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Rule change proposal

**Price and revenue regulation of gas distribution and transmission services
AER's proposed changes to the rate of return provisions of the National Gas Rules**

APA Group is Australia's largest owner and operator of gas pipeline and network infrastructure.

APA Group therefore welcomes the opportunity to comment on the AER's proposed Rule change relating to the rate of return provisions in the National Gas Rules.

APA Group will remain engaged throughout this consultation process, and would welcome the opportunity to further discuss its views with the Commission.

Questions and comments on this submission can be addressed in the first instance to Ms Alexandra Curran on (02) 9275 0020.

Yours faithfully

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APA Group

Submission to the AEMC

AER Rule Change proposal to
the rate of return provision of
the National Gas Rules



Contents

1	Introduction	1
1.1	About APA Group	1
1.2	Focus of this submission	1
2	Background and considerations relevant to Rule change request	2
2.1	Background to the gas access regime	2
2.1.1	Predecessors to the National Gas Law and National Electricity Law	2
2.1.2	Impetus for gas and electricity sector reform	3
2.1.3	Final form of gas and electricity access regimes	3
2.1.4	The “fit for purpose” regulatory model	5
2.2	AEMC consideration of AER Rule change request	6
2.2.1	Applicable Rule change provisions	6
2.2.2	AER’s Rule change request – APA Group summary position	6
3	AER’s cost of capital Rule change request	8
3.1	Overview of AER cost of capital Rule change	8
3.2	Discussion of AER’s reasons for proposed cost of capital Rule change	9
3.2.1	Overall rate of return commensurate with regulatory and commercial risks	9
3.2.2	Certainty in the rate of return, encouraging investment	15
3.2.3	Reducing the administrative cost for regulated businesses, consumers and the regulator	17
3.2.4	Balance between flexibility over the longer term and certainty and consistency in the short to medium term	21
3.2.5	Avoid investment distortions	21
3.3	Further issues raised by AER proposed rule change	22
3.3.1	Effective loss of merits review rights for the sector	22
3.3.2	The need for merits review	24
3.3.3	Impact of AER WACC decision errors	24
3.3.4	Which approach promotes the National Gas Objective?	25
3.4	Summary discussion of the AER’s cost of capital rule change request	26
4	AER’s nominal post tax WACC Rule change request	27
4.1	Overview of AER’s proposed post tax WACC rule change	27



4.2	Discussion of AER’s reasons for proposed post tax WACC Rule change	27
5	AER’s prescription of the CAPM Rule change request	29
5.1	Overview of AER’s proposed CAPM rule change	29
5.2	Discussion of AER’s reasons for proposed CAPM Rule change	29
6	Energy Users return on debt Rule change request	31
6.1	Overview of Energy Users return on debt rule change require	31
6.2	Discussion of Energy Users Rule change request	31
6.2.1	Foundational analysis with Energy Users analysis	31
6.2.2	Use of benchmark	31
7	AER’s regulatory discretion and regulatory process Rule change request	34
7.1	Exercise of discretion – capex and opex	34
7.2	Capital expenditure overspends	34
7.3	Treatment of shared assets	35
7.4	Curtailement of consultation process	35
A	Ernst and Young report	37



1 Introduction

APA Group welcomes the opportunity to comment on the AER's proposed Rule change to the National Gas Rules (NGR) rate of return provisions.

1.1 *About APA Group*

APA Group is Australia's largest natural gas infrastructure business, owning and/or operating more than \$8 billion of gas transmission and distribution assets.

Its pipelines span every state and territory in mainland Australia, delivering more than 50 per cent of the nation's gas usage.

In addition, APA Group holds minority interests in energy infrastructure enterprises including Envestra, SEA Gas Pipeline and Energy Infrastructure Investments, which include the MurrayLink and DirectLink electricity transmission interconnectors.

APA Group's interest in the AER's proposed Rule change therefore extends beyond that of a gas transmission and distribution service provider, but also as a major investor in pipeline and other energy infrastructure assets, many of which will be impacted by the AER's proposed Rule change.

APA Group has also contributed to and supports submission to this process made by the Australian Pipeline Industry Association, and the Financial Investors Group.

1.2 *Focus of this submission*

In this submission, APA Group focuses on the AER's proposed changes to the NGR rate of return provisions. This discussion also addresses key aspects of the AER's proposed changes to the rate of return provisions in the National Electricity Rules (NER).

APA Group also comments on the AER's changes to the NER in relation to regulatory discretion and regulatory process. APA Group notes that these changes are not directed at the gas industry, however, APA Group takes this opportunity to raise key differences between the regimes applying to each sector that suggest that issues identified by the AER in relation to electricity have little if any relevance to the gas regime.

APA Group also responds to key elements of the Energy Users return on debt Rule change request, consultation on which has been combined with the AER's cost of capital Rule change request.



2 Background and considerations relevant to Rule change request

2.1 *Background to the gas access regime*

The rate of return provisions in the current NGR and NER are fundamentally different in their style and approach. These differences reflect the ways in which the gas and electricity regimes have evolved separately, but also key concerns of policy makers at the time these rules were developed.

2.1.1 Predecessors to the National Gas Law and National Electricity Law

Prior to the development of the current National Gas Law (NGL) and NGR (together, the current Gas Access Regime), gas pipeline infrastructure was regulated under the Gas Pipelines Access (South Australia) Law, with enacting legislation in each state and territory except Western Australia. The Gas Pipeline Access Law applied the National Third Party Access Code for Natural Gas Pipeline Services (Gas Code). The Gas Code was applied in Western Australia through stand alone legislation, making the Gas Code a single national access regime applying to gas distribution and transmission businesses.

The Gas Access Regime focused on provision of third party access to transmission pipelines as the basis for development of gas markets. Much of its architecture comes from Part IIIA of the then *Trade Practices Act 1974*, and a reflection of the commercial arrangements of the gas markets.

This situation, with a national access regime applying to gas transmission and distribution, was significantly different to that in the electricity sector. While the National Electricity Code (NEC) included provisions for regulation of both electricity distribution businesses and transmission businesses, its focus was on regulation of the electricity market. The provisions in Chapter 6 were broad and not well defined. As a result, state regulators responsible for regulation of distribution businesses in National Electricity Market (NEM) connected states did not apply Chapter 6, and in their place developed varying rules and approaches as a result of derogations from the NEC.

The ACCC regulated electricity transmission assets in NEM-connected states, applying provisions under the NEC. However, because of the lack of clarity about application of Chapter 6 of the NEC, the ACCC developed a Draft Statement of Regulatory Principles in 1999 that it applied with varying degrees of consistency in undertaking Price and Revenue Determinations for the electricity transmission businesses. This Draft Statement was updated from time to time until, in December 2004, it was finalised as a Statement of Regulatory Principles.



2.1.2 Impetus for gas and electricity sector reform

The call for reform of the energy sector emerged not long after the gas and electricity regimes commenced in the second half of 1998. The first review was conducted by Warwick Parer in 2002 and led to the formation of the Ministerial Council on Energy (MCE), which then pursued an active agenda of reform based on recommendations from Parer.

One of the initial acts of the Ministerial Council on Energy (MCE) in 2003 was to seek a review of the Gas Code. This review followed a comprehensive review of the National Access Regime (the then Part IIIA of the Trade Practices Act 1974), conducted by the Productivity Commission (PC) in 2001, which recommended, amongst other things, the introduction of a clear objective and pricing principles into the National Regime.

The review of the Gas Code was initiated at the urging of the gas industry, which saw that there was scope for similar improvement to the existing gas regime, particularly in relation to establishing clear objectives and pricing principles, the lack of which had led to uncertainty under the Gas Code. The PC was charged to conduct the review during 2003/04.

During this time, the MCE made a number of decisions regarding the energy governance structure, agreeing to form the AER, AEMC and Australian Energy Market Operator (AEMO).

Of relevance here, the MCE determined that the AER would regulate electricity and gas transmission and distribution networks, applying a new National Electricity Law and National Gas Law and associated Rules for each sector.

