



Assessment of Prime Infrastructure Overhead Costs

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Table of Contents

1.	INTRODUCTION	1
1.1	Background	Error! Bookmark not defined.
1.2	Project Brief	1
1.3	Approach	1
1.4	Limitations	1
1.5	Tax treatment	2
2.	PRIME'S CLAIM.....	3
3.	APPROACHES TO COST ALLOCATION.....	4
3.1	Cost definitions.....	4
3.2	Cost Allocation Methods.....	4
3.2.1	Fully Distributed Costs (FDC)	4
3.2.2	Activity Based Costing (ABC).....	4
3.2.3	Marginal Costing (MC)	4
3.2.4	Avoidable / Incremental Cost (AC).....	4
4.	DETAILED ANALYSIS OF PRIME INFRASTRUCTURE CORPORATE OVERHEAD.....	7
4.1	Approach to cost allocation adopted	7
4.2	Prime's business function.....	7
4.3	Non-Contested Costs	9
4.4	Type Contested Costs.....	9
4.5	Size Contested Costs.....	10
4.6	Excluded Costs	15
4.7	Corporate Overhead Rate based on Prime Infrastructure Cost Summary.....	15
5.	TOP DOWN VIEW.....	17
5.1	Port Kembla Coal Terminal	17
5.2	Port Waratah Coal Services	18
5.3	Coal Mine Operations.....	18
6.	CORPORATE OVERHEADS AND TERMINAL PRICES	19
6.1	Comparison of Terminal Charges	19
6.2	Contribution of Corporate Overheads	20
6.2.1	Based on Prime's Claim.....	20
6.2.2	Based on Re-Allocated Prime Infrastructure Costs.....	20
6.3	Commentary.....	21
7.	OVERALL CONCLUSION	22

1. INTRODUCTION

1.1 Project Brief

Meyrick and Associates was engaged by the Queensland Competition Authority to provide an independent view as to the appropriate amount for corporate overheads for inclusion in Prime Infrastructure's cost base. The specific terms of reference for the brief required us to:

- Assess whether the corporate overhead costs claimed by Prime were reasonable for current and future years out to 2008-09, given Prime's management responsibilities for DBCT, including an assessment of the basis on which Prime's costs are allocated between its various activities, both current and prospective
- Set out in detail the reasoning behind the assessment
- Determine whether the corporate overhead costs proposed by Prime are in line with what a similar or normal business in its market would incur and
- Provide a Draft Report on our assessment for comment prior to finalising our assessment.

1.2 Approach

The approach that we proposed to take to the brief was outlined in a letter proposal submitted to the QCA. In this proposal, we suggested three lines of inquiry:

- an assessment as to whether the aggregate level of overhead costs (as a percentage of total operating costs) is reasonable. This would be based on a mixture of detailed analysis of the cost structure of bulk loading installations for which we have data, and a general review of industry norms
- specific assessment of individual overhead cost item of significance
- a complementary 'top down' assessment which would compare the overall unit costs of DBCT, when all three cost elements (capital costs, operating and maintenance costs met by the operating entity, and Prime corporate overheads) are taken into account, with costs/prices at other terminals

This report encompasses all three of these approaches.

1.3 Limitations

In our proposal, we pointed out that there is no uniform practice with respect to what is defined as a 'corporate overhead' and what is defined as an 'operating and maintenance cost'. We indicated that, to ensure that we properly understood what has been done in the case of DBCT, we would need to have information on the cost structure of the operating entity as well as Prime itself. In making this request, we reaffirmed that we understood that QCA was not seeking an opinion on the reasonableness of the operating entities costs: our purpose in seeking this information was to ensure that we interpreted correctly the costs included in the Prime overhead component.

Early work on the project reinforced our view on the importance of clarity on this point, and revealed some additional information needs. Accordingly, on 21 July we requested certain additional information. We understand that the QCA passed these requests on to the relevant parties. Mindful of our undertaking to provide a report to the QCA prior to the end of July, we prepared and submitted a preliminary report using the information that was to hand. This report emphasised the importance of the additional information requested, and our willingness to revise our figures when it came to hand.

On 24 August additional information on forecast expenditure levels was provided to QCA: this has been forwarded to us, and the analysis of FY2004 expenditure levels has been updated using this data. However, the new information did not include a response to our original request. Given our commitment to finalise our report promptly, we have had no option but make the best estimates that we could based on the data that has been provided. However, we stress that we continue to consider the information that we requested is important to the robustness of our conclusions, and may provide cause to revise them. The results and opinions contained in this document should therefore be read with this caveat in mind.

However, despite this caveat, we consider it unlikely that the fundamental conclusion of the analysis – that the claimed overhead expenditure is in excess of that which we would normally expect – would be overturned by the availability of further information.

1.4 Tax treatment

The 24th August communication from Prime to QCA links the tax treatment of Prime to the range of costs that should be allowed in calculating corporate overheads. A discussion of the tax treatment of Prime is beyond our terms of reference, and we have not attempted to comment on this discussion. Consistent with our terms of reference, we have limited our work to assessing how the type and magnitude of Prime's operating expenditures compare to the costs that one would expect to be incurred by a stand-alone terminal operator.

2. PRIME'S CLAIM

In Prime Infrastructure's original submission, likely corporate overhead expenditure in 2004 was estimated at \$4 million.

