



Assessment of Prime Infrastructure
Overhead Costs:
Response to comment by Ernst & Young

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Queensland Competition Authority

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Table of Contents

1.	INTRODUCTION	1
1.1	Original Project Brief	1
1.2	This report	1
1.3	Limitations	1
2.	GENERAL ISSUES	2
2.1	Choice of comparators	2
2.2	Top-down and bottom-up approaches	3
2.3	'Doubling up' of overhead costs	5
3.	DETAILED ANALYSIS OF PRIME INFRASTRUCTURE CORPORATE OVERHEAD.....	6
3.1	Accounting and Taxation Fees.....	6
3.2	Corporate communications	7
3.3	ASX and share registry fees.....	8
3.4	Salary	9
3.5	Board Expenses	10
3.6	Consultancy Fees.....	11
3.7	Legal Fees.....	12
3.8	Office Rentals.....	12
3.9	Other employment related costs	13
3.10	Airfare and accommodation	14
3.11	DBCT Credit Rating.....	14
3.12	Distribution expenses	15
3.13	Regulatory Related Costs	15
3.14	Depreciation	15
4.	SUMMARY	16

1. INTRODUCTION

1.1 Original Project Brief

Meyrick and Associates was engaged by the Queensland Competition Authority to provide an independent view as to the appropriate amount for Prime Infrastructure corporate overheads for inclusion in DBCT'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 This report

In line with its customary practice, QCA made our assessment of operating costs publicly available. Prime subsequently commissioned Ernst and Young (E&Y) to undertake an independent assessment of the appropriate level of corporate overhead costs, and undertake a review of our work. The E&Y review was provided to the QCA as an Appendix to Prime's submission to the review. This report documents our response to the information, argument and assessments contained in the E&Y review.

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 entity's 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. A copy of this request was included as an Appendix to our original report. We understand that the QCA passed these requests on to the relevant parties.

Neither the E&Y report nor Prime's submission contains this information, and it has not been provided to us by any other means. We continue to consider the information that would be useful in refining our conclusions, and may in some instances provide cause to revise some of aspects of the assessment. The results and opinions contained in this document should therefore be read with this caveat in mind.

2. GENERAL ISSUES

The E&Y review presents considerable new information and analysis, some of which has been very useful to us in refining our estimates. In several instances, this has led to a significant downward revision of the cost proposed by Prime. As will be seen from the detailed analysis in Section 3, it has also led us to reconsider some of the cost components.

But there are some fundamental issues on which the E&Y approach differs from that which we have adopted, and which in our view leads E&Y to overestimate the appropriate level of corporate overhead costs. This section is devoted to a discussion of these issues of general principle.

2.1 Choice of comparators

This is perhaps the most important and most fundamental difference of view between E&Y and Meyrick. E&Y appears to believe that the most important criterion for selection of comparator companies is that they share a similar structure, and hence focus their comparison on a set of companies that are involved in the delivery of a totally different type of service (primarily the distribution of gas) through a totally different type of infrastructure (a pipeline network) delivered to a very different customer base (DBCT's customer base is much more concentrated). The justification of this is ultimately an appeal to the way they are structured.

We believe that this is inappropriate, and betrays a basic misunderstanding of the regulatory task. The general preference in benchmarking for choosing firms from the same industry or undertaking similar tasks is well-established

The essential function of regulation of coal terminal activity is to ensure that services are delivered efficiently, and that the charges levied for the provision of these services are appropriate. The assessment which this demands is a comparison between Prime's costs and the costs of an efficient and well-managed coal terminal. The specific form of the company, financing or dividend structure that the owners may wish to wrap around the facility is ultimately irrelevant to the decision on what charges users should pay. The function of regulation is to force companies to behave as if they were operating in a competitive environment. It is quite possible that, in such an environment, different operators would choose very different models of operation: some may choose the Prime model, separating operations and ownership; other may choose an integrated model, such as that operated by Gladstone Port Corporation, or a half-way house between these, such as operates at PWCS and KPCT.

The important point is that in a competitive environment, the chosen corporate structure must ultimately deliver a cost/service package that is as good as that provided by rivals operating under a different structure. The test is applied in the market into which these services are delivered: in our case, in the market for coal terminal services. The comparison that must be made is therefore with other providers of the same service. This is the comparison that users of the DBCT would make in a highly competitive environment; and this is therefore the comparison that a regulatory regime, seeking to emulate the pressures of a competitive market, must make.