While at the time agreeing to the general principle of alignment between the gas and electricity sectors, the MCE also consciously adopted different approaches for the gas and electricity regimes. Alignment between the sectors was limited to legislative structure, objectives, pricing principles, review, rule change and information gathering.¹

2.1.3 Final form of gas and electricity access regimes

The MCE reform process for gas and electricity occurred in separate streams with one exception being the convening of an Expert Panel on Energy Pricing in early 2006, which developed principles that were to be applied to both sectors and assist in achieving relevant convergence.

Consultation on the development of both the electricity and gas access regimes was extensive. Over a period of four years starting with the review of the Gas Code, the

¹ Ministerial Council in Energy Standing Committee of Officials 2006, *A National Legislative Framework for Gas and Electricity: Statement of Scope*, July, p 11



development of the new national framework involved over 35 MCE Standing Committee of Officials Bulletins, over 100 information, consultation, discussion and decision papers, upwards of 1000 submissions by interested parties on reforms, and passage of multiple legislative packages through multiple Parliaments.

Key parts of the reform package relevant to access regulation included:

- The inclusion of consistent objectives and pricing principles across gas and electricity;
- Changes in the scope of regulatory discretion, including the clear guidance on how the AER should exercise its discretion, and limits to the AER's discretion in key areas of decision making;
- Maintenance of the access arrangement approach to regulation in the gas sector, in contrast to price or revenue determinations in the electricity sector;
- Consistent regulatory information gathering powers;
- Consistent arrangements for review of regulatory decisions; and
- Consistent rule change processes.

The AER commenced regulation of electricity transmission from July 2005. With the well recognised problems with Chapter 6 of the NEC, the AEMC was charged with developing Chapter 6A specifically for electricity transmission.

A core concern in developing Chapter 6A was the uncertainty around the rules governing the ACCC's decision making, notwithstanding the existence of the Draft Statement of Regulatory Principles. This drove a pursuit of stability about regulatory decision-making around the rate of return. The AEMC's response was to propose that the rate of return should be based on an approach comprising five yearly reviews of the Weighted Average Cost of Capital (WACC reviews) based on the Sharpe Lintner Capital Asset Pricing Model (CAPM) embodied in the Statement on the Cost of Capital (SOCC) process in 2006. With its history of regulatory uncertainty, there was an inclination on the part of the electricity transmission businesses to accept the AEMC's proposal to adopt very limited regulatory discretion in this area.

The Rules to apply to the economic regulation of electricity distribution assets were based on chapter 6A, with key changes to that framework as determined by policy makers.

In particular, the electricity distribution Rules moved away from the rigidity of the five yearly SOCC process with its lack of recourse to merits review in the event of poor decision-making by the AER. The approach adopted by the MCE was the Statement of Regulatory Intent (SORI) process, which was similar to the SOCC process, but allowed for variation from WACC parameters resulting from the five-yearly SORI



process where there was persuasive evidence that the SORI parameters should be replaced by ones that better reflect the prevailing conditions in the market. The AER's decision around the Rate of Return was therefore (and remains) open to merits review for electricity distribution.

The first drafts of the NGL and NGR were developed during 2006, with ongoing consultation during 2007 and 2008 with commencement from July 2008. The content of the National Gas Law and Rules largely followed that of the former Gas Code, with key changes and alignment as recommended by the PC, and the Expert Panel on Energy Access Pricing.

With respect to the rate of return, in contrast to the process of developing the five yearly WACC parameter process, the NGR adopts the Gas Code's long established approach of case-by-case reviews that applies in every other form of infrastructure regulation in Australia. The MCE SCO stated at the time:

The initial NGR largely replicate the current Gas Code, which has proved to be adequate.²

2.1.4 The 'fit for purpose' regulatory model

The differences between the approaches to the rate of return for gas and electricity reflect the different paths of regulatory development, but this is not the only reason for difference between the regimes. One of the key conclusions of the previous review of access regimes was a clear decision on the part of the MCE to adopt a 'fit for purpose' regulatory model.

Importantly, the AEMC should be mindful that while the MCE at all times looked for opportunities for consistency between gas and electricity regimes, it also recognised that there were good reasons for divergence between the regimes. The resulting 'fit for purpose' framework reflected those areas where consistency was considered appropriate, as well where differences should be maintained.

This approach is consistent with the recommendations of the Expert Panel on Energy Access Pricing:

In the panel's view, the preferred approach is to recognise the desirability of the AEMC being permitted to develop its Rules on a 'fit for purpose' basis, but to do so within a legislative framework which provides clear principles (including a requirement to consider regulatory risk) to guide Rule making, as well as merits and judicial review and coverage arrangements which ensure that the riskier investments with lesser market power are excluded from price control. If a propose respond model is to be adopted it should be done in a way that relies on the 'reasonable estimate' formulation and buttresses this

² Ministerial Council on Energy Standing Committee of Officials 2007, *SCO Response to issues raised in submission on the National Gas Rules*, 14 May, p 10



with clearer guidance on evidentiary standards and minimises the opportunity for regulatory gaming.³

The AEMC clearly recognised this in its previous review of the electricity transmission Rules:

In the context of the process, methodology and decision criteria for revenue determinations, the relevant consideration for the Commission is whether the balance between increased guidance or increased discretion encompassed in the Rules will provide superior outcomes with reference to good regulatory design and practice principles.

As an overarching principle, the Commission considered that the extent to which the Rules codify matters of process, methodology or decision making criteria should be determined on a 'fit for purpose' basis.⁴

2.2 AEMC consideration of AER Rule change request

2.2.1 Applicable Rule change provisions

Section 291 of the NGL requires that the AEMC may only make a Rule if it is satisfied that the Rule will or is likely to contribute to the achievement of the National Gas Objective. In addition, for certain Rule changes (of which the AER's Rule change request is one), the AEMC must also take into account the revenue and pricing principles.⁵ Both the National Gas Objective and the Revenue and Pricing Principles are set out in section 3.2.1.1 of this submission.

2.2.2 AER's Rule change request – APA Group summary position

As discussed further in the following sections, the AER's Rule change request seeks alignment between the electricity and gas access regimes in respect to the Rules for determining the cost of capital, the approach to taxation and the codification of the CAPM. The AER's proposal raises a number of points in support of this aim.

APA Group does not consider, however, that the AER has shown that its proposal better contributes to the achievement of the National Gas Objective and Revenue and Pricing Principles than the current NGR. The AER's proposal appears centred on the drive for consistency between regimes and regulatory expediency, at the expense of good decision making that takes into account available evidence and delivers outcomes that reflect prevailing market conditions.

³ Expert Panel on Energy Access Pricing 2006, *Report to the Ministerial Council on Energy*, April, p 84

⁴ Australian Energy Market Commission 2006, *National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006: Rule Determination*, 16 November, p 32

⁵ National Gas Law section 293



As such, APA Group considers that the cost of capital provisions in the current NGR are appropriate and far superior, both from an investor's perspective and in terms of achieving the National Gas Objective. Accordingly, the AEMC should not make the AER's proposed Rule changes in whole or in part.



3 AER's cost of capital Rule change request

3.1 *Overview of AER cost of capital Rule change*

The AER proposes to change the cost of capital provisions in the NGR to apply a single five-yearly process whereby parameters and/or methodologies for determining WACC are determined in a dedicated review to be conducted every five years, the result of which will apply in all access arrangements made within the following five years, without further consideration of those parameters. This process replaces the current NGR provisions, which provide for consideration of cost of capital parameters at each access arrangement review.

The AER's proposed Rule change is consistent with changes that it proposes for the NER, where the AER also seeks to 'lock-in' WACC review outcomes for electricity distribution businesses, in line with the current electricity transmission Rules.⁶

The AER presents a number of arguments in support of its gas Rule change proposal. These are listed below and discussed in detail in the following sections.

The AER states that the proposed rate of return Rule change would have the following benefits:⁷

- Strengthen the AER's ability to approve an overall rate of return commensurate with the regulatory and commercial risks faced by service providers, rather than a rate of return subject to cherry picking of individual parameters and is higher than an efficient level;
- Provide more certainty in how the rate of return is to be determined, in turn encouraging an environment in which service providers are able to attract more investment;
- Reduce the administrative cost for regulated businesses, consumers and the regulator associated with regulatory decision making by focusing on a single periodic review of WACC, as opposed to the current continual review of arguments in price determination processes; and
- Provide a greater balance between the need for flexibility in the cost of capital framework over the longer term with greater certainty and consistency in the short to medium term.

