WA ERA DRAFT DECISION FOR ATCO GAS

ENA Response, 12 January 2015

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EXECUTIVE SUMMARY

The Energy Networks Association (ENA) welcomes the opportunity to respond to the Economic Regulation Authority of Western Australia's (ERA) Draft Decision in relation to ATCO Gas's Access Arrangement Proposal for the July 2014 to December 2019 access arrangement period.

The ENA wishes to indicate its strong concerns with a number of aspects of the ERA's Draft Decision and urges that the Authority reconsiders its approach in its Final Decision.

In the context of network regulation in Western Australia, the ENA considers that greater consideration needs to be given to ensuring that the right investment incentives are in place so that sufficient investment flows in energy networks. The ENA considers that regulatory outcomes in Western Australia currently provide poor incentives to invest in Western Australia's gas network infrastructure. Over time, poor investment incentives have the potential to adversely impact on the long-term interests of gas and electricity consumers across Western Australia if reliability deteriorates, safety risks increase and capacity is unavailable.

The ENA is concerned with the robustness of the approach that the ERA has adopted for developing a substitute forecast of operating expenditure for ATCO Gas's upcoming access arrangement period. In particular, the ERA has utilised the revealed cost approach to test ATCO Gas's bottom-up forecast expenditure. However, the ERA has failed to correctly apply the revealed cost approach, resulting in a substitute forecast that cannot be supported given the information before the ERA.

Another issue of concern relates to the ERA's Draft Decision to disallow all customer-initiated greenfield capital expenditure. If the ERA's Draft Decision was implemented, residents of newly developed suburbs will be denied access to a natural gas supply despite being willing to pay for it, which is in direct conflict with the achievement of objective of the *National Gas Law* (NGL) and economically efficient outcomes.

The ENA has significant concerns in relation to the ERA's decision on cost of capital, which provides for the rate of return as low as 5.94 per cent. The Draft Decision rate of return approved for ATCO Gas appears to be too low to attract efficient levels of investment in Western Australia's gas distribution infrastructure. The ENA urges that the ERA should fundamentally reconsider its Draft Decision in this area.

Finally, the ENA is also concerned with ERA's Draft Decision to disallow recovery of taxation costs arising as a result of capital contributions. The ENA considers that the taxation costs associated with capital contributions should be recovered through ATCO Gas's regulated revenue.

The ENA addresses each on these issues in the following sections of this submission.

BACKGROUND

ENERGY NETWORKS ASSOCIATION

The Energy Networks Association is the national industry association representing the businesses operating Australia's electricity transmission and distribution and gas distribution networks. Member businesses provide energy to virtually every household and business in Australia. ENA members own assets valued at over $100 billion in energy network infrastructure.

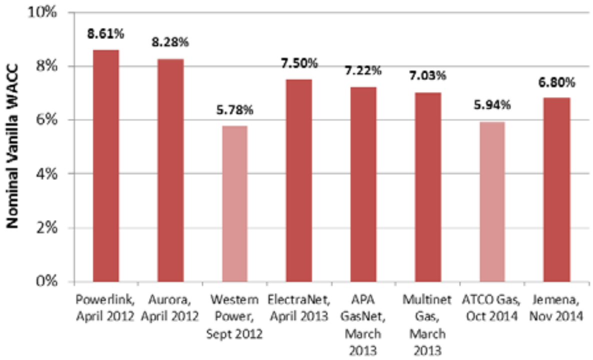
INVESTMENT INCENTIVES

The ENA is concerned that regulatory outcomes in Western Australia provide poor incentives to invest in critical Western Australian network infrastructure.

The ENA observes that the ERA typically provides significantly lower rate of return allowances for investments undertaken by the businesses it regulates when compared to network decisions by the Australian Energy Regulator (AER) made at around the same time. This Draft Decision is not an exception, providing for the rate of return as low as 5.94 per cent.

As presented in Figure 1, the ERA has delivered significantly lower rate of return determinations when compared to the rates of return approved by the AER for identical network investments. Also, the most recent (draft) decisions were made under the identical set of rules.

Figure 1 **Rate of Return allowances (AER and ERA)***



*light colour shading represents ERA's decisions; rates of return for ATCO Gas and Jemena are from draft decisions.

Source: AER and ERA regulatory decisions

In its response to the ERA's Draft Decision, ATCO Gas has noted that the return on equity determined for ATCO Gas is lower than any other regulated entity in the ATCO Group, making it difficult to internally compete for the required capital.[1]

The ENA is concerned that systematically lower cost of capital determined by the ERA will discourage long-term investment in Western Australia's energy networks as it does not adequately recognise the opportunity cost of capital. Over time, poor investment incentives have the potential to adversely seriously impact on the long-term interests of gas consumers across Western Australia by lowering reliability, increasing potential safety risks and leading to capacity being unavailable – outcomes which are inconsistent with the *National Gas Objective*.

