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Charles Millsteed
Chief Executive Officer
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Dear Charles

QCA Rate of Return Review Draft Decision

I am writing to you on behalf of the Dalrymple Bay Coal Terminal User Group (the ***DBCT User Group***) in relation to the Queensland Competition Authority's (***QCA***) June 2021 Draft report in its Rate of return review process.

The DBCT User Group are generally supportive of those elements of the Draft report which confirm the QCA's intention to continue to apply its existing, transparent and well understood methodologies for estimating an appropriate rate of return for a regulated service.

However, two key matters of concern to the DBCT User Group are:

(a) the QCA's draft proposal to assess reasonableness of the WACC without a bottom-up estimate (at least where that occurs in the context of a negotiate-arbitrate regime); and

(b) the QCA's draft proposal to adopt the trailing average approach to estimating the cost of debt for a regulated entity (instead of the 'on the day' approach the QCA has previously adopted, which estimates prevailing cost of debt through a short averaging period close to the time the cost of debt is to be estimated). As outlined below, the DBCT User Group has serious concerns with the application of the trailing average approach as a matter of general economic principle, in its application in the context of a negotiate-arbitrate regime, and in its application to the Dalrymple Bay Coal Terminal service specifically.

Initial assessment of reasonableness of the WACC should be applied only within certain limits

The DBCT User Group understands that, in the example of the circumstance given in the Draft report (of a service provider proposing a WACC based on the existing QCA methodology for determining parameters, applying the same firm-specific parameters as approved by the QCA in previous reviews, and where there has been no material changes in risk profile and regulatory framework), a bottom-up estimate may not be required to assess the appropriate price. We appreciate that this would improve both the efficiency of the regulatory process, and predictability of the regulatory outcome.

However, it is concerned that outside of circumstances of that nature, an assessment of reasonableness without any bottom-up estimate creates material risks of inappropriate outcomes. That is, the outcome may adversely impact overall economic efficiency, especially when outcomes are unpredictable and hence investment decisions may be deferred.

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The DBCT User Group's concern is particularly held where the assessment is occurring in the context of a negotiate-arbitrate regime. This is because a user may not be presented with the same level of information in a negotiation as would be the case in an undertaking or pricing principles investigation process. In that context it presents two issues:

(a) in a negotiation between a service provider and its customers which has failed to reach a resolution (otherwise the matter would not be before the QCA for arbitration), starting solely with the service provider's proposal gives it a level of precedence that creates significant risks of an erroneous upwards bias that will both create the potential for inefficient and uncertain arbitration outcomes and, through that potential, undermine the prospects of efficient and reasonable negotiated outcomes; and

(b) in respect of DBCT in particular, the service provider has indicated in public submissions that it considers a higher price should apply under a negotiate-arbitrate regime than applied under a reference tariff regime, such that the circumstances before the QCA are likely to be significantly different from the clear cut example of continuing previous practices that the Draft report envisages.

The DBCT User Group would encourage the QCA to clearly define a narrow set of circumstances in which it would consider accepting a WACC proposal, without undertaking a bottom-up assessment, such as where the infrastructure provider's proposal was consistent with the QCA's prevailing methodology. This would help improve predictability and regulatory certainty, and hence overall economic efficiency.

General Issues with the Trailing Average Approach

The DBCT User Group is also concerned that the trailing average approach has been proposed despite there not being a clear merits based justification for moving away from the QCA's well established and understood existing approach.

Contrary to the regulatory certainty justification provided in the Draft report for the adoption of a trailing average approach, a sudden change in approach from that long adopted by the QCA immediately before the price falls to be determined for some regulated services, including DBCT, creates significant uncertainty.

Further, the reasons that the QCA has previously preferred the on the day approach continue to apply.

In particular, the DBCT User Group notes the QCA's April 2015 Final decision on trailing average cost of debt where the QCA determined that there was no compelling case for changing the QCA's existing methodology for estimating the cost of debt to the trailing average approach.