⁶ Australian Energy Regulator 2011, *Economic Regulation of transmission and distribution network service providers – AER's proposed changes to the National Electricity Rules: Rule change proposal*, September, p 66

⁷ Australian Energy Regulator 2011, *Price and Revenue regulation of gas distribution and transmission services - AER's proposal changes to the rate of return provisions of the National Gas Rules: Rule change proposal*, September, p 14



A further justification presented by the AER within the rule change proposal is that different processes between electricity and gas could lead to different benchmark parameters (in particular the MRP) when the risks of investment reflected in these parameters should be the same⁸.

3.2 Discussion of AER’s reasons for proposed cost of capital Rule change

3.2.1 Overall rate of return commensurate with regulatory and commercial risks

The AER states in its rule change proposal that the imposition of a single WACC review framework in the gas sector would strengthen the AER’s ability to approve an overall rate of return commensurate with the regulatory and commercial risks faced by service providers. This outcome is delivered by a framework that would not allow service providers to ‘cherry-pick’ individual parameters, leading to a rate of return that is higher than an efficient level.

3.2.1.1 Relevant National Gas Law and National Gas Rules provisions

It is important to assess the AER’s claim in regarding its ability to approve an overall rate of return commensurate with the regulatory and commercial risks faced by service providers in the context of the NGL and NGR.

The current NGL and NGR contain the following provisions relevant to the AER’s consideration and determination of the rate of return to apply in individual access arrangement decisions.

NGL s. 23 - The National Gas Objective:

The objective of this law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of natural gas.

NGL s. 24 – Revenue and Pricing Principles:

- (1) The revenue and pricing principles are the principles set out in subsections (2) to (7)
- (2) A service provider should be provided with a reasonable opportunity to recover at least the efficient costs the service provider incurs in-
 - (a) providing reference services; and
 - (b) complying with a regulatory obligation or requirement or making a regulatory payment.

⁸ AER 2011, *Price and Revenue regulation of gas distribution and transmission services: Rule change proposal*, p 3



- (3) A service provider should be provided with effective incentives in order to promote economic efficiency with respect to reference services the service provider provides. The economic efficiency that should be promoted includes-
 - (a) efficient investment in, or in connection with, a pipeline with which the service provider provides reference services; and
 - (b) the efficient provision of pipeline services; and
 - (c) the efficient use of the pipeline.
- (4) Regard should be had to the capital base with respect to a pipeline adopted-
 - (a) in any previous-
 - (i) full access arrangement decision; or
 - (ii) decision of a relevant Regulator under section 2 of the Gas Code
 - (b) in the Rules.
- (5) A reference tariff should allow for a return commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff relates.
- (6) Regard should be had to the economic costs and risks of the potential for under and over investment by a service provider in a pipeline with which the service provider provides the pipeline services.
- (7) Regard should be had to the economic costs and risks of the potential for under and over utilisation of a pipeline with which a service provider provides pipeline services.

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 - (a) efficient investment in, or in connection with, a pipeline with which the service provider provides reference services; and
 - (b) the efficient provision of pipeline services; and
 - (c) the efficient use of the pipeline.
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- (i) full access arrangement decision; or
 - (ii) decision of a relevant Regulator under section 2 of the Gas Code
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- (5) A reference tariff should allow for a return commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff relates.
- (6) Regard should be had to the economic costs and risks of the potential for under and over investment by a service provider in a pipeline with which the service provider provides the pipeline services.
- (7) Regard should be had to the economic costs and risks of the potential for under and over utilisation of a pipeline with which a service provider provides pipeline services.

NGR r. 87 – Rate or Return provisions:

- (1) The rate of return on capital is to be commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services.
- (2) In determining a rate of return on capital:
 - (a) it will be assumed that the service provider:
 - (i) meets benchmark levels of efficiency; and
 - (ii) uses a financing structure that meets benchmark standards as to gearing and other financial parameters for a going concern and reflects in other respects best practice; and
 - (b) a well accepted approach that incorporates the cost of equity and debt, such as the Weighted Average Cost of Capital, is to be used; and a well accepted financial model, such as the Capital Asset Pricing Model, is to be used.

APA Group has reproduced these at length as it is important to show the *actual* limitations placed on the AER's decision making in respect of WACC parameters in the gas regime, as opposed to those imposed by the AER through its own *practice*.

3.2.1.2 No limitation in NGL or NGR as suggested by the AER

As can be seen from the laws and rules above, there are no limitations in the NGL or NGR that would limit the AER's ability to determine or approve an overall rate of return for gas service providers commensurate with the regulatory and commercial risks faced by service providers. In fact, were the AER to do otherwise, its decision would be inconsistent with section 5 of the revenue and pricing principles, as well as Rule 87. In contrast, the AER states:



Under the NGR it remains open for gas service providers to accept some outcomes of the WACC review process but cherry pick others which they consider unfavourable for them without overall consideration of the overall rate of return.⁹

APA Group does not dispute that it is open to service providers, and to gas users and other stakeholders, to challenge particular aspects of the AER's decision making in respect of rate of return. Many service providers and users have taken the opportunity to argue for particular parameters contrary to the AER's WACC review outcomes.¹⁰ What APA Group does dispute is that the AER is somehow compelled to adopt changes to some parameters that are challenged in individual review processes, but bound to retain other unchallenged parameters as per the AER's WACC review process.

The AER provides no evidence that individual cost of capital decisions, and the ability to challenge individual parameters in each review process, has led to a rate of return that is higher than an efficient level through purported 'cherry-picking'. Indeed, the law and rules described above provide no basis on which the AER could be considered bound to adopt WACC parameter values other than those commensurate with the regulatory and commercial risks faced by service providers.

The AER specifically references the 'propose-respond' model of access arrangement proposals as contributing to inefficient outcomes. APA Group notes, however, that WACC parameters are subject to full regulatory discretion under the NGR, and are more accurately described as 'consider-determine' provisions.¹¹ This means that the AER can withhold its approval of an access arrangement if it considers that a preferable alternative exists, including a preferable alternative to a particular WACC parameter.

APA Group notes that the AER has exercised this right in respect of individual WACC parameters in every access arrangement decision it has made under the NGR. In addition, recently the AER has moved to lower the level of the Market Risk Premium (MRP) to 6.0 per cent, from 6.5 per cent in its 2009 WACC review decision, despite submissions to the contrary from service providers.¹² It is therefore clear that the AER does not feel constrained under the NGR from withholding its approval to a single WACC parameter, as suggested by the AER in its Rule change proposal, even where those parameters reflect the prevailing WACC review decision.

⁹ AER 2011, *Price and Revenue regulation of gas distribution and transmission services: Rule change proposal*, p 4

¹⁰ For example the submission made by the Northern Territory Major Energy Users in respect of the Amadeus Gas Pipeline access arrangement revision proposal, Major Energy Users 2011, *Submission to AER regarding application by NT Gas for new gas access arrangement for Amadeus Gas Pipeline*, February

¹¹ Rule 87 is a "full discretion" Rule under Rule 40(3) of the NGR

¹² Australian Energy Regulator 2011, *Envestra Ltd Access Arrangement proposal for the Qld gas network: Final Decision*, June, p 46



The AER's concern appears to instead stem from its current *practice* in applying the electricity WACC review outcomes consistently across the electricity and gas sectors.¹³

Rule 6.5.4(g) of the NER states that a distribution determination to which a WACC statement of regulatory intent applies must be consistent with the statement unless there is persuasive evidence justifying a departure, in the particular case, from a value, method or credit rating set in the statement.

The AER appears to apply the same persuasive evidence test to deviating from its WACC review parameters in gas sector decisions, as presumably any deviation adopted in the gas sector will also be applied in the electricity sector. A clear example of this approach is shown in respect to the AER's decision to deviate from its WACC review value for MRP for the first time in respect of the Envestra South Australian and Queensland gas networks access arrangement decisions. This decision was followed up with the same value for MRP applied by the AER in respect to the Aurora electricity network draft decision released in November 2011, a decision covered by the persuasive evidence test.¹⁴

There is no provision in the NGL or NGR, however, that compels this approach, and, as pointed out above, should the AER's voluntary adoption of the persuasive evidence test in gas lead to an outcome inconsistent with the regulatory and commercial risks faced by service providers, it would leave itself open to challenge. Presumably, the AER's decisions to deviate from its WACC review outcome in fact reflect its view of an appropriate rate of return, otherwise it would be acting contrary to both the NER and NGR.