Subsequently, Prime has claimed that, based on actual corporate overhead costs incurred in the six months ended 31 December 2003 and the forecast amount for the full financial year ended 30 June 2004, Prime Infrastructure has underestimated the corporate overhead allowance included for each year in the regulatory period.

Prime Infrastructure has claimed that actual corporate overhead cost (not including the QCA charge or the site remediation provision) for the six month period ended 31 December 2003 was \$3.1 million, and that the forecast corporate overhead for the full year ended 30 June 2004 is \$9.7 million.

Prime has further claimed that the estimated costs for 2004 still underestimate the sustainable costs of the operation. Prime notes that it has gradually been increasing its resourcing during the 2003/2004 financial year, and its staffing has been at full strength only for a part year. In future years, these costs will have to be included for a full year, and the reasonable corporate cost base for the regulatory period should take this into account. Prime estimates that if a corresponding adjustment were made for the 2003/2004 year, it would take the total cost for 2003/2004 to \$10.5 million.

Prime did not explicitly adjust the corporate overhead costs for each future year of the regulatory period in its submission. However, based on the discussion outlined above, and assuming the same rate of inflation as in the original regulatory model, the revised estimates of future overhead costs would be as shown in Table 1 below.

In its 24th August response to the request for additional information, Prime provided a further update in the estimated level of corporate overheads. The estimated 2005 expenditure included a further increase of \$1 million.

The estimates from the original submission¹, those contained in the first revision, and the latest figures provided on 24 August are shown in Table 1 below. (Only the corporate overhead component of the operating costs is included in the table: the QCA charge and provision for site remediation are omitted).

TABLE 1. PRIME CORPORATE OVERHEAD COSTS – ORIGINAL SUBMISSIONS

	2004	2005	2006	2007	2008	2009
Original	4,000	4,100	4,203	4,308	4,415	4,526
Revised	9,700	10,981	11,257	11,538	11,824	12,122
2 nd Revision 24/8/04		11,977	12,297	12,604	12,919	13,242

¹ For future years, we have increased the overhead estimate from the original submission at 2.5% . p.a.

3. APPROACHES TO COST ALLOCATION

3.1 Cost definitions

Cost allocation for pricing purposes is normally a two-step process:

- cost specification as per Generally Accepted Accounting Principles (GAAP), and
- cost allocation, depending on the cost allocation methodology selected.

3.2 Cost Allocation Methods

3.2.1 Fully Distributed Costs (FDC)

Under this method of cost allocation, a business unit's cost base comprises all cost exclusive to the unit and a pro-rata share of the entity's overheads and capital cost.

3.2.2 Activity Based Costing (ABC)

Under the ABC approach of cost allocation, categories of indirect cost are identified, and these costs are allocated to products or services using a criterion which most closely reflects the usage of the resource by the product or service.

3.2.3 Marginal Costing (MC)

Marginal cost is the cost of producing an additional unit of a good or service. It will generally include direct costs that vary with output and some indirect costs. Marginal cost can be measured in the short run or the long run. In contrast to FDC, it excludes indirect costs that are fixed in the longer run, such as corporate overheads and their associated capital cost.

In practice the application of SRMC and LRMC can be difficult, due to definitional problems and the 'lumpy' nature of some cost, especially capital costs.

3.2.4 Avoidable / Incremental Cost (AC)

Avoidable cost includes all those costs that would be avoided if an output was no longer provided by the entity concerned. Incremental cost are very similar to avoidable cost, as the cost saved by not producing a product is usually the same as the additional cost of making the product available.

A summary of the types of cost included under each approach to cost allocation is given in Table 2.

TABLE 2. TREATMENT OF COSTS UNDER DIFFERENT ALLOCATION METHODS

Cost Category	FDC	ABC	SRMC	LRMC	AC
Direct Cost	yes	yes	yes	yes	yes
Executive Costs	yes	yes	no	no	no
Rent	yes	yes	no	often	often
Other overhead Costs	yes	yes	no	yes	if avoidable yes
Capital costs exclusive to the activity	yes	yes	no	yes	yes
Joint Capital Cost	yes	yes	no	no	if avoidable yes

Table 3 shows the cost allocation methods that have been accepted for pricing purposes in each Australian jurisdiction. It is apparent the fully distributed cost basis is the most widely accepted approach, and it has been assumed that this should, all other things being equal, form the basis of our assessment of what is reasonable.

TABLE 3. COST ALLOCATION AND PRICING POLICIES, BY JURISDICTION

Jurisdiction	Main costing method	Are others acceptable?	Pricing Approach	Flexibility in pricing
New South Wales	FDC	Yes – Avoidable cost	Reflect full cost	Yes MC in short run
Victoria	FDC	Yes	Reflect costs in the medium to LT	Yes MC in short run
Queensland	FDC	Yes – MC or avoidable cost	Medium RoR	Yes
South Australia	FDC(ABC)	Yes	FDC only one factor in setting prices	Yes eg MC in SR where unused capacity
Western Australia	FDC	Yes	Adjust full cost for net competitive advantage	Yes MC in SR
Tasmania	FDC	No	Need not be cost plus	Yes
Australian Capital Territory	FDC	Not specified	Not specified	Not specified

However, we would qualify by limiting the costs that should be allocated on a FDC basis to those costs that are of a type that would be incurred by the entity in undertaking the business to which the costs are being allocated. To take a hypothetical example, a utilities company may have both several water businesses and several electricity businesses. It may incur a corporate cost in the negotiation of water rights that cannot be meaningfully and conveniently assigned to any individual water business. However, in our view the appropriate allocation method would allocate this cost only to the water businesses: none of the cost should be borne by the electricity businesses. Otherwise, the electricity businesses, taken as a whole, will be in effect subsidising the water businesses, taken as a whole.

