

DBCT User Group

153 Schneider Rd
ROSEVALE QLD 4340
Ph: (07) 5464 0533
Fax: (07) 5464 0550

2 April 2004
Queensland Competition Authority
GPO Box 2257
Brisbane Qld 4001

Attention: Mr John Hall

Dear Sir,

Re: Dalrymple Bay Coal Terminal, Draft Access Undertaking

The DBCT User Group (User Group) welcomes the opportunity to respond to the report prepared by Associate Professor Lally (the Lally report). The Lally report is comprehensive and highly technical in its approach and raises a variety of issues related to the allowed cost of capital for a firm subject to the Authority's regulatory purview.

In responding to this report, the User Group does not wish to respond to all of the issues it raises. In particular, the User Group does not wish to comment on:

- the market risk premium of 6% under the Officer model of capital asset pricing model (CAPM) – this is consistent with the User Group's original submission;
- gamma of 1.0 – the User Group notes that this value is consistent with the unit-holding of Prime Infrastructure which is dominated by Australian domiciled companies.

The issues the User Group seeks to raise in this submission relate to:

- issues arising from departing from the currently generally accepted CAPM;
- the approach that should be adopted for addressing capital gains issues;
- the appropriate beta to be applied to Prime Infrastructure in respect of its interests in the Dalrymple Bay Coal Terminal (the Terminal);
- the use of a risk free rate that is consistent with the regulatory period rather than the longest available bond;

- the attribution of financing charges; and
- the approach to be taken to the assessment of asymmetric risk.

Departing from the Officer model of CAPM

The User Group notes Dr Lally's suggested model for CAPM differs markedly from that adopted by Australian regulatory authorities. The User Group questions the wisdom of abandoning an approach which has received widespread acceptance in Australian regulatory and financial circles. Indeed, the User Group submits that the version of the CAPM applied by Australian regulatory bodies (the so called Officer model) in reality represents a minor change to the classical characterisation of the CAPM applied internationally.

The User Group notes that the CAPM is necessarily an abstraction from reality because the assumptions underlying the theory are not observed in practice. For example, the CAPM model assumes a perfect capital market with no taxes or transaction costs. Neither the Lally model nor the Officer model addresses these real world deficiencies.

In the absence of compelling empirical evidence indicating the superiority of the model Dr Lally has proposed, the User Group advocates continued use of the Officer model. This is because:

- there is merit in continuing to apply a relatively transparent and accessible model of the CAPM;
- the Officer model has at least gained the benefit of widespread acceptance amongst regulatory authorities in Australia; and
- the continued application of the Officer model will provide confidence for all interested parties that the parameters that are adopted by the Authority are comparable with those used by other regulatory bodies.
- the Lally model introduces unnecessary complexity to the assessment of the cost of capital.

Finally, the User Group understands that the approach used by Dr Lally seeks to identify the tax conditions applying to the investors comprising a particular company. The User Group submits that at best such an objective is problematic in practice and departs from the QCA's accepted practice. However, if this approach is to be applied, it is submitted that careful investigation and modelling of the tax arrangements applying in each case is required. In the case of Prime Infrastructure (Prime), the User Group understands that the securities are likely to be particularly attractive to superannuation funds which attract concessional tax status. Moreover, there are unlikely to be capital gains accruing to Prime's unit holders, an issue to which we now turn.

Capital gains tax

The Lally report suggests that the failure to properly account for the incidence of Capital Gains Tax (CGT) liability has created a bias in the estimation of the cost of capital.

If CGT liabilities are to be considered in relation to the cost of providing a service, then such liabilities should be explicitly modelled and considered as part of the cash flows rather than making an adjustment to the discount rate. The User Group believes that such treatment is more transparent and is more likely to prevent the biases that can be introduced when considering taxation issues in the discount rate rather than in the underlying cash flows.

Indeed, the User Group considers that the regulation of the Terminal provides a useful illustration of the dangers of adopting an alternative approach as proposed by Dr Lally. The User Group's modelling of the asset value attributable to the Terminal indicates a material decline in the regulatory asset base in nominal terms in the long run because of the effect of straight line depreciation. This is the case even after allowing for the impact of incentive payments that Prime may be able to earn in the future.

The User Group recognises that capital gains tax is only paid upon the disposal of an asset and that, in the current circumstances, it will be the disposal of units by unit holders that will be of greatest interest to the QCA. However, far from a capital gain being attributed to this asset, the most likely scenario is that the Terminal will generate capital losses over time because of the effects of straight line depreciation which will offset capital gains secured from Prime's other investments. The User Group therefore believes that these capital losses will be of benefit to Prime's unit holders by virtue of the losses offsetting the capital gains tax liability that would otherwise arise when unit holders dispose of units in Prime. Accordingly, the User Group considers that these capital losses should be modelled and recognised in conjunction with the Authority's assessment of Prime's revenue cap.