APA Group therefore does not consider that the AER has provided sufficient evidence that the AER's proposed cost of capital Rule change contributes to the National Gas Objective and Revenue and Pricing Principles by strengthening the AER's ability to approve an overall rate of return commensurate with the regulatory and commercial risks faced by service providers. There are no limitations in the current NGR impeding achievement of the National Gas Objective and Revenue and Pricing Principles.

3.2.1.3 *Proposed rule change creates limitations in determination rate of return commensurate with regulatory and commercial risks*

In contrast to the AER's statement that the proposed rule change would strengthen its ability to approve an overall rate of return commensurate with the regulatory and commercial risks faced by service providers, APA Group considers that the AER's proposed Rule change would instead detract from this principle.

¹³ For example the AER decisions in respect of the Victorian electricity distribution service providers (2010), Amadeus Gas Pipeline (2011), and the South Australian Gas network (2011)

¹⁴ Australian Energy Regulator 2011, *Aurora Energy Pty Ltd 2012-13 to 2016-17: Draft Distribution determination*, p 27



A key feature of the AER's proposed approach is to establish, through a single review process, a set of parameters and methodologies for determining the rate of return to apply to individual businesses in all decisions for the life of the relevant WACC review decision. In practice, this means that the WACC review outcomes will prevail for a period of up to 10 years.

For example, under accepted access arrangement review timings, the last gas access arrangement decisions to which an AER WACC review decision made on 1 March 2014 would apply is the Victorian gas transmission and distribution assets. Revisions to the Victorian gas transmission and distribution access arrangements are due to commence on 1 January 2013. These revised access arrangements are expected to span 5 years, meaning that the following access arrangement will commence 1 January 2018. Under the AER's proposed Rule change, these access arrangements would be required to adopt the AER's 1 March 2014 WACC review decision, to apply for a further 5 years. In practice, this means that a single AER WACC review decision applying to multiple rate of return parameters has the potential to impact investment decisions of service providers in Victoria for a period of almost nine years.

This shows that the AER's statement that its proposal would lead to the review of WACC provisions at least every five years is demonstrably incorrect. While a industry-wide review would occur every five years, provisions would not be revised for businesses until the next review of that access arrangement. Contrary to the AER's claims, the result would be that for most businesses, they would not feel the effect of a WACC review correcting parameters for prevailing conditions at the time of the WACC decision for up to ten years, and most would see periods between effective 'updating' of WACC parameters of six years or longer.

APA Group considers that this outcome would considerably undermine the revenue and pricing principles, which require that the reference tariff should allow for a return commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff relates. The approach undermines this principle by forcing the application of potentially out of date decisions on service providers without consideration of market conditions prevailing at the time of the regulatory decision.

The AER's own decision making over the past three years demonstrates this risk. The AER made its current Electricity Statement of Regulatory Intent in May 2009. As noted above, this decision included a value of the MRP of 6.5, reflecting prevailing conditions in the market following the Global Financial Crisis. Less than two years after this decision (February 2011) the AER determined that this value had 'returned' to its previous long term average 6.0, and applied this value in respect of the Queensland and South Australian gas distribution reviews.¹⁵

¹⁵ AER 2011, *Envestra Ltd Access Arrangement proposal for the Qld gas network: Final Decision*, June, p 46; Australian Energy Regulator 2011, *APT Allgas Access Arrangement proposal for the Qld*



The AER's proposed approach would have effectively entrenched the higher value for almost nine years. While APA Group challenges the AER's conclusion that the MRP is appropriately set at 6.0, by the AER's own reasoning its proposed approach, had it applied at the time of the South Australian and Queensland decisions, would entrench a higher cost of capital than it now considers to be an efficient level.

In contrast to the AER's proposed approach, in respect of the South Australian and Queensland decisions, the AER was instead able to apply the provisions in the existing NGR to determine what it considered to be an outcome commensurate with the regulatory and commercial risks faced by service providers at the time of its decision. APA Group considers that this flexibility should be retained in the NGR (and indeed would provide benefits if applied in the NER), and this flexibility (and scope for regulatory discretion) better meets the National Gas Objective and Revenue and Pricing Principles than the AER's proposed Rule change.

3.2.2 Certainty in the rate of return, encouraging investment

The AER states in its Rule change proposal that the proposed changes to the process for determining the cost of capital would provide more certainty in how the rate of return is to be determined, in turn encouraging an environment in which service providers are able to attract more investment.

3.2.2.1 *Does the AER proposal provide certainty in WACC parameters and encourage investment?*

There are two main assumptions in the AER's assertion that its proposal contributes to certainty and encourages investment:

- First, that the proposed WACC review process provides more certainty to service providers that the current review-by-review determination of WACC parameters; and
- Secondly, that certainty in the parameters that will apply, regardless of the parameters, would encourage investment.

APA Group considers that neither of these claims are supportable by evidence.

The AER provides no evidence that the current practice of assessing cost of capital parameters in individual access arrangement decisions every five years detracts from certainty or investment. The current framework of five-yearly reviews of cost of capital parameters for individual access arrangements delivers the same stability and certainty on an asset-by-asset basis as the AER's five-yearly review process, where in both cases WACC parameters are known and locked in for a period of five

gas network 1 July 2011-30 June 2016: Final Decision, June p 35; Australian Energy Regulator 2011, *Envestra Ltd Access Arrangement proposal for the SA gas network: Final Decision*, June, p 52



years. Therefore from the perspective of investment decisions relating to individual assets, service providers currently have stability in the parameters that will apply for at least five years (the term of the access arrangement), to support investment.

APA Group further notes that the timing of this stability in the context of the access arrangement also aligns with the timing that the service provider gains certainty in other factors such as capital and operating expenditure allowances, demand, incentive mechanisms and terms and conditions of access. There is no suggestion that certainty in WACC provisions to apply before an access arrangement contributes additional certainty to support investment. In fact that certainty could detract from investment as the following discussion shows.

The AER's assertion that certainty on WACC provisions encourages investment also embeds a second assumption that knowledge of future WACC parameters to apply, regardless of the value of those parameters, would encourage investment. This is plainly incorrect where those parameters are out of date, or lock in error in the setting of those parameters.

The AER's rule change proposal at no stage contemplates or addresses the risk of regulatory error in setting the WACC provisions. This is surprising given that this was a key concern in the establishment of the WACC review framework in electricity distribution, with the ultimate adoption of flexibility in the adoption of the WACC review outcomes¹⁶. In addition, in practice the AER's WACC review decisions have, in the AER's opinion and as a result of regulatory error corrected by the Australian Competition Tribunal (the Tribunal), required change within the term that they are intended to apply. This is shown, for example, through the Tribunal's decision in respect of the Ergon, ENERGEX and ETSA Utilities application for review of gamma, where the Tribunal overturned the AER's WACC review decision.¹⁷

What is certain is that entrenched error in any of the WACC parameters is likely to distort investment, whether that is through delivering inappropriately high returns or through inappropriately low returns. Both outcomes would be contrary to the National Gas Objective and Revenue and Pricing Principles.

3.2.2.2 *The cost of error in WACC review decisions*

The Ernst & Young (EY) report accompanying this submission (Attachment A) calculates the cost of error in the AER's current electricity statement and regulatory

¹⁶ Ministerial Council on Energy Standing Committee of Officials 2007, SCO response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing (Chapter 6), August, pp15-19

¹⁷ Application by Energex Limited (Gamma) (No 5) [2011] ACompT 9



intent as identified by the Tribunal. For the regulated gas sector, these errors amount to approximately \$89 million in annual revenues.¹⁸

While the correction (or avoidance) of these errors would have led to higher gas prices for gas consumers, it should be noted that the lower price was a result of errors made by the AER, which set prices at artificially low levels.

A key economic consequence of under-estimating regulated returns is the chilling of investment. Certain knowledge that WACC parameters to apply in the future are inappropriate cannot be said to support investment. This effect is further exacerbated by the loss of merits review rights embedded in the AER's rule change, an issue discussed in section 3.3.1 of this submission.