This point is of considerable importance in our assessment of 'reasonable' level corporate overheads to be allocated to the Dalrymple Bay Coal Terminal operation.

4. DETAILED ANALYSIS OF PRIME INFRASTRUCTURE CORPORATE OVERHEAD

Cost analysis below has been based on the Prime Infrastructure 2004 Corporate Overheads as at June 2004. The total Corporate Overhead forecast was \$10.7m, with a net cost allocated to DBCT of \$9.7m. Finalisation of the Prime Infrastructure accounts which became available after the submission of the Preliminary Report, shows that the actual 2004 Corporate Overheads had increased to \$13.3m with a net allocation to DBCT of \$11.5m.

We have reviewed this information in finalizing our report, and updated the relevant tables in the light of these latest data. However, all of the significant changes relate to areas in which we have argued either that:

- the type of expenditure should not be included in the corporate overheads allocated to DBCT or
- the level of expenditure actually incurred by Prime differs substantially from the level that we would expect to see incurred by a 'stand alone' coal terminal operator.

The new information therefore has had no material impact on our estimates of the appropriate level of corporate overheads.

4.1 Approach to cost allocation adopted

In the data originally provided, Prime allocated a total of \$9.723 million in overhead costs to the coal terminal operations at Dalrymple Bay Coal Terminal (DBCT). From the information provided, it appears that this figure is obtained by:

- adjusting the actual 2003/2004 cost estimates to what they would have been if the full staffing complement was engaged for the full year, giving a total of \$10.719 million
- deducting a number of specific costs that clearly relate to other activities, leaving a total forecast corporate overhead cost of \$9.7m to be borne by DBCT.

Under normal accounting principles, it would be anticipated that the corporate entity's overhead would be allocated to subsidiary activity through the application of a suitable cost allocation model. The approach adopted by Prime appears to have the effect of allocating to DBCT all costs that cannot be specifically allocated to other activities. This will tend to overstate the overhead costs for the terminal.

4.2 Prime's business function

In its submission to QCA, Prime states that 'Prime Infrastructure estimated its likely operating expenditure (corporate overhead costs) as owner of the Dalrymple Bay Coal Terminal (DBCT)'.

However, in its Annual Report, Prime Infrastructure makes it clear that it operates primarily as an investment vehicle,

Since listing on the ASX on 24 June 2002, Prime Infrastructure has established itself as a robust and reliable independent infrastructure investment vehicle with an exciting and rewarding future

2003 Annual Report

Prime Infrastructure covers two broad areas of investment:

- Bulk Terminals – DBCT – 100%
- Power Generation
 - Ecogen Power – Newport and Jeeralang gas-fired power and generation plants in Victoria – 50%
 - Redbank Power Station – coal tailings fired power station in the Hunter Valley, NSW – 50%
 - Global Wind Partners – wind energy investment vehicle (Renewable Energy) – 50%

Forecast revenue (2004) for the Prime Infrastructure Group is just under \$200m, with 76 % derived from DBCT. If revenue was used as a cost driver, the majority of Prime Infrastructure overheads would be allocated to DBCT. But it should be noted that profit derived from operating assets is not the only measure of performance for an investment vehicle; the value of the underlying share is also a key performance indicator for the group. The importance of this measure is indicated by the Incentive Fee structure for BBIS, where the fee is based on the value of Prime shares as compared to the ASX 200. No corporate overhead is allocated to support this function.

Prime holds assets in three separate operations, and it appears from the due diligence note for Terranova that it may be seeking to further expand its investment base. This suggests that two questions should be asked with respect to the costing approach applied to DBCT, in terms of the nature the level of costs incurred by Prime f Prime Infrastructure.

- If Prime were to operate solely as a coal terminal owner rather than as a venture capital company, would the **same set of corporate overhead costs** be incurred?
- If Prime were to operate solely as a coal terminal owner rather than as a venture capital company, would the **same level of corporate overhead costs** be incurred?

This is consistent with generally regulatory practice of basing pricing decisions on efficient costs.

In our view, rather than simply apply a fully distributed costing approach to Prime's operating expenditure, we need first to assess whether the items listed by Prime Infrastructure as corporate overhead costs would be incurred if Prime were operating purely as owner of Dalrymple Bay Coal Terminal.

To assist in the initial analysis, we have divided costs into four broad categories:

1. Non-contested costs – costs that are both of a type and of a scale that we would expect to see incurred by a coal terminal owner
2. Type contested costs – costs that are of a type that we would not expect to see incurred by a coal terminal owner
3. Size contested costs – costs that are of a type that we would expect to see incurred by a coal terminal owner, but the value of which is substantially in excess of the values that we would expect to see
4. Excluded costs – cost that were incurred by Prime but which Prime itself has excluded from its assessment of the operating costs that could appropriately be assigned to DBCT.

