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>> REPORT

>> RESPONSE TO SUBMISSIONS

>> POTENTIAL ECONOMIC IMPACTS ON THE PORT OF TOWNSVILLE: A REVIEW OF THE POTENTIAL FOR COSTS TO BE BROUGHT-FORWARD AS A RESULT OF THE TOWNSVILLE OCEAN TERMINAL AND BREAKWATER COVE DEVELOPMENT

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1 INTRODUCTION

This report presents a response to submissions made concerning the potential economic impact on the Port of Townsville in terms of “brought-forward” costs. Other potential costs are addressed separately. The idea of brought-forward costs relate to additional capital expenditure – such as new equipment, port expansions etc. – that is required to be undertaken sooner than planned or anticipated, as a direct result of the proposed Townsville Ocean Terminal (TOT) and Breakwater Cove development.

The ‘brought-forward’ costs issue in the context of six (6) key aspects, these being:

1. What is meant by brought-forward costs and what specific activities would need to be “brought-forward” as a consequence of the proposed TOT and Breakwater Cove development;
2. A review of the *Port Master Plan* to identify planned future capital expenditures that may need to be “brought-forward”, the magnitude of those costs and the justification for those capital expenditures;
3. Legislative requirements on or conditions governing future Port development activities and specifically approval processes for capital expenditures by Townsville Port Authority (TPA);
4. The need to address “opportunity costs” when assessing capital expenditure outlays, regardless of the timing of those outlays;
5. The need to assess the “net” impacts associated with earlier than anticipated expenditure to ensure the impact does not present only as a partial outcome. The basis of this argument is that planned future capital expenditures would normally have been considered alongside future anticipated revenues derived from those capital expenditures; and
6. The potential for lost economies of scale associated with the timing of capital expenditures.

The next section addresses each of these in more detail.

The focus of the report is on the potential impacts on the Port of Townsville. The potential cost impacts on port users is integrated with consideration of the political risk of the proposed TOT project on future operating conditions, particularly in relation to environmental regulations and legislation etc. These issues have been canvassed separately in Transpac Consulting’s (2008) *Report on Port Compatibility*.

The discussion in this present document should be considered together with the broader analysis of port compatibility issues.

2 DISCUSSION

2.1 SCOPE OF "BROUGHT-FORWARD" COSTS

The concept of brought forward costs needs to be considered within a broader regulatory framework governing the investment activities of Government Owned Corporations (GOC) such as the TPA. Such GOC's are bound by State legislative requirements (see 2.3 below), and would be required to consider changes to the magnitude and timing of costs in a formal assessment framework (i.e. a formal Cost-Benefit Analysis [CBA]) that would include opportunity costs (see 2.4 below) and changes to revenue streams (see 2.5 below).

Submissions nominate new equipment and port expansion as potential brought-forward costs, but are not specific about the nature of equipment requirements, the activities that need to be "brought-forward" nor the causal relationship between brought-forward port expansion costs and the Breakwater Cove development. Moreover, potentially legitimate brought-forward costs associated with mitigation (as opposed to compliance) are not specifically identified by submissions.

Within the broader regulatory framework, the likelihood that brought-forward expenditures will rarely occur in isolation and will be accompanied by a number of other factors including but not limited to:

1. Revenue streams generated by capital expenditures; and
2. Economises of scale issues associated with rescheduling of capital works expenditures (see 2.6 below).

Lastly, brought forward costs (and associate revenues) will normally be assessed under a Net Present Value (NPV) framework and will need to be put into a benefit-cost analysis context. The contention that, for example, anticipated costs in 2025 will need to be brought-forward to 2015 will need to consider, among other things, the time value of money (i.e. discount rates), opportunity costs associated with alternative expenditure patterns and an evaluation of risk. None of these will be assessable without a clear plan of future capital expenditure (see 2.2 below).

2.2 PORT MASTER PLAN

The idea of "brought forward" presumes that there is a reasonably solid understanding of an appropriate baseline timeframe for future anticipated capital expenditures. To be able to 'bring-forward' an expense requires knowledge of when that expense was otherwise planned for.

The most appropriate document for this is the (draft) *Port of Townsville Master Plan*, which lays out a blueprint for Port expansions to 2030. The Master Plan indicates the TPA anticipates a potential trebling of trade through the Port of Townsville by 2030 and this will require new and upgraded berths, land reclamation, improved transport and storage facilities, and strategically positioned land developments. This includes seaward expansion of the Port of Townsville in coming years to cater for increased bulk trades.

While it is always difficult to predict with certainty the timing of future capital expenditures, the Master Plan attaches no timelines to planned future infrastructure developments based on meeting this projected growth.

The level of information available at this time is inadequate to conduct a comprehensive

evaluation of potential impacts on the timing of specific capital expenditures.

2.3 LEGISLATIVE AND REGULATORY CONDITIONS

Any decision by TPA to undertake capital expenditures needs to comply with legislative requirements under the *Government Owned Corporations Act 1993* (GOCA) and will require them to work with Office of Government Owned Corporations (OGOC) to meet policy and performance guidelines.

A core role of the OGOC will be to undertake risk assessments and examine expenditures and returns faced by GOCs in their pursuance of business and investment strategies (http://www.treasury.qld.gov.au).

In fulfilling its functions, OGOC produced the *GOC Investment Guidelines* (Queensland Government, April 2003). The *Guidelines* cover all non-financial investments including "asset refurbishment and replacement, new capital expenditure etc." (p.3). The key objective of the *Guidelines* is to "clearly set out the expectations, priorities and risk concerns of shareholding Ministers without compromising the responsibility and accountability of board directors" (p.3).