3.2.2.3 *AER's rule change does not contribute to the National Gas Objective*

APA Group considers that the AER has not shown that its proposed Rule change contributes to the achievement of the National Gas Objective or is consistent with the Revenue and Pricing Principles. The AER's claims that moving to five-yearly WACC review decisions would increase certainty, and through that, investment, are not based in evidence or fact.

The AER provides no support for its assertions that the WACC review contributes to certainty for individual service providers, or that certainty, if it were provided, would necessarily encourage investment. Evidence from recent decisions show that the contrary is in fact the case, and the rigid application of a five-yearly WACC review decision would detract from investment as that decision embodied error delivering an artificially low returns to businesses.

3.2.3 Reducing the administrative cost for regulated businesses, consumers and the regulator

The central claim made by the AER in support of its proposed Rule change is that a move to five-yearly WACC reviews applying to the gas and electricity sectors would decrease administrative costs for regulated businesses, consumers and the AER.

In support of this claim the AER cites concerns of repetitive debates on certain parameters across multiple reviews¹⁹, the considerable investment of resources from regulated businesses in debating cost of capital parameters at each review²⁰,

¹⁸ Ernst and Young 2011, *Analysis of costs associated with WACC-related errors: APA Group*, 8 December, p 2

¹⁹ AER 2011, *Price and Revenue regulation of gas distribution and transmission services: Rule change proposal*, p 4

²⁰ AER 2011, *Price and Revenue regulation of gas distribution and transmission services: Rule change proposal*, p 3



the cost of the AER being in continuous 'WACC review mode'²¹, the relative stability in parameters over time making this debate wasteful²², and the costs to consumers and other stakeholders in contributing to continuous cost of capital debate²³.

The AER states:

The AER agrees with the AEMC's reasoning, when developing chapter 6A, that prescribing WACC review outcomes for transmission determinations reduces administrative costs and increases investment certainty. The AER's proposed rule changes seek to achieve the same objectives for gas service providers.²⁴

APA considers that the AER has only considered some of the costs associated with conducting a single WACC review, and has disregarding key consequences of its approach, including the effect of the AER's rule change on future investment.

3.2.3.1 *AER's assessment of its own administrative cost savings*

APA Group considers that the AER overstates its own administrative cost savings (which it never quantifies) by not considering the costs and lost benefits associated with:

- Recruitment of specialist staff and contractors for each WACC review, as opposed to retaining staff with skills between reviews;
- The need to retain specialist skills within the broader ACCC in relation to WACC, which can be drawn on by the AER for individual reviews; and
- The development and retention of in-house capabilities in respect of cost of capital for all regulated sectors.

The AER's discussion of administrative cost savings appears to assume that it will incur no administrative and staffing costs between WACC reviews in respect to cost of capital. This approach appears to inadequately consider the costs of recruitment and training of staff, and expects that skilled staff will be available over the short term to conduct WACC reviews. APA Group does not consider that this is the case, and in practice the AER would instead retain capabilities between reviews, either within the AER itself or in the wider ACCC, and therefore expected cost savings in the AER's administrative costs would be minimal.

²¹ AER 2011, *Price and Revenue regulation of gas distribution and transmission services: Rule change proposal*, p 4

²² AER 2011, *Price and Revenue regulation of gas distribution and transmission services: Rule change proposal*, p 4

²³ AER 2011, *Price and Revenue regulation of gas distribution and transmission services: Rule change proposal*, p 5

²⁴ AER 2011, *Price and Revenue regulation of gas distribution and transmission services: Rule change proposal*, p 6



There is potentially further loss of benefit arising from the AER’s proposal where the loss within the AER of skilled and qualified in-house capability in respect of cost of capital would undermine confidence of investors in appropriate and correct cost of capital decisions being made on a five-yearly basis. APA Group considers that the continual development of skills and understanding within the AER through ongoing consideration of WACC issues delivers a benefit that would be lost under the AER’s proposed Rule changes.

3.2.3.2 Savings accrued to other participants in cost of capital decisions

The AER references expected savings to consumers and other stakeholders conducting an ‘all in’ WACC review. Again, these savings are not quantified, and indeed the AER makes no effort to support these expected savings through evidence.

Review of past practice shows the energy users made lengthy and substantive contributions to the WACC review process, clearly at considerable cost. This participation was presumably because of the broad impact of that decision on a large number of consumers. What is not clear is whether energy users’ participation in that review was hindered by its size and the ‘all in’ nature of that review, meaning that users were forced to contribute large sums over a short period to have an impact on the review.

The AER makes no effort to quantify or consider whether user participation in cost of capital debates are better made through ‘small bites’ than one off processes with high up front costs, or whether some groups are more likely to participate in reviews of individual decisions, but not an industry-wide review. APA Group makes these points to demonstrate that the AER’s assertions in respect of cost savings and participation are not supported by any evidence, and in fact contrary arguments could be made regarding users’ and other stakeholders’ effective participation in cost of capital decisions. Evidence is required to distinguish between these possibilities – evidence not provided by the AER in its Rule change proposal.

3.2.3.3 Actual drivers of AER’s concern

The AER puts considerable effort to highlighting the repetitiveness of discussions and evidence forwarded by service providers in respect of individual cost of capital parameters. The AER appears to be suggesting that this process is wasteful, particularly referencing its own arguments which disregard this evidence in its decision-making.²⁵

To date the AER has not generally accepted evidence presented to it by service providers in review processes such that it has led to a change in cost of capital

²⁵ AER 2011, *Price and Revenue regulation of gas distribution and transmission services: Rule change proposal*, p 4



parameters in resultant AER decisions. This, however, does not indicate that this evidence is without value. Evidence presented in the context of a price review (electricity or gas) has been substantively relied upon by service providers in merits review processes where the AER has not given that evidence sufficient weight in its decision-making. A particular example relates to the value ascribed to gamma by the AER in its review process, which was overturned by the Tribunal on the evidence presented during the review process, thereby highlighting regulatory error. Further examples are available in respect of the debt risk premium.

3.2.3.4 *Countervailing cost of regulatory error*

As noted above in respect of certainty, the AER’s rule change proposal in no way considers the countervailing costs of regulatory error that would be embedded in the AER’s WACC review decisions.

In light of the significant cost of regulatory error already uncovered in the AER’s first WACC review (annual impact across electricity and gas sectors of \$725 million, with \$89.1 million attributable annually to error in gas industry decisions alone), the AER’s expected administrative costs savings can only amount to a fraction of the cost of the broad application of regulatory error.²⁶

The AER’s proposed cost of capital rule changes could mean that even greater costs than those discussed above can be expected arising from out of date decisions applying to regulated businesses. This is a by-product of the WACC review process that applies parameters without review or consideration of prevailing market conditions. Even without regulatory error in decisions, this cost to the regulated sector is likely to dwarf any savings (albeit questionable) experienced by regulators, users, or the regulated sector in participating in five-yearly reviews.

It is important to note this is an actual cost, rather than a transfer, as the effect of under compensation of regulated businesses is likely to be long term impacts on investment. As noted by the Productivity Commission (PC) in respect of its Review of the National Access Regime, there was an “asymmetry in the consequences of regulatory pricing errors”:

.....the Commission accepts that there is a potential asymmetry in effects:

- Over-compensation may sometimes result in inefficiencies in the timing of new investment in essential infrastructure (with flow-ons to investment in related markets), and occasionally lead to inefficient investment to by-pass parts of a network. However, it will never preclude socially worthwhile investments from proceeding.
- On the other hand, if the truncation of balancing upside profits is expected to be substantial, major investments of considerable benefit to the community could be forgone, again with flow-on effects for investment in related markets

²⁶ Ernst and Young 2011, *Analysis of costs associated with WACC-related errors: APA Group*, 8 December, p 2



In the Commission's view, the latter is likely to be a worse outcome. Accordingly, it concurs with the argument that access regulators should be circumspect in their attempts to remove monopoly rents perceived to attach to successful infrastructure projects.²⁷

In respect of the errors discussed in this submission, the risk is not the removal of monopoly rents *per se*, but instead the loss of the ability to correct for regulatory error and ensure that cost of capital decisions reflect prevailing conditions. APA Group does not consider that introducing this risk into the NGR is consistent with the National Gas Objective, and certainly does not contribute to the National Gas Objective more than current provisions which provide for flexibility and contemporaneous decision-making in respect of the cost of capital to apply to individual regulated gas businesses.