Finally, the User Group submits that the QCA should maintain its approach to the assessment of tax liabilities for regulatory purposes and assess Prime's tax liabilities based on those that are actually incurred, consistent with the benefit sharing approach outlined in the Statement of Regulatory Principles. In this regard, the User Group submits that the half of the current value of the benefit that will already have been secured by Prime in the period before regulation commenced should be ascribed to Users.

The assessment of beta

The User Group accepts the view expressed in the Lally report that adjustments to the beta, such as those proposed by Blume, should not be adopted. The User Group accepts the adoption of a debt beta of zero so long as a consistent approach is adopted for the de-levering and re-levering processes.

The User Group also agrees that reliance upon comparator firms should be adopted where possible. However, the User Group is not aware of an infrastructure provider (or for that matter, any listed firm) that presents the risk profile comparable to that of Prime's investment in the Terminal, particularly in light of the regulatory environment suggested by the User Group in its original submission (as well as that suggested by Prime in its draft access undertaking) which provides for:

- a revenue cap;
- operating cost pass through;
- long term contracts;
- a take or pay pricing structure; and
- secure counterparties.

In light of this, and the factors suggested by Dr Lally, the User Group submits that Prime's free cash flows from its ownership of the Terminal will exhibit virtually no volatility and as such:

- there is no material sensitivity to GNP shocks as the combination of the revenue cap and operating cost pass through totally insulates Prime against such movements;
- there is no exposure to customer mix;
- there is no risk to demand changes;
- there is a high degree of monopoly power and low income elasticity;
- the available growth options for the Terminal involve new investments which would be subject to the regulatory environment as currently applies and hence cannot be said to influence the assessment of beta.

Finally, the User Group reiterates that its original submission stated beta estimates for previous QCA decisions assuming a debt beta of zero.¹ Similarly, the User Group wishes to restate the relevant beta estimates from its original submission assuming a debt beta of zero:

Company	Equity beta	Asset beta (0.20 debt beta)	Asset beta (zero debt beta)
Adsteam Marine	0.33	0.25	0.13
Auckland International Airport	0.53	0.37	0.27
Australian Infrastructure Fund	0.72	0.66	0.63
Hills Motorway Group	0.36	0.31	0.24
Macquarie Infrastructure Group	0.39	0.32	0.25
Transurban Group	0.69	0.48	0.39
Average (simple)			0.32
Average (value weighted)			0.25
Infratil Australia	0.86	0.57	0.49
Toll Holdings	1.31	1.17	1.15
Patrick Corporation	1.33	1.18	1.16
Port of Tauranga	0.44	0.38	0.33
Northland Port Corporation	0.75	0.75	0.75
Ports of Auckland Ltd	0.51	0.45	0.42

¹ DBCT User Group, Submission to the Queensland Competition Authority, 3 September 2003, page 101.

The User Group also notes that the most recent estimate of Prime's equity beta is 0.06.²

If a zero beta is adopted, then the applicable asset beta associated with the equity beta of 0.42 that was recommended in the User Group's original submission should be revised from 0.30 to 0.17.

Risk free rate

The User Group notes that the use of the risk free rate corresponding to the horizon of the regulatory period as opposed to 10 year bond (which is the longest deeply traded bond currently available in Australia) has created considerable controversy in regulatory circles in Australia.

The User Group simply notes that the principal concern raised in relation to the approach suggested by Dr Lally relates to the failure of the approach to accommodate uncertainty over time.

However, the User Group notes that in relation to the regulation of the Terminal, there is an unusually high degree of certainty attached to the regulatory cash flows over time. This is due to:

- the User Group's suggested approach to regulation of a revenue cap, removing the volatility of cash flows associated with variations in throughput (subject to the possible exception of asymmetric risk events addressed below);
- the fact that Prime's proposed approach to the regulation of Terminal revenue is based on a model in which the costs associated with the operation of the Terminal would be a pass through to Terminal Users. Under such an approach, there is no exposure to Prime from changes to these costs over time. This is in contrast to the approach that normally arises in regulatory processes where an estimate is made of efficient operating costs as part of the assessment of allowed regulatory revenue. As such, the regulatory model proposed by Prime relating to operating cost (and also proposed by Users, and as is currently in place at the Terminal) provides it with complete protection against operating costs moving over time; and
- future capital expenditure being explicitly incorporated into the asset base, and in turn, the pricing structure via adjustments to the revenue cap from the time of commissioning of new infrastructure.