It is not always easy to obtain a clear definition for each cost, as a number of the costs do not fall neatly into one or other of the classifications, and a significant level of judgement is inevitably involved. One specific issue of some consequence is that Prime Infrastructure, as an investment vehicle, maintains its Head Office in Brisbane. This location choice, which impacts on a number of ‘company’ costs, such as Travel Costs, Car Parking and Office Rental, is probably not the one that would be made by a company purely concerned with terminal ownership. This view is reflected in the analysis below.

4.3 Non-Contested Costs

This category includes those costs that would normally be found listed as a corporate overhead, and is not assumed to be abnormal in magnitude.

Non-contested costs covered a wide range of expenditures: the most significant items in this grouping were:

- General insurance expenditure
- Computer/IT Maintenance & Software
- Risk Management Fees
- Compliance Committee Fees
- Telephone/Fax/Internet
- Temporary staff costs.

These six items account for approximately 85% of the total of \$708,000 per year of uncontested expenditure.

4.4 Type Contested Costs

This grouping includes those expense items that appear to us to be unusual for inclusion in the corporate overhead pool for allocation to DBCT.

TABLE 4. COMMENTARY ON COSTS CONTESTED BY TYPE

Nature of Expense	Comment
DBCT Credit Rating	This cost is incurred by Prime Infrastructure to meet the requirements of being an investment vehicle. On the one hand, it is quite likely that the expense would be avoidable by DBCT, if it owned and operated as a stand-alone terminal. DBCT has established supply and delivery contracts, some of which are 18-24 months out, which may be sufficient to secure funds without establishing a formal credit rating. On the other hand, if the cost was incurred to support on-going capital expansion projects in the terminal, then the expense should be capitalised within the project cost.

Nature of Expense	Comment
BBIS Incentive Fee (FY03 3 rd Instalment)	Badcock & Brown Investor Service have an advisory role to Prime Infrastructure Trust in terms of investment advice and structure, and thus its relationship with Prime is in respect to the investment vehicle and not the terminal operations. It should be noted that in the original forecasts an estimate could not be made for the BBIS incentive payment because the <i>'fee was dependant on the Prime Infrastructure staple security out performing the ASX 200 Accumulation Index over the period up to 30 June 2003'</i> . The first instalment of this fee was actually paid by a combination of 40% cash and 60% in securities. The expense seems clearly related to Prime's functions as an investment vehicle rather than as terminal operator.
BBIS Trust Fees	Contested for similar reasons to those outlined above
BBIS Incentive Fee (FY04, 2 nd Instalment)	Contested for similar reasons to those outlined above
Parking	Appears to be a Brisbane based cost, due to Head Office location. Would be avoided if DBCT operated as a stand alone operation
Distribution Expenses	An unusual corporate overhead expense item for a coal terminal operation, and appears likely to reflect the investment banking function of the ownership vehicle. Prior to accepting the expense, we would need to understand the nature of it.

These items accounted for a total of approximately \$5.4 million in the 28th August update by Prime (up from \$5.1 million in the earlier submission from Prime).

4.5 Size Contested Costs

The majority of these costs would appear in the corporate overhead pool category, but the size of the expense is unusually high, when compared to other port facility or companies with similar turnover.

TABLE 9. COMMENTARY ON COSTS CONTESTED BY SIZE

Nature of Expense	Estimated Efficient Level	Comment
Accounting and Taxation Fees	\$120,000	Amount incurred by Prime appeared high when compared to companies with similar turnover, very high when compared against 'standard' port operations, especially for a single operation terminal.
Annual General Meeting	\$40,000	Annual meeting was held at The Marriott Hotel, Brisbane, as would be the norm for a venture capital company trying to attract investors. It would not be typical for a coal terminal owner.

Nature of Expense	Estimated Efficient Level	Comment
Annual Report	\$50,000	Annual report is very biased to the investment community, emphasis on the performance of Prime Infrastructure as opposed to DBCT. If DBCT was a stand-alone company, it would need to meet legal reporting requirements, but could do so at a much lower cost.
ASX Fees	\$50,000	DBCT as a stand-alone company, it would incur ASX fees, but not to the level that Prime Infrastructure.
Bank fees and charges	\$4,000	Bank fees and charges are based on transactions which would be lower for the DBCT part of the total business.
Board Expenses	\$150,000	Board member payments made by Prime are at about middle tier for \$400-500m turnover companies, thus high for both Prime Infrastructure and a stand-alone DBCT. (Payments to Directors of Port Waratah Coal Services total \$127,000).
Consultancy Fees	\$150,000	Both Fremantle Port and the Port of Melbourne Corporation showed a higher cost for consultants in 2003/2004, but a closer investigation showed that this was over a much broader range of activities. The expenditure level appears to be very high when related back to a well established terminal operation with a revenue turnover of just over \$150m. (This judgement has been made in the absence of information on the specific nature of the consultancies assigned and the motivation for undertaking them. More detailed information could lead to a revision on this item).
Entertainment – Deductible	\$8,000	Amount incurred appears high for a stand-alone DBCT.
External Audit Fees	\$100,000	Amount incurred appears high for a company with a forecast annual turnover of \$200m. The nature of the ‘combined business’ environment operating in regulated and non-regulated markets would be a contributing factor in the higher than usual audit fees. Allow \$100,000 (External audit fees for Port Waratah Coal Services are \$72,000).
Internal Audit	\$50,000	As with external audit fees, amount listed by Prime appears high for a company of this type and scale.
Legal Fees	\$0	Legal fees tend to be the result of special issues. It is not clear from information to hand that the expenditure was due to issues associated with DBCT and not Prime Infrastructure as an investment vehicle.