Overall, the Draft Decision rate of return approved for ATCO Gas appears to be too low to attract on an ongoing basis adequate levels of private sector investment. This is a significant concern which needs to be addressed not only in the context of this access arrangement review process, but more generally in the economic regulation of energy networks in Western Australia.

Persistently inadequate rates of return have the potential to discourage private investment, leading to a position emerging over time in which government may be the only party which will be willing to fund required new investment. This outcome would result in inefficient subsidies and costs to state taxpayers.

The ENA also observes that in a number of areas the ERA significantly departs from sound, predictable and consistent regulatory practice, which also negatively impacts on investment incentives in Western Australia, as well as regulatory certainty intended to be fostered by the regime. This submission addresses two such instances, being the inappropriate application of the revealed cost approach and the ERA's treatment of taxation costs arising as a result of capital contributions.

COMMENTS ON ERA'S DRAFT DECISION

GREENFIELD DEVELOPMENTS

The ERA has disallowed all customer-initiated greenfield capital expenditure that was included in ATCO Gas's access arrangement proposal.

The ERA's Draft Decision suggests that the connection rate should be reduced to 2,000 customers per year. As an indication of the significance of the ERA's decision, ATCO Gas has been connecting up to 22,000 customers per year over the past 8 years.[2] The ENA is concerned that if the ERA's Draft Decision was implemented, residents of newly developed suburbs will be denied access to a natural gas supply and remaining customers will entirely bear the costs of ongoing sustaining investment.

If the ERA's approach is maintained at a Final Decision stage, ATCO Gas will face significant commercial disincentives to connect new customers. This is because in addition to not being able to recover the financing costs during the current access arrangement period, there is a significant risk that the costs and returns for this investment will also not be recovered in future periods. This is because the ERA has determined *ex ante* that the investment is not efficient and therefore, there is a significant risk that this investment will not be included in the future capital base following *ex post* assessment of capital expenditure under the rule 79 of the *National Gas Rules* (NGR).

Further, even if the cost of connection was paid through capital contributions, not only will ATCO Gas receive no benefit from this investment, but it will also face increased tax costs which would add to the costs to new customers and may never be recovered as a result of the circularity arising from the increased revenue associated with the recovery of higher tax costs.

[1] ATCO Gas, Response to the ERA's Draft Decision, p.5.

[2] ATCO Gas, Response to the ERA's Draft Decision, p.2.

APPROACH TO OPERATING COST ASSESSMENT

The ENA is concerned with the robustness of the approach that the ERA has adopted to develop a substitute forecast of operating expenditure for ATCO Gas's upcoming access arrangement period. The ERA Draft Decision reduces ATCO Gas's total proposed operating expenditure by 17.5 per cent.

The ENA considers that the ERA's application of the revealed costs approach is inconsistent with accepted practice for other regulated businesses and other Australian regulators. This again increases the regulatory risks associated with investments in regulated infrastructure assets in Western Australia.

The ERA appears to have accepted step changes in *network* operating costs until 2015 but not allowed any increase in costs for growth in the network or customer numbers. Nor has it provided for an increase in labour costs above the consumer price index (CPI), an accepted element in cost estimation elsewhere and even by the ERA for Western Power electricity distribution network. A claim that any scale growth or further step changes in costs can be absorbed as a result of unspecified future productivity gains is unsubstantiated and not supported by the benchmarking analysis or comparisons of partial factor productivity.

The ERA has adopted the same flawed approach in its application of the revealed cost approach to other categories of operating expenditure. The ERA provided no allowance for growth in the network and customer numbers and assumed that all legitimate and efficient step changes in costs incurred in the next access arrangement period will be offset by efficiency improvements. It is unclear on which empirical basis the ERA arrived at this important conclusion. The ERA's Draft Decision does not include any assessment as to whether the assumed efficiency improvements will actually offset the additional costs, nor identify how significant efficiency improvements can be expected when ATCO Gas is already one of the lowest cost gas distribution businesses in Australia.

The ERA has then further applied an across the board reduction of $1.1 million per year to account for IT efficiency gains achieved from IT projects. This assumption appears to be arbitrarily determined and further undermines the robustness of the ERA's forecast. Given the productivity analysis presented in the review process to date, estimates of productivity gains of this magnitude cannot be supported.

