DBCTM submission to the QCA's Cost of Capital Methodology Review

Introduction

DBCT Management (DBCTM) is pleased have the opportunity to make this submission to the QCA's Cost of Capital Methodology Review.

Dalrymple Bay Coal Terminal (DBCT) is a multi-user coal export facility located 38 kilometres south of Mackay at the Port of Hay Point. DBCT is owned by the Queensland State Government and is leased to DBCT Management through a 50 year lease with a further 49 year option.

DBCT Management is managed by Brookfield Asset Management's (Brookfield), Infrastructure Group (Brookfield Infrastructure). Brookfield is a global asset manager focused on property, renewable power and infrastructure assets with over $150 billion of assets under management.

DBCT is declared for third party access under the Queensland Competition Authority Act with terms and conditions of access regulated by a QCA approved access undertaking.

Our key points

In 2010 the rate of return that DBCTM is allowed to earn on the regulated DBCT asset base was negotiated and agreed with terminal users as part of an overall agreement for resetting the access undertaking. The ability to reach a commercially negotiated outcome with its users places DBCTM in a unique position among QCA regulated entities.

The thrust of our submission on this review is that the regulatory framework should be designed so as to promote the commercial negotiation of access undertakings between interested parties, including the rate of return as a component part of those negotiations, with recourse to the QCA as arbitrator only as a last resort.

The brevity and relative ease of the 2010 reset of DBCTM's draft access undertaking (DAU), when compared with the lengthy, complex and sometimes confrontational process that led to the approval of DBCT's first access undertaking in 2006, is a very clear indication of the value of proactive engagement with users to obtain agreement on key aspects of the reset as early as possible in the process.

In 2010 all parties benefitted from taking a commercial approach to achieving a negotiated outcome. Going forward, DBCTM will now always seek to reset regulatory parameters, including (and especially) the rate of return, through commercial negotiation with users in the first instance.

The regulatory practice of encouraging commercial negotiations in the first instance, with the regulator assuming the role of arbitrator where negotiations break down, is consistent with current Australian and international regulatory practice.

We elaborate further on these key points below.

The 2010 DAU reset

The QCA approved DBCTM's 2010 DAU for coal handling services at DBCT in September 2010. In granting its approval the QCA noted that it was able to approve the DAU without amendment and within a relatively short period of time largely because of the reasonableness of DBCTM's claims and the support that the DAU received from customers.

The brevity and relative ease of the 2010 process stands in contrast to the lengthy, complex and sometimes confrontational process that led to the approval of DBCT's first access undertaking in 2006.

The protracted process for approval of the 2006 DAU:

- 20 June 2003 – DBCTM submits a DAU for approval.
- July 2003 – QCA releases a paper seeking comment on the DAU from interested parties.
- 15 October 2004 – QCA draft decision not to approve the DAU.
- 26 November 2004 – further submissions received.
- 20 April 2005 – QCA decision to refuse to approve the DAU.
- DBCTM and the users enter into discussions to resolve all outstanding matters.
- 21 October 2005 – concerns over the time being taken to finalise discussions prompted the QCA to issue DBCTM with an initial undertaking notice under the QCA Act. This notice required DBCT Management to submit a revised DAU which was consistent with the QCA's decision by 19 January 2006.
- 4 January 2006 - DBCTM submits a revised DAU.
- QCA seeks and receives submissions on the revised DAU.
- 15 June 2006 - QCA published its decision approving the 2006 DAU.

Source: http://www.qca.org.au/ports/2006-dbct-dau/

The QCA's review of the 2006 DAU was the first substantial review of a bulk commodity port in Australian regulatory history. The lack of regulatory precedent to guide the assessment undoubtedly contributed to the length and complexity of the process.

DBCTM learnt significant lessons from the 2006 DAU process, the most important of which is the value of proactive engagement with users to obtain agreement on key aspects of the reset as early as possible in the process. DBCTM now applies this as its first principle for approaching the reset and amendment of all regulatory settings.

Entirely consistent with this principle, we would always seek to reset the rate of return through commercial negotiation with users in the first instance.