3.2.4 Balance between flexibility over the longer term and certainty and consistency in the short to medium term

The AER lists as a benefit the balance between flexibility, certainty and consistency in its summary discussion of the Rule change, however it does not discuss this expected benefit explicitly in the rule change proposal.

As discussed above, APA Group does not consider that the AER's proposed Rule change to the cost of capital provisions provides any benefits through certainty, and instead removes all discretion and flexibility currently in place in the NGR to determine a cost of capital for gas businesses that is commensurate with the regulatory and commercial risks faced by those businesses.

APA Group considers that these changes are contrary to the National Gas Objective and the Revenue and Pricing Principles, and accordingly should not be accepted by the AEMC.

3.2.5 Avoid investment distortions

The AER states in a number of places in its proposed cost of capital Rule change proposal that the proposal would have the effect of removing scope for investment distortions. For example the AER states:

An unintended consequence of having different WACC frameworks is that they could produce different benchmark parameters (in particular the MRP) when the risks of investment reflected in these parameters should be the same across all regulated energy networks. This gives risk to investment distortions between sectors.²⁸

²⁷ Productivity Commission 2001, *Review of the National Access Regime*, Inquiry Report No 17, 28 September, p 83

²⁸ AER 2011, *Price and Revenue regulation of gas distribution and transmission services: Rule change proposal*, p 3



The AER raises the spectre of this risk, however it is not specific as to processes through which the risk arises. The AER does not reference differences between the current NGR and NER rules that may give rise to this risk, or why this risk particularly arises in respect of the MRP.

In fact, the AER appears to present the potential for deviation between sectors as a feature rather than a flaw in its earlier discussion of this matter:

It is important to note that the AER's 2009 WACC review could have resulted in different parameters being determined for transmission and distribution businesses, but this does not imply that separate rule provisions or processes for setting the WACC should apply, nor does it detract from the benefits of being able to consider whether there is a need for different parameters of energy networks (including gas service providers) as part of a single WACC review process.²⁹

The AER is responsible for making cost of capital decisions for both the electricity and gas sectors, and its practice to date has been to apply consistent decisions, despite different processes to arrive at those decisions. The only deviation between the sectors as to the parameters applied currently arises in respect of electricity transmission, which is bound for the next 2.5 years to adopt a gamma value that has been demonstrated to be incorrect, an error which has been able to be corrected for gas sector and electricity distribution sectors through the existence of flexibility in their respective regimes (flexibility that would be removed by the AER's proposed Rule change).

The AER's concern over investment distortions arising from the current NGR appears to be misplaced, and instead the current practice in the electricity transmission sector, which the AER is seeking to replicate for the gas and electricity distribution sectors, is more likely to give rise to investment distortions by locking in incorrect, and potentially out of date decisions for up to ten years.

3.3 Further issues raised by AER proposed rule change

3.3.1 Effective loss of merits review rights for the sector

APA Group is very concerned that the AER's Rule change submission does not acknowledge the clear implications of its proposal for merits review of cost of capital decisions. APA Group considers that this is at the very least disingenuous, and amounts to a submission with a material omission as to its impact on the electricity and gas access regimes, and the rights of service providers and users in respect of merits review.

APA Group acknowledges that the AER's proposed Rule change does not propose any changes to the merits review provisions of the NGL. This requires a separate

²⁹ AER 2011, *Price and Revenue regulation of gas distribution and transmission services: Rule change proposal*, p 3



process, conducted at the ministerial level. APA Group is most concerned, however, that the AER is using a ‘back door’ process to curtail access to merits review on its cost of capital decisions. APA Group refers to this as a ‘back door’ approach to curtailing merits review because the curtailment arises from indirect action, as described below.

Section 244 of the NGL specifies the types of decisions that are “reviewable regulatory decisions”:

reviewable regulatory decision means—

- (a) a Ministerial coverage decision; or
- (b) a light regulation determination or a decision of the NCC under Chapter 3 Part 2 not to make a light regulation determination; or
- (c) decision of the NCC under Chapter 3 Part 2 to revoke or not revoke a light regulation determination; or
- (d) an applicable access arrangement decision (other than a full access arrangement decision that does not approve a full access arrangement); or
- (e) an AER ring fencing determination; or
- (f) a decision of the AER under section 146 to give an exemption; or
- (g) an associate contract decision; or
- (h) a decision of an original decision maker that is prescribed by the Regulations to be a reviewable regulatory decision,

but does not include a decision of the AER made under Chapter 10 Part 2

Given that a decision on a particular WACC parameter to be applied in the CAPM is not a decision of the type specified in section 244 of the NGL, the AER’s proposed statement on the cost of capital decision is not a ‘reviewable regulatory decision’ and is therefore not eligible for merits review.

Allowable grounds for review are set out in section 246 of the NGL as follows:

- (a) the original decision maker made an error of fact in the decision maker’s findings of facts, and that error of fact was material to the making of the decision;
- (b) the original decision maker made more than 1 error of fact in the decisions maker’s finding of facts, and those errors of fact, in combination, were material to the making of the decision;
- (c) the exercise of the original decision maker’s discretion was incorrect, having regard to all the circumstances;
- (d) the original decision maker’s decision was unreasonable, having regard to all the circumstances.

APA Group considers that it would be virtually impossible for a service provider to establish ground for an application for leave to appeal under NGL section 246(2) when the decision of the AER was simply to apply the parameters specified in the WACC review.



That is, as long as the AER applies the cost of capital parameters codified under the WACC review (which effectively makes them Rules as the AER would not have discretion not to apply those parameters), the service provider would not be able to establish grounds for review. It is this relationship between the relevant decisions that removes cost of capital decisions from merits review, regardless of how unreasonable or incorrect the AER's cost of capital decision may be under the circumstances.

3.3.2 The need for merits review

The record shows that the AER has made errors in its cost of capital decisions in the past, and that those errors are material.

A report prepared by EY for the Financial Investors Group³⁰ reviews the history of merits review applications before the Tribunal. In summary, this report clearly shows that the AER has made decisions in its conclusions on cost of capital parameters which the Tribunal has found to constitute reviewable error.

Were this error to be 'locked in' through an energy industry WACC review with no avenue for appeal, the impact of those errors would be applied to all of the businesses regulated by the AER, as all would have the WACC review outcomes applied to its regulatory proposal filed over the course of the five year regulatory cycle.

3.3.3 Impact of AER WACC decision errors

In the attached report by EY on the costs associated with WACC errors,³¹ evidence is presented that the AER's 2009 Statement of Regulatory Intent has been found by the Tribunal to be in error, and the impact of that error is 1.04% on the WACC.

The significance of these errors should not be underestimated. EY calculates the regulatory asset base of the businesses regulated by the AER to be in the order of \$70 billion. EY then calculates the impact of the identified WACC errors as \$725 million per year. Over the course of a five year regulatory period, these errors amount to some \$3.6 billion impact of demonstrated AER errors.

The impact of these errors is concentrated on the infrastructure businesses; in contrast, the tariff reductions experienced by consumers are widely distributed. EY calculates that, for the gas industry, the tariff reductions attributable to the AER's identified WACC errors is in the order of \$0.02 per GJ. This should be compared to a commodity price in the order of \$8-10 per GJ. The impact on infrastructure businesses, however, is significant.

³⁰ Financial Investors' Group, Merits review in the regulated energy network industry Forthcoming.

³¹ Ernst & Young, Analysis of costs associated with WACC-related errors, December 2011



It is reasonable to conclude that an uncorrected error of this sort of magnitude would be expected to have a chilling effect on investment in infrastructure. However, the wide distribution of tariff reduction benefits is so small to individual users that it is unlikely to affect user decisions.

The Chair of the PC, Gary Banks, addressed the impact of this fact:

While the Commission has found that regulation appears warranted, it has signalled a need for greater legislative recognition — both in the application of regulation and the setting of terms and conditions — of the tradeoff between cheap services today and inadequate services tomorrow.³²

3.3.4 Which approach promotes the National Gas Objective?

As discussed above, a framework which allows material errors to continue uncorrected has significant scope to discourage investment in infrastructure.