By contrast, the comparison that E&Y undertake may provide some insight as to whether Prime is an efficiently managed investment vehicle, but tells us nothing whatsoever about whether it delivers value to coal terminal users. It is important to recognise that many of the higher corporate costs incurred by Prime have been done so as to advance the ‘listed infrastructure’ aspect of the company.

2.2 Top-down and bottom-up approaches

E&Y express a preference for the use of ‘top down’ rather than a ‘bottom up’ approach, on the grounds that a ‘bottom up’ approach must ‘by its very nature be highly subjective and assumes an intimate knowledge of the operations and management of Prime’.

There are three points that should be made with respect to this comment.

Firstly, we do not have a general preference for either a ‘top down’ or ‘bottom up’ approach, and of course we use both in our analysis. The issue is how much weight to put on each. This is an empirical question rather than one of basic principle: it depends on the quality of the data available. If detailed reliable information on the overall operating costs (including corporate overheads) were publicly available for a reasonable sample of very similar companies, then it would be appropriate to assign a lot of weight to a ‘top down’ comparison. Unfortunately, this is not the case. E&Y implicitly (in its choice of comparators and comments on p10, final paragraph) recognises that there are few ideal comparators for DBCT, and information on those few is incomplete.

On the other hand, through long involvement with the ports’ industry, and working closely with over a dozen port corporations and terminal operators, we have developed considerable understanding of their cost structures and typical levels of expenditure on specific cost items. This provides a stronger – though still admittedly imperfect – basis for establishing reliable estimates of reasonable costs. In this instance, we have therefore relied more heavily on the ‘bottom up’ estimates, and used ‘top down’ analysis as a secondary check on the reasonableness of our conclusions. This continues to appear to us to be the appropriate way to proceed.

Secondly, we acknowledge that there is a considerable element of subjectivity – perhaps more appropriately referred to in this context as ‘professional judgement’ – involved in estimating appropriate operating costs (including corporate overheads). But we would argue that this is an ineradicable characteristic of the task of estimating reasonable costs, rather than a feature of the particular approach that we adopt. The ‘top-down’ approach adopted by E&Y is itself shot through with subjective judgments. This is apparent in, to name but a few areas, the choice of comparators, in judgements on where within broad statistical ranges Prime’s costs could reasonable be expected to lie, and in the appropriate way of apportioning costs between DBCT and Prime’s other activities. We do not say this by way of criticism: it is both necessary and appropriate that E&Y should exercise its professional judgement in these areas. In fact, there is no way that it can be avoided. However, it does suggest that the implied criticism of our approach that is embedded in E&Y’s use of the term ‘subjective’ is unwarranted.

Thirdly, we disagree with E&Y's claim that the application of a 'bottom up' approach requires 'intimate knowledge of operations and management of Prime'. The dangers of relying on the actual costs of the regulated entity are well-known and well-documented. What is relevant from a regulatory perspective is not what Prime actually spends, but what an efficient and well-run terminal operator would spend. This requires a sound knowledge and understanding of generic cost levels and structures in the industry rather specific information on Prime's expenditure.

This is not to say that information on Prime's actual costs is not useful. There are some specific instances in which access to this information might help to explain why the costs of operating DBCT may, for unavoidable reasons, differ from the cost of operating another similarly sized terminal. The detail on Prime's costs provided by E&Y has been used for this purpose in the analysis documented in Section 3 below. But for the most the levels of actual expenditure must be validated against norms for the specific industry, and it is these norms that provide the most important element of the analysis.

2.3 'Doubling up' of overhead costs

In our report, we look initially at Prime's overhead costs as a percentage of total costs, and point out that, on a superficial comparison with conventional 'rules of thumb' on overhead cost ratios, it appears modest. We go on, however, to assert that comparing this ratio to conventional benchmarks for overhead cost ratios would be inappropriate. E&Y infer from this that we believe that there is likely to be a 'doubling up' of costs as the operator level, and moreover that we have made 'a fundamental assumption than an "outsourcing" model is inherently inefficient' (page 10).