In approving the 2010 DAU, the QCA noted that DBCTM used a methodology for determining the weighted average cost of capital (WACC) that was not consistent with the QCA's WACC methodology at the time. For the 2010 DAU DBCTM proposed to roll forward the WACC parameter values determined in the 2006 undertaking. In particular, DBCTM proposed:

a) re-estimating the time-variant WACC parameter values (e.g. the risk-free rate and debt margin) using the same methodology that was used in the 2006 undertaking; and
b) retaining the other key parameter values (e.g. the equity beta, gamma and the market risk premium) from the 2006 undertaking.

The QCA's approval of the 2010 DAU did not imply that the QCA accepted DBCTM's proposed WACC methodology, but rather the approval recognised that the WACC methodology proposed was part of a negotiated package of arrangements agreed with users.

The practical and commercial benefits gained by users through a process of negotiation can be clearly demonstrated. For example, as part of the 2010 reset DBCTM agreed to update and amend the DAU to include a number of principles from the Long Term Solution work that was being driven at the time by the Integrated Logistics Company. Although these amendments provided no benefit to DBCTM, they were important to the users, and DBCTM was pleased to make them as part of the negotiated solution. This demonstrates the relative strength that users have in negotiations, a position that enables them to effectively bring about meaningful improvements to the access regime as a whole.

A comparison of the 2010 and 2006 DAU processes clearly illustrates the significant advantages to be had by all interested parties from engaging in early and proactive commercial negotiation.

Australian regulatory practice: the ACCC's negotiate/arbitrate framework

The regulatory practice of encouraging commercial negotiation in the first instance, with the regulator assuming the role of arbitrator where negotiations break down, is consistent with current Australian and international regulatory practice.

In Australia the commercial negotiation of infrastructure services and the role of the Australian Competition & Consumer Commission (ACCC) in the arbitration of disputes under the *Competition and Consumer Act 2012* is well established. The ACCC has published guides as to how it exercises its dispute resolution power under the Act.

Extract from the ACCC Guide:

> In the first instance, terms and conditions for third party access to a declared service should be on the basis of terms and conditions commercially agreed between the access seeker and the provider of the infrastructure.
>
> In the event that an access seeker and provider cannot agree on the terms and conditions of access to a declared service, either party may request the Australian Competition and Consumer Commission (ACCC) to arbitrate the dispute by making a determination. In arbitrating access disputes, the ACCC must reach its determination through the application of specific statutory criteria.

Source: ACCC, A Guide To Resolution Of Access Disputes Under Part IIIA Of The Trade Practices Act 1974 (now Competition and Consumer Act 2012)

International regulatory practice[1]

In the United States, the Federal Power Commission (FPC) pioneered the use of negotiated settlements in the early 1960s as a means of coping with an increased workload and backlog. The FPC was suddenly faced with thousands of pipeline rate cases following a Supreme Court decision that extended its

[1] *Source: More extensive expositions of these ideas, with reference to the underlying research, are available in Prof. Stephen Littlechild's papers "Some alternative approaches to utility regulation", Economic Affairs, September 2008, and "Some applied economics of utility regulation", Energy Journal, September 2008*

regulatory jurisdiction from 157 natural gas companies to 4,365 independent producers. In 1960 it was estimated that, even with tripled staff, the FPC would take at least 82 years to deal with the 3,200 rate applications then filed.

The FPC urgently needed regulated businesses to reach negotiated settlement with their customers as an alternative to the time consuming and expensive process of litigated rate cases. It soon became clear that in addition to coping with the overload of regulatory work, saving time and money, negotiated settlements also better served the needs of all parties, allowed greater flexibility and innovation, and could achieve results that lie beyond traditional regulatory authority. Outcomes negotiated with customers can be more closely tailored to their particular needs. In addition, negotiated settlements have been associated with improvements in information provision and understanding within the industries, and better relationships between regulated entities and customers.

By 1980 negotiated settlements were reached in approximately two-thirds of all electric rate cases in the US, and in 1986 in over 70% of gas pipeline rate cases. Presently, no less than 90% of the rate cases at the Federal Energy Regulatory Commission (FERC- successor to the FPC) are settled by the participants rather than determined by FERC through the conventional litigation process.

The key to this development has been the active involvement of the users and customers themselves, and/or their representatives, negotiating with the regulated entity. The regulator no longer sees its role as taking all the decisions itself. Rather, its role is to facilitate discussion, negotiation and, if possible, agreement among the interested parties. The price control decision reverts to the regulator in the event that the parties fail to agree.

