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Rate of Return Guidelines Review
Economic Regulation Authority

Lodged electronically by e-mail: publicsubmissions@erawa.com.au

Attention: Dr Duc Vo

Submission on ERA Draft Rate of Return Guidelines

APA Group (APA) appreciates the opportunity to comment on the Draft Rate of Return Guidelines (Draft Guidelines) and the accompanying Explanatory Statement issued by the Western Australian Economic Regulation Authority (ERA) in its process of developing the rate of return guidelines now required under rule 87(13) of the National Gas Rules (NGR).

APA is a major energy infrastructure investor which operates some 13,000 kilometres of gas transmission pipelines and associated gas storage facilities in Australia. In Western Australia, APA Group operates both regulated and unregulated assets, including the Goldfields Gas Pipeline, and the Mondarra Gas Storage Facility.

APA is a member of the Australian Pipeline Industry Association (APIA), and is participating in the ERA's rate of return guidelines process through its membership of that association. In making this submission in its own right, APA does not present views at variance with those of the APIA. Rather, APA takes the opportunity to give emphasis to a number of those views from its perspective as a major energy infrastructure investor.

Changes to the NGR and the requirement for rate of return guidelines

In November 2012, the Australian Energy Market Commission (AEMC) made changes to the NGR which, APA believes, will have significant consequences for future investment in Australia's gas transmission pipeline infrastructure.

The AEMC included, in the NGR, an allowed rate of return objective which should focus rate of return determination on delivery of the right outcome: an allowed rate of return which is commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of the provision of reference services.

To ensure that this objective could be achieved, the AEMC also changed the rules to allow greater flexibility in the process of rate of return determination by requiring that regard be had to relevant estimation methods, financial models market data and other evidence.

Furthermore, the changes to the NGR also included a requirement that the regulator periodically make and publish rate of return guidelines which set out and explain the approach to be taken in determining the allowed rate of return.

The AEMC saw the guidelines as providing pipeline service providers, the users of pipeline services, and investors in pipelines with a degree of certainty about the rates of return which they could expect in regulatory decisions. They were to narrow debate when regulatory decisions were to be made. The guidelines were not to lock-in any parameters or methodologies from which departure would not be permitted. This was necessary to ensure that rate of return determination would have the flexibility needed to deliver allowed rates of return which achieved the allowed rate of return objective.

The Draft Guidelines

APA has reviewed the Draft Guidelines, and the further explanation and supporting arguments of the Explanatory Statement. We make the following comments.

Criteria

APA is very concerned about the criteria for the application of regulatory discretion set out in paragraph 35 of the Draft Guidelines.

The criteria of paragraph 35 are advanced, not unreasonably, to facilitate decision making where the NGL and the NGR are silent and the exercise of judgement is required. However, in the Explanatory Statement they cease to be subsidiary principles. They become the primary criteria against which the ERA decides on the main elements of the guidelines.

The criteria are not linked to hierarchy of objectives set out in rule 87 for the purpose of deciding on how the rate of return is determined. In consequence, the Draft Guidelines give little or no consideration to delivering an allowed rate of return which achieves the allowed rate of return objective, and to how flexibility is to be incorporated into the process of rate of return determination to allow the objective to be achieved.

We see this most clearly in the ERA's choice of models for estimation of the rate of return on equity and the rate of return on debt. However, before turning to those models, we comment on the way in which the Draft Guidelines propose to apply the construct of the benchmark efficient entity.

Benchmark efficient entity

APA sees identification of the benchmark efficient entity as the key to application of rule 87.

The rate of return on equity is to be estimated such that it contributes to achievement of a rate of return commensurate with the efficient financing costs of the benchmark efficient entity. The rate of return on debt is to be estimated such that it contributes to achievement of a rate of return commensurate with the efficient financing costs of the benchmark efficient entity. The allowed rate of return is to be commensurate with the efficient financing costs of the benchmark efficient entity.