Whilst the User Group notes that arguments have been raised against the approach suggested by Dr Lally, it also submits that in a regulatory environment such as that which is proposed for the Terminal, there may be some merit in adopting the duration of the regulatory period as the horizon for the risk free rate.

² Source: Bloomberg.

Financing charges

The User Group accepts the approach suggested by the Lally report in respect of the financing charges associated with equity. However, the User Group notes that the proposed allowance associated with the cost of raising debt materially exceeds established precedent for such allowances.

The User Group notes that the allowance for the cost of raising debt has generated controversy in Australian regulatory circles. The User Group believes that the appropriate allowance is more likely to be in the vicinity of 12.5 basis points (reflected in the cash flows) rather than the 20 basis points suggested by the Lally report.

Returning to the costs associated with raising equity, the User Group notes that Prime claimed an allowance for the costs associated with procuring equity as part of its opening asset valuation.³ Prime did not provide a specific methodology to justify the quantification of the fees and costs it sought to recover from the Users, referring instead to an uplift to the "Base DORC" to account for these costs. The allowance sought to be recovered by Prime may include the cost associated with securing finance for the original bid for the lease of the Terminal and as well as the subsequent float of Prime. Such costs would not be allowed for regulatory pricing purposes under the approach suggested in the Lally report.

Nevertheless, the User Group believes it is appropriate to briefly review the financing costs sought to be recovered by Prime in the event that the QCA does not accept the approach suggested by Dr Lally.⁴ The User Group rejects any claim related to the acquisition of the Terminal. There are several reasons for this view:

- Babcock & Brown's acquisition of the Terminal merely represented a step in its commercial strategy to develop a successful infrastructure investment fund, an objective which it has already substantially accomplished through Prime. Already, Prime has acquired an interest in the Redbank power station and in the assets of EcoGen Victoria. These acquisitions illustrate a commercial strategy to build a portfolio of assets around a foundation asset, namely the Terminal. Consequently, the User Group sees no justification for any of the costs associated with the creation of Prime to be considered in the current assessment;
- the Statement of Regulatory Principles contained no suggestion that the transaction costs associated with the acquisition would be allowed. In such a case, the User Group believes that Babcock and Brown, along with the other bidders, would have factored their bid costs into the setting of their bid price (together with the costs associated with raising finance for their bid if successful).

³ DBCT Management, Dalrymple Bay Coal Terminal Access Undertaking, Accompanying Submission prepared by Prime Infrastructure (DBCT Management) Pty Limited, page 15.

⁴ The User Group does not wish to revisit issues associated with the capitalisation of interest as part of the asset valuation process in this submission and refers to its previous submissions on this issue.

The User Group does not consider it reasonable that the financing costs associated with the purchase of the Terminal and the subsequent float of Prime be recovered from the Users of the Terminal. To do otherwise would mean that Users would be funding Babcock & Brown's wider commercial strategy associated with its interests in the Terminal.

If however the Authority does allow Prime any equity raising costs, then the User Group submits that it is not reasonable that Users of the Terminal should meet the full cost of the float of Prime. Clearly, substantial economic benefits have already accrued to Babcock and Brown from the successful float of Prime – as illustrated by the growth in assets outlined above and the management fees that have already been secured⁵.

The User Group also notes that there are limited precedents for the recognition of equity raising costs in regulatory decision making in Australia but that in the current circumstances such precedent represents the upper limit that should be allowed to Prime. In this regard, the most relevant regulatory decision relates to the ACCC's allowance in GasNet where an allowance of 0.224% of regulated equity was allowed to be recovered as an annual non-capital cash flow.⁶ Should the Authority allow any equity financing charges, the User Group considers that these allowances represent the upper limit of Primes' reasonable recovery of equity financing costs.

Asymmetric risks

The User Group agrees that asymmetric risks should be addressed through the cash flows as recommended in the Lally report.

The User Group is considering appropriate arrangements for the recognition of asymmetric risk for the Terminal in light of the recent failure of RL1 and will provide a separate submission on this issue in due course.

Finally, the User Group reiterates the position it presented in its original submission that there is no evidence of stranding risk for the Terminal, and that, to the extent that such a risk emerges in the future, the most appropriate regulatory response is to rely on accelerated depreciation.

⁵ Prime Infrastructure 2002/2003 Annual Report, page 2.

⁶ ACCC, 2002, GasNet Australia access arrangement revisions for the Principal Transmission System, p151.

As you are no doubt aware, the Lally report is a highly technical review of the issues associated with the cost of capital. In this submission the User Group has set out its views on the issues raised in the report in a non-technical way. The User Group would appreciate the opportunity of making a further submission to the Authority on the technical issues to emerge from the Lally report.

Please let me know if you require any further information at this stage.

Yours sincerely
DBCT User Group

Viv Forbes
Chairman