We have been unable to find anything in our report that would explain this reading of it. We make no judgement, implicit or explicit, on whether or not Prime's fundamental business model is appropriate or not. Our only contention is that, if it is efficient, then it should be able to deliver coal terminal services to the end user at or below the costs that would be incurred by a coal terminal operator with a less complex structure. Benchmarking costs against industry norms, and implementing regulation that enforces prices consistent with these norms, provides an empirical test of whether the Prime business model is efficient.

With respect to the issue of 'doubling up', there are two comments that need to be made:

1. Our comment on the overhead costs as a percentage of total costs expresses a concern with the danger of inconsistent use of terminology, not a comment on efficiency. This is we think quite clear from the discussion of Section 1.4 of our original report. The issue is that there is no clear and universally accepted definition of corporate overhead costs. It is probable that, in a simply structured organisation, some of the management costs that are currently borne by DBCTPL would be counted as 'corporate overheads', as well as all of the cost borne by Prime. A conventional ratio of overheads to operating costs would include both of these cost elements in the numerator. In order to construct a comparable indicator for DBCT, it would therefore be necessary to identify this element of DBCTPL costs, and add it to Prime's corporate overhead costs. It should be borne in mind that, as we do not and did not have the information required to do this, we pursued this line no further, and the issue is therefore not material to our analysis or conclusions.
2. Because most comparable enterprises operate on a unitary model, in order to judge whether the amount claimed by Prime with respect to specific cost elements is reasonable, it is useful to know the extent of expenditure by DBCTPL on the same element. The total expenditure by the two entities should be comparable to industry norms. This does not imply a presupposition that Prime's corporate structure is inherently inefficient. It is merely a facet of the standard benchmarking requirement that like should be compared with like.

3. DETAILED ANALYSIS OF PRIME INFRASTRUCTURE CORPORATE OVERHEAD

This section provides a detailed discussion of specific cost estimates challenges by E&Y. For each major item, Prime's 2005 claim and E&Y's assessment are shown alongside:

1. Our estimate of reasonable costs in 2004 as recorded in our original report
2. Our revised estimate for 2005. This revision includes both specific adjustment made in response to new data or argument presented by E&Y, and any adjustments made for cost increases over the period. In most instances, when a specific adjustment is made, this incorporates general cost increases between 2004 and 2005, since E&Y's discussion is frame throughout in terms of budgeted costs for 2004/5.

3.1 Accounting and Taxation Fees

Comparison of estimated reasonable costs

	Prime proposed	Meyrick	Ernst & Young	Meyrick revised
Accounting and taxation fees	\$180,000	\$120,000		\$123,000
External audit	\$ 99,000	\$100,000		\$103,000
Internal audit	\$ 77,000	\$ 50,000		\$ 51,000
Total accounting and Taxation	\$356,000.00	\$270,000	\$296,000	\$277,000

Discussion

The essential difference between the E&Y and Meyrick estimates with respect to this cost category arises from the difference of view about appropriate comparators discussed in Section 2.1 above. Our assessment was based on the scope of audit work required for ports and coal terminals. E&Y's primary basis of comparison is with listed infrastructure companies. For the reasons outlined earlier, we continue to believe that this is an inappropriate choice.

It seems inherently plausible that Prime and similarly structured companies will incur higher accounting and taxation costs than a relatively simple stand-alone operator. Prime's business model is for instance likely to be a contributing factor in the higher audit fees (external audit fees for Port Waratah Coal Services, for instance, are \$72,000). The additional costs incurred by Prime are a function of the organisational structure it requires to achieve the investment aims of an infrastructure company in the longer term. They are not in our view relevant to an assessment of the efficient costs of a coal terminal operation.

As a secondary estimate of the appropriate level for these costs, E&Y uses the ASX average. It does not seem to us that this is particularly helpful. Using a larger database does not necessarily lead to better benchmarking: the first and most important criterion is that the comparator companies are similar in the appropriate respect.

Comparing DBCT costs with the average of a large sample of companies none of which are engaged in the same industry is not in our view likely to provide any useful insight.

