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Mr. Malcolm Roberts
Chairman
Queensland Competition Authority
Level 19, 12 Creek Street
BRISBANE QLD 4000

Dear Malcolm

Aurizon Network Pty Ltd – Submission in response to the Queensland Competition Authority’s Cost of Capital Methodology Review 2012-13

Aurizon Network Pty Ltd (Aurizon Network) welcomes the opportunity to respond to the Queensland Competition Authority’s (QCA) Cost of Capital review applicable to regulated firms under its jurisdiction.

As you are aware, the Authority published three papers in support of the review and has sought public comment on their conclusions and proposed recommendations:

- The first discussion paper, *Risk and the Form of Regulation*, predominantly addressed various forms of regulation and the ensuing impacts upon a regulated firm’s risk and cost of capital;
- The second discussion paper, *The Risk-free Rate and the Market Risk Premium*, focused upon issues relating to key components of the Capital Asset Pricing Model (CAPM), specifically the risk-free rate and the market risk premium and their role in the determination of the cost of equity for regulated firms; and lastly
- The review also consisted of a paper prepared by Associate Professor Martin Lally, *Riskfree Rate and the Market Risk Premium*, which addresses a number of issues posed by the Authority in relation to the risk-free rate and the market risk premium within an Australia context.

Aurizon Network would like to respond to the variety of issues and discussion points raised in these papers through the submission expert reports prepared by:

- NERA Economic Consulting (NERA), who was commissioned to respond to the first discussion paper, *Risk and the Form of Regulation*; and
- SFG Consulting (SFG), who was commissioned to provide views on the second discussion paper, *The Risk-free Rate and the Market Risk Premium*, as well Associate Professor Lally’s 2012 discussion paper, *The Risk-free Rate and the Market Risk Premium*.

Specifically, the key issues that Aurizon Network seeks to address include:

- Regarding the first discussion paper, *Risk and the Form of Regulation*:
 - The implicit assumption that the CAPM methodology is correct does not adequately recognise several established inadequacies;
 - The “split” cost of capital concept is subject to a number of conceptual and practical difficulties, many of which have been raised by regulators in the United Kingdom; and
 - While the form of regulation under which a regulated business operates can theoretically affect a company’s beta (β), empirical evidence on the subject presents a greater level of uncertainty. In addition, estimation of the impact of beta on different forms of regulated businesses is difficult to establish due to the current state of available experimental literature.

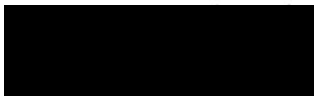
- Regarding the second discussion paper, *The Risk-free Rate and the Market Risk Premium*
 - There is some debate as to whether “term to maturity” matching is needed to achieve an NPV neutral position, where this view only holds under the tenuous assumption that the forward curve represents an unbiased assessment of expected future interest rates; and
 - Aside from differences of opinion with respect to appropriate valuation techniques, there are also a set of pragmatic issues that need to be overcome before moving away from longer-dated bonds in estimating the risk-free rate.

- Regarding Associate Professor Lally’s discussion paper, *The Risk-free Rate and the Market Risk Premium*:
 - SFG provides a critique of the effectiveness of the ‘averaging’ approach, currently used by the Authority in setting the market risk premium, in determining a robust return on equity; and
 - We would also like to draw the QCA’s attention to the prevailing direction of regulatory practice in Australia, and how a number of regulators have begun to move away from a purely ‘mechanistic implementation’ of the CAPM.

Aurizon Network remains committed to working with the Authority, our customers and stakeholders in clarifying these important issues throughout the consultation process.

Should you have any queries in relation to this draft amending access undertaking, please do not hesitate to contact Matthew Cronin on 07 3019 5695.

Yours sincerely,



Michael Carter
Executive Vice President
Aurizon Network Pty Ltd

18 April 2013