Consistent with the views of the PC outlined above and its comments regarding the asymmetry in the consequences of regulatory pricing errors in its *Review of the National Access Regime*, APA Group considers that the National Gas Objective should be considered as a longer term objective. While short term price reductions may promote the short term interests of Users in respect of price, the longer term chilling effect on investment and resulting shortage of capacity is clearly not in the best interests of Users in the longer term.

APA Group considers that the current NGR provisions for cost of capital, with the continued availability of merits review to correct regulatory error, better achieves the National Gas Objective than the AER's proposal that has the potential to entrench regulatory error, remove oversight, and disconnect decisions on the cost of capital from the prevailing regulatory and commercial risks faced by service providers.

APA Group is concerned that the AER is now attempting to remove the merits review as an avenue to have its decisions corrected, when the record clearly shows that:

- its decisions have been in error in the past; and
- those errors have been material.

³² Gary Banks Chairman Productivity Commission *The good, the bad and the ugly: economic perspectives on regulation in Australia* Address to the Conference of Economists, Business Symposium, Hyatt Hotel, Canberra, 2 October 2003 <http://www.pc.gov.au/speeches/cs20031002>



3.4 Summary discussion of the AER's cost of capital rule change request

APA Group does not consider that the AER's proposed Rule change will contribute to the achievement of the National Gas Objective or is consistent with the Revenue and Pricing Principles.

The AER's Rule change proposal is centred on a desire for consistency between electricity and gas, however the AER has not shown how consistency will contribute to the National Gas Objective, or how other changes in other respects improve the NGR over its current structure.

As such, APA Group considers that the cost of capital provisions in the current NGR are appropriate and far superior, both from an investor's perspective and in terms of achieving the National Gas Objective. Accordingly, the AEMC should not make the AER's proposed Rule changes in whole or in part.



4 AER's nominal post tax WACC Rule change request

4.1 *Overview of AER's proposed post tax WACC rule change*

The AER proposes to change the NGR to mandate the use of a post tax revenue approach. The AER's reasons for change are as follows:³³

- The NER prescribe the use of the post tax nominal framework;
- Pre and post tax frameworks should yield equivalent results where the effective company tax rate is accurately calculated under the pre tax framework;
- Determining an effective tax rate under a pre tax model requires modelling of cash flows in post tax terms, meaning that the regulator would be performing a post tax calculation in either case;
- Adoption of a nominal approach better enables comparison with data reported in financial markets;
- Prescribing a post tax nominal approach would streamline the access review process and provide certainty for stakeholders;
- There are unlikely to be any changes in circumstances of the service provider or in regulatory practice that would justify having the flexibility in the NGR to reconsider these issues in each access arrangement; and
- The potential of gas service providers proposing alternatives to a nominal post tax approach appears unlikely, but the possibility of this occurring introduces potential administrative costs in assessing such alternatives.

4.2 *Discussion of AER's reasons for proposed post tax WACC Rule change*

The AER's reasons for its post tax WACC Rule change appear centred on regulatory expediency, effectively codifying its preferred approach to compensating for tax in its price determinations. It is important to note, however, that the AER's preferred position is not shared by the WA Economic Regulatory Authority, which maintains a pre-tax approach in respect of the Goldfields Gas Pipeline, applying the corporate tax rate. It was this (legitimate) diversity of approach that led policy makers to allow a diversity of approaches in the NGR at its inception. APA Group considers that scope for alternative approaches should be maintained in the NGR, in

³³ AER 2011, *Price and Revenue regulation of gas distribution and transmission services: Rule change proposal*, pp 7-9



line with other areas of the NGR where flexibility and regulatory discretion are supported.

The AER's concern to provide regulatory certainty in the NGR in respect of the approach to taxation is not grounded in any real concerns raised by stakeholders over this matter. APA Group has detected no groundswell of concern amongst stakeholders or the community related to uncertainty over the AER's approach to taxation. This would therefore suggest that the certainty is sought by the AER, and is related to expediency rather than concerns in the market.

APA Group considers that the AER's rule change is directed at regulatory expediency, and the case for change to the NGR has not been sufficiently made. Consistency with the NER does not contribute to the achievement of the National Gas Objective (as required of any Rule change). The AEMC should therefore not make the AER's proposed post tax WACC Rule change.



5 AER's prescription of the CAPM Rule change request

5.1 *Overview of AER's proposed CAPM rule change*

The AER proposes to change the NGR to modify the CAPM as the only financial model that can be used to determine the cost of capital.

The AER's reasons for this change are as follows:³⁴

- The CAPM is a well accepted financial model that has been applied by the AER and the Economic Regulatory Authority in WA in all decisions to date;
- The CAPM is currently prescribed by the NER;
- Debate over the use of the CAPM in recent gas determinations has led to administrative burden;
- Finance theory and methods are slow to develop, and it appears unlikely that there would be a justifiable departure from the use of the CAPM over the medium to long term; and
- Prescription of the CAPM would introduce investment certainty on fundamental aspects of the rate of return approach.

5.2 *Discussion of AER's reasons for proposed CAPM Rule change*

As noted in the Competition Economists Group (CEG) submission provided with the APIA submission to this process, it is important to recognise that the acceptance and use of financial models evolves over time with experience and research (both theoretical and empirical).

APA Group considers that it is appropriate to be informed by all reliable information relevant to estimating the prevailing cost of funds. As such it would be a mistake to simply adopt one theoretical model, and one of the multiple possible ways of implementing that model, and to assume that the outputs of that process are all that one should have regard to.

The AER does not make any distinction between using alternative models to inform the application of the CAPM, and using those models as an alternative to the CAPM. In effect, the AER's rule change has the potential to entrench a single view of finance theory, to the exclusion of all other finance theories that could inform that

³⁴ AER 2011, *Price and Revenue regulation of gas distribution and transmission services: Rule change proposal*, pp 11-2



view. APA Group does not consider that this would be consistent with good regulatory practice, and considers this would detract from the achievement of the National Gas Objective.

APA Group notes that a key concern of the AER is that it is drawn into debates on other theories. Contrary to this being a flaw in the NGR, APA Group considers that this debate is essential and healthy, and is the only way to determine whether the use of alternative models is likely to better contribute to the achievement of the National Gas Objective. It should not be troubling to the AER that these debates to date have not yielded a material change in approach – this is in fact the operation of the NGR as drafted that require any alternative to the CAPM to also be a ‘well accepted’ financial model.

APA Group considers that the AER’s Rule change is directed a regulatory expediency at the expense of good decision making, and the case for change to the NGR has not been sufficiently made. Consistency with the NER does not contribute to the achievement of the National Gas Objective (as required of any Rule change). In contrast, providing scope for debate and development of new models should contribute to the National Gas Objective. The AEMC should therefore not make the AER’s proposed CAPM Rule change.



6 Energy Users return on debt Rule change request

6.1 *Overview of Energy Users return on debt rule change require*

On 17 October 2011, the Energy Users Rule Change Committee (EURCC) filed a proposal to change the NER pertaining to the measurement of the cost of debt. This proposed Rule change focused primarily on the cost of debt applicable to government owned businesses. APA Group's comments are therefore restricted to a high level.

APA Group notes that, as this Rule change is targeted primarily at government owned electricity businesses, there is some scope, through the harmonisation objectives outlined by the AER, for this proposed Rule change to impact privately owned gas businesses.

APA Group considers that the current NGR on cost of capital, reflecting the primacy of the cost of funds in the marketplace, are working well. That assessment applies equally to the current Rules relating to the cost of debt.

Particularly in the case of privately owned gas businesses, there is no clear demonstration that a change is required, or that the proposed change would better promote the National Gas Objective.

6.2 *Discussion of Energy Users Rule change request*

6.2.1 Foundational analysis with Energy Users analysis

APA Group notes that Table 1 of the EURCC's proposal outlines face values and coupon rates of various utility debt issues. This table does not include a premium or discount associated with the debt issues, and therefore does not reflect the yield to maturity at the time the debt was issued.

This naïve analysis of debt issues does not necessarily reflect the cost of debt commensurate with the prevailing conditions in the market for funds at the time the various debt instruments were issued. It is not clear that this information demonstrates the existence of a problem with the existing Rules.