It should be acknowledged of course that E&Y disagree with us on what constitutes a comparable company: E&Y takes the view that gas network companies such as Envestra, GasNet and APT are more appropriate comparators than port operators. However, even if one were to accept this point, it does not follow that the ASX average is of any relevance to the comparison being made. It is true that the companies that E&Y regard as comparators are included in the ASX average. But it is also true that companies of this type form only a small part of the ASX sample, and that the accounting, taxation and audit needs of other companies that have much more weight in the ASX data – banks, for example – will be vastly different. It is doubtful whether including an ASX average adds any useful additional information.

3.2 Corporate communications

Comparison

	Prime proposed	Meyrick	Ernst & Young	Meyrick Revised
AGM	\$106,000	\$40,000	\$106,000	\$41,000
Annual Report	\$140,000	\$50,000	\$140,000	\$51,000
Newsletter	\$ 41,000	\$0	\$ 41,000	\$0
Total corporate communication	\$287,000	\$90,000	\$287,000	\$92,000

Discussion

Once again, the fundamental reason for the difference of view between E&Y and Meyrick is rooted in the choice of yardstick. Prime Infrastructure’s annual meeting was held at the Marriott Hotel, Brisbane, which may well be a typical venue for a venture capital company. But it would not be typical or representative for a coal terminal owner, and the level of expenditure indicated would not normally be sanctioned by the shareholders of a coal terminal company. It should not therefore be regarded as an expenditure that is necessarily involved in the efficient operations of a coal terminal; rather it is an expenditure that is incidental to Prime’s choice of business model.

Similar comments apply to the Annual Report of the company. While the need to publish and present to shareholders adequate information on the affairs of the company is axiomatic, the style and manner of this communication – and hence the level of expenditure on it – is discretionary. The scope of the report is also relevant: the focus of the Prime Annual Report is very clearly on the investment community, with a very clear emphasis on the performance of Prime Infrastructure as a general infrastructure investment vehicle rather than purely as the owner of DBCT.

We therefore continue to hold the view that it is appropriate that DBCT should bear some, but by no means all, of the cost of preparing the annual report. We believe that the appropriate proportion should be determined by reference to what one might reasonably expect a stand-alone terminal company to spend.

Similar considerations apply to the newsletter.

We were unable to locate a specific bulk terminal benchmark for these corporate communication instruments: it appears that formal reports of a publishable standard are not often published. Our estimates for reasonable expenditure on report/newsletter production are based on information on the level of such expenses in a major capital city port.

3.3 ASX and share registry fees

Comparison

	Prime Proposal	Meyrick	Ernst & Young	Meyrick Revised
ASX Fees	\$134,000	\$50,000	\$ 64,000	\$ 50,000
Share Registry Charges	\$178,000	\$40,000	\$101,000	\$ 51,000
Total ASX and Share Registry	\$312,000	\$90,000	\$165,000	\$101,000

Discussion

E&Y have had access to detailed information on the composition of this item, and have reported it quite fully in their report. This is very helpful in clarifying the differences that exist in our estimates of reasonable levels of expenditure for a stand-alone entity.

Prime proposed ASX fees of \$134,000. E&Y's analysis identified specific costs associated with the issue of new capital that have been included in the ASX costs incurred by Prime, and judges (correctly in our view) that these costs are not attributable to DBCT activities and should therefore not be included in the cost base for regulatory purposes.

The remainder of the ASX fees consists of a fixed listing fee plus a fee related to the volume of transactions through the CHESS system. E&Y estimates the first element on the basis that the initial capitalisation of Prime was \$400 million, and as DBCT was its sole asset, this can serve as an indicator of what capitalisation would be if DBCT were its sole asset. On this basis, E&Y arrives at a value of \$28,000 for the fixed annual ASX fee. This seems to us a reasonable approach.

E&Y then identifies \$39,000 in transaction charges, which it apportions in the ratio 400/435: although E&Y is not entirely clear on this point, the numerator appears to reflect the number of securities originally issued (at which time DBCT was Prime's only asset); the denominator reflects the 'weighted average... of securities on issue' during 2003/4.

In our view, apportioning the cost of transactions in this way is not particularly meaningful. The real question once again is to what extent the volume of transactions is driven by Prime's activities as an active and growing investment vehicle rather than as the owner of a coal terminal. It is admittedly very difficult to find an objective yardstick for measuring this, but our view is that both equity and efficiency are both best served by doing the best we can to make a rough estimate of the *right* measure – which is what we attempted to do in our analysis – rather than use a verifiable and precise quantification of the *wrong* measure – which is what, in our view, E&Y method of apportionment does.

