Dalrymple Bay Coal Terminal User Group

2015 Draft Amending Access Undertaking

Supplementary Submission to the Queensland Competition Authority – Debt Risk Premium (Incenta Report)

21 July 2016

1 Background

In response to an initial undertaking notice issued by the Queensland Competition Authority (***QCA***) on 23 June 2015, on 12 October 2015 DBCT Management Pty Ltd (***DBCTM***) lodged a draft access undertaking (the ***2015 DAU***) to replace the current access undertaking.

The QCA invited submissions on the 2015 DAU and, following consideration of submissions received from stakeholders, issued its draft decision on 19 April 2016 (the ***Draft Decision***).

The users of the Dalrymple Bay Coal Terminal (***the DBCT User Group***), provided a submission on 8 July 2016 in response to the Draft Decision.

On 30 June 2016 the QCA also released a report by Incenta Economic Consulting 'DBCT – debt risk premium to 31 May 2016' (the ***Incenta Report***), and invited further submissions concerning the debt risk premium and risk free rate analysis provided in the Incenta Report.

This supplementary submission principally addresses those issues.

As it does not restate in their entirety previous submissions the DBCT User Group has made on the issues under consideration in respect of the 2015 DAU, it should be read together with the three previous submissions made by the DBCT User Group during the 2015 DAU process including:

(a) the DBCT User Group Submission dated 24 November 2015;

(b) the DBCT User Group Supplementary Submission dated 22 January 2016; and

(c) the DBCT User Group Submission dated 8 July 2016 (the ***DBCT User Group Third Submission***).

2 Risk Free Rate

As noted in the DBCT User Group Third Submission, the DBCT User Group supports the methodology for determining the risk free rate set out in the QCA's Draft Decision (which is consistent with the initial submissions of the DBCT User Group and the advice of its independent consultant, PwC).

It is acknowledged that the assessment of the risk free rate will be updated by reference to the average of five-year Commonwealth Government nominal bond yields over the relevant 20 business day period agreed with DBCTM (being the period ending 31 May 2016).

The updated estimate in the Incenta Report is consistent with the estimate provided by the independent consultant engaged by the DBCT User Group (PwC), and is supported by the DBCT User Group.

3 Debt Risk Premium

3.1 Overview

The DBCT User Group is concerned with the move away from the previous approach to estimating the debt risk premium that was supported by the QCA Draft Decision and the previous Incenta report.

It considers that the debt risk premium of 2.50% (which the Incenta Report indicates is produced by that previously applied methodology) is the appropriate estimate.

The DBCT Users Group's concerns are based on:

(a) the economic evidence provided by the Incenta Report being insufficient to support the conclusion that the 2.65% estimate is a better estimate of the debt risk premium in respect of DBCTM than the 2.50% estimate; and

(b) the adverse impacts on regulatory certainty that would arise from such a change in methodology being adopted in these circumstances.

3.2 Economic analysis

The methodology applied by Incenta to estimate the debt risk premium for DBCTM differs from the approach previously approved by the QCA (not only in the Draft Decision, but also in the context of other regulated services).

In particular, in both the SEQ Price Monitoring 2013-15 decision for South East Queensland (***SEQ***) water retailers,[1] and the Price Monitoring 2015-20 decision for Gladstone Area Water Board (***GAWB***),[2] the debt risk premium was estimated using a BBB+ centred pooled approach, with a BBB 'premium' included to reflect the higher cost of debt for BBB rated entities. That is the approach the QCA adopted in its Draft Decision in respect of DBCTM's 2015 DAU.

In its most recent report, Incenta estimated the debt risk premium directly from a sample of BBB rated bonds. Incenta noted that the relationship between debt risk premium and term to maturity could be stronger for BBB rated bonds than for BBB+ rated bonds, and that the debt risk premium estimated using the BBB+ centred pooled approach could understate the true cost of debt for a BBB rated entity.[3]

The difference in debt risk premium calculated for DBCTM using the BBB+ centred pooled approach and the BBB rated only approach is 15 basis points. In comparison, PwC advised that the difference between the two methodologies for SEQ water retailers was 3 basis points. This was not considered material enough to rely on a sample of BBB rated bonds. The debt risk premium estimated for GAWB using the pooled approach is also likely to have differed from that estimated from BBB rated bonds only, though this difference was also not considered sufficient to change approach.

There is no definitive evidence provided in the Incenta Report which demonstrates why a 15 basis point difference is sufficient to apply a different methodology to that previously approved by the QCA. Neither does PwC's methodology (nor the QCA's cost of debt estimation final decision) outline any specific criteria which identifies when the pooled sample should be replaced with a sample from a single credit rating.

There is also no explanation as to why the 'dummy variables regressions' (that the Incenta Report indicates 'corroborate the 2.65%'), which generates estimates for the BBB debt risk premium of 2.49% to 2.57%, is not, in fact, evidence which is more supportive of the 2.50% estimate produced using the existing methodology. The 2.50% is actually in the range provided by this alternative methodology, rather than the new estimate of 2.65% which is completely outside the range.