There have been similar developments in other parts of the US and in Canada. For example, the Florida Public Service Commission (FPSC) has accepted and indeed, encouraged settlements. In Canada the National Energy Board (NEB) has explicitly encouraged parties to settle. Initially, the NEB set out annually how it would determine the cost of capital in the event that a rate change was referred to it instead of being settled. Publishing a methodology was intended to facilitate negotiation and agreement on this and other issues.

The US energy regulator, FERC takes a particularly pro-active approach to encouraging and facilitating negotiation and settlement. FERC trial staff analyse initial proposals and then lead discussions among the interested parties with a view to finding a mutually acceptable outcome. Settlements facilitated by FERC generally take around 6 to 8 months to finalise. This stands in contrast to litigated rate cases that typically take many years to conclude.

Regulatory determination as the last resort

The key principles at stake for DBCTM are that:

- QCA's framework must continue to allow, and indeed encourage and, where appropriate, help facilitate, negotiated settlements.
- Negotiated settlements are a "package deal" that include agreement on an appropriate rate of return. The basis on which the negotiated rate of return is set may differ from the QCA's approved methodology.

- QCA approval of a negotiated settlement does not imply acceptance of the proposed WACC methodology, but recognises that it represents part of a package agreement that is supported by all parties.

Despite this being the key thrust of our submission, DBCTM remains an interested party in the outcome of QCA's Cost of Capital Methodology Review, and particularly in methodological changes that may result from the review, as:

- Regardless of the best intentions and efforts of all parties, instances may occur where negotiations break down to the extent that the regulator is required to make a determination that is binding on all parties. Should such a breakdown occur in negotiations between DBCTM and the users of DBCT, then the QCA's WACC methodology may have to be directly applied to determine an appropriate rate of return for DBCT.
- The QCA's methodology represents an approved and recognised framework which can aid in directing negotiations.

The following are some high level principles, which we would ask the QCA to consider in its Cost of Capital Methodology Review.

Market test

The outcomes of rate of return determinations should be subjected to a market test. The market test should be applied to the rate of return as a whole, rather than to the methodology or the parameter values used in the determination.

Much of the debate over the setting of regulated rates of return has focused on methodology and on estimation of the parameter values. The methods of WACC calculation require the use of financial models such as the Capital Asset Pricing Model (CAPM). Use of any specific method, and of any specific financial model, involves simplification and approximation. The CAPM, for example, is a simplified description of complex financial market interactions and cannot, of itself, provide a complete view of the way in which the rate of return is determined. The simplification and approximation which necessarily accompany the use of particular methods and financial models, and the errors which occur in the estimation of the parameter values to be used with those methods and models, mean that their use may not deliver a rate of return which reflects a regulated entity's efficient financing costs.

Market testing of the outcome of a rate of return determination as a whole, would require that the regulator consider not only a range of market evidence and commercial considerations relevant to the determination of the rate of return in each particular case, but also the way in which market experts deal with problems relating to data and limitations in the underlying approaches and financial models.

The requirement for market testing the outcome of a rate of return determination as a whole is consistent with the rule change for energy networks recently approved by the Australian Energy Market Commission (AEMC).

Consider the *overall* outcome, against an *overall* objective

The AEMC rule changes also require the regulator to determine a rate of return consistent with an *overall objective* (the allowed rate of return objective). The allowed rate of return objective requires the rate of return to be commensurate with the efficient financing costs of a benchmark efficient service

provider with a similar degree of risk to the service provider whose rate of return is being determined. The emphasis is on the rate of return decision as a whole, rather than on a specific methodology or parameter. The regulator must ensure that the *overall* estimate of the rate of return satisfies the *overall* objective.

In summary, our proposal is that, regardless of the choice of financial model or parameters, the QCA's Rate of Return Methodology should include as its final step a reasonableness or market test of the rate of return as a whole to ensure that it is consistent with the cost of capital faced by efficient service providers in the current market.

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We appreciate the opportunity to make these observations for the QCA's consideration. We would be pleased to discuss and elaborate on any aspect of our submission. Please contact Anthony Timbrell in the first instance.