Moreover, even if we set aside this fundamental problem, it is far from clear that the approach E&Y have adopted would be appropriate. Suppose that we accept the implicit assumption of E&Y that it would be appropriate to assign CHES fees to DBCT in relation to its importance in Prime's portfolio of assets. The most obvious way of estimating the proportion to DBCT in this case would be the share of DBCT in Prime's total holdings. In its annual report, Prime notes that:

At the commencement of the year, Prime Infrastructure held its foundation asset (a 100% interest in DBCT), a 50% equity interest in Ecogen Power, and a 50% interest in Redbank Power Station. (p10).

On the basis of information provided on page 11 of the report, we estimate that this would imply that DBCT constituted approximately 80% of the value of Prime's portfolio at that time. The acquisition of Global Wind Partners during the year reduced this to around 73%.

Moreover, since we are dealing with budget 2004/5 expenditure, a forward looking percentage is more appropriate. A chart on the same page suggests that the Powerco acquisition has reduced DBCT to 32%. Moreover, it does not seem unreasonable to suggest that anticipation of this or a similar acquisition may also have had some effect on the volume of securities traded. As a result an allocation of around 50% of share-trading costs to DBCT seems more reasonable.

Applying this ratio would reduce the proportion of transaction fees attributable to DBCT to \$19,500, and produce an estimate of \$47,500 for ASX fees, compared to our original estimate of \$50,000. Given the distance between these figures and the original Prime proposal of \$134,000, and the uncertainties that are inevitably present in such estimation, the difference between the number we originally proposed and the value arrived at using the (adjusted) E&Y approach is materially different.

E&Y has examined the Share Registry Charges proposed by Prime (\$167,000) and identified \$57,000 of one-off charges that should not be included in the regulatory cost basis. Using the allocation percentage previously discussed, E&Y assigns \$101,000 to DBCT.

For the reasons outlined above, we believe that the percentage used by E&Y is excessive. Using the 50% estimated above, this figure reduces to \$50,500. This is higher than our original estimate, but is based on better information and a reasonable methodology. We therefore propose to use this estimate.

3.4 Salary

Comparison

	Prime Proposal	Meyrick	Ernst & Young	Meyrick Revised
Salary inc Super	\$2,700,000	\$1,190,000	\$1,880,000	\$1,470,000

Discussion

E&Y claims that 'Meyrick's rejection of the costs proposed by Prime....appears to be based on a misunderstanding of the Prime corporate role and business model'. This is not the case. Rather, as pointed out in the earlier discussion, we consider that the specifics of how a particular company chooses to conduct its business are not particularly relevant to the regulatory task. What matters is the level of costs that would be incurred by an efficient business operating in the regulated industry.

E&Y consider turnover as the key indicator of executive salary. Industry type and location are significant factors in the setting of salary rates. The levels of remuneration that are typical in the management of ‘diversified infrastructure investment vehicles’ are higher than those that are typical of the port sector. This difference does not reflect the peculiarities of ‘user-owned’ infrastructure: our benchmarks for the most part are not taken from user-owned terminals but from multi-purpose port operations. Nor does the difference reflect the lack of ‘strategic asset management skills’ and ‘capital management skills’: the executive teams that we use as our benchmarks are responsible for all aspects of strategic planning and asset financing. The essential difference is that the remuneration levels of senior executives of firms such as Prime contain a significant component that is a reward for the ability to identify, frame and negotiate complex transactions for the acquisition of assets. High levels of skill in these areas can generate high returns to shareholders in such vehicles, and shareholders are therefore prepared to reward such skills generously. But they are not necessarily required for the management (including strategic planning and appropriate financing) of a stand-alone coal terminal. We therefore continue to believe that the appropriate point of comparison is the salary levels paid in the ports industry.

