Thursday 28 March 2013

Dr Malcolm Roberts
Executive Chairman
Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001

By email: research@qca.org.au

Dear Dr Roberts,

Asciano Submission to the QCA Cost of Capital Methodology Review

1. Introduction

Asciano welcomes the opportunity to make a submission to the Queensland Competition Authority (QCA) review of its cost of capital methodology.

Asciano is a major stevedoring operator and above rail operator in Australia. In particular Asciano, through its subsidiary Pacific National, operates both coal trains and general freight trains in Queensland. Pacific National coal trains operating in Queensland largely operate on the Aurizon rail network. This rail network uses a regulated "building blocks" approach to determining its prices. The cost of capital, as approved by the QCA, is a major component of this "building blocks" approach.

Asciano recognises that the derivation of the cost of capital for use in a regulated "building blocks" approach is problematic and has been the subject of substantial and wide ranging regulatory debate over the previous fifteen years.

In this submission Asciano does not intend to discuss each of the cost of capital components in detail. Asciano believes that the methodologies used to derive these components should be used consistently across regulatory frameworks and industries to ensure that there is minimal regulatory distortion to investment decisions made by investors in regulated infrastructure assets.

Asciano's main concern with the QCA cost of capital methodology is that it accurately reflects the risks carried by the regulated asset. In particular, Asciano has concerns that the risks attributed to the Aurizon rail network in the QCA cost of capital methodology overstate the risks which apply to this regulated asset.

Asciano notes that the QCA released two discussion papers; one which focuses on risk and the other which focuses on the risk free rate and the market risk premium. This response focuses on risk issues. Asciano's main concern with the risk free rate and the market risk premium is that regulators move towards consistent approaches to deriving the values of these components.

MELBOURNE
Level 4, 476 St Kilda Road,
Melbourne VIC 3004 Australia
Telephone: +61 3 9248 7000
Facsimile: +61 3 9699 2869

SYDNEY
Level 6/15 Blue Street,
North Sydney NSW 2060 Australia
Telephone: +61 2 8484 8000
Facsimile: +61 2 8484 8154

Email: info@asciano.com.au
www.asciano.com
ABN 26 123 652 862

The main focus of this submission is the cost of capital and risks associated with Aurizon Network. Asciano has no specific position on the cost of capital as it is applied to other regulated infrastructure.

This submission is public.

2. Consistency of Cost of Capital Approaches

Asciano believes that to the extent that the components used to derive the cost of capital are common across industries and organisations then the methodologies used to derive these components and the values of the components should be consistent between regulatory processes. Asciano considers that the following cost of capital components should have a common value across industries and regulated entities:

- the risk free rate;
- the market risk premium; and
- the value of imputation credits.

Thus at a given point in time the values for the components above should be identical across regulatory frameworks and industries in order to ensure efficient investment price signals are sent to infrastructure investors. To the extent that the values of these components are not consistent between regulatory frameworks then regulators and industry participants should quickly move towards consistent approaches to deriving the values of these components.

Asciano believes that the following cost of capital components should be based on common methodologies but their values may vary due to differing inputs across regulated entities and industries:

- gearing;
- equity betas;
- debt premiums; and
- effective tax rates.

Although the values of the components above may be different Asciano believes that the methodologies used to derive the values of these components should be identical across regulatory frameworks and industries in order to ensure efficient investment price signals are sent to infrastructure investors. (That is the values should differ due to different inputs rather than different methodologies). To the extent that the methodologies used to derive these components are not consistent between regulatory frameworks then regulators and industry participants should quickly move towards consistent methodological approaches. Differences in the cost of capital applied to regulated assets should reflect differences in risk rather than differences in methodological approach.

Asciano notes that there are multiple infrastructure regulators in Australia who make decisions on cost of capital. In addition to the current QCA review of the cost of capital Asciano is aware of the following reviews of cost of capital being undertaken by infrastructure regulators:

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- the Australian Energy Regulator (AER) is currently conducting a broad ranging review of the cost of capital;
- the Independent Pricing and Regulatory Tribunal (IPART) in New South Wales is conducting a review of the methodology it uses in determining the cost of capital for regulated businesses; and
- the Economic Regulation Authority (ERA) in Western Australia is conducting both a review of the cost of capital to apply to regulated railway networks in 2013 and a broader review of the method for calculating the cost of capital to apply to regulated railway networks from 2014 onwards.

Asciano is seeking that regulators move towards a common approach to determining the cost of capital. Asciano is concerned that differing regulatory approaches towards the determination of the cost of capital can lead to inefficiencies in the allocation of capital investment in regulated industries and the potential for "jurisdiction shopping" by regulated entities.

3. Cost of Capital and Risk

The current form of building blocks regulation applied to Aurizon Network reduces risk through various mechanisms built into the regulatory approach. These mechanisms transfer risk to the users and customers of the Aurizon Network.

These mechanisms are outlined below.

Revenue Cap and Unders and Overs Adjustment
Aurizon Network is subject to revenue cap regulation rather than price cap regulation, thus any impact of changes in volume on Aurizon Network's revenues over time is effectively negated as the revenue is effectively guaranteed by the workings of the form of regulation and the pricing mechanism.

The regulated pricing mechanism (via an unders and overs account) shifts volume risk to users of Aurizon Network as the prices paid by these users will fluctuate from year to year in order to ensure that Aurizon Network meets its revenue cap.