Nature of Expense	Estimated Efficient Level	Comment
Newsletter	\$0	First newsletter (8 pages) was published in April 2004. The newsletter will be published three times per year to inform <i>'our stapled security holders of new investments, financial information and general information relating to Prime Infrastructure and its current assets'</i> . The newsletter is directed to the investment community and does not address any of the specific communication issues that would be relevant to DBCT. A newsletter to DBCT employees may exist, but it would already be included in the direct DBCT costs.
Office Rentals	\$50,000	Figure incurred appears to relate to Brisbane based office rates rather than Port of Hay or Mackay.
Printing & Stationery	\$20,000	DBCT operates in a very stable market and deals with a well established supplier and customer base requiring limited high quality printing. Fremantle Port Authority, a more complex operating environment, allocates less than \$20,000 to its Outer Harbour operation for printing costs.
Salaries and Wages	\$1,100,000	Annual Report states that there were 8 staff included under the Employee benefits schedule. Average salary cost is high when compared to a number of Australian and New Zealand ports. Total salaries as per the Executives' Remuneration report is substantially higher than for equivalent position at Fremantle Port (highest paid four positions at FPA \$887,000). A generous allowance for the corporate office for a stand-alone coal terminal would be about 10 employees at an average salary of \$110,000. Allow \$1.1m.
Payroll Tax	\$58,000	See comments on Salaries and Wages. As a consequence, all payroll expenses appear on the high side for a stand-alone DBCT or specialised port facility. Proportionate downward adjustments have been made.
Recruitment Costs	\$35,000	
Fringe Benefits	\$20,000	
Tax		
Staff	\$90,000	
Superannuation		
Share Register Fees	\$40,000	All listed companies must maintain their share registers, often carried out by a third party. Rates charged depend on number of shares and share trading volatility. Prime Infrastructure would rate higher on both than a stand-alone DBCT.
Staff Training & Seminars	\$9,000	High when considered against the 'corporate' element of a coal terminal.

Nature of Expense	Estimated Efficient Level	Comment
Stage 6 Opening Costs	\$0	It is difficult to determine an appropriate allowance for this item. If an essential part of the development and bringing into operation of the facility, the cost should have been capitalised as part of the project cost. If it was a cost that was incurred to bring investors to the site to enhance Prime Infrastructures profile, then it should not be recovered from DBCT users. As the item is treated as an expense, it is assumed that the latter is the case.
Subscriptions	\$3,000	High for a simple single-product facility
Sundry	\$0	It is not usual to include Sundry costs as part of corporate overheads. In any event, this item was booked as a credit: as such, it is likely to be a one off.
Taxi Fares	\$3,000	High for a stand-alone DBCT.
Travel – Airfares and Accommodation	\$35,000	Tends to reflect the structure of the organization, head Office in Brisbane and operation in three different locations. DBCT, as a stand-alone operation, would incur minimal travelling expenses. Compared with other port operations, expense is high when compared against revenue/turnover.

The size-contested corporate overhead costs, and the figures which we would regard as more typical corporate overhead costs likely to be incurred by the owner of a coal terminal, are summarised in Table 5 below.

TABLE 5. SIZE CONTESTED CORPORATE OVERHEAD COSTS

Nature of Expense	Included in Corp Overhead Pool
Accounting and Taxation Fees	\$120,000
Annual General Meeting	\$40,000
Annual Report	\$50,000
ASX Fees	\$50,000
Bank fees and charges	\$4,000
Board Expenses	\$150,000
Consultancy Fees	\$120,000
Entertainment – Deductible	\$8,000
External Audit Fees/Internal Audit	\$100,000
Fringe Benefits Tax	\$20,000
Internal Audit	\$50,000
Legal Fees	\$0
Newsletter	\$0
Office Rentals	\$50,000
Payroll Tax	\$58,000
Printing & Stationery	\$20,000
Recruitment Costs	\$35,000
Salaries and Wages	\$1,100,000
Share Register Fees	\$40,000
Staff Superannuation	\$90,000
Staff Training & Seminars	\$9,000
Stage 6 Opening Costs	\$0
Subscriptions	\$3,000
Sundry	
Taxi Fares	\$3,000
Travel – Airfares and Accommodation	\$35,000
Total	\$2,155,000

4.6 Excluded Costs

For the sake of completeness, Table 11 summarises our comments on the costs excluded from the corporate overhead costs attributed to DBCT. (As these costs are excluded by agreement, they have not been updated to the 24 August submission).

TABLE 11. COMMENTS ON EXCLUDED COSTS

Item	Comment
Investment Management Fee (Ecogen)	Non DBCT activity
Due Diligence	Non DBCT activity
Due Diligence – Wind (Terranova)	Non DBCT activity
On Going DD budget	Non DBCT activity
Other Redbank & Ecogen Costs	Non DBCT activity. Included items are not identified in the Corporate Overhead schedule. We have assumed that the sum reported is an internal Prime Infrastructure estimate as to the corporate overheads that can be allocated directly the Redbank and Ecogen activities. It would be useful to review the allocation methodology used.

