



26 November 2004

Mr E J Hall
Chief Executive
Queensland Competition Authority
Level 19, Comalco Place
12 Creek Street
Brisbane Queensland 4000

Dear Mr Hall

Dalrymple Bay Coal Terminal (DBCT) – Draft QCA Decision

The Australian Pipeline Industry Association (APIA), the peak national body representing Australia's gas transmission sector, welcomes the opportunity to make this submission in response to the Queensland Competition Authority's Draft decision regarding access conditions for the DBCT.

APIA is concerned that a number of aspects of elements of regulatory judgement in the Draft Decision are incorrect and would have potential adverse implications for regulated infrastructure owners in general, including for gas transmission pipelines regulated under the National Gas Access Code.

The specific issues on which APIA wishes to comment are:

- The approach adopted to the determination of the Weighted Average Cost of Capital (WACC) in the Draft Decision, including the approach taken to determine an appropriate beta and failure to adjust for the inherent limitations of the Capital Asset Pricing Model (CAPM) methodology
- Issues which arise in relation to QCA's approach in determining an allowance for corporate overheads.

WACC/CAPM Issues

The CAPM model is applied in the "building block" approach to determining tariffs, a methodology that has been widely adopted to determine allowable rates of return for regulated gas assets. The emphasis given to the CAPM methodology by regulators as a "quantitative" model is a matter of ongoing concern to the gas transmission sector and has been the subject of an appeal to the Australian Competition Tribunal. An important insight from the Tribunal's decision in the GasNet case (reflecting the range of outcomes arising under the WACC/CAPM approach) is that the Regulator's role is to assess whether the service provider's proposal falls within a reasonable range, not whether the proposal is consistent with the regulator's view of the preferred outcome. This is a

fundamentally different approach from that which has been adopted by regulators to date, where regulators have substituted their preferred outcome for that of the service provider, irrespective of whether or not the service provider's position fell within a reasonable range.

Support for APIA's concern regarding the quantitative and restrictive application of CAPM to derive permitted rates of return for regulated infrastructure can also be found in the recent report by the Productivity Commission on its Review of the Gas Access Regime. In that report, the Productivity Commission has noted (page 299):

“Given that the CAPM is a theoretical model based on debatable assumptions, the Commission is concerned that the model has become the de-facto requirement under the regime.”

The Commission recommended that regulators be given more clear guidance about the uncertainty associated with calculating an ex-ante rate of return (Recommendation 7.9).

“The role of the relevant regulator is therefore to assess whether the Service Provider's:

- (a) proposed method has a plausible conceptual basis; and***
- (b) values used in applying the method lie within the range of plausible estimates.***

The Relevant Regulator must approve the proposed method if (a) is satisfied. The Relevant Regulator must approve the values used in applying a method if (b) is satisfied.”

APIA believes that the regulation of Australia's infrastructure industries must:

- Avoid promoting competition and lower prices at the expense of necessary investment – otherwise consumers will become worse off over time
- Avoid seeking to impose the concept of “perfect competition”, but rather work to replicating outcomes consistent with “workable competition”
- Ensure greater emphasis on incentives to invest.

Against this background APIA is concerned with the heavy reliance placed on proxy beta comparisons to establish a beta for the DBCT. APIA observes that Australian regulators have noted concerns about the statistical unreliability of the proxy beta approach and have reached judgements based on the general adoption of significantly higher beta values.

APIA is also concerned that the QCA appears to have relied entirely on a report from the Allen Consulting Group (ACG) to provide guidance on this matter. In view of the consequences (ie to investment) of regulatory error based on such judgements, it is essential that the assumptions of the ACG analysis be subject to detailed scrutiny by QCA and others, including in relation to issues that have been raised regarding limited sampling, the judgements applied and whether appropriate comparators have been used. Having regard for the commentary provided by the Productivity Commission in relation to the application of WACC/CAPM in regulated gas industries, APIA is particularly concerned that the ACG data has been applied without allowance for these uncertainties.

Non Capital Costs

APIA is unable to agree with the principle that the corporate structure of a service provider should be ignored and non-capital costs be allowed only to the extent that they directly concern operations. As with all major infrastructure in this country, the financial and strategic management of the asset is a major undertaking and costs for executive and strategic management, financial, taxation, legal control and other matters should be allowed as a normal cost of doing business. More importantly, based on the experience of APIA asset owner members, such costs are generally accepted as being incurred by a prudent service provider acting in accordance with accepted industry practice.

The principle proposed by the QCA relies on an artificial distinction which seems to presume that anything other than the physical day to day operation and maintenance of an asset is not part of the costs incurred by the asset owner in providing services by means of that asset. This is an extraordinary presumption and one which must be corrected.

APIA is also concerned that QCA's "bottom up" approach to assessing an appropriate level of corporate costs is prescriptive, arbitrary and presumes a deep level of understanding of the business, its structure and its management. It is indicative of the overly forensic and prescriptive approach which has developed in the regulatory environment in this country. Such approaches are not only arbitrary and costly for service providers, but also create a very misleading impression regarding the level of precision that can be achieved.

Conclusion

APIA considers that the Draft Decision, if implemented, would:

- be inconsistent with the inherent limitations and uncertainties of the WACC/CAPM methodology;
- have an adverse impact on the legitimate business interests of the service provider for the DBCT; and



- establish a regulatory precedent which could further erode the investment climate for regulated infrastructure in this country, including in the regulated gas sector.

Yours sincerely

Allen Beasley
Chief Executive

Cc Mr D McDonough, Chairman, QCA