



Submission to the WA Economic Regulation Authority

Response to Draft Decision

Review of Proposed Access Arrangement Revisions

18 March 2005

National Office

Level 3, 40 Blackall Street, Barton ACT 2600
Telephone: +61 2 6272 1555 Facsimile: +61 2 6272 1566
Email: info@ena.asn.au Website: www.ena.asn.au

1. Overview

The Energy Networks Association (ENA) welcomes the opportunity to comment on the Draft Decision on AlintaGas Networks' proposed Access Arrangement revisions for the Mid-west and South-west gas distribution systems (draft decision) released by the WA Economic Regulation Authority (the Authority) in February 2005.

The ENA has several significant concerns with the potential for reliance to be placed by the Authority on some elements of a May 2004 Allen Consulting report *AlintaGas Networks Revised Access Arrangement – Proposed Rate of Return*. The report offers a potentially flawed interpretation of the requirements on the Authority under the National Gas Code, based on an incomplete assessment of the recent *GasNet* ruling of the Australian Competition Tribunal. A further weakness of the Allen Consulting report is a failure to adequately assess the broad range of access pricing issues considered in the Productivity Commission's *Review of the Gas Access Regime*.

The Authority's draft decision represents the lowest nominal pre-tax weighted average cost of capital (WACC) to be proposed for a gas distribution network to date. Taking into account recent movements in the risk-free rate, the decision embodies a significant erosion of the incentives facing AlintaGas Networks for new and ongoing network investment provided by an adequate allowance for returns on capital. The ENA considers this erosion of incentives to be contrary to the outcomes of recent independent reviews of the national and gas access regimes, and the broad medium-term interests of the community in ongoing investment in gas infrastructure expansion and renewal.

Recent academic evidence provided to Australia regulators on the relationship between the parameters of market risk premium and the valuation of franking credits (gamma) also supports the proposition that the Authority's real pre-tax WACC of 6.5 per cent fails to consistently integrate market evidence on the actual level of alternative returns available to potential investors in energy network infrastructure. The incorporation of a consistent treatment of the market risk premium and the valuation of franking credits would require some significant adjustments to the parameters initially proposed as consistent with the Code by the Authority.

The ENA also has significant concerns regarding the approach of the draft decision in relation to the estimated cost of debt for an efficient service provider, and its rejection of a proposed debt margin which falls within the range of debt margins previously accepted in a number of Australian regulatory decisions.

While acknowledging that the assessment of proposed revisions to an Access Arrangement is a complex regulatory task, the ENA also has some concerns regarding the time taken to issue the draft decision. This has required the Authority to issue three notices of extensions under Section 2.44 of the Code, to provide the regulatory authority with an exemption from the Code's normal requirement that a final decision should be issued within six months of revisions being lodged. While the Code timeline is challenging, it appears inevitable that the Authority's Access Arrangement assessment process will at completion have taken the longest time of any 'second-round' gas distribution process to date.

2. Background

This submission responds to the *Draft Decision on the Proposed Revisions to the Access Arrangement for the Mid-West and South-West Gas Distribution Systems* released by the WA Economic Regulation Authority in February 2005.

The Energy Networks Association is the national representative body for gas and electricity distribution network businesses. The members of the ENA include:

- ActewAGL
- AGL Energy Networks
- AlintaGas Networks
- Aurora Energy
- Citipower
- Country Energy
- ENERGEX
- EnergyAustralia
- Envestra
- Ergon Energy
- ETSA Utilities
- Integral Energy
- Multinet Gas
- NT Power and Water Corporation
- Powercor
- SPI Networks
- United Energy Distribution
- Western Power

Energy network businesses deliver electricity and gas to over 12 million customer connections across Australia through approximately 800 000 kilometres of electricity lines and 75 000 kilometres of gas distribution pipelines. These distribution networks are valued at more than \$34 billion, and each year energy network businesses undertake investment of around than \$5 billion in network operation, reinforcement, expansions and greenfields extensions.