4.7 Corporate Overhead Rate based on Prime Infrastructure Cost Summary

In the submission on which the analysis on which this report was based, Prime Infrastructure identified \$9.7m as Corporate Overhead costs that should be allocated to DBCT operations. This was later increased to \$10.4 million).

Our line by line assessment of the claimed costs compared to those which we would expect to be incurred by a coal terminal owner is considerably lower, at \$2.9 million. The biggest contributory factor to this discrepancy is the payments made to BBIS, which in our view are not costs that one would expect to be incurred by a coal terminal owner. In addition, the level of expenditure of a range of cost items is, in our view, considerably higher than one would expect to be incurred by a terminal owner.

Table 12 summarises the difference between the overhead costs claimed by Prime and those that we would expect to be incurred by a coal terminal owner.

TABLE 12. SUMMARY OF ASSESSMENT OF CORPORATE OVERHEADS

Nature of Expense	Preliminary Report	Prime August 2004	Included in Corp. Ohd. Pool
Non-contested overheads	\$707,330	\$708,000	\$708,000
Contested due to type	\$5,082,906	\$5,482,000	\$0
Contested due to magnitude	\$4,183,109	\$4,481,000	\$2,155,000
Non-DBCT overheads	\$746,518	\$746,518	\$0
Re-allocation	-\$996,518	-\$996,000	0
Total	\$9,723,345	\$10,421,518	\$2,863,000

5. TOP DOWN VIEW

In the previous section, we undertook a bottom up analysis of the suggested overhead expenditure.

As a reality check on this approach it is useful to ask the question, *Taken as a whole, does the level of overhead costs claimed by Prime represent a reasonable percentage of total terminal costs or operating revenue?*

At first sight the overhead share does not appear unreasonable: \$10 million dollars on a revenue base of approximately \$150 million equates to 6%-7% in corporate overhead costs, which would generally be regarded as very modest.

However, we do not believe that this is an appropriate yardstick in this case. Many of the cost items that would be classified as overheads in an operation in which ownership and management of the terminal are integrated will be included in the accounts of the operating entity when ownership and operations are separated. In order to construct an appropriate measure for comparison with industry and cross-industry norms, these would first need to be added to Prime's corporate overheads. As of the time of writing, we have not been able to obtain the breakdown of operating entity costs that would allow us to do this.

An alternative approach is to examine those industry actors that have similar structures: that is, in which a terminal operating company that is distinct from the owners exists, and some services or benefits are provided by the owners in return for a payment from the operating company. This approach must be adopted with caution, as the ranges of service and benefits may vary considerably. Nevertheless, it does provide some insight into what a reasonable relationship between the cost of these corporate services and operating revenue may be.

5.1 Port Kembla Coal Terminal

Port Kembla Coal Terminal is a relatively small terminal with a capacity of 16 million tonnes and a throughput of around 8.7 million tonnes. The Terminal is currently leased to Port Kembla Coal Terminal Limited (PKCTL), a company owned by the six mining companies that export coal through the Terminal. PKCTL operates the Terminal and incurs all charges in relation to its operation, including the lease charge. A common user per tonne charge is levied by PKCTL on all throughput to recover its operating and other costs.

BHP Billiton, one of six equal shareholding companies, manages PKCTL on behalf of the user mines. The General Manager and three senior managers are BHPB employees whose salaries are reimbursed by PKCTL.

PKCTL makes a payment to BHP Billiton, the largest shareholder, for corporate support services. We understand that the level of payments was originally negotiated at \$0.5 million, but we understand that in response to the financial stress on the terminal due to declining coal volumes this has now been reduced. The current figure represents approximately 1% of terminal revenue.

5.2 Port Waratah Coal Services

Port Waratah Coal Services Limited (PWCS), based in Newcastle, makes an annual payment to its major shareholder (Coal and Allied) for certain corporate support services, including the provision of a board chairman and general manager, access to financial services and access to the Rio Tinto group's purchasing agreements and supply management systems (Rio Tinto owns 70% of Coal and Allied). For these services, PWCS pays Coal and Allied \$1 million per annum under a Technical Services Agreement. (Under a separate arrangement, PWCS also reimburses Coal and Allied for the cost of a number of Coal and Allied personnel seconded to management positions in the terminal).

The Technical Services Agreement payment to Coal and Allied represents approximately 0.5% of terminal handling revenue.

5.3 Coal Mine Operations

According to industry sources, the separation of asset ownership from operations is common in the coal mines, particularly in Queensland. Payment to one of the owning companies for a range of management services/corporate support is common. Industry sources suggest that such payments are typically in the range 0.5%-1.0% of revenue.

Although there are clearly differences between coal mining operations and coal terminal services, there is no immediately obvious reason to believe that these differences should materially affect this ratio.

These examples suggest that a figure of around 1% of revenue would be a reasonable benchmark for corporate overheads as a percentage of operating revenue, and that 2% would probably be a generous allowance. In the case of DBCT, this converts to a range of \$1.5 to \$3 million per annum. This is broadly consistent with the results from our bottom-up analysis.