However, based on a very recent review of salaries at three Australian ports, we have concluded the view that \$110,000 average included in our original advice is somewhat understated. The port of Melbourne is the largest container port in Australia and the task faced by senior management - including both asset management and strategic planning - is much wider and more complex than at DBCT. Average senior executive salaries for the port in 2004 were \$155,000. More typical levels for average senior executive salaries are now around \$135,000 per annum. Based on a corporate workforce of ten devoted to strategic management of DBCT – which is, in our view – a very generous allowance for such a facility – the total annual salary cost would be to \$1.35 million, with a corresponding increase of superannuation from \$90,000 to \$120,000.

If we compare this figure to the total remuneration of senior management at Prime (given by E&Y at \$2.84) this implies that a little over 50% of the Prime’s total senior management value comes from its efforts in managing to DBCT. Given the range of other activities – and in particular the magnitude and complexity of the Powerco deal that will more than double the value of Prime’s portfolio – this appears generous.

3.5 Board Expenses

Comparison

	Prime Proposal	Meyrick	Ernst & Young	Meyrick Revised
Total Board expenses	\$259,000	\$150,000	\$217,000	\$158,000

Discussion

E&Y notes that there ‘are a wide range of Directors’ fees’ paid by publicly listed companies.

The E&Y analysis shows that the Directors' fees paid by Prime are not excessive when compared with other listed infrastructure investment firms. This is a conclusion which we have no difficulty in accepting. The real issue is to what extent this cost should be borne by users of DBCT.

The data presented by E&Y in Appendix 3 shows that total Directors' fees paid by Prime are above the third quartile for ASX listed companies. This is neither surprising nor unreasonable, given the complexity of the financial and governance issues faced by Prime. But this complexity arises because of Prime's activity as a general infrastructure investment vehicle, not as owner and manager of a coal terminal. A stand-alone coal terminal operation would be a far simpler operation. It is likely to have more in common with the 1st quartile group (average directors fees \$127,000) than the average, let alone the 3rd quartile. We therefore continue to regard our \$150,000 as reasonable.

There is another way of approaching this issue. The E&Y estimate is based on assigning 90% of the total cost of Board costs in 2005 to DBCT. It seems difficult to justify assigning 90% of these costs to an asset which, according to Prime's 2004 annual report, comprised 73% of its total portfolio in June and 32% following the Powerco acquisition. Indeed, as the DBCT is an acquisition which is now 'bedded down', one would expect that it would require less-than-proportionate board time: some allowance should be made for Board time required to integrate new acquisitions as well to identify and pursue new investment opportunities. Our estimate would imply that slightly more than half of the value of the Board contribution to Prime investors comes through its input to the strategic management and governance of the DBCT. We believe it would be very difficult to justify a higher figure.

3.6 Consultancy Fees

Comparison

	Prime Proposal	Meyrick	Ernst & Young	Meyrick Revised
Total Consultancy Fees	\$238,000	\$150,000	\$238,000	\$238,000

Discussion

E&Y make the point that it very difficult if not impossible to benchmark these costs, as they are entirely entity specific. We agree. E&Y has presented information not previously available to us on details of the specific consultancies undertaken. One of these – the DBCT Master Plan Project Review – is clearly attributable to the DBCT, and is of a type that would be undertaken by any prudent manager of the terminal. This accounts for \$239,000, which is very similar to the amount proposed by Prime.

In the light of this additional information, we have revised our advice.

3.7 Legal Fees

Comparison

	Prime Proposal	Meyrick	Ernst & Young	Meyrick Revised
Total Legal Fees	\$86,000	\$-	\$86,000	\$86,000

Discussion

In our original advice to the QCA, we noted that only legal costs specifically related to the DBCT should be included, but that we had insufficient information on which to base any assessment of how large this component is likely to be. E&Y has had access to Prime's records, and identified specific legal costs associated with DBCT of \$200,000 in 2004. Both Prime and E&Y expect these to decrease in 2005 because of the appointment of an internal counsel. On the basis of their analysis, E&Y has assessed Prime's claim of \$86,000 for DBCT-related legal advice as reasonable.

We can not independently verify E&Y analysis of Prime's legal expenditure, but both the procedure adopted and the resulting figure seem reasonable. We recommend the adoption of the figure proposed by E&Y and have amended our advice accordingly.

3.8 Office Rentals

Comparison

	Prime Proposal	Meyrick	Ernst & Young	Meyrick Revised
Office Rental	142,000	50,000	142,000	51,000

Discussion

E&Y argues that it would be inefficient for Prime to locate other in Brisbane, even it operated only DBCT, because the management of all of its major customers are located there.