3. Reliance on Allen Consulting rate of return paper

The ENA has some concerns regarding the apparent reliance placed by the Authority on the Allen Consulting paper *AlintaGas Networks Revised Access Arrangement – Proposed Rate of Return*. Two specific concerns are:

- potential flaws in the interpretation offered by Allen Consulting of recent judicial and merits review outcomes
- a lack of an adequate commentary on the broad policy implications of the draft report of the Productivity Commission *Review of the Gas Access Regime*.

Potential flaws in interpretation of judicial and merit review outcomes

The Allen Consulting paper contains a critique of a KPMG report provided to the Authority by AlintaGas on the issue of implications of recent judicial and merit review outcomes for the assessment of Alinta's proposed Access Arrangement revisions.

Included in this critique is the following quotation from the recent *GasNet* ruling:

[29] ...[W]here the AA proposed by the Service Provider falls within the range of choice reasonably open and consistent with Reference Tariff Principles, it is beyond the power of the Relevant Regulator not to approve the proposed AA simply because it prefers a different AA which it believes would better achieve the Relevant Regulator's understanding of the statutory objectives of the Law.¹

Following this quotation, the Allen Consulting paper continues:

The KPMG Report (p.10) contends that this means it is “not open to the regulator to reject the service provider's proposed access arrangement and replace it with its own judgements as to what is more appropriate, unless it is found that the proposals do not comply with the factors listed in Section 2.24 of the Code”. This contention is not consistent with the requirements of the Code. *Compliance with factors listed in section 2.24 of the Code is not a relevant matter. The factors listed in section 2.24 are not objectives or criteria to be complied with*, but rather – in respect of Reference Tariffs – are factors that should guide the regulator in determining, if necessary, the manner in which the objectives in section 8 (1)(a) to (f) can best be reconciled or which of them should prevail.² [emphasis added]

The contention made by the paper appears to be inconsistent with a key element of the *GasNet* judgement. The Australian Competition Tribunal in *GasNet* in fact identified that Section 2.24 was directly relevant to determining whether an Access Arrangement met the requirements of the Code. In a passage directly following the quotation from the *GasNet* ruling in the Allen Consulting paper, the Tribunal states:

[30] This follows because the power of the Relevant Regulator to require amendments, or to itself draft and approve its own AA, does not arise until it is of the opinion that the AA proposed by the Service Provider does not comply with the Code, and in determining the question of compliance, it must act in accordance with s.2.24 of the Code.³ [emphasis added]

The ENA is unable to reconcile the interpretation placed by Allen Consulting on this section of the judgement with the full text of the relevant sections, and considers that the potentially flawed interpretation provided by Allen Consulting on this issue should not be relied upon by the Authority its pending final decision.

Flaws in assessment by Allen Consulting of the review of the gas access regime

The Allen Consulting paper provides a short commentary upon the Productivity Commission *Review of the Gas Access Regime – Draft Report*. The ENA notes that this commentary was developed in May 2004, prior to the release of the final report, and hence does not incorporate consideration of the Commission's 51 recommendations.

The Allen Consulting paper contends that the work of Kolbe, Tye and Myers on regulatory truncation ‘heavily influenced’ the findings of the Commission's review, without any systematic analysis of the influence of any of the other approximately 150 sources cited by the Commission in its report.⁴ The Allen Consulting report focuses on the issue of ‘regulatory truncation’, a conceptual element discussed in the Commission's analysis in the draft report, but one which cannot be accurately

¹ *Application of GasNet Australia (Operations) Pty Ltd* [2003] ACompT [29]

² Allen Consulting Group *AlintaGas Networks Revised Access Arrangement: Proposed Rate of Return*, May 2004, p.4

³ *Application of GasNet Australia (Operations) Pty Ltd* [2003] ACompT [30]

⁴ Allen Consulting Group (May 2004), p.9

identified as the core finding of the draft Commission report. On the basis that Kolbe, Tye and Myers offered theoretical insights into US access pricing regulation, the Allen Consulting report seeks to dismiss the relevance of the broader findings of the Productivity Commission *Review of the Gas Access Regime* to the Authority’s task. The ENA considers that dismissal of consideration of the outcomes of the Commission’s review on the narrow basis asserted by Allen Consulting would be unreasonable.⁵