However, identification of the benchmark efficient entity receives minimal attention in the Draft Guidelines, and is inadequately dealt with in the Explanatory Statement. Different benchmarks are invoked at different places in the Explanatory Statement (for determining gearing, establishing a credit rating, estimating the rate of return on equity, and estimating the debt risk premium) without consideration of whether they have the attributes of efficiency and similar degree of risk to the service provider in its provision of reference services required by rule 87.

In the discussion of the benchmark entity in the Explanatory Statement we find that the risk of the benchmark entity is confused with the risk for which investors might be compensated through the market determined prices of financial assets.

If, for example, an equity beta is to be used in calculating a premium for risk in a rate of return on equity, as might be done when applying the Sharpe-Lintner Capital Asset Pricing Model (SLCAPM), then that beta must be the beta for the benchmark entity. The benchmark entity must be identified and established before the equity beta can be calculated.

If an equity beta is calculated – to estimate the compensation which equity investors require for risk – from a sample of entities which do not have a degree of risk similar to that of the service provider in its provision of reference services, there will be no reason to expect that the rate of return on equity estimated using that beta will contribute to achievement of the allowed rate of return objective.

Through their giving inadequate attention to efficiency, and to the risk of the service provider in respect of the provision of reference services, the Draft Guidelines fail to provide the proper basis for establishing the benchmark efficient entity required by rule 87. There is, then, no reason to expect that a rate of return determined by applying the guidelines will achieve the allowed rate of return objective.

APA sees this as a major deficiency in the ERA's proposals, which should be addressed before rate of return guidelines are made and published.

Rate of return on equity

Rule 87 is clear: in determining the allowed rate of return, the regulator must have regard to relevant estimation methods, financial models, market data and other evidence. In requiring that methods, models, data and evidence be "relevant", the AEMC intended that the threshold of what might be taken into account in rate of return determination was "low".

Through the application of the criteria set out in paragraph 35 of the Draft Guidelines, criteria which, at best, are only loosely linked to the NGL and the NGR, the ERA has rejected all relevant financial models which might be used to estimate the rate of return on equity save for the SLCAPM.

Neither the rejection of those other models, nor the requirement that rate of return on equity estimation use only the SLCAPM, has been based on considerations of whether the estimated rate of return on equity which might be produced contributes to achieving the allowed rate of return objective.

APA acknowledges that the SLCAPM is a relatively simple and widely used model. It is likely to have a role in estimating the rate of return on equity, and that will require an approach to estimating beta using methods similar to those of the ERA's 2013 beta study.

However, as the Explanatory Statement explicitly acknowledges, the CAPM does not explain investor returns with precision, and beta estimation is imprecise.

If a financial model cannot explain equity returns with precision, and if estimates made of the parameters of that model are also imprecise, then there is no reason to expect that rate of return estimates made using that model and that estimation method can contribute to achieving the allowed rate of return objective.

Comparative analysis is required. The results obtained using the SLCAPM and the ERA's beta estimation methods must be compared with estimates of the rate of return on equity made using other financial models, other estimation methods and other data. This comparative analysis will be a carefully reasoned assessment of the results from alternative financial models, alternative estimation methods and different data sources, made in the context of the specific circumstances of the each service provider and its provision of reference services.

This is no more than the requirement of rule 87 for having regard to relevant estimation methods, financial models, data and other evidence. That requirement should be recognised in the rate of return guidelines.

Return on debt

In its proposals concerning estimation of the rate of return on debt, the Draft Guidelines are similarly deficient. Reliance is placed on a single model which may, or may not, produce estimates which contribute to achievement of the allowed rate of return objective.

The Draft Guidelines propose that the rate of return on debt be the sum of the risk free rate of return and a debt risk premium.

