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Our Ref:

Thursday, 19 February 2009

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

Dear Mr Dumas

Draft Determination on the Weighted Average Cost of Capital for the Pilbara Infrastructure Railway

This letter is a public submission from Hancock Prospecting in response to the above draft determination that proposed a real pre-tax WACC value of 10.25 percent.

The various elements that go together to produce the draft WACC were all commented on in the submission from Acil Tasman, on behalf of HPPL, that was sent to the ERA on 10 December 2008. The ERA is directed to that paper for more detailed arguments in favour of the recommendations made in that paper. This submission draws on those arguments and provides some supplemental comments. HPPL will not be commenting directly on the CRA paper, other than where our comments on the draft determination impinge on that paper. Our comments will be made under the headings used in the draft determination and follow.

WACC Methodology

The WACC methodology is supported by HPPL, but we continue to recommend that the ERA uses a post tax approach. We would also continue to argue against using the statutory rate of corporate income tax as we believe this would overstate the TPI tax liability. We would encourage the ERA to estimate the effective tax rate paid by TPI and use that rate if it is more than marginally below the statutory tax rate.

Parameter Values

Risk free rate of return and inflation

HPPL is comfortable with the approach taken by the ERA, but notes that conditions have changed since the release of the draft and both the long term bond rate and inflation expectations are now trending lower as the world economy continues to falter. No doubt the ERA will look at these parameters again in preparing its final determination.

Market risk premium

Again HPPL is comfortable with the approach taken by the ERA. The market risk premium is derived from historical information and this has the risk that the past may not be a good guide to the future. With the world economic situation, positive returns from any investment are going to be difficult to achieve in the short run and things could get worse, delaying a return to more

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normal economic conditions and returns. As things stand now HPPL supports the use of 6% and would not discourage the ERA from finding that a downward adjustment of some type would be required to reflect the weakness evident in world markets. Certainly a higher premium would not be justified.

Financial structure and credit rating

TPI has been set up and promoted by FMG as an infrastructure provider, providing open third party access. On this basis alone there should be no support for including in the CAPM a gearing that is anything other than related to other providers of infrastructure services. Equally we would not think that Westnet is a suitable basis on which to set the gearing for the TPI railway. The regulatory examples given in our December submission appear to more relevant to the TPI situation and we would continue to argue for a higher gearing of 50 per cent. We would agree that a BBB rating is appropriate and that the rating should reflect that for an infrastructure provider and not have any regard to the credit rating of the major infrastructure customers.

Cost of Debt

There seems to be general agreement that 12.5 basis points, as an allowance for the costs of raising debt, is an appropriate input to the WACC. We argued against an allowance for the costs of raising equity finance being included in the WACC. Part of this argument was around the way to estimate the cost and our belief was that the estimate should be based on rail, not mining, oil and gas firms costs. In addition we queried whether equity raisings would be required in any event. The approach of the ERA, which is to include this cost in the asset base in the future, if appropriate, puts the full resolution of the matter into the future where the actual situation will be able to be taken into account and real numbers used. This is a sensible approach and is supported.

Debt beta

HPPL agrees that the best estimate for the debt beta is zero. The case for a small positive debt beta exists, but has not developed to the point where it could provide a better estimate. The ERA position is seen as being a pragmatic response that we support.

Systematic Risk (Beta)

The ERA position is a little confusing. In para 110 the ERA notes that it; "...has consistently rejected the argument that the systematic risk of an infrastructure owner necessarily reflects the customer base." Then at para 119 the ERA places the beta at the higher end of the range it has settled on for the beta because of; "...the particular circumstances of the TPI railway (remote railway with a single mining commodity)."

HPPL has argued for an asset beta of 0.44 to 0.5 based on the Hunter Valley and QR rail networks. While not as remote as the Pilbara, both rail systems are hardly metropolitan in nature and would seem to still seem to be reasonable comparisons. We could accept that TPI may be seen as being at the high end of the Australian examples, but would find it difficult to see that it should be at the high end of the US/Canada examples. Then to add in a large premium for the "particular circumstances" by going from an equity beta of 0.7 to 1.0 is even more difficult to understand.

While not a lot has been made of the history of the TPI railway, it should not be overlooked that it was built and economically justified to carry iron ore from the FMG mines to the FMG port facilities at Port Hedland. If there was never to be any third party traffic the rail would still have been built. On this basis the third party use is extra revenue that is above that required to justify the building of the rail and entails no risk as it is all clear profit. On this argument alone it is hard to see why TPI should be somehow rewarded for building the railway by having a beta that is higher than other heavy haul railways in Australia and therefore be able to gain more revenue from third parties use of the rail. Significantly FMG will "contract" with TPI outside of this

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whole process because of the state agreement provisions. This will mean this whole exercise is academic for nearly all of the iron ore that is likely to be carried on the railway. The only people that will pay the regulated price are third parties that will cost literally nothing to accommodate on the rail. But they will have to negotiate within the regulated framework and the lack of risk to TPI in terms of their traffic means that the WACC parameters should not reflect any special risk to TPI from the Pilbara location and circumstances.

HPPL would submit that the ERA should reconsider its position and, at the highest, allow an equity beta at the top end of the range suggested by us of 0.5. That reflects a reasonable amount of risk and probably more than TPI is entitled to see benefit from in the equity beta. If the ERA is not inclined to that position, we would argue that there is no case for an equity beta of 1.0 and the ERA should be satisfied that lower end of its range ie an equity beta of 0.7 is appropriate to the TPI railway. This is above the highest equity beta of the regulated railways in Australia and well above the equity beta we believe is appropriate.

Taxation and Dividend Imputation

HPPL agrees that given the current state of the debate on the value of dividend imputation, 0.5 is an appropriate value of gamma, although the debate seems to moving in the direction of gamma being higher and the ERA might want to reconsider this value in reaching its final determination.

HPPL has already argued that the ERA should consider whether a lower tax rate than the statutory rate should be used in the WACC and refers the ERA to those arguments.

Asymmetric risk

No comment required.

TPI railway and Asymmetric Risk

HPPL agrees with the ERA position that stranding risk is better considered under the future floor and ceiling cost considerations rather than in the WACC. However, as our submissions make clear we are by no means convinced that TPI faces a stranding risk that it could not have protected itself against through contractual requirements. In addition, the third parties that will be transporting under the regulated regime are not critical to the railway operation and they will never be of such importance to the TPI revenues as to lead to stranding of the asset because they are no longer using the rail. In fact it could be argued they are in greater risk of being stranded because of FMG problems that lead to the line losing a major part of its revenue or its major customer and that loss causing problems for the third party users. As a result of these considerations we are even less convinced now about the stranding risk argument and would be unlikely to support it being taken into account the future considerations by the ERA on floor and ceiling prices.

Conclusion

The ERA determination of a real pre tax WACC of 10.25% is noted. HPPL would observe that the changes and reconsiderations outlined in this submission would be expected to reduce this WACC to the advantage of third party users.

This concludes the HPPL submission in response to the ERA draft determination.

Peter Murphy
General Manager, External Affairs and Government Relations
Hancock Prospecting Pty Ltd

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