Wesfarmers Chemicals, Energy & Fertilisers

28 February 2013

Rate of Return Guidelines Review
Economic Regulation Authority
PO Box 8469
Perth BC WA 6849

Email: publicsubmissions@erawa.com.au

Re: Wesfarmers Chemicals, Energy and Fertilisers submission to the ERA Consultation Paper 'Guidelines for the Rate of Return for Gas Transmission and Distribution Networks'

Dear Dr Duc Vo,

Wesfarmers Chemicals, Energy and Fertilisers ("WesCEF") welcomes the opportunity to provide initial comments in response to the Economic Regulation Authority's ("ERA") consultation paper for the development of Rate of Return ("RoR") guidelines for regulated gas assets.

As a frequent user of regulated natural gas pipelines and distribution systems in Western Australia, WesCEF's main concern is that the cost of accessing these regulated assets remains competitive whilst ensuring that the regulated RoR afforded to the owners and operators of these assets is sufficient to encourage an appropriate level of service as well as investment in market expansion.

Appendix A to this submission provides initial comments in response to specific sections of the Paper. It is important to note that these comments have been provided in good faith and reflect WesCEF's broad view on the ERA's approach. They are not intended to be used as expert technical advice; but to provide comments for consideration by the ERA in forming its guidelines.

Apart from the comments provide in Appendix A to this submission, WesCEF considers the ERA's current view and proposed approach for the development of guidelines for the RoR for Gas Transmission and Distribution Networks to be appropriate.

Should you wish to discuss any points raised in this submission please contact Mel Gordon on 0409 704214 or mgordon@wescef.com.au.

Yours sincerely,

Mel Gordon
Senior Project Analyst - Business Development
Wesfarmers Chemicals, Energy & Fertilisers

Appendix A to WesCEF submission dated 28 February 2013

Comments on specific 'Issues for Consideration' in the ERA Consultation Paper 'Guidelines for the Rate of Return for Gas Transmission and Distribution Networks'

1.1.1 The ERA's approach to developing the RoR guidelines

- WesCEF considers the ERA's proposed approach of setting indicative RoR parameter values for the development of RoR guidelines with a case by case approach to developing the specific parameters for the rate of return is appropriate.

2.1.1 Efficient financing costs

- WesCEF considers the ERA's concept that the rate of return to debt and equity investors (being re and rd in the WACC formula) should be sufficient to attract debt and equity finance but not excessive (i.e. it should be at or only marginally above the rate of return for the next best investment available to the investors).
- In considering this return the ERA should be mindful of actual investors to which these investments are available. On the debt side, if the relevant operator only borrows from state treasury, then the return on debt should only be sufficient to satisfy their requirements and not the requirements of the broader market. On the equity side, the equity rate of return should be considered in light of the returns available on similar assets to the broader market.
- With regard to considering the return on debt and equity together, WesCEF considers this is appropriate and should be informed by the consideration of the actual investors mentioned above. In a situation where, for example, state treasuries require a lower return on debt, the return on equity should also be lower on the basis that the financial risk is reduced.

2.1.2 Benchmark efficient entity

- Benchmarking is useful in developing the appropriate RoR; however, an appropriate benchmark company needs to be developed for each determination that is appropriate to the operator being considered.
- WesCEF considers that benchmarking of gearing, debt premium and beta are generally appropriate but consideration of the efficient financing costs for the operator being considered and how that may justify a movement away from the comparator group is also necessary.

2.1.3 Degree of risk associated with provision of reference service

- WesCEF would propose the degree of risk should be developed with reference to the Australian regulated industry in the first instance, but reference to international markets should also be considered as appropriate (particularly in considering how the level of risk is compensated where the investors in the project have global alternatives). Risk should reflect the risk inherent in the particular asset type rather than across all regulated asset types.

3. Overall regulatory framework

- WesCEF considers the use of a vanilla WACC and the post-tax revenue model to be appropriate, but cannot comment on whether there are any transitional issues associated with the change.

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4. Gearing

- The ERA should consider matching as closely as possible, the comparator group used in the development of the benchmark gearing to the relevant operator being considered and adjusting for any differences in the efficient return on debt in the comparator companies.
- The ERA should also consider the level of gearing that is sustainable for the relevant operator on the basis of its efficient return on debt, as commented in 2.1.1 above.

5. Nominal risk free rate

- On the choice of risk free asset, in addition to the ERA's comments, the risk free asset chosen should be zero coupon (i.e. no interim coupon/interest payments to the investor prior to maturity of the asset). Coupons introduce reinvestment risk as the investor has interim receipts to reinvest, however the return on the reinvestment in the future is unknown.

6.1 Models for estimating return on equity

- In regards to terms of setting the parameters under the Sharpe-Lintner CAPM model, ERA should consider qualitative assessments on the size of the operator and the extent of intangible assets (the other factors in the Fama three factor model) in comparison to the comparator group. The UK/NZ method of using the outputs of the other models to inform this qualitative assessment appears to be appropriate.

6.2 Market Risk Premium ("MRP")

- Considering that the MRP changes over time depending on the risk aversion of investors and other factors, if the ERA ran the NPV = 0 argument and use 5 year assumptions for the risk free rate, they should potentially assess the MRP over a shorter time period as well to be consistent.

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