As stated in that Final decision, the QCA reached that conclusion on the basis that, the trailing average approach:

(a) compensated infrastructure owners for historical rates rather than prevailing rates (and the only way to resolve that issue was to modify it to compensate for investments made at prevailing rates, which in turn would introduce significant complexity); and

(b) is likely to materially overstate the cost of debt because efficient firms will have an incentive to trade off risk and return to obtain a shorter term of debt, and an overstated cost of debt is not in the interests of consumers.

Whereas the QCA considered that the 'on the day' approach was preferable as it:

(a) is consistent with ensuring the revenue sufficiency of the firm, including meeting the firm's cost of debt financing, while preventing excess prices to customers;

(b) provides efficient signals for new investment and is relatively straight forward to implement;

(c) provides an appropriate and manageable benchmark to enable all of the regulated firms under the QCA's jurisdiction to manage their debt efficiently; and

(d) is forward-looking, and therefore consistent with the QCA's broader cost of capital methodology, which focuses on current market conditions.

There is no discussion in the Draft report of why those arguments do not continue to justify the on-the-day approach. The DBCT User Group submits they clearly do. There is no doubt that a trailing average approach applied today will result in an artificially high estimated cost of debt, compared to the present efficient cost of financing, providing a significant and inefficient windfall gain to infrastructure providers at a significant cost to customers. The DBCT User Group submits that is not consistent with the factors the QCA requires to be considered in the context of an undertaking (s 138(2) QCA Act) or in the context of an access determination (s 120 QCA Act).

Issues with the Trailing Average Approach in the Context of a Negotiate Arbitrate Regime

The DBCT User Group notes the QCA's clear statement in the Draft report (at page 9) that where it was required to make a future access determination it would consider and weigh the relevant statutory factors as the rationale for not committing to a particular methodology for estimating an appropriate price in the context of a negotiate-arbitrate regime.

Consistent with that reasoning the DBCT User Group requests that that position is also made absolutely clear in respect of the approach to the cost of debt.

While the DBCT User Group acknowledges this is a matter for the current negotiations with DBI and, if required, arbitration it raises this concern in this review because a trailing average approach is clearly not appropriate in the context of a negotiate-arbitrate regime.

That is the case because:

(a) the key perceived advantage to a trailing average approach of smoothing the anticipated cost of debt outcomes across regulatory periods to reduce volatility may well not arise because:

  (i) the price outcomes can be set by commercial negotiation rather than QCA regulatory decision; and

  (ii) there is no guarantee there will be a roll forward of the type the Draft report (in Appendix C) assumes will necessarily occur,

  interrupting the very consistency the approach is justified on the basis of; and

(b) it will be more costly and complex to estimate an appropriate trailing average approach relative to estimating the cost of debt in the fashion the QCA has for multiple regulated assets over many years, thereby undermining the informed negotiations the QCA placed emphasis on in considering a negotiate-arbitrate form of regulation was appropriate for DBCT.

Issues with the Trailing Average Applying to DBCT

Leaving aside the economic principles of how best to estimate the cost of debt in the abstract, the DBCT User Group also has particular concerns with its application to Dalrymple Bay Infrastructure Limited (***DBI***) as the provider of the DBCT service being inappropriate.

First, the historical information disclosure requirements which the QCA considered appropriate in the context of the DBCT access undertaking do not address calculating the cost of debt using a trailing average approach.

Secondly, the trailing average approach is ill-suited to the actual financing arrangements of DBI. In particular, the DBCT Users note that in its November 2020 prospectus DBI indicates (see pages 146 and 218-220) that:

(a) it had a significant amount of debt maturing in 2021 and 2022; and

(b) further debt maturing in the years following.

Consequently, it is clear that current rates will be far more relevant to DBI's actual cost of debt than a long term historical trailing average.

Where a trailing average cost of debt is employed and historical rates are higher than the prevailing rates at the time DBI obtained finance, estimating the cost of debt on a trailing average approach will simply provide an inefficient windfall gain to DBI with inefficiently high prices borne by customers.

Accordingly, the DBCT User Group sincerely requests that the QCA not pre-determine that a trailing average approach is an appropriate method for estimating the efficient cost of debt, and at most indicates that it may be an appropriate methodology depending on the circumstances.

Yours sincerely

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