The reduction to ATCO Gas's operating expenditure forecast - which is based on an incorrect application of the revealed cost approach, including an inappropriate selection of the base year to forecast network operating expenditure and no explicit consideration of network growth, as well as a broad undocumented assumption about likely potential efficiency gains - risks delivering a forecast that lacks a transparent or rational basis. The ERA's approach, which is inconsistent with accepted practice and lacks rational basis, will lead to greater uncertainty and reduce confidence in the regulatory regime.

The ENA urges that, to the extent that the ERA rejects the bottom-up forecast presented by ATCO Gas, the revealed cost approach should be applied properly to ensure stability and certainty to all regulated network businesses. The ERA has provided insufficient reasons to impose such significant efficiency expectations, despite the fact that ATCO Gas compares favourably to its peers, using partial productivity measures and comparative benchmarking.

Further, the ENA notes that given the unavoidable delays resulting from the 2012 rule changes, at the time the ERA makes its Final Decision, it will have the actual expenditure information for 2014. Given that the decision relates to a period that includes the past, a decision that does not recognise expenditure actually incurred in that period would be further inconsistent with the accepted application of the revealed cost approach and, in ATCO Gas's case, result in it making losses where the cost estimate is below the actual costs incurred. There is no ability for ATCO Gas to reduce expenditure already incurred and therefore, no incentive for efficiency is provided by applying a lower cost base for that period. Indeed, this would result in ATCO Gas being penalised for an unavoidable delay in the process.

Both individually and collectively, these elements of ERA's methodology are fundamentally inconsistent with the ERA's legal duty to ensure a reasonable opportunity to recover at least efficient costs under the NGL revenue and pricing principles.

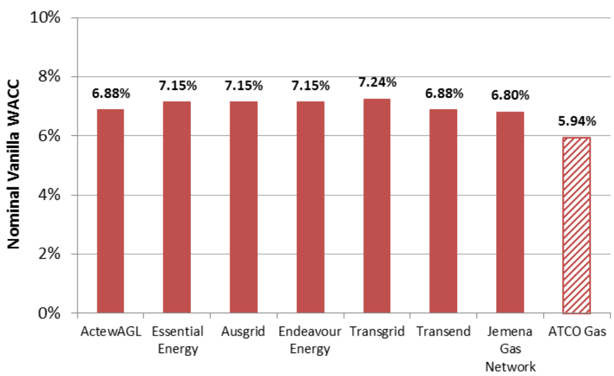
RATE OF RETURN

The ERA's Draft Decision provides for a rate of return allowance of 5.94 per cent. The ENA considers that the ERA's Draft Decision rate of return approved for ATCO Gas is insufficient to reliably attract efficient levels of ongoing investment in gas network infrastructure.

The ENA observes that such an allowance is significantly below the cost of capital allowances approved by the AER in its draft decisions for other Australia's gas and electricity network service providers at around the same time – Figure 2. This is despite the fact that these draft decisions were made under the identical set of rules in relation to the rate of return, noting that these are drafts that will only be finalised following further empirical analysis and expert input by the AER, relevant businesses and stakeholders.

The ENA has argued that there are key issues with the approach that the ERA has selected in its Rate of Return Guideline. In particular, the ENA considers that the guideline approach has a high risk of falling short of meeting the requirements of the rate of return objective in the revised *National Gas Rules*. This is because the ERA's guideline gives all weight to Sharpe-Lintner CAPM, thereby wrongly excluding genuine consideration of relevant alternative models and evidence in setting the required return on equity, and adopts flawed approach to estimation of the return on debt.

Figure 2 AER and ERA recent draft decisions on rate of return



Source: AER and ERA regulatory decisions

The revised NGR require regulators to consider and weigh a broader range of estimation methods, financial models, market data and other evidence in determining the allowed rate of return.

The ENA considers that the ERA has failed to consider relevant models and evidence to derive a cost of equity outcome which is consistent with the allowed rate of return objective. The ENA notes that the ERA took into account the Dividend Growth Model (DGM) when determining a range of the market risk premium (MRP) estimates and considered the evidence provided by the Black CAPM when determining a range of the equity beta estimates. However, this approach still falls short of genuinely considering all relevant evidence and fails to give full effect to the policy intent and provisions of the NGR.

The ENA considers that the 'multi-model' approach that was proposed by ATCO Gas is consistent with the requirements of the NGR. This is because it transparently considers all relevant evidence, discusses the reliability of each piece of evidence, and assigns weights to each piece of evidence, as well as specifies the reasons for assigning those weights.

In relation to the cost of debt, the ENA contests the ERA's 'Bond Yield' approach for estimating the debt risk premium (DRP). This is because it is not transparent and does not result in the cost of debt which is commensurate with the current market rates.