6. CORPORATE OVERHEADS AND TERMINAL PRICES

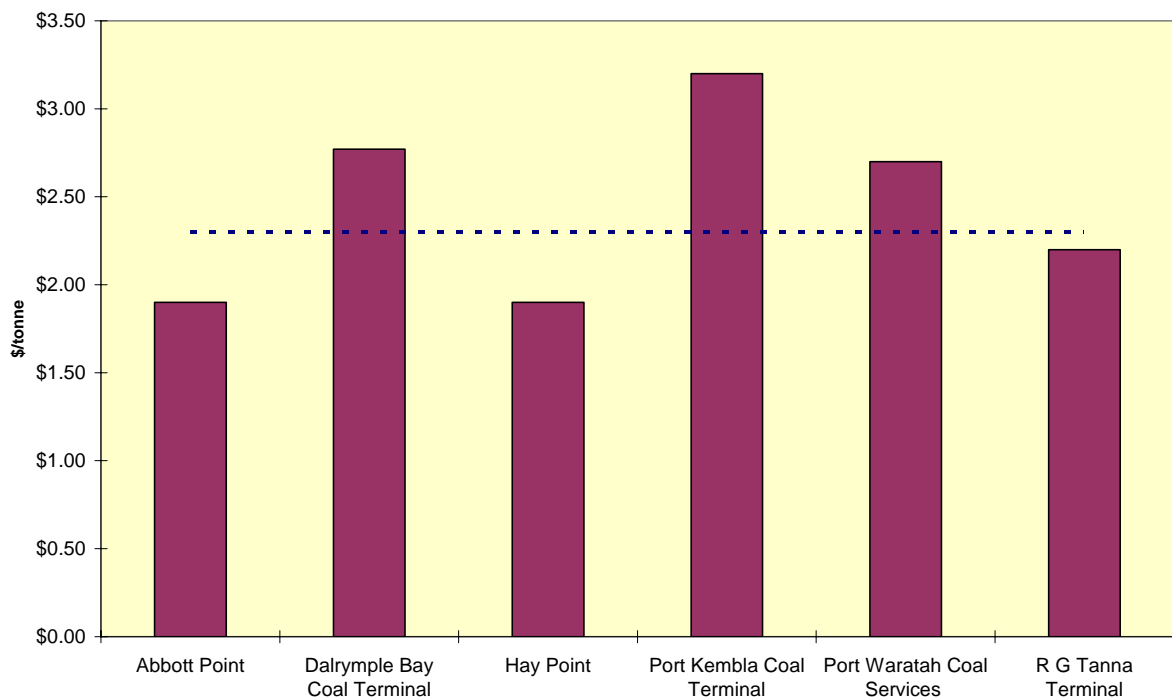
6.1 Comparison of Terminal Charges

DBCT is a large terminal, operating continuously 24 hours per day, 365 days per year, with a current capacity of 54.5 million tonne per annum.

Figure 1 compares the average charge per tonne for Australia's major coal terminals.² The figure indicates that, despite its very high throughput, current Dalrymple Bay Coal Terminal Charges lie towards the top end of the range of coal terminal charges, exceeded only by charges at the small-scale Port Kembla Coal Terminal. However, it should be noted that the charges at the high volume terminals operated by Port Waratah Coal Services Limited at Newcastle are, at \$2.70 per tonne, only slightly lower than those at Dalrymple Bay.

The total user charge is affected by a range of other factors, many of which will have a more profound affect on total cost than the allocation of overhead charges. It is therefore not possible to draw strong conclusions from this comparison. However, a negative conclusion can be drawn: that is, there is no evidence in the level of total user charges of any beneficial effect of the expected scale economies on overhead costs.

FIGURE 1. COMPARATIVE COAL TERMINAL USER CHARGES



² The figure is based on secondary data obtained from industry sources.

6.2 Contribution of Corporate Overheads

Coal terminal users are charged on the basis of the operating cost incurred by DBCT, capital costs, and an allocation of the Prime Infrastructure corporate overhead costs.

The corporate overhead rate will be the result of the total overhead cost pool to be allocated and the allocation base used. An appropriate allocation basis would be a performance measure linked to the practical capacity of 54.4 million tonne per annum (this includes the contribution of Stage 6 completed in June 2003).

6.2.1 Based on Prime's Claim

Application rate

at Actual Tonnage	=	\$9.723/45.5
	=	\$0.2137 per loaded tonne
at Capacity Tonnage	=	\$9.723/54.5
	=	\$ 0.1784 per loaded tonne

6.2.2 Based on Re-Allocated Prime Infrastructure Costs

On the basis that DBCT were to operate as a stand-alone coal terminal, the total corporate overhead cost would be substantially less than has been allocated under the current single step cost allocation method used by Prime.

