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Dear Mark

Role and powers of the QCA in considering the 2015 DAU

1 Background

In October 2015 Dalrymple Bay Coal Terminal Management Pty Ltd (***DBCTM***) submitted to the Queensland Competition Authority (***QCA***) a draft access undertaking in relation to provision of services at the Dalrymple Bay Coal Terminal (the ***2015 DAU***).

In DBCTM's supporting submissions to the 2015 DAU (***DBCTM Submissions***), DBCTM made a number of assertions regarding the QCA's role and powers in considering the 2015 DAU, including describing the principle in section 168A(a) that the price of access:

> *should generate expected revenue for the service that is at least enough to meet efficient costs of providing access to the service and include a return on investment commensurate with the regulatory and commercial risks involved*

as being variously 'central' to the Pricing Principles in section 168A (see page 6), something the QCA Act 'entitles DBCTM to' (see page 6) and a 'requirement' (see page 16).

The DBCTM Submissions go on to propose that the approved weighted average cost of capital (***WACC***) should be set above the mid-point of what the QCA considers an acceptable range as a consequence of 'uncertainty' (page 18), 'asymmetric consequences of error' (page 16) and as 'insurance against the underinvestment problem' (page 18).

You have asked us to advise on the requirements of the QCA Act in relation to assessing draft access undertakings in respect of the issues raised in the submissions made by DBCTM, which are noted above.

2 Determining the 'appropriate' undertaking

The QCA may approve a draft access undertaking only if it considers it appropriate to do so having regard to each of the factors specified in section 138(2) of the QCA Act.

In determining whether a draft access undertaking is appropriate, the QCA must:

(a) have regard to each of the matters specified in section 138(2) QCA Act (s 138(2) QCA Act), which includes a specified list of factors and 'any other issues the authority considers relevant' (section 138(2)(h) QCA Act);

(b) have published the draft access undertaking, invited submissions on it and considered submissions received within the permitted time (section 138(3) QCA Act);

(c) otherwise provide natural justice to all stakeholders; and

(d) not refuse to approve a draft access undertaking only because the authority considers a minor and inconsequential amendment should be made to a particular part of the undertaking (section 138(5) QCA Act), with 'minor and inconsequential amendment', in relation to part of a draft access undertaking, meaning an amendment that, if made, would have no real effect or consequence in relation to that part of the undertaking and the undertaking as a whole (section 138(6) QCA Act).

Outside of those requirements, the QCA has a very wide discretion as to how it determines what is an appropriate form of access undertaking.

If any stakeholder (including DBCTM) disagrees with the QCA's assessment of appropriateness (and due process was followed in the QCA's decision making), that is an issue that goes to the merits of the QCA's decision. The merits of QCA's decision cannot be challenged under the *Judicial Review Act 1991* (Qld) unless the decision is so unreasonable no reasonable decision maker could have made that decision, which is an extremely high threshold.

3 Alleged 'centrality' of the pricing principle in s 168A(a)

In relation to DBCTM's assertions regarding section 168A(a), the first key point is that section 138(2) QCA Act does not impose a list of mandatory conditions that must be satisfied before an undertaking can be approved. None of the pricing principles are requirements or entitlements.

Rather, the QCA Act specifies a number of matters which the QCA must 'have regard to'.

This is important in understanding the relevance of the section 168A pricing principles, because (as one of the factors the QCA must 'have regard to' under section 138(2)(g)) the only requirement of the QCA Act is that they be taken into account and considered in making the appropriate decision about whether to approve or refuse to approve an undertaking.

Having had regard to the principle in section 168A(a) (so that the QCA decision is not subject to challenge for failure to take account of a relevant consideration), there is no further requirement in the QCA Act that the appropriate decision be consistent with, or gives 'central' importance or priority to, any particular one or more of the factors to which regard is to be had. The Authority's role is clearly specified in the QCA Act as one involving the balancing of a number of factors to reach an appropriate decision on a draft access undertaking. Consequently, a particular factor may be given less weight, or departed from in what the QCA ultimately determines is the appropriate decision on the relevant draft access undertaking.

In fact, it is clearly evident on a review of the factors to be taken into account (as set out in section 138(2)) that the QCA Act is not intended to provide for the QCA to follow or ensure its decision is absolutely consistent with all of the factors to which regard must be had – as there is often a clear tension between some of the factors. To mention the obvious examples:

(a) there is a clear tension between the 'legitimate business interests of the owner or operator of the service' (s 138(2)(b) QCA Act) and 'the interests of persons who may seek access to the service' (s 138(2)(e) QCA Act); and

(b) section 138(2)(f) QCA Act refers to 'the effect of excluding existing assets for pricing purposes', when any such exclusion may have some tension with providing 'a return on investment commensurate with the regulatory and commercial risks involved' (pricing principle in s 168A(a), to be had regard to under section 138(2)(g) QCA Act).

That, of itself, makes it clear that it is possible for the QCA to determine the appropriate position for the draft access undertaking as being one that is not consistent with a particular section 138(2) factor, including each of the section 168A pricing principles.

4 Uncertainty and asymmetric error

4.1 Relevance of uncertainty

The DBCTM Submissions indicate that the QCA gives no guidance as to how uncertainty regarding the weighted average cost of capital should be addressed (page 17).