The approach proposed by the Incenta Report is also reliant on direct regression from a single credit band – something which was specifically cautioned against in the original PwC Report on which the QCA's approach is based, which noted that 'the limited number of bonds on issue

[1] PricewaterhouseCoopers (2013) *Queensland Competition Authority: Cost of Debt for SEQ distribution-retail water and wastewater entities*

[2] Queensland Competition Authority (2015) *Final report: Gladstone Area Water Board Price Monitoring 2015-20*

[3] Incenta (2016) *DBCT – debt risk premium to 31 May 2016*

makes it very difficult to distinguish the debt risk premium within a credit band' (PwC, A Cost of Debt Estimation Methodology for Business Regulated by the Queensland Competition Authority, June 2013 at page v).

In light of those issues, the DBCT User Group is sceptical of the Incenta Report's conclusion that the highest of the 3 estimates provided in the Incenta Report (2.50%, 2.49-2.57% and 2.65%) should be preferred.

Rather, the DBCT User Group considers the 2.65% estimate proposed by the Incenta Report is not sufficiently supported to be appropriate for the QCA to adopt as the preferred estimate of debt risk premium.

3.3 Regulatory Certainty

As noted in the DBCT User Group Third Submission, regulatory certainty is a positive attribute that promotes efficient investment. It is also a matter that is clearly in the public interest. Consequently, regulatory certainty is a matter that must be considered by the QCA in determining whether an undertaking is appropriate to approve in accordance with section 138(2) of the *Queensland Competition Authority Act 1997* (Qld).

As noted above, the change in approach proposed by the Incenta Report is a change in methodology from each of:

(a) the previous QCA Draft Decision in respect of the 2015 DAU (and related previous Incenta report);

(b) the SEQ Price Monitoring 2013-15 decision in respect of SEQ water retailers;

(c) the Price Monitoring 2015-20 decision in respect of GAWB; and

(d) the August 2014 Final Decision – Cost of Debt Methodology paper.

The DBCT User Group recognises that estimation of the debt risk premium will need to respond to changing market conditions, and that a cost of debt estimation methodology developed at a point in time cannot foresee future fluctuations in capital markets which may necessitate change.

However, if a change was adopted in these circumstances, it is not clear to the DBCT User Group under what conditions the QCA now considers it would or would not be appropriate to estimate the debt risk premium using a pooled sample, or rely on sample of bonds within a single credit rating.

In that regard, the DBCT User Group notes the apparent tension between that uncertainty and the QCA's comments in the August 2014 Final Decision – Cost of Debt Methodology paper that 'it is important to ensure that the benchmark cost of debt is estimated using a robust, transparent and replicable method.'[4]

Given the importance of regulatory certainty, departures from methodology which the QCA has consistently applied (which create regulatory uncertainty not just for the parties impacted by the decision in respect of DBCTM, but stakeholders for other QCA regulated services as well) should not be adopted lightly.

Consequently, the DBCT User Group considers the methodology for estimating the debt risk premium contained in the QCA's Draft Decision is appropriate to retain (in favour of the revised methodology now proposed by the Incenta Report).

[4] Queensland Competition Authority (2014) *Final decision: Cost of debt estimation methodology*, p 8.

4 Need for procedural fairness in respect of issues in DBCTM's recent submission

While the QCA has only specifically invited submissions on the Incenta Report, the DBCT User Group has reviewed the recent submission by DBCTM and notes the following issues of concern where it considers that, without further disclosure it will not have been provided with procedural fairness:

(a) DBCTM makes numerous claims about the outcomes of their legal advice when they are unwilling apparently to disclose that legal advice – if the QCA is considering accepting that position, the DBCT User Group should be provided an opportunity to review and address that legal advice.

(b) DBCTM has redacted a significant amount of information from their submission (including the letter from DBCT Holdings which apparently indicates an interpretation to the Port Services Agreement that the DBCT User Group does not agree with) – again if the QCA is considering accepting that position, the DBCT User Group should be provided an opportunity to review and address the redacted material.

In addition to those issues, the DBCT User Group notes that DBCTM's recent submission raises a number of new issues on which the DBCT User Group has not been provided with an opportunity to respond. In addition to being necessary to provide procedural fairness, a short opportunity to make further submissions on those issues would presumably assist in allowing the QCA to make a more informed decision on those matters (while not delaying the timing for the final decision given that other aspects of the final decision could be progressed in the meantime). In particular, the DBCT User Group requests the opportunity to provide further submissions on:

(a) DBCTM's assertions about the extent of competition provided by the Abbot Point Coal Terminal and why individual customers executed contracts in respect of Abbot Point;

(b) DBCTM's assertion that the equity beta in connection with the current undertaking was somehow set for all future periods;

(c) DBCTM's submissions on the approach to inflation;

(d) DBCTM's reliance on the State's position in respect of the Port Services Agreement interpretation; and

(e) DBCTM's different formulation of the test for when differential pricing should apply.

The DBCT User Group looks forward to these matters being addressed in advance of the QCA's Final Decision.