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Mr John Hall
Chief Executive
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Dear John

THE COST OF CAPITAL FOR REGULATED ENTITIES

The Queensland Resources Council (QRC) welcomes the opportunity to comment on the report prepared for the Queensland Competition Authority (QCA) by Dr Martin Lally.

Infrastructure services are a vital input to the mineral resources sector particularly rail, port, electricity and water. The Queensland resources sector is a significant provider of raw and semi processed materials to global industry. The timely provision of competitive, reliable and efficient infrastructure is a key to the sector's ability to participate in a highly competitive global market for energy and mineral commodities.

The QRC acknowledges that the provision of infrastructure, as with resource development requires long-term, capital intensive investment. In Queensland most of the services are provided by regulated entities. The regulated cost of capital is one of the key components in the determination of the pricing of these services and therefore an important influence on both the decision to invest and the competitiveness of the industries the infrastructure sector services.

QRC understands that the QCA commissioned the Lally report to review the historical approach adopted to determine the cost of capital for the regulated industries in Queensland. The QCA will consider this report together with stakeholder responses, to assist it in determining the regulation of pricing infrastructure in the future.

While this report was commissioned during the assessment of draft Dalrymple Bay Coal Terminal Access Undertaking, QRC understands that it represents a general review of the alternative approaches and factors that should be considered in determination of the cost of capital generically rather than for specific application to DBCT.

The Capital Asset Pricing Model and Alternatives

The Lally report offers a comprehensive review of alternative models developed by the financial community and addresses the various elements including market premium, risk free rates, the treatment of imputation credits and corporate tax rates. QRC cannot add to the specific comments made by Lally in his assessment of the merits and shortcomings of the various approaches adopted in the models examined.

The review does however highlight that the determination of the cost of capital is an inexact science with the factors contributing to the final outcome being subject to the

interpretation of historical market observations and the testing of numerous hypotheses. QRC notes that there is a wide range of views within the academic financial community and these are highlighted by Lally.

QRC also notes that Lally recommends departure from current accepted Capital Asset Pricing Model (CAPM) approaches. While this is not necessarily incorrect, QRC suggests that QCA should satisfy itself that departure from current accepted practice is justified. In QRC's view the justification would be that the alternative approach delivers a more efficient outcome.

Throughout the review Lally acknowledges the uncertainty of the various approaches - both those he rejects and those he adopts. He also notes the consequences of estimating either too low or too high. Lally observes that adopting a cost of capital that is too low gives rise to output prices that are too low, which will lead to under investment. However one that is too high will lead to excessive output prices. These observations need to be considered carefully. On a number of occasions Lally states that the former risk is more serious than the latter and he suggests that where there is uncertainty one should tend toward a higher cost of capital in order to encourage investment. QRC takes issue with such an approach.

In Queensland there is a general expectation of further growth in the resources sector that will require parallel growth in the provision of infrastructure and this will require substantial capital investment. QRC acknowledges that, whether public or private, investors should expect an appropriate return. Nevertheless QRC does not agree with the view that the risk of under investment is more serious than the risk of excessive output prices. If the cost of capital is set too high the price of infrastructure services will result in an uncompetitive resource sector. This will reduce, and ultimately eliminate the demand for infrastructure. Indeed when considered in the context of a competitive industry competing in global markets with the direct and indirect jobs and export earnings that result, there is an argument, particularly in the case of public sector investment, that it would be more appropriate to be conservative on the low side. Choosing the lower end of the cost of capital range would ensure competitive output prices.

Asset Beta

Section 9 of the review discusses the factors that need to be considered in the assessment of the asset beta for an infrastructure entity. While this is only one of the input factors to the CAPM it has a significant influence on the final outcome and is the least generic of the input factors. It is the one factor that relates to the specific entity. Specific characteristics of the Queensland infrastructure sector can, in QRC's view be considered in the context of Lilly's discussion and QRC offers the following observations regarding the various characteristics outlined by Lally in Section 9.2 of the review. These comments primarily relate to the rail and port industries serving the bulk materials transport requirements of the coal and metals sector but can also apply to other infrastructure services such as electricity and water.

- The first characteristic identified by Lally is the sensitivity of returns to real GNP shocks. The Queensland mining sector competes in a global market place. It is primarily an export industry with its products being sold to every corner of the world with a very diverse customer base. It is important to note that the industry

is not dependent on any single country / economy. Whereas in the past there may have been a single significant exposure to Japan, Queensland markets are now significantly more diverse. Queensland's heavy haul rail, bulk commodity ports and indirectly, much of the electricity sector have been established to service these exports. Therefore while these infrastructure entities may be located in Australia and service local customers they are in fact servicing the global economy rather than the domestic economy.