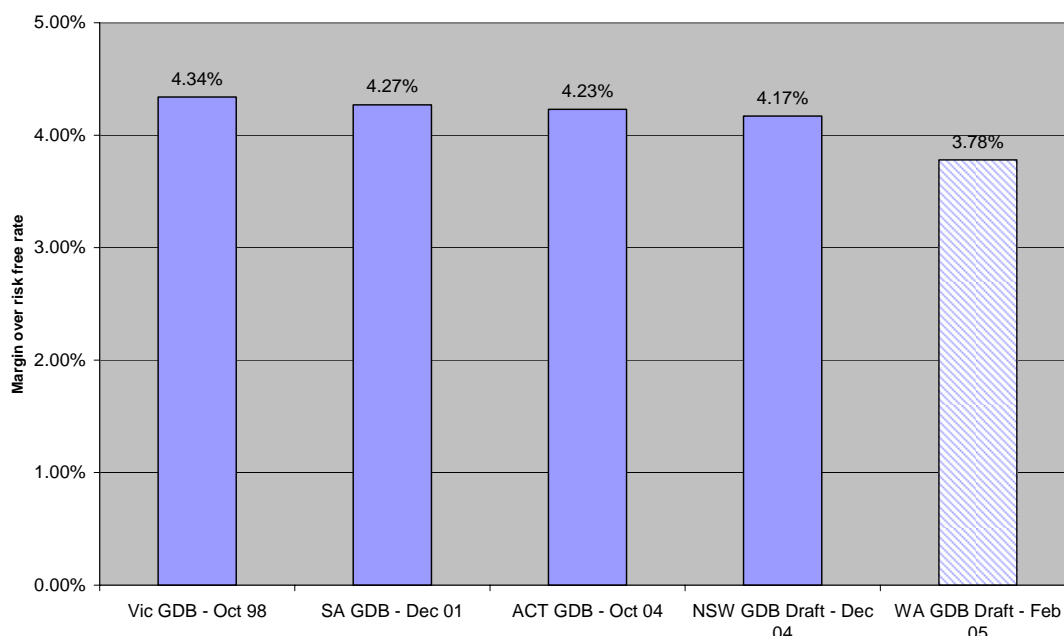
4. Weighted average cost of capital

The Authority’s draft decision proposes a real pre-tax weighted average cost of capital of 6.5 per cent. This decision is the lowest estimated real pre-tax cost of capital which has ever been proposed to apply to an energy network business in the Australian regulatory environment.

In part, this is a function of recent movements in the risk free rate as measured by the 10-year Commonwealth bond rate, however, other aggressive WACC parameter estimates proposed by the Authority also mean the draft decision represents a step reduction in proposed returns on capital.

This point is reinforced when the Authority’s decision is compared with recent regulatory determinations relating to gas distribution networks on the basis of the margin of the pre-tax WACC over the risk-free rate prevailing at the time of the decision (see [Figure 1](#)).

Figure 1 – Recent gas distribution cost of capital determinations



⁵ While the implications of the review of the gas access regime are poorly treated in the Allen paper, the ENA is also concerned at the omission of any disclosure that Allen Consulting undertook significant commercial work on behalf of major gas users and producers participating in the review (See attachment to BHP-Billiton *Initial Submission to the Productivity Commission Review of the Gas Access Regime*, sub.26). In ENA’s view the lack of disclosure of this matter does not provide for transparency and the appropriate critical framework in which to consider the whether the assessment contained in the Allen Consulting paper of the Productivity Commission review is fair and balanced.

The draft decision does not provide any detailed evidence to support movement to a historically low real pre-tax cost of capital, in a period in which there is significant community and government focus on the significant impacts of potential underinvestment in key economic infrastructure, compared with the lesser impact of the risk of over-investment in some infrastructure assets.⁶ This focus has arisen in part following the Productivity Commission's recent reviews of the national and gas access regimes. After extensive processes of consultation, investigation and analysis the Productivity Commission concluded that the gas access regime as currently applied is likely to be distorting investment outcomes.⁷

Ensuring a consistent approach to market risk premium and gamma parameters

The Authority proposes accepting a market risk premium (MRP) of 6.0 per cent and a valuation of franking credits (gamma) of 0.5, largely relying upon past Australian regulatory practice.