Under the *Guidelines*, any investment with a value of greater than $2m for Ports Corporations would require notification to Shareholding Ministers.

Further, the *Guidelines* make it clear that significant investment proposals would be evaluated and approved by Shareholding Ministers based upon the "commercial merit of the proposal and the ability of the investment to contribute to the long-term strategic objectives of the entity" (Principle 3, p.13). The centrality of a project's ability to enhance shareholder value will be at the core of any go-ahead for an investment proposal.

Uncommercial investments undertaken at the direction of the Government will be financially supported through Community Service Obligation arrangements (p.16).

In addition to the *Guidelines*, OGOC has produced the *Government Owned Corporations – Cost of Capital Principles* (February 2006). This document provides details on the preferred approach to calculate the cost of capital to GOCs, and complements the broader requirements outlined in the *Guidelines* document. Of note is that the Principles document reinforces the fact that GOC investment decisions will be very much driven by the commercial merits and potential returns that can be delivered to shareholders resulting from the decision.

The key point from this brief overview of the regulatory environment governing GOC investment decisions is that any notion of "brought-forward" investments must pass a range of strict commerciality tests before such investments can proceed; and, importantly, a critical element of these tests is the likely return to shareholders or potential for the investment to deliver enhanced shareholder value. In principle, therefore, investment decisions take into account not only the "costs" incurred but the likely returns over time.

2.4 OPPORTUNITY COSTS

As noted above GOC's such as the TPA are bound by State legislative requirements with any major capital expenditures subject to a formal assessment framework (i.e. risk assessment, CBA) that would include any opportunity costs associated with expenditure. Regardless of the timing of those outlays, there will be a need to examine the opportunity costs in terms of direct expenditure alternatives (i.e. the next most productive investment) and the prospect that allocation of expenditures to one specific project may compromise funding available for other projects.

As noted above, with no detail available on likely scheduling of projects (e.g. new and upgraded berths, land reclamation, improved transport and storage facilities) and anticipated costings of these infrastructure works within the *Port of Townsville Master Plan*, it is not possible to undertake a more detailed assessment of opportunity cost issues.

2.5 ASSESSING NET IMPACTS

As noted above, there is a need to assess the net impacts associated with earlier than anticipated expenditure to avoid only a partial assessment of the outcome. This will require planned future capital expenditures, regardless of timing, to be considered alongside future anticipated revenues derived from those capital expenditures.

Considering for the time being works involving the building of new or upgrading of existing berths. There are two points to consider in relation to this:

1. It would be reasonable to assume that any anticipated future expenditures will be premised on capacity needs. Bringing-forward the development of infrastructure earlier than anticipated may result in capacity under-utilisation that affects the "bottom line". As previously noted the OGOC must review major capital expenditures of GOC such as the TPA, and the tenets of efficiency and productivity figure highly in the OGOC's assessment. Any major capital expenditure involving port expansion would need to be based on existing capacity being insufficient to meet growing demand; and
2. Bringing forward of expenditures would be accompanied by changes in revenue streams and create potential new revenue opportunities. Appropriately delivered infrastructure development would create additional revenue streams whereas poorly schedule and delivered projects may create net revenue shortfalls.

There are two key points to bear in mind here. The first is that "brought-forward" costs cannot be considered in isolation and must be considered in terms of the revenue streams they generate and the net impacts of bringing-forward development. The second is that while under a formal assessment framework that takes into account the time value of money, brought-forward costs will be higher in NPV terms than costs deferred until a later date, revenue streams will be subject to the same NPV considerations.

2.6 ECONOMIES OF SCALE

Issues surrounding economies of scale associated with the timing of capital expenditures are twofold. The first of these relates to premature delivery of infrastructure projects that lead to capacity under-utilisation of for example, new berths.

The second is that construction economies of scale can be obtained from appropriate scheduling of infrastructure development in the same way that dis-economies of scale can arise from revisions to the scheduling of capital works programs.

3 CONCLUSION

Based on the above discussion of issues associated with the idea of "brought-forward" costs, the consultants make the following observations:

- Consideration of potential brought forward cost impacts needs to be considered in the context of broader issues such as revenue generation and economies of scale that are part-and-parcel of all investment decisions. Any consideration of brought-forward costs must take place within a NPV framework that addresses the above aspects of revenue generation, and would do so through the application of discount rates and appropriate consideration being given to opportunity costs;

- All Port capital investments in excess of $2m require notification to shareholding Ministers, and investments of greater than $5m require Shareholder Ministerial approval. These approvals will be provided on the basis of the commercial merit of the proposed investment, taking into account the potential of the investment to enhance shareholder value. The timing of possible future capital expenditures by TPA would have to pass these tests; and

- The level of information available at this time in relation to the timing and nature of anticipated capital costs (as described in the 2030 Masterplan) is insufficient to enable a more detailed assessment of potential impacts on the timing of particular anticipated expenditures.

Given the legislative conditions governing GOC investments in Queensland, the *timing* of future TPA capital investments will typically be driven by market need and commercial merit. It is reasonable to expect that future capital expenditure would have to pass a range of robust business tests on need, timing and return (shareholder value) and any discussion of investment timing cannot be considered in isolation of these parameters.

4 REFERENCES

Queensland Government (February 2006), *Government Owned Corporations – Cost of Capital Principles*

Queensland Government (2003), *GOC Investment Guidelines*

Townsville Port Authority (2007), *Port Master Plan (draft),* prepared by Maunsells