6.2.2 Use of benchmark

APA Group supports the Users' approach to use a benchmark for the cost of debt rather than actual debt costs. Actual debt costs can only reasonably reflect the cost of funds commensurate with the cost of funds in the marketplace at the time the debt was issued. This is not a suitable foundation for future investment.



However APA Group does have some concerns about the benchmark proposed by the Users.

The EURCC proposes to define the cost of private sector debt as follows:

RoD(p)(i) is the Return on Debt issued to private lenders. It is to be calculated as the simple *average yield to maturity* of A and broad BBB fair market value estimates of corporate bonds issued in Australia over the five year period ending on December 31st of year (i-1).³⁵

6.2.2.1 *Benchmark credit rating*

The EURCC has proposed that the benchmark debt rating should be broadened to include BBB and A rated debt. APA Group is concerned that this is not internally consistent with the rest of the cost of capital framework, as a business with a 60 per cent gearing ratio is unlikely to be able to obtain an 'A' credit rating.

APA Group acknowledges the paucity of data available in the Australian market, and in this regard would support the EURCC's proposal to broaden the benchmark to include 'broad BBB' rated bonds.

6.2.2.2 *Benchmark term*

The EURCC notes that its consultant 'recommends 5 year rather than 10 year debt to be used in the benchmark, thus properly reflecting actual NSP practice.'³⁶

APA Group considers that the EURCC's assertion that 'actual NSP practice' reflects a shorter yield to maturity is not supported by its own evidence. An examination of the debt issues in the EURCC's Table 1 clearly indicates a majority of debt is issued longer than a five year term. The EURCC appears to inappropriately focus on the most recent years dominated by then unsettled markets of the Global Financial Crisis to support its assertion.

APA Group also notes that the Users' Table 1 (page 14) did not include the APT Pipelines Ltd ten-year bond issued in July 2010, maturing in 2020, notwithstanding that this bond has featured prominently in the AER's cost of debt decisions for electricity and gas businesses since its issue.

APA Group continues to support a ten-year benchmark bond yield over a five-year benchmark as proposed by the EURCC. As discussed extensively in the AER's WACC review, this aligns better with the longer term investment outlook of

³⁵ Energy Users Rule Change Committee 2011, *Proposal to change the National Electricity Rules in respect of the calculation of the Return on Debt* Proposal by Amcor, Australian Paper, Rio Tinto, Simplot, Wesfarmers, Westfield and Woolworths 17 October, p 51

³⁶ Energy Users Rule Change Committee 2011, *Proposal to change the National Electricity Rules in respect of the calculation of the Return on Debt*, p 43



infrastructure businesses and reduces the refinancing risks associated with long term investments in infrastructure assets.

The use of a long term benchmark to measure the risk free rate and the debt risk premium was discussed at length in the AER's 2009 WACC Review.

The AER's final decision is that the 10-year term assumption for the risk-free rate will be retained. This position reflects detailed consideration of additional and new information submitted in response to the AER's explanatory statement.³⁷

In summary, APA Group submits that the EURCC has not made a case that a Rule change is required for privately owned gas businesses, but rather the EURCC is proposing a change to the methodology applied to assess the cost of debt.

Regarding the EURCC's proposed methodology, APA Group:

- supports the use of a benchmark cost of debt over the business' actual cost of debt;
- supports the widening of the benchmark debt issues to the 'broad BBB' category to enhance the population of comparators; and
- does not support the curtailment of the benchmark term from ten to five years, on the grounds that this will introduce refinancing risk into the investment in long term assets.

³⁷ AER 2009, *Final decision - Electricity transmission and distribution network service providers Review of the weighted average cost of capital (WACC) parameters*, May, pp140-168



7 AER's regulatory discretion and regulatory process

Rule change request

The AER's Rule change request in respect of the NER included a number of changes to those Rules related to broadening regulatory discretion and further confining the regulatory process. APA Groups makes the following high level comments on some of those Rule changes, in particular highlighting differences between the electricity and gas sectors and regimes relevant to the proposed Rule changes.

7.1 *Exercise of discretion – capex and opex*

APA Group notes that many of the provisions targeted in the AER's Rule change proposal are not reflected in the NGR. For example, the NGR do not include requirements that forecasts 'reasonably reflect' the capital operating expenditure criteria, or to the extent to which the AER can amend a forecast if it considers that it is not consistent with the NGR.

By providing for limited discretion for the regulator to withhold its approval of a capital or operating expenditure forecast that is consistent with the NGL and NGR, APA Group considers that the NGR reflect an appropriate balance for the gas industry between the primacy of the service provider in planning and operating regulated assets, and the regulator in ensuring prudent and efficient outcomes.³⁸

7.2 *Capital expenditure overspends*

The AER's Rule change specifically targets a perceived problem with the NER regarding a lack of discretion on the part of the regulator over the rolling into the asset base of capital overspends in the previously access arrangement period. The AER argues that the automatic roll forward of actual capital expenditure provides incentives for electricity service providers to incur greater than efficient costs.³⁹

APA Group notes that the NGR includes an *ex post* review of capital expenditure incurred in the earlier access arrangement period. APA Group notes that the gas regime, as a consequence, does not include the potential risks identified by the AER for efficient capital expenditure.

³⁸ Limited discretion rules under the NGR are at Rule 40(2), and apply to the AER's decisions to approve or not to approve a service provider's capital and operating expenditure forecasts (Rules 79 and 91 respectively)

³⁹ Australian Energy Regulator 2011, *Economic Regulation of transmission and distribution network service providers – AER's proposed changes to the National Electricity Rules: Rule change proposal*, September, p 37



7.3 Treatment of shared assets

The AER argue that where assets forming part of the regulatory asset base for standard control services are used or could be used in the provision of services other than standard control service, the AER should be able to adjust or include a mechanism in the distribution determination to compensate standard control service customers for the use or potential use of these assets.

The principle behind the AER's Rule change appears very similar to that in the NGR which allocates costs between regulated and unregulated services and then reference and non-reference services. In addition, the NGR include provision for rebateable services.⁴⁰

APA Group notes, however, that the AER's use of provisions such as rebateable services is constrained under the NGR due to the potential for such rebates to distort investment and undermine incentives on service providers to provide new services. These issues are discussed at length in APA Group's submission to the AEMC in regard to the AER's proposed change to the definitions of reference and rebateable services.⁴¹

7.4 Curtailment of consultation process

The AER's rule change seeks to curtail the rights of service providers to make submissions during the review process, including within the allowable time limits for submissions to be made by 'any person' under the NER.

APA Group is concerned that the AER seeking to curtail the rights of service providers to provide information to the regulator and interested stakeholders that is relevant to the review process. Contrary to the AER's claims that the provision of this information detracts from transparency and good process, APA Group considers that the provision of public submissions and further information can only contribute to transparency and good decision-making.

APA Group does not agree with the AER's assertions that the ability to make submissions to the regulator, in addition to regulatory proposals, creates an incentive on the service provider not to provide a full proposal to the regulator. As noted by the AER earlier in its rule change proposal, the service provider's proposal is afforded special status in the review process. In contrast, regulators are only required to consider submissions in making their decisions. This provides a strong incentive on service providers to provide full and complete proposals to the regulator

⁴⁰ See NGR Rule 93

⁴¹ APA Group submission to the AEMC on AER's proposed Rule changes regarding the definition of reference and rebateable services, available at <http://www.aemc.gov.au/Gas/Rule-changes/Open/Reference-service-and-rebateable-service-definitions.html>



within statutory time limits, to ensure that all issues and arguments in that submission is addressed by the regulator.

APA Group also has considerable concerns over the workability of the AER's proposed revisions which make a distinction between submissions on issues that are 'common' between proposals, and those that are 'shared' between proposals. APA Group is concerned that in practice these distinctions are subjective and somewhat arbitrary, and leave interpretation to the regulator as to whether service provider submissions will be regarded in the review process. APA Group considers that this creates considerable uncertainty in the review process as to information that the regulator will take into account in its decision-making, with clear implications for the conduct of merits review proceedings which must be based on material properly before the decision maker.⁴²

⁴² National Electricity Law section 71O



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