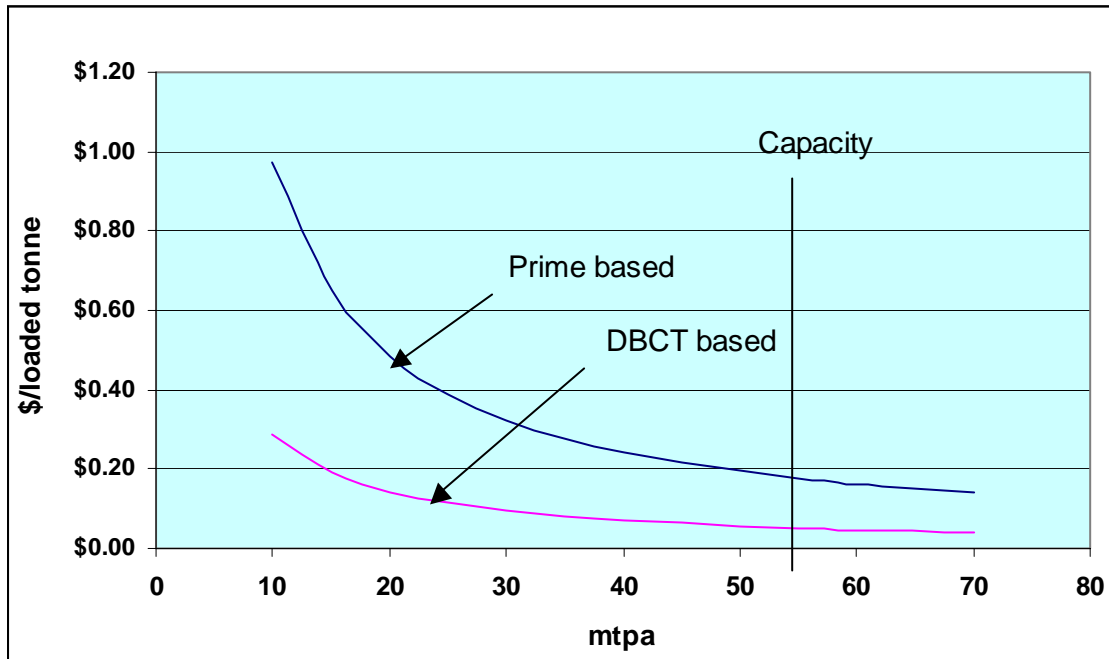
Application rate

at Actual Tonnage	=	\$2.862/45.5
	=	\$0.06291 per loaded tonne
at Capacity Tonnage	=	\$2.862/54.5
	=	\$ 0.05251 per loaded tonne

From available data, the average loaded tonne price across Australian coal terminals was \$2.30 in 2003. In that comparison DBCT was at the highest, with a price of \$2.77. If we applied the revised rate (based on actual throughput tonnes) the rate would be reduced to \$2.62. This would still place DBCT with PWCS and PKCT at the upper end of the price range.

The sensitivity of the overhead rate per tonne to changes in the reference volume is more fully explored in Figure 2.

FIGURE 2. PRIME INFRASTRUCTURE BASED RATES VS DBCT STAND-ALONE RATES



A 70% reduction in corporate overheads would reduce the cost per loaded tonne by \$0.15 (5%), which equates to a cost reduction in excess of \$8m for coal terminal users.

6.3 Commentary

Even at the rate claimed by Prime, the average corporate rate per loaded tonne is fairly low compared to what we would expect in multi purpose terminals, due to the continuous operations (24/7) and the very high throughput tonnes. However, it is arguably high for high volume single purpose terminals.

A point of comparison is provided by the annual accounts of Port Waratah Coal Services Limited. These record the total costs of 'other expenses from ordinary activities' as \$10.95 million in 2003/2004. This category includes all operating expenses other than employee services and purchases of materials and services, and appears to cover most if not all of the cost that would be classified as corporate overheads. Distributed over a throughput of 74 million tonne, this amounts to approximately 14c/tonne.

The average corporate rate per loaded tonne is low compared to what we would expect in multi-purpose terminals, due to the continuous operations (24/7) and the very high throughput tonnes.

This rate includes all costs of an overhead nature that are incurred by the operating entity. To make a valid comparison with DBCT total overheads, it would be necessary to include 'corporate overhead' type costs that may be incurred at DBCT. This information is not yet available, but it is quite likely that these are substantial. The physical separation of the terminal and prime management offices also suggests there may be a duplication of some corporate overhead charges.

7. OVERALL CONCLUSION

The detailed analysis of individual cost items presented and a review of industry norms on the relationship of ownership expenses to total revenue both appear to support the view that the corporate overhead costs claimed by Prime are high. These approaches converge on an appropriate value for allowable overheads of around \$2.9 million per annum (excluding site remediation costs and the QCA levy). Our third approach, based on overall terminal charges and cost per unit throughput is inconclusive – partly because the necessary information is not yet to hand – but does not provide any grounds for doubting the conclusion arrived at using the first two approaches.

In Table 13, taking the adjusted equivalent full year overhead costs of Table 12 as a starting point, we have applied an inflation factor of 2.5% per annum to produce estimated overhead costs for future years. We have then adjusted to the 2004 value to account for the fact that, as noted by Prime, during this year some of these costs were not incurred. (This has been done by simply pro-rating our estimated full-year value using the proportion of actual expenditure to sustainable full-year expenditure implied by Prime’s figures). Finally, we compare these values to those claimed by Prime in its submission.

TABLE 13. ESTIMATED REASONABLE OVERHEAD COSTS 2004 TO 2011

	2004	2005	2006	2007	2008	2009
Prime - Original	4,000	4,100	4,203	4,308	4,415	4,526
Prime – Revised	9,700	10,981	11,257	11,538	11,824	12,122
Prime – 24/8/04		11,997	12,297	12,604	12,919	13,242
Meyrick Estimates	2,562	2,901	2,974	3,048	3,124	3,202