A move from a revenue cap to a price cap without an unders and overs account would shift a portion of the volume risk on to Aurizon Network (note that take or pay issues discussed below would ensure that Aurizon Network is not carrying all of the volume risk).

(Asciano believes that a move to a price cap will improve the Aurizon Network focus on volume forecasting and result in more accurate and consistent forecasting approaches for traction types and geographical systems across financial periods and regulatory periods).

Take or Pay
The Aurizon Network pricing structure, as approved by the QCA, includes both relinquishment fees and a strong take or pay component.

The relinquishment fees and the take or pay component ensure that any impact of volume risk on Aurizon Network's revenues is substantially reduced as users must pay a given amount even if they do not use the service provided by Aurizon Network in a given time period.

These regulator approved pricing structures shift the volume risk to users of Aurizon Network, as if volumes fluctuate below the take or pay level the costs per unit to users will fluctuate whereas the Aurizon Network revenues will have a floor placed under them by the take or pay pricing structure. Similarly if a user of Aurizon network permanently relinquishes pathing entitlements relinquishment fees act to place a floor under Aurizon Network revenues.

Asciano recognises that in assessing the impact of take or pay on risk that take or pay is common in some industries and so it may be reflected in the betas of comparator organisations. However, Asciano believes that under the current approach the combination of a revenue cap and take or pay effectively removes any volume risk to Aurizon Network and this should be reflected in the risk measures determined for Aurizon Network.

Cost Pass Through
The Aurizon Network pricing mechanism also allows for the pass through of costs, particularly via the annual revenue adjustment mechanism and via review event mechanisms. These pricing mechanisms shift cost risk to users of Aurizon Network as if certain costs fluctuate they are passed through to users of the network.

Capital Procurement and capital Expenditure Pre-Approval Mechanisms
The regulatory process includes pre-approval mechanisms for capital procurement and capital expenditure which substantially reduces the risk that any capital expenditure will be later disallowed by the regulator or otherwise be stranded.

Overview
Overall, Asciano believes that risk and return should be must be related, and there is currently a mismatch between the cost of capital received by Aurizon Network and the risks that they carry.

Under the current regulatory approach applying to Aurizon Network risks have been minimised by using both the form of regulation (such as revenue caps) and by ancillary mechanisms (such as cost pass through mechanisms). Given this the beta of Aurizon Network should be adjusted to take these factors into account. In particular when considering comparator companies for use in deriving Aurizon Network betas the QCA should focus on companies which have similar multiple risk minimisation and risk shifting mechanisms built into their contracting processes (and if appropriate their regulatory processes).

4. Split Cost of Capital Concept

Asciano notes that the QCA risk discussion paper raises the concept of a "split" cost of capital whereby a low risk cost of capital is applied to the existing regulated asset base and a higher cost of capital is applied to a capital base applied "operating and capital expenditure" (which Asciano interprets to mean new capital expenditure and operating capital expenditure).

Asciano queries how the risks of new capital expenditure and operating capital expenditure can be determined and in particular how comparator companies will be selected in order to determine a beta for these risks. In particular Asciano believes that the betas of comparator

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companies will not be able to be meaningfully split between existing capital and new capital.

Asciano believes that having two different costs of capital may create perverse incentives for Aurizon Network. For example operating and maintenance processes and expenditure may be increased due to the relatively higher returns available even if such actions are not efficient. In addition an increased focus on such processes may have an impact on system capacity as maintenance related capital works receive a higher return and so will be undertaken more often even if they are not needed.

Asciano believes that more details on the "split" cost of capital concept should be provided by the QCA in this current process. In particular there should be focus on mechanisms to ensure that any "split" cost of capital does not lead to perverse incentives for the asset owner.

Asciano believes that the concept of a split cost of capital is problematic and more information on how such an approach would work is needed before it can be progressed.

5. Treatment of Revenue in the Regulatory Framework

Asciano believes that Aurizon Network is developing a number of sources of revenue from the regulated network asset (such as wagon storage and ancillary movement charges) which are outside the regulated network's current allowable revenue. Asciano believes that all revenue derived from utilising assets in the regulatory asset base or based on costs incurred in activities related to the regulatory asset base should be recognised as regulated revenue for the purpose of the revenue cap.

In particular Asciano is concerned that Aurizon Network may receive a cost of capital in excess of that provided for by regulation by providing services which are effectively part of its regulated natural monopoly business.

6. Conclusion

The items identified in section 3 above all act to substantially reduce the risks of Aurizon Network. Asciano does not object to Aurizon Network reducing its risk but Asciano believes that risks and rewards must be balanced.

Asciano believes that the current regulatory framework which applies to Aurizon Network systematically minimises risks and this risk minimisation must be reflected in the rate of return going forward.

Asciano agrees with the broad direction of the QCA paper that the form of regulation impacts on the risk and that specifically that the regulated firm's beta is affected by the form of regulation (such as revenue caps) and by ancillary mechanisms (such as cost pass through mechanisms).

Asciano believes that the QCA should more explicitly take into account the form of regulation and ancillary mechanisms in considering the appropriate level of risk to be included in the cost of capital for a regulated entity.

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Feel free to contact Stuart Ronan on 02 8484 8056 to discuss this submission.

Yours faithfully

[redacted]

Tim Kuypers
General Manager Regulatory

MELBOURNE
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Melbourne VIC 3004 Australia
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