Department of Industry and Resources
Government of Western Australia

Your ref:
Our ref: R0019/200401
Enquiries: Peter Kiossev - Ph 08 9222 0928 Fax 08 9222 6158
Email: peter.kiossev@doir.wa.gov.au

Mr Russell Dumas
Director - Gas and Rail Access
Economic Regulation Authority
PO Box 8469
Perth BC WA 6849

Dear Mr Dumas

DRAFT DETERMINATION - 2008 WEIGHTED AVERAGE COST OF CAPITAL FOR FREIGHT (WESTNET RAIL) AND URBAN (PUBLIC TRANSPORT AUTHORITY) RAILWAY NETWORKS

Thank you for the opportunity to comment on the Economic Regulation Authority's (ERA) draft determination relating to the applicable weighted average cost of capital (WACC) rates assigned to WestNet Rail and the Public Transport Authority.

DoIR's comments primarily relate to the real pre tax WACC calculated by the ERA (using the Allen Consulting Group report) for the freight network. Some comments may be relevant to the urban network, however, the real pre tax WACC calculated for the urban network has not been DoIR's focus in this response. In providing these comments DoIR has been able to duplicate the model to arrive at the ERA's WACC results (as presented in Table 1 of its Report).

As an underlying principle, DoIR believes that infrastructure regulation must be implemented in a manner that is cost effective and results in efficient investment decisions being made. Regulation should not distort the timing or scope of the State's infrastructure projects, nor adversely affect the upkeep of existing infrastructure.

It is on this basis that DoIR is providing comments on the ERA's draft report.

DoIR supports the following adjustments to the variables underpinning the ERA's recalculation of the WACC:-

- The CPI being set in the middle of the RBA's target range on the basis that the RBA will be managing interest rates to achieve the target range.
- The debt beta being set at zero. DoIR has noted that the ERA has in effect assumed this through omitting such a variable from the real pre tax WACC calculation (i.e Table 1 of its report).
- In providing the owner of the infrastructure a return on capital, the WACC to be applied to the capital base being based on *real pre-tax WACC.*

In relation to certain other aspects of the WACC formula ***DoIR acknowledges*** and notes the following:-

- The ERA could simply have continued to apply the WACC formula in the way it has since 2003, which means changing only the *inflation rate* and the *nominal risk-free rate of return* variables. Were the ERA to have done so, the *real pre tax WACC* calculated at 30 June 2008 for the freight network would be less than 7.1% (the 2007/08 actual figure used by the ERA). Had this been the case, DoIR believes that this would have adversely impacted investment in the south west rail freight network. As a result, DoIR acknowledges and supports the general increase in the *real pre tax WACC* rate proposed by the ERA.

- The ERA's intention to increase the *debt margin* but notes that the *nominal pre-tax cost of debt* is likely to be higher still in Australia. The *nominal pre-tax cost of debt* is still less than the current Australian (pre-tax) housing and business lending rates, although DoIR does recognise that large companies may be able to source cheaper capital offshore. DoIR has noted the current trend in Australia towards interest rate movements independent of Reserve Bank intervention, thus further increasing the cost of debt and *debt margins* within Australia. In addition, DoIR also notes that for those companies sourcing funds from overseas that there could be risks attached, especially those relating to exchange rate movements and the way this is dealt with, if used, in any subsequent hedging contract.

- The proposed increase by the ERA in the *asset beta*, but notes that the resulting computed *equity beta* outcome is less than one, and indeed the *equity beta* has fallen since last calculated by the ERA in 2003. DoIR recognises that the *equity beta* is also a critical component to calculating a *nominal post- tax cost of equity*, and ultimately the *real pre tax WACC*. In light of current economic circumstances, in accepting this *equity beta* outcome, the ERA needs to be convinced that the freight network is less risky than the average of the market, with that risk falling since the last time the *equity beta* was calculated (from *asset beta*) in 2003. (The *nominal post-tax cost of equity* is a key WACC computation outcome as this figure needs to broadly reflect, where appropriate, the return on equity that a company requires to proceed with an investment.)

- That the ERA has not changed the *market risk premium* (MRP) since the first time WACC was calculated for WestNet Rail, with this figure remaining at 6%. DoIR believes that further work needs to be done on the MRP. It is noted that some submissions to the Allen Consulting Report requested an increase, and that Australian Regulators have used a MRP figure of 6% for some time now. It remains unclear to DoIR why this figure has not changed over such a considerable period of time, and in light of changing economic circumstances as well as (more recently) increased market volatility.

Emerging issues

Notwithstanding DoIR's comments relating to the imputed asset beta and equity beta outcomes (discussed above) for WestNet Rail, DoIR notes that for other railway infrastructure that the ERA may subsequently be required to determine a WACC for (i.e such as those located in the Pilbara) that the asset beta/equity beta are unlikely to be the same as that assumed for WestNet Rail. Asset beta (and equity beta) should be linked to the market in which the asset owner is operating in to properly reflect the risks faced by the company in that industry. For Pilbara based rail infrastructure, DoIR would also expect that the gearing ratios could also be very different.

DoIR understands that the Railways Access Code 2000 requires the Regulator to set a WACC for WestNet Rail (and the Public Transport Authority) on 30 June each year (not an earlier date). By that date, for example, DoIR recognises that the *nominal risk free rate of return* variable of the WACC calculation may be different to the rate currently used in the ERA's draft determination.

I thank you for the opportunity to input into your determination process and look forward to reviewing its outcomes.

Yours sincerely

Colin Slattery
Assistant Director General
STATE DEVELOPMENT STRATEGIES

2 May 2008