19 September 2013

Mr Greg Watkinson
Chief Executive Officer
Economic Regulation Authority
4th Floor, Albert Facey House
469 Wellington Street,
Perth WA 6000

Dear Mr Watkinson

APIA submission to ERA draft Rate of Return Guideline

Thank you for the opportunity to comment on the ERA's draft rate of return guidelines and accompanying explanatory statement. While APIA member businesses will make more fulsome submissions, APIA's comments are targeted and relatively brief.

At the highest level, APIA is concerned with the ERA's Draft Guidelines and Explanatory Statement in three primary areas:

- the draft guideline appears not to follow the primary intent of the new Rules, being to focus on an outcome rate of return 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 (the *allowed rate of return objective*);
- the draft guidelines do not follow the letter of the Rules, specifically a clear requirement to have regard to a broad suite of relevant information (where "relevant" is a very low threshold); and
- the draft guidelines do not demonstrate how each of the steps detailed to determine the allowed rate of return contributes to and how the overall rate of return meets the ARORO.

Overall, it appears to APIA that the process to be applied by the ERA under the draft guideline is precisely the same as it applied before the Rule change – complete reliance on a single model with no valid cross-checks. In short, the ERA's process demonstrates none of the evolution in rate of return processes that has been reflected in the new Rule 87.

The allowed rate of return objective

The primary intent of the new Rules is encapsulated in the allowed rate of return objective (the "ARORO") in Rule 87(3):

> The *allowed rate of return objective* is that the rate of return for a service provider is to be 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 (the *allowed rate of return objective*).

APIA submits that the ARORO is the key element in the Rules pertaining to the rate of return, and should be the primary point of reference for the guideline.

The Tribunal's interpretation of the previous Rule 87 in *DBNGP*[1] could be expressed as placing primary focus on the approach and its inputs, and trusting that the outcome would be right. In *DBNGP*, the effect of the Tribunal's decision was that, under the old Rule 87, it was not necessary for the ERA to turn its mind to the question of whether the application of its approach delivered sensible outcomes.

This has now changed under the new Rule 87, with its key element of the ARORO. This key element of the Rules is, in APIA's view, designed to remove any doubt that the purpose of the exercise is focused on the outcome and the methodologies and inputs, rather than just on the methodology and inputs. The ARORO makes it explicit that the key focus is on the determined number, and Rule 87(5) makes it clear that the regulator is not to limit its considerations to the workings of a single tool to meet that objective.

In APIA's view, the draft guidelines has not given the ARORO the primacy it deserves, and that is required under Rule 87. Moreover, neither the draft guidelines nor the explanatory statement outline how the methodologies the ERA proposes to use to estimate the allowed rate of return are proposed to result in the determination of a rate of return that is consistent with the ARORO (as is required by Rule 87(14)(a).

The importance of getting the determined number right

It is critical, as the AEMC makes clear, that the primary focus needs to be on the overall rate of return.

APIA member businesses must compete for capital in the open marketplace. To the extent the regulator's determination of the allowed rate of return falls short of the cost of capital in the marketplace, the pipeline business will not be able to source capital to invest in extending or expanding its regulated pipeline assets.

To the extent the allowed rate of return resulting from the application of the ERA's guideline is less than the rates of return investors can earn on non-regulated activities, then the pipeline business will not be able to attract capital to invest in its regulated assets.

[1] Application by DBNGP (WA) Transmission Pty Ltd (No 3) [2012] ACompT 14 (26 July 2012)

Moreover, to the extent the allowed rate of return emanating from ERA decisions is lower than that in the decisions of the Australian Energy Regulator applicable to infrastructure businesses operating in the eastern states, capital will naturally flow to the higher-earning eastern states in preference to Western Australia.

In either case (the ERA's rate of return being too low to attract investment in absolute terms, or being low relative to those emanating from AER decisions), the result will invariably be a chilling effect on Western Australian infrastructure investment, and a consequential chilling effect on those sectors of the Western Australian economy that rely on that infrastructure investment.

APIA urges the ERA, in accordance with the Rules, to ensure that its allowed rate of return enables regulated assets to attract the capital necessary to invest.

Having regard to relevant estimation methods, financial models, market data and other evidence

It is clear from the AEMC determination that it wrote its new Rule 87 in response to the Tribunal decision in *DBNGP* and the *ATCO* case. The Tribunal's interpretation of the previous Rule, in APIA's view, could be expressed as placing primary focus on the model and its inputs, and trusting that the outcome would be right. In *DBNGP*, the effect of the Tribunal's decision was that, under the old Rules, it was not necessary for the ERA to turn its mind to the question of whether the application of a single methodology delivered sensible outcomes. [2]

It was this interpretation of the old Rules that drove the AEMC to draft its preferable rule, notably Rule 87(5)(a):

> (5) In determining the *allowed rate of return*, regard must be had to:
>
> > (a) relevant estimation methods, financial models, market data and other evidence;

APIA firstly notes the inclusion of the word "must" in Rule 87(5). This clearly indicates that the application of this rule is not discretionary on the part of the regulator.

Discussions between APIA and the AEMC clearly indicated that the AEMC struggled with the concept of "relevant" and sought to express as low a hurdle as possible. However, the policy position in the AEMC determination on the Rules change is clear – the formulaic application of a single model under the old Rule 87 has resulted in rate of return determinations that are not in accordance with the cost of funds in the marketplace, and to solve this issue the regulator is to have regard to as broad a suite of information as possible in determining the appropriate rate of return to apply to regulated businesses.

APIA is concerned that the draft guidelines continue to focus on a single model (the Sharpe-Lintner Capital Asset Pricing Model, or SLCAPM). While we acknowledge that the SLCAPM is widely used and does provide some information on required returns, it is also widely known to have flaws and relatively poor predictive power.