The risk free rate of return is to be estimated using yields on Commonwealth Government bonds with terms to maturity of 5 years. This is a small, but important, departure from prior regulatory practice, which used the yields on bonds with terms to maturity of 10 years. The use of the longer term yields in this context is consistent with the long term financing of long lived pipeline assets, and with established commercial practice. It should not be abandoned for theoretical reasons which are not convincing.

APA notes that in its *Draft rate of return guideline*, issued on 30 August 2013, the Australian Energy Regulator (AER) proposes estimation of the risk free rate of return from yields on Commonwealth Government bonds with terms to maturity of 10 years.

The Draft Guidelines advise that the debt risk premium to be used in estimating the rate of return on debt is to be calculated using the ERA's bond yield approach. Application of that approach requires bond yields for a sample of comparable firms. APA is concerned that the ERA's approach to selection of that sample overlooks the requirement of rule 87 that the estimate of the rate of return on debt contribute to the achievement of the allowed rate of return objective.

Sample selection for the bond yield approach proceeds in two steps. A benchmark credit rating is established, and then a sample of bonds with that benchmark credit rating is selected.

If a credit rating is required for the purpose of estimation of the rate of return on debt, then that rating must be the credit rating of the benchmark efficient entity. If it is not, then there will be no reason to expect that any estimate of the rate of return on debt made using that rating will contribute to the achievement of the allowed rate of return objective.

Once the benchmark credit rating has been determined, sample selection seems to be driven by past practice and issues of data availability. It does not appear to be guided by the requirement that the rate of return be commensurate with the efficient financing costs of a benchmark efficient entity with degree of risk similar to that of the service provider in respect of its provision of reference services. Again, there is no reason to expect that the resulting estimate of the rate of return on debt made using the debt risk premium calculated from those data will contribute to the achievement of the allowed rate of return objective.

APA's concerns

In an earlier submission responding to issues in the ERA's cost of debt working paper, APA advised that investors saw inclusion of the objective in the NGR as a step towards ensuring that regulatory rate of return allowances were aligned with rates of return investors expected to earn on their investments in that infrastructure. An allowed rate of return which achieves the objective will be seen by investors as a signal that the regulatory regime is providing returns consistent with market expectations. This outcome will be achieved through an approach to rate of return determination which makes use of the flexibility introduced by the AEMC requiring that regard be had to relevant estimation methods, financial models, market data and other evidence.

We see, in the Draft Guidelines and the Explanatory Statement, little regard for the allowed rate of return objective, and for the requirement to consider a range of methods, models, data and evidence so that the objective might be achieved.

Instead, we see an approach to rate of return determination which perpetuates the mechanical approach which prevailed prior to the rule change, an approach which the AEMC explicitly rejected.

APA sees the Draft Guidelines as not giving recognition to the AEMC's stated intention that focus of the new rule 87 was the right rate of return outcome, being a rate of return which was commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of the provision of reference services.

APA is concerned that the Draft Guidelines do not follow the letter of the rules, specifically in their clear requirement that regard be had to a broad range of relevant information in determining a rate of return capable of achieving the allowed rate of return objective.

On 30 August 2013, the AER issued its draft rate of return guidelines. In contrast to the ERA, the AER is proposing to incorporate into its guidelines at least some of the flexibility in rate of return determination sought by the AEMC.

With the apparent lack of concern for the right outcome, and the absence of any requirement to consider a broad range of information, there is a real prospect that the Western Australian guidelines will lead to regulated rates of return which are lower than elsewhere in Australia. We are concerned that the ERA's approach will lead to rates of return which are less than the rates which will allow regulated businesses to compete for capital in financial markets in Australia and globally. Western Australian pipeline operations will have difficulty attracting capital. Investors in pipeline infrastructure are likely to seek opportunities outside the State with a consequent slowing of investment, which will constrain future growth in the Western Australian economy.

APA Group would be pleased to discuss with the ERA any issue arising from our submission on the Draft Guidelines. Please contact Dr John Williams on (08) 6189 4594 or john.williams@apa.com.au.

Yours faithfully

for

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