However, DBCTM nevertheless submits (page 18) that:

> *it is essential that regard is given to the considerable uncertainty associated with the estimate of WACC, especially when the outcome that is set in the current challenging market must remain fixed for the next 5 years.*

The suggestion appears to be that:

(i) in view of the fact that the approved WACC is an estimate at a fixed point in time which applied for a regulatory period (proposed to be 5 years), it is possible that during the term of the undertaking there will be times when the WACC would, based on a subsequent spot estimate at that future time, have been higher than the approved WACC; and

(ii) in order to be consistent with the principle in section 168A(a) that the price of access should:

> *generate expected revenue for the service that is at least enough to meet the efficient costs of providing access to the service and include a return on investment commensurate with the regulatory and commercial risks involved …*

the WACC should be set in such a way that the approved WACC is always higher than what a spot WACC estimate would produce.

I consider the following factors are indications that it is not consistent with the pricing principle in section 168A(a) to set the WACC in the way that DBCTM appears to be suggesting:

(i) there will be periods during the regulatory term and the economic life of the infrastructure in question where the WACC would, if it was estimated at that time, have been lower than the applicable approved WACC (most relevantly that is, even in DBCTM's submissions, recognised as clearly being the case under DBCTM's current undertaking at the time of this advice);

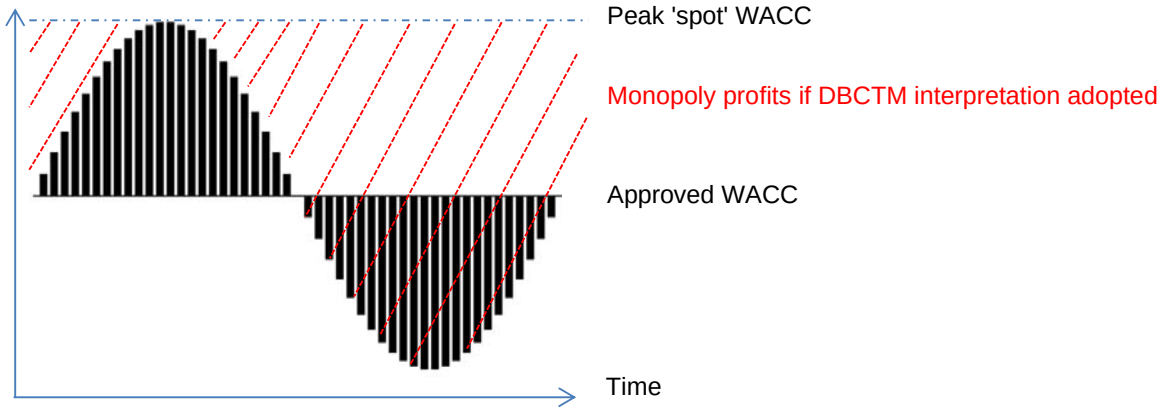
(ii) there is no evidence that the decisions of the QCA or economic regulators more generally in respect of WACC, disadvantage regulated entities more than they advantage them – such that measured over a regulatory period or the longer term it would be expected this uncertainty is revenue neutral;

(iii) as shown in in Figure 1 below, setting access pricing in a way that avoids the risks of the approved WACC being less than any hypothetical spot estimate over the regulatory term would involve setting the WACC at the highest anticipated spot estimate over the term – effectively delivering substantial monopoly profits to DBCTM over the term;

(iv) due to the very uncertainty DBCTM notes, there is no way of measuring with certainty what the anticipated spot estimate over the term is going to be – such that any adjustment to the approved WACC for this uncertainty would be arbitrary; and

(v) setting prices in a way that delivers substantial monopoly profits would be anticipated to result in inefficient use of, and potential over-investment in, infrastructure, which would be contrary to the object of Part 5 of the QCA Act (as set out in section 65E QCA Act).

Figure 1 – Simple illustration of monopoly profits produced by DBCTM interpretation



4.2 An unduly high WACC as insurance against under-investment

In relation to the submission that the WACC should be set higher as 'insurance' against under-investment, the justification raised by DBCTM (and in submissions to the other regulators that DBCTM refers to in their submissions) is that underinvestment will result in asymmetric and inefficient outcomes.

In other words, the assumption is that the results of underinvestment (arising from the uncertainty leading to a WACC that is 'too low') are worse than the results of overinvestment (arising from the uncertainty leading to a WACC that is 'too high') (see DBCTM submissions, page 16). One can imagine an example of an infrastructure owner refusing to invest in non-expansion capital expenditure even though that would substantially increase operation and maintenance expenditure to a point where investing non-expansion capital would have been more efficient.

Clearly efficient investment is part of the object of Part 5 of the QCA Act, such that an outcome that results in underinvestment is one the QCA would legitimately be cautious about adopting.

However, even if it was accepted as a general proposition that an under-estimated WACC may reduce economic incentives to invest, the QCA should not consider that economic issue in isolation of the non-financial parts of the legal and regulatory framework which provide 'insurance' against underinvestment by DBCTM. As discussed in the earlier sections of this advice, the QCA needs to consider the undertaking as a whole is appropriate – pricing outcomes only form a part of the equation.

Most relevantly the 2015 DAU as submitted (and the current access undertaking in a similar manner) imposes a number of obligations regarding investment:

(a) Section 12.3 of the 2015 DAU requires investment in expansions in specific circumstances; and

(b) section 12.10(a) of the 2015 DAU requires investment in non-expansion capital expenditure as is necessary to ensure that the terminal complies with 'Good Operating and Maintenance Practice'.

As a result, the risk of under investment is an outcome that the regulatory framework can (and the 2015 DAU currently proposes to) deal with in other ways. The presence of such provisions would be anticipated to be taken into account by the QCA in determining the appropriateness of a proposed WACC and whether it created risks of inefficient under-investment.

Yours sincerely

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