We do not find this argument persuasive; nor do we accept the assertion that a regional location 'is inconsistent with the operating model for just about every other piece of infrastructure in Australia'.

It appears that E&Y's focus on inappropriate comparators has led them to overlook the fact there is a difference between gas networks – with assets spread over a large area – and port terminals – which are concentrated at a specific location. Other coal terminal operators, including the Port of Gladstone, Port Kembla Coal Terminal, and Port Waratah Coal Services have all found it more economical to locate all levels of management at the regional city in which the terminal is located. The same is true of ports everywhere, which invariably locate their headquarters in or very close to the city in which the port is located, irrespective of where the head offices of their customers may be. The only exceptions to this of which we are aware are those port operators whose activities cover a wide range of different sites, in which case – as with other owners of dispersed infrastructure assets – the firm will tend to locate at a regional or national capital. However, this clearly would not apply to DBCT as a stand-alone operation.

In all cases, the senior management levels of most major exporting companies are located in State capitals, but communications are handled either electronically or through visits made to clients' offices by terminal management on an as required basis. We continue to hold the view that the location decision of Prime is driven by its character as an investment vehicle rather than by the strategic planning, financing or customer relations needs of the terminal. We have therefore made no change in our advice with respect to this item.

If, however, we were to accept E&Y's claim that a Brisbane location is a necessity for Prime's head office, the issue of an appropriate allocation of the total costs to DBCT would arise. For the reasons outlined in previous sections, we believe that it would be difficult to justify allocating more than 50% of costs to DBCT. This would reduce the relevant office costs to around \$78,000.

3.9 Other employment related costs

Comparison

	Prime Proposal	Meyrick	Ernst & Young	Meyrick Revised
Payroll Tax	\$140,000	\$ 58,000	\$105,000	\$ 82,000
Payroll processing	\$ 14,000	\$ 5,200	\$ 10,500	\$ 8,000
Recruitment costs	\$110,000	\$ 35,000	\$ 82,500	\$ 36,000
Fringe Benefits Tax	\$50,000	\$ 20,000	\$ 37,500	\$ 29,000
Work cover	\$ 10,000	\$ 5,800	\$ 7,500	\$ 6,000
Total employment related expenses	\$324,000	\$124,000	\$243,000	\$161,000

Discussion

E&Y make the point that expenditure in these categories is closely related to salaries. Our difference of view with E&Y on these items therefore flows directly from our difference of view on the appropriate level of salaries to be attributed to DBCT, which was discussed earlier in section 3.4 of this paper. Similarly, some adjustment to our earlier advice is required on the basis of the revised salary estimates contained above. In making this adjustment, we have made a further minor adjustment to align our estimates of 'salary-related costs' as a percentage of salaries with that of E&Y, which is based on more current information.

This has been done with all items other than recruitment expenses. The recruitment expenses included should only be those that would be necessary for the purposes of managing DBCT. We have no detailed information on which to base a precise calculation of this. However, Prime is clearly diversifying its interests rapidly, and in the absence of other information it is reasonable to assume that most of its recruitment expenses will relate to new acquisitions and expansion. In this context our original allowance, which attributes approximately 30% of recruitment expenses to DBCT, continues to appear reasonable.

3.10 Airfare and accommodation

Comparison

	Prime Proposal	Meyrick	Ernst & Young	Meyrick Revised
Airfares and accommodation	\$281,000	\$35,000	\$89,000	\$42,000

Discussion

The E&Y report provides a breakdown of travel costs, which is very helpful in clarifying points of difference.

Components	E&Y Estimate	Comment
Brisbane-Mackay	\$41,000	As discussed previously, we do not accept E&Y's contention that a stand-alone DBCT operation would be based in Brisbane. This decision is responsible for a significant proportion of total travel costs, particularly between Mackay and Brisbane. We would expect a stand-alone operator based in Mackay to incur approximately half this cost (24 person-trips per year and an average cost per trip of \$900).
Board Travel	\$22,000	We accept E&Y's claim that a listed company would generally draw its directors from the Australian market, and therefore also accept this cost component as reasonable
Analysts and Institutions	\$26,000	This component relates more to Prime's general marketing of its investment services than the needs of DBCT. We do not believe that it should be included.