The ENA considers that there is a substantial case for the Authority to review this position, following the release of the SFG Consulting Report *The relationship between franking credits and the market risk premium* in November 2004.⁸ This report details an important inconsistency in current regulatory approaches to approving appropriate market risk premium and gamma parameters, which should be a core issue of concern for the Authority in its assessment of proposed revisions to the existing Access Arrangement.

The SFG Consulting report concludes that setting gamma equal to 0.5 is inconsistent with the latest empirical evidence in a way which systematically understates the appropriate levels of returns on capital suggested by the application of the capital asset pricing model.⁹ All existing estimates of market risk premiums drawn upon by Australia regulatory authorities to support an estimate of 6.0 per cent estimate the MRP in terms of capital gains and dividends only. Likewise, survey data from market practitioners about MRP expectations is also based on participant expectations of possible capital gains and dividend outcomes. These measurement methodologies are consistent with setting a gamma at zero. If, however, gamma is greater than zero, then market returns must represent the sum of capital gains, dividends, and the value of franking credits.

The practical implications of this finding for the Authority are that it has two feasible options:

- first, to set gamma to zero, to ensure that the Authority's views on what constitutes a WACC consistent with Section 8.30-8.31 is internally consistent; or
- second, assume gamma is set at a level above zero (such as the 0.3-0.4 range – see further discussion below) and undertake an upwards adjustment to the market risk premium parameter to ensure consistency.

⁶ See Productivity Commission *Review of the National Access Regime – Draft Report*, March 2001, p.71 and p.100

⁷ Productivity Commission *Review of the Gas Access Regime – Inquiry Report*, June 2004, pxlii

⁸ See SFG Consulting *The relationship between franking credits and the market risk premium*, November 2004 – Draft report for Ergon Energy, November 2004 <www.qca.org.au>

⁹ SFG Consulting (November 2004), p.3

Using all other the parameters set out by the Authority in its draft decision and applying the first methodology would result in a real pre-tax WACC of 7.61 per cent, substantially above the 6.5 per cent estimate included in the draft decision. The ENA notes that this higher WACC is at a level broadly comparable to that proposed by AlintaGas Networks in its proposed Access Arrangement revisions.

The SFG Consulting report provides a possible methodology for undertaking the second option, and provides an example where assuming a gamma of 0.5, a risk-free rate of 5.84 per cent, and a MRP from capital gains and distribution only of 4.8-7.2 per cent, an adjusted MRP including franking credits should be in the range 7.1-10.0 per cent.¹⁰ Applying this adjusted form of the MRP would also lead to a substantial correction of the estimate contained in the draft decision. In this regard, the ENA notes that applying this methodology the MRP of 7.0 proposed by AlintaGas Networks would be likely to fall within the lower bounds of a feasible MRP range.

New evidence on the valuation of franking credits

A related issue of concern to the ENA with the franking credit assumption of 0.5 proposed in the draft decision is that it may not represent an estimate which incorporates all relevant information. New evidence on the valuation of franking credits supports a value in the lower bounds of the range of franking credit values set out in AlintaGasNetworks' proposed Access Arrangement revisions.

The draft decision states:

In Australia, regulators under the Code have generally adopted a “ γ ” value of 0.5, based on the 1999 study by Hathaway and Officer, which estimates gamma at close to 0.5. The Authority takes the view that this assumption is appropriate for the GDS.

Recently, Hathaway and Officer have updated their original analysis, which was contained in an unpublished manuscript. In a paper released in November 2004 entitled *The Valuation of Imputation Tax Credits*, Hathaway and Officer provide updated data and further analysis, although the paper retains the same general approach as the previously relied upon work. Hathaway and Officer find that the Australia-wide average gamma over the reference period of 1988-2002 is 0.355.¹¹

The ENA considers that taking into account the previous reliance placed by Australian regulatory authorities (including the Authority) on prior work carried out by Officer and Hathaway, there is no sound basis for the Authority to conclude that a gamma value of 0.35 falls outside of a feasible range, or is inconsistent with the requirements of Section 8.30-8.31 of the National Gas Code.