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[2] Application by DBNGP (WA) Transmission Pty Ltd (No 3) [2012] ACompT 14 (26 July 2012)

Importantly, no single model can tell the complete story - all models have strengths and weaknesses, and varying levels of predictive accuracy in different market conditions.[3] But all models have *some* information to add to the decision making process, which is why it is very important to consider the information being provided by as many of these models and other market information as possible. This is the clear requirement of the Rule.

APIA is concerned with the approach taken by the Explanatory Statement in discussing which models would and would not be considered by the ERA in reaching its rate of return determinations. Specifically, the ERA has applied a set of criteria, drawn from outside the Rules, which are more demanding than the criteria provided in the Rules themselves. Aside from the question of whether the ERA would be acting *ultra vires* in its application of these non-Rule criteria, APIA is concerned that the criteria appear to have been selected and applied with the purpose of allowing the ERA to reject virtually every model and information source assessed. Moreover, APIA is concerned that nowhere in the draft guidelines or the explanatory statement has the ERA sought to demonstrate that its criteria are an appropriate proxy for assessing compliance with the ARORO.

The result of the ERA's application of these non-Rule criteria is twofold:

- there is only one model remaining for the ERA to use – the SLCAPM; and
- there are no other models or information sources remaining for the ERA to use to inform the exercise of judgement or to allow the ERA to ascertain whether the SLCAPM is delivering a rate of return that meets the requirements of the *allowed rate of return objective*.

It appears to APIA that the process to be applied by the ERA under the draft guideline is precisely the same as it applied before the Rule change – complete reliance on a single model with no valid cross-checks. In short, the ERA's process demonstrates none of the evolution in rate of return processes that has been reflected in the new Rule 87.

In its final determination, the AEMC concluded that none of the previous rate of return frameworks was capable of best fulfilling the requirements of the National Gas Objective and the Revenue and Pricing Principles. The AEMC's policy determination was that a new rate of return framework was therefore required.[4]

In summary, APIA submits that the approach flagged in the draft guideline, being the application of a single model with no valid cross checks, is not in accordance with the Rules. Rule 87(5) clearly requires the ERA to have regard to a broad range of estimation methods, financial models, market data and other evidence in its assessment of the allowed rate of return to apply to regulated businesses.

The benchmark efficient firm

The allowed rate of return objective clearly requires that the rate of return "is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that

[3] See The Brattle Group, *Estimating the Cost of Equity for Regulated Companies*, 17 February 2013, Attachment to 13 March 2013 APIA submission.
[4] AEMC, *Final determination*, 29 November 2012, p. 42.

which applies to the service provider *in respect of the provision of reference services*" (emphasis added).

APIA submits that gas transmission pipelines are particularly unique in terms of their location, terrain, supply and demand profiles, and the dynamics of the markets they serve. Each therefore bears quite different risks "in respect of the provision of reference services".

However, the Capital Asset Pricing Model only compensates investors for bearing what it defines as systematic risk – it does not explicitly acknowledge the range of risks that might apply "in respect of the provision of reference services" on the grounds that many of them can be diversified away through creation of a diversified portfolio of investments. This is a definitional feature of the model.

APIA considers that the ERA's consideration of the risks associated with providing reference services is, at best, superficial and very general. There is no specific analysis of the risks or providing the services of WA regulated pipelines and gas networks to determine what the degree of "systematic' risk for these businesses is as considered by the SLCAPM, or other risks which may be priced into the cost of equity and the cost of debt.

Rule 87(3), however, specifically requires the regulator to provide for a rate of return reflecting "a similar degree of risk as that which applies to the service provider *in respect of the provision of reference services*" (emphasis added). The ERA's sole application of the SLCAPM explicitly excludes this type of risk from consideration, and is therefore clearly not in accordance with the Rules.

The ERA's analysis does not reflect the fact that the cost of debt considers risks other than systematic risk – specifically default and liquidity risk, which is very particular to an individual pipeline. As a consequence the draft Guideline arrives at a position on the appropriate credit rating which is also superficial and not in accordance with the Rules.

APIA considers that, in order to develop a rate of return that is in accordance with the Rules, the ERA must perform an assessment of the risks facing the relevant service provider specifically in respect of the provision of reference services, and must then demonstrate similarity with the entities from which it will draw data to inform the Benchmark Efficient Entity, before applying the cost of equity and debt methodologies.

Where to from here?

As discussed above, APIA has three major concerns, all focused on achieving the rate of return outcome intended by the Rules:

- the use of a single model to determine the allowed rate of return; and
- the narrow scope of risk attributed to the benchmark efficient firm.

In both cases, APIA is of the view that the ERA's draft guidelines approach is not in accordance with the Rules and will not result in an allowed rate of return that meets the allowed rate of return objective.

APIA submits that the draft guidelines require amendment in the following key areas:

- to embrace the Rule requirement that a wide range of financial models, market data and other information must be afforded full and fair consideration in informing the ERA's exercise of judgement on the allowed rate of return as required by Rule 87(5);
- to demonstrate how each of the steps used to determine the allowed rate of return contributes to and how the overall rate of return meets the ARORO; and
- to clearly analyse and account for the risks borne by the service provider, specifically in the provision of reference services as required by Rule 87(3).

APIA member companies will file submissions of a more detailed nature to the draft guideline process, and APIA commends these submissions to your consideration.

APIA would be pleased to discuss this submission with you at your convenience. Please call Steve Davies, Policy Adviser, on (02) 6273 0577 or 0433 833 247.

Yours sincerely

CHERYL CARTWRIGHT
Chief Executive