CRG Information Request for ERA
for rate of return review

3 February 2022

The CRG has an information request in relation to:

1. The regulatory arrangements where they may impact risk and an efficient rate of return.

2. Commercial investment/independent expert practice in relation to key parameters of the allowed rate of return.

3. The price impacts of different rate of return parameters for (1) average households; and (ii) large industrial customers.

1 The regulatory arrangements

We would like to understand the regulatory arrangements for the recovery of cost and the setting of prices over the regulatory period as the arrangements are considered likely to affect risk and have implications for the rate of return.

Set out below are points describing our understanding of some key matters and queries we have. We would appreciate ERA confirmation of our understanding and responses to our queries.

1. The regulated gas pipelines can choose to have their prices regulated by a revenue cap or a price cap. At the moment they all choose a price cap.
   - Is this correct?
2. Irrespective of whether a revenue cap or price cap applies the rate of return is assumed to be the same.
   - Why is this assumption made?
3. With a revenue cap the total revenue cap is calibrated to recover estimated costs over the regulatory period based on forecast demand but there are annual adjustments to prices to allow for inflation, certain costs such as debt risk premium updates and other cost pass through items. When these adjustments are made the total revenue cap and prices are recalibrated but based on forecast demand and not actual demand.
   - Please itemize the cost pass through items and explain why they are considered to be items that are treated as not diversifiable from the perspective of investors.
   - What have been the actual NPV outcomes based on actual demand in the most recent regulatory periods?
   - What have been the actual demand outcomes relative to forecast demand in the most recent regulatory periods.

- What have been the actual price profiles over time in the most recent regulatory periods.

4. The historical asset base rolls forward from one regulatory control period to the next and from year to year within each regulatory control period with indexation for actual inflation over the past year and guarantees the recovery of allowed historical asset costs through deprecation, a real return on the asset and recovery of the depreciation component of ongoing efficient capital expenditure;
    - Is this correct?
    - What happens to the cost savings or cost overruns (who receives or pays for them) if actual capital expenditure during the regulatory period is less than or more than forecast capital expenditure?
    - What have been the actual capital expenditure outcomes relative to forecast expenditure in the most recent regulatory periods.
5. Are there provisions for re-opening a determination for capital expenditure relating to an event that is beyond the reasonable control of the service provider, and unforeseen at the time of making the determination?
6. Could you please explain how depreciation is determined and the extent and circumstances under which accelerated depreciation is allowed?
7. It is understood that there is an operating cost efficiency scheme in place.
    - Could you please explain the scheme and the extent to which cost savings are shared with consumers?

- Is the provision for tax in determining total revenue based on notional or actual tax figures?
- Could you please explain the tariff structures for the regulated firms and in particular the existence of fixed and variable components?

2 Commercial investment/independent expert practice in relation to key parameters of the allowed rate of return.

There is a lot of information about rate of return parameters in consultant, stakeholder and regulatory reports in the context of regulated industries. Another source of information is the views of analysts and independent experts involved in commercial investment activities, some of which may make its way into regulatory determinations as well. Information on commercial practice may be useful in understanding how market participants address the issues in applying the CAPM in particular circumstances.

Care needs to be taken in using such information to ensure that it will reasonably relate to regulated monopoly type businesses. However, there are some parameters that relate to the market as whole and not a particular firm and some practices in estimating parameters that are still likely to be relevant.

One type of authoritative commercial information that may be helpful is independent expert reports that are legally required for the benefit of shareholders in transactions of publicly listed companies involving mergers and acquisitions, share issues and other capital transactions.

We would be interested in knowing what the ERA thinks of these reports and if it has access to any that would contain relevant information and be of assistance.

Key issues where we would like information are:

1. Estimation of the market risk premium, including period for estimation, the use of arithmetic or geometric averages and the relationship between the risk free rate and the market risk premium.

2. The period and frequency for data in the estimation of beta.

3. The use of international beta estimates in a domestic context.

3 The price impacts of different rate of return parameters for (1) average households; and (ii) large industrial customers.

We would like to request the ERA be able to calculate the impact of different rate of return parameters on both the overall WACC and gas bills of (1) average or typical households; and (2) large industrial customers, in both absolute dollar and percentage change terms.