3.11 DBCT Credit Rating

Comparison

	Prime Proposal	Meyrick	Ernst & Young	Meyrick Revised
Credit Rating Expenses	135,000	-	40,000	40,000

Discussion

The E&Y document provides additional detail on the reasons why this charge is incurred, and we accept that a similar charge could be incurred by a listed entity whose sole business is the operation of DBCT. The cost suggested by E&Y has therefore been accepted.

3.12 Distribution expenses

Comparison

	Prime Proposal	Meyrick	Ernst & Young	Meyrick Revised
Distribution expenses	156,000	50,000	150,000	51,000

Discussion

We accept that any listed entity would incur costs of this type. However, the magnitude of Prime's distribution expenses is once again affected by the nature of its ongoing investment activities as well as by its ownership of DBCT. A stand-alone terminal operation would incur significantly lower costs. It is difficult to be definitive about how much lower, but we continue to believe that our estimate of \$50,000 is reasonable for such an entity.

On the other hand, should it be decided to adopt the approach advocated by E&Y, and allocate a proportion of Prime's actual expenditure to DBCT, then for the reasons outlined earlier the proportion adopted by E&Y seems untenably high. Based on a rough average of the value of DBCT as a proportion of Prime's Assets over 2004/2005, a figure in the order of 50% would be more appropriate.

3.13 Regulatory Related Costs

Costs incurred by Prime as a result of the regulation of the DBCT were not included in Prime's original schedule of costs, and were not part of our original review. However, they do in our view form an unavoidable part of the cost base of any terminal operator subject to regulation, and should be included. The quantum proposed by E&Y (\$200,000) is of the same order as QCA's regulatory charge and does not seem excessive.

3.14 Depreciation

As E&Y point out, depreciation of office furniture and equipment does not figure in Prime's original claim. We assume that E&Y's claim that it does not appear in the regulatory asset base is also correct. If so, then it would be reasonable to include an allowance for the depreciation of these items in the calculation of overhead costs.

The level of expenditure indicated by E&Y is not unreasonably high, and the amount allocated to DBCT is broadly in line with the costs that a stand-alone terminal operator would incur. We therefore recommend that the \$60,000 estimated by E&Y be included in the overhead calculation.

We should however note in passing that this recommendation is based on our view that a stand-alone terminal operator would incur costs at this level. If we were to use E&Y's approach of allocating Prime's project costs, we would not accept that the allocation of 75% of these costs to DBCT was appropriate. As noted earlier, DBCT now comprises on 32% of Prime's portfolio.

4. SUMMARY

Table 1 compares our revised and updated estimates of reasonable corporate overhead costs with those provided by E&Y. For each of comparison with our original report, the original categories have been retained. Our original recommendations for 2004 are also included in the table, as our Prime's original claim and its revised 2005 claim.

TABLE 1: COMPARISON OF ESTIMATES

	Prime 2004 Forecast	Prime 2005 Forecast	E&Y Recommended Corporate O/H Pool	Original Meyrick Corporate O/H Pool	M&A Adjustments post review of E&Y material	Adjusted M&A Corporate O/H Pool
Non Contested Overheads	\$695,260	\$831,000	\$831,000	\$694,507	\$136,493	\$831,000
Contested Overhead - due to Type	\$5,082,906	\$298,000	\$197,000	\$0	\$91,000	\$91,000
Contested Overheads - due to \$ Value	\$4,195,179	\$5,340,000	\$3,684,000	\$2,167,823	\$556,177	\$2,724,000
Additional Items	\$0	\$0	\$260,000	\$0	\$260,000	\$260,000
	\$9,973,345	\$6,469,000	\$4,972,000	\$2,862,330	\$1,043,670	\$3,906,000

Inflating the 2005 estimates at 2.5% per year provides the forward estimates shown in below.

TABLE 2: FORWARD ESTIMATES OF CORPORATE OVERHEADS

Year	Growth Rates	Reasonable corporate overheads
2005	2.50%	\$ 3,906,000
2006	2.50%	\$ 4,004,000
2007	2.50%	\$ 4,104,000
2008	2.50%	\$ 4,207,000
2009	2.50%	\$ 4,312,000