovers from those contractors and subcontractors. Without such an arrangement QR Network would arguably not suffer any loss and therefore contractors would have no compensation obligation.

Termination

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The Construction Agreement codifies the parties' entitlement to terminate the agreement.

QR Network may terminate the agreement where the Funding User fails to pay an amount due under the agreement and that amount remains outstanding after a remedial period has expired.

The Funding User may only terminate the agreement if QR Network is insolvent.

The agreement should be modified to permit the Funding User to terminate the agreement where specified breaches are not remedied within a specified remedial period.

Miscellaneous

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The Construction Agreement sets out a full form confidentiality agreement.

The exceptions to the confidentiality agreement should include:

- disclosure to the QCA (and not just in accordance with the Access Undertaking – which is overly restrictive);
- disclosure among Funding Users – which is necessary to enable the User Committee process to operate effectively; and
- disclosure to the independent engineer.

22	3.7	Clause 3.7(b) acknowledges that QR Network will be the principal contractor where a construction contractor is not appointed principal contractor.	Clause 3.7(b) should oblige QR Network to do all things required to be done to register as principal contractor.
23	12	Clause 12 obliges QR Network to obtain and maintain certain insurances, as well as dealing with the responsibility for premiums, deductibles and the like.	Clause 12 should be amended as follows: <ul style="list-style-type: none">• QR Network should be obliged to obtain and maintain property insurance covering its own plant and equipment;• User Funders should not be responsible for paying the deductibles where the event was caused by QR Network's act or omission;• User Funders should be named insureds under the works and public liability policies. Those policies should also include a waiver of subrogation in favour of the User Funders.
24	n/a	n/a	The Construction Agreement should include provisions which oblige QR Network: <ul style="list-style-type: none">• to seek to have the Extension Costs included in the regulatory asset base;• to seek 'regulatory pre-approval' for the scope of works, standard of works and procurement strategy in respect of the Extension; and• where appropriate, access conditions for the relevant Extension.