The more specific concerns in relation to the ERA's approach are listed below:

- The ERA adopted a 5-year term to maturity assumption for estimating risk free rate, which is inconsistent with the 10-year term assumption supported by the evidence and commonly adopted by the AER, IPART and other Australian regulators.
- The ERA adopted an equity beta assumption lower than supported by the recent equity beta estimates derived from four approaches, which take into account all of the relevant evidence to inform the equity beta estimate.[3]
- Adoption by the ERA of the market risk premium of 5.5 per cent contrary to the current evidence. In the Rate of Return Guideline development process the ERA concluded that a forward-looking MRP using the DGM falls within the range of 6.0 per cent and 7.5 per cent. In this regard, it is unclear how the MRP of 5.5 per cent takes into account the DGM evidence.
- The ERA introduced a so-called 'guide rails' approach, which requires that the DRP falls within the range of 1 per cent to 3 per cent regardless of the prevailing rate. It is unclear on what rational basis this approach has been adopted given recent evidence of the potential for volatility in the cost of finance. This approach is flawed due to its arbitrary nature, and inconsistent with the rate of return objective.
- The ERA continued to rely on its 'Bond-Yield' approach, which has been contested by the industry in the past, including a regulatory determination for Western Power in 2012, as well as during the Rate of Return Guideline development process.

From the view point of national consistency, the ENA notes that in their Rate of Return Guidelines, the ERA and the AER adopted both divergent methodologies and parameter

[3] ENA, Response to the Equity Beta Issues Paper of the Australian Energy Regulator, October 2013, p.27.

estimates in estimating the cost of equity and cost of debt, as well as the range of evidence and information to be taken into account. The ENA considers such major divergence in views on regulated rates of return cannot be justified, especially given that both guidelines were developed under the same set of rules. Such a divergence results in significantly different incentives for investment based on state borders – an outcome not likely to have been anticipated when the national rules were adopted. Such distortions in incentives between individual jurisdictions represent a deterrent to achieving efficient investment outcomes.

The ENA observes that having gone through an extensive consultation process; the approach adopted by the ERA in its Rate of Return Guideline guidelines is almost identical to its previous practice and does not appear be consistent either with the intention of the Australian Energy Market Commission in adopting the rule amendments or the requirements of the revised rules themselves. This outcome distorts investment signals for current and potential investment in Western Australia energy infrastructure - an outcome which is not consistent with the long-term interests of consumers in efficient investment patterns and incentives.

The ENA urges that the ERA should fundamentally reconsider its Draft Decision on the rate of return for ATCO Gas. This is to avoid the adverse outcomes associated with underestimation of the rate of return allowance and provide ATCO Gas with the right incentives to undertake efficient network investment for the benefit of Western Australia's gas consumers.

CAPITAL CONTRIBUTIONS

The ENA considers that the ERA should provide ATCO Gas with an allowance for recovery of additional taxation costs associated with capital contributions and gifted assets through the taxation building block. The ENA is concerned that the ERA's current approach in relation to this matter distorts investment away from Western Australia and imposes additional costs to new customers who may thereby be dissuaded from connecting. This prevents the benefits of sharing costs over a greater customer base from being realised by existing customers. The AER provides allowances for capital contributions and gifted assets when calculating businesses' tax liabilities recognising that the contributions result from the provision of reference services and can provide future benefits to all customers.

The regulatory regime does not provide for a return on and return of capital associated with contributed assets. However, these contributions are associated with the provision of reference services and the tax costs arising from the contributions should be included in the tax cost building block. In addition, ATCO Gas cannot refuse establishing new connection under its Gas Distribution Licence if the customer bears the cost.[4]

The ENA considers that in these circumstances the taxation costs associated with capital contributions and gifted assets should be recovered through regulated revenue.

RECOMMENDATIONS

The ENA considers that a materially preferable decision under the NGL would:

- » Include an allowance for labour input cost escalation above CPI to ensure that a gas distribution network business can recover the efficient costs of providing services,
- » Adopt an accepted methodology for producing an operating expenditure forecast that was adequately supported by reason and acknowledges that losses will accrue and no incentive is provided by assuming costs are lower than that which are actually incurred so that the risks to the business of recovering its costs are not increased,
- » Ensure the efficient provision of services to future customers so that new customers willing to pay are not prevented from being offered the service,
- » Provide a rate of return that allows a gas distribution business to attract financial capital for efficient investment and an approach that does not introduce new risks to future returns, and
- » Allows a gas distribution business to recover the costs of providing reference services, including the tax costs arising from receiving a capital contribution for the providing of those services.

[4] ATCO Gas, Response to the ERA's Draft Decision, p.230.