- The resource sector produces the raw materials, both energy and metalliferous that underpin global industrial production and are essential for the global economy. Demand for such products generally has low elasticity. While the sector experiences volatile prices this should not be interpreted as a high elasticity of demand. For several decades tonnage / volume demand has shown relatively steady growth with little volatility. It is this volume that determines the demand for infrastructure services not the price of the commodity.
- Lally's second characteristic is the nature of the customer, which for the resource sector is typically offshore, private or public sector and is a business rather than personal customer. All of these contribute to the argument for a lower asset beta.
- While not unique, Queensland's infrastructure sector has few direct comparators around the world particularly in countries often used to identify comparators in the determination of assets betas - USA and UK / Europe. Much of Queensland's infrastructure sector has been established solely to supply the export resource sector. In the mature capital market economies few, if any, would have infrastructure entities that are as exposed to the global economy as Queensland. The diversity of economic risk the Queensland sector is exposed to compared with most other comparators points to a reduction in the asset beta.
- The third characteristic is pricing structure. Typically in Queensland the regulated entities enjoy variations of take-or-pay type pricing structures i.e. a high proportion of fixed pricing which lowers their sensitivity to shocks.
- The fourth and fifth characteristics relate to the duration and regulation of prices. Typically the Queensland infrastructure sector is subject to price regulation with term pricing that can be equated to a revenue cap or hybrid price and revenue cap. While prices tend to be set for a regulatory period, typically five years, there are usually reset provisions These take the form of volume triggers and other contract re-openers which enable adjustment to the output price within the period and thus reducing the entities' sensitivity to economic shocks. Coupled with long term contracts and take or pay arrangements, Queensland infrastructure entities are typically not exposed to economic shocks, again a factor that should contribute to a lower asset beta.
- The degree of monopoly power is Lally's sixth characteristic. Queensland's infrastructure sector, particularly that serving the resource sector, has strong regional monopoly characteristics. The mining industry is based on geological resources, which cannot be relocated, and therefore the resource company often

has little or no choice for the provision of infrastructure services. These services must contribute to the overall competitiveness of the resource product in the global marketplace that limits the monopolistic power of the resource entity but location rent can be a major factor in the global trade of resources.

- The seventh characteristic is the extent of the entities' growth options, which in the area of rail and port tend to be relatively limited and closely tied to the options within the resource sector itself.
- Queensland resource entities tend to have high levels of fixed costs (principally but not confined to capital costs) relative to total costs. However as noted above the exposure to global rather than single GNP shocks and the pricing structure typically employed reduces the sensitivity due to this factor.
- The eighth and last characteristic identified by Lally is market weight. Until recently infrastructure provision in Australia and many other economies was almost the sole domain of the public sector. While the private sector has recently entered this sector and is now represented in the local and international capital markets, there are few examples with long market histories that can be used as comparators. Infrastructure remains significantly under represented in many markets. It is unclear how the historical observations used in the research of CAPM are affected by the fact that the infrastructure sector, such a large part of the economy has been significantly underrepresented in global capital markets.

In summary QRC considers that the typical characteristics of infrastructure entities in Queensland, particularly those that service the resource sector, would contribute to a low sensitivity to economic shocks, which suggests a low asset beta. QRC notes that there are few examples around the globe that can be regarded as comparators - infrastructure entities with high exposure to the resource sector, global rather than domestic markets and pricing structures that further reduce the sensitivity to economic shocks.

Asymmetric Risk

Section 15 of the review addresses the issue of asymmetric risk and QRC makes the following observations in relation to the matters raised in this section.

In relation to optimisation the resource industry has been taking the approach of fully consultative capacity planning and capital investment analysis with the infrastructure sector. Such processes are being explored in the context of the new rail access undertaking, as an example, with the intention being to minimise if not eliminate the risk of optimisation.

While the asset-stranding risk cannot be totally dismissed it needs to be considered in the context of the Queensland resource sector. Infrastructure providers seek to avoid specific asset stranding risk in relation to single project exposures by, for example, requiring the project sponsor to provide the capital investment. The majority of the sector has the advantage of exposure to a diversity of projects which tend to have a cost structure with

high sunk cost and low operating costs. There have been very few examples of project failures (as opposed to company failures) in the Queensland resource sector. Offsetting the risk of stranding is the potential for infrastructure service demand extending beyond the originally expected economic life due to extension of reserves or establishment of new projects. This has been a common characteristic in the Queensland resource sector and therefore offers some upside to the infrastructure sector which QRC argues more than offsets any potential stranding risk.

Should you wish to discuss any aspect of this response please contact Keith Barker on 3295 9560.

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