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

Dear Russell,

Draft Determination on Weighted Average Cost of Capital for The Pilbara Infrastructure Pty Ltd's Railway from the Cloud Break Iron Ore Mine in the Pilbara to Port Hedland

The North West Iron Ore Alliance (NWIOA) is pleased to respond to the Economic Regulation Authority's (Authority) Draft Determination on Weighted Average Cost of Capital (WACC) for The Pilbara Infrastructure Pty Ltd's Railway from the Cloud Break Iron Ore Mine in the Pilbara to Port Hedland (the Determination).

As an overarching comment the NWIOA commends the Authority and is in strong agreement with the direction and many of the outcomes captured in the Determination. Additionally, the NWIOA submits the following specific comment in support of the Determination and/or pertaining to WACC parameters and related matters:

- **Capital Base:** The NWIOA agrees with the Determination regarding the WACC financial parameters and suggests the Authority treat the TPI railway on a stand-alone basis when determining the Regulated Asset Value (RAV). As indicated to the Authority in the NWIOA Issues Paper (dated 15 October 2008), we are concerned with probable overestimation of the appropriate capital base for an efficient stand alone railway through the use of the actual capital and financing costs incurred by FMG. The NWIOA considers the TPI railway is neither a modern equivalent asset (MEA) nor an efficient cost railway[1].

- **Initial Equity Raising Costs:** The NWIOA supports the Determination to capitalise equity raising costs within the RAV. If this did not occur, and subsequent decisions require reincorporation into the RAV, regulatory issues may arise[2].

[1] NWIOA Submission to ERA Issues Paper – Weighted Average Cost of Capital, 15th October 2008, p9.

[2] The Allen Consulting Group (2005), Queensland Rail – Coal: Financing Charges, Capital Structure and Debt Margin p18.

- **Systematic Risk (Beta):** The NWIOA seeks to respond to comments by the Authority that there are few comparator companies for accurately determining the TPI asset beta and the determination by the Authority that the asset beta is in a range of 0.7 to 1.0 and, that as TPI is a "remote railway with a single mining commodity", the appropriate asset beta is 1.0.

  The CRA report to the Authority, whilst noting the Hancock and ARTC submissions regarding coal haulage railways, considered the USA comparators (who undertake both bulk and general freight tasks) and infrastructure firms (railways and ports) in recommending the beta range ie without further consideration of coal comparators. The Determination beta range appears broadly in line with the CRA determined ranges and above the Hunter Valley coal haulage and the Queensland Rail coal haulage ranges. The NWIOA believes that from an economic demand viewpoint, both coal and iron ore are similarly linked to the demand for steel. Hence, they have similar systematic risks. The current economic crisis highlights the relationship between domestic economic growth and the demand for steel. As a consequence, the NWIOA requests the Authority review the beta range Determination.

  In doing so, the NWIOA also asks the Authority to review its setting of the beta at the high end of the range (ie at 1.0). In reviewing the Allen Consulting Reports on proxy betas (commissioned by the Queensland Competition Authority), Professor R. G. Bowman[3] noted extreme inaccuracy in estimating asset betas. He recommended that the comparisons be done over a long time frame, that the forward view be over a lengthy time horizon and that regulators choose a WACC value from the 75th percentile of the range (as a lower percentile may lead to underinvestment).

  The NWIOA does not disagree with submissions to the Authority indicating the beta range may be above that of a general freight railway. However, consideration of key factors underpinning demand for Australian exports, and the lower demand volatility for iron ore over a longer time horizon, suggest the beta value should not be at the highest end of the range.

- **Asymmetric Risk:** The Determination's treatment of stranding risk in cash flows is noted. It is also noted that at point 150 of the Determination, the Authority is in agreement with the NWIOA's Issues Paper that the railway should not be treated as a whole when assessing stranding risk.

  At point 147, the Determination notes the NWIOA comment that "third party users are likely to be a small number of junior miners". At point 148, the Determination notes the TPI statement that "TPI is exposed to significant stranding risk on <u>its rail network investments</u>". In contrast to this latter statement, in the Determination at point 20, Synergies in support of the TPI Submission, regarding systematic risk states "even if the new junior miners come on stream, their contribution to revenues, and hence TPI's risk profile, will be relatively minimal". Given that additions to capacity would be financed by the access seeker with no debt raising by TPI (as distinct from <u>TPI's rail network investments</u>) the NWIOA reiterates its view that stranding risk would be minor on the main line. The capacity increment on the main line is minor compared to the total planned capacity and, if the number of miners decreases, it does not necessarily mean tonnage on the main line decreases - the residual risk is therefore minor. Alternatively, the Authority may wish to consider applying the stranding risk to sections of line but in any event, the NWIOA considers there is merit in urging the Authority to take note of these considerations when assessing floor and ceiling pricing.

[3] QUEENSLAND RAIL – DETERMINATION OF REGULATED WACC, *Response to Reports Prepared by the Allen Consulting Group,* August 2005, pages 9 & 11, QCA web site.

- **Depreciation:** Finally, given the difficulties of estimating the capital base, the NWIOA again suggests that the Authority consider the use of an approved Major Periodic Maintenance program in lieu of a broad depreciation charge with an uplift for stranding risk if found to be material for the TPI Railway.

In closing, the NWIOA extends its thanks to the Authority for preparing and issuing their Draft Determination on the Weighted Average Cost of Capital for The Pilbara Infrastructure Pty Ltd's Railway from the Cloud Break Iron Ore Mine in the Pilbara to Port Hedland. We appreciate the opportunity to provide comment and look forward to the Final Determination and the Authority's recommendations for the remaining Part 5 instruments.

Yours faithfully,

Dr Justin Walawski FCPA
Deputy Chairman & Chief Executive