Consideration of proposed debt margin and debt issuance costs

The issue of appropriate cost of debt assumptions in access pricing decisions is a significant issue for energy network businesses required to finance ongoing capital investment.

¹⁰ SFG Consulting (November 2004), p.9

¹¹ Hathaway N and Officer, B. *The value of imputation tax credits – update 2004*, 2 November 2004, p.7

The Authority’s draft decision rejects the range of 1.4 to 1.8 per cent put forward by AlintaGas Networks in its proposed Access Arrangement revisions as inconsistent with the National Gas Code.

The ENA considers that this rejection cannot be supported, as:

- both past regulatory decisions and current draft decisions of other regulatory bodies have incorporated debt margins in the range proposed by AlintaGas Networks (see Table 1 overleaf)
- the three limited examples of ‘market evidence’ on debt margins provided in the draft decision cannot reasonably be interpreted as providing a definitive estimate of the upper bounds of the cost of debt facing a Western Australian gas distribution business¹²
- other evidence relied upon by the Authority are outputs from econometric analysis and modeling based on a limited number of market observations.¹³

The ENA is concerned that the approach outlined by the Authority in its draft decision appears to assume a debt margin lower than almost any access pricing decision currently proposed or in place for an Australian energy distribution network.

Table 1- Current regulatory approaches to debt margin assumptions

| Regulatory authority | Sector | Total debt margin assumption (%) | Cost of debt issuance included (%) |
|--|----------------------------------|----------------------------------|------------------------------------|
| WA Economic Regulation Authority – February 2005 | Gas distribution (draft) | 1.125 | 0.125 |
| Queensland Competition Authority – December 2004 | Electricity distribution (draft) | 1.265 | 0.125 |
| NSW Independent Pricing and Regulatory Tribunal – December 2004 | Gas distribution (draft) | 1.145-1.245 | 0.125 |
| Essential Services Commission of South Australia – November 2004 | Electricity distribution (draft) | 1.64 | 0.125 |
| Independent Competition and Regulatory Commission – October 2004 | Gas distribution (draft) | 1.245-1.43 | 0.125 |
| Australian Competition and Consumer Commission (as amended by Australian Competition Tribunal) – December 2003 | Gas transmission | 1.71 | 0.25 |
| Office of the Tasmanian Energy Regulator – September 2003 | Electricity distribution | 1.25 | Not specified |
| Victorian Essential Services Commission – October 2002 | Gas distribution | 1.70 | 0.05 |

An additional concern is treatment in the draft decision of the outcomes of the *GasNet* ruling, where the Australian Competition Tribunal ordered that debt issuance costs of

¹² WA Economic Regulation Authority *Draft Decision on the Proposed Revisions to the Access Arrangement for the Mid-West and South-West Gas Distribution Systems*, February 2005 [para 329]

¹³ ERA (February 2005) [para 328]

0.25 per cent be recognised in an amended ACCC decision. The draft decision states that:

The Authority notes, however, that the Australian Competition Tribunal's decision was based upon an agreed position reached between the parties without the Tribunal making a determination of an appropriate allowance.¹⁴

The draft decision apparently attaches little weight to the outcome of the *GasNet* ruling on this basis, and states that it considers a debt issuance cost allowance of 0.125 is at the 'upper bound' of an appropriate range for debt raising costs.¹⁵

The ENA considers that the reasoning supporting this conclusion is unclear. On face value, agreement between the ACCC and the appellant in the *GasNet* appeal proceedings that a debt raising margin of 0.25 per cent was appropriate could be argued to provide significant and compelling evidence that 0.25 per cent is more likely to closely reflect the true level of these costs than the Authority's own estimate. Agreement between these parties on this issue, and the endorsement by the Tribunal of the agreed outcome would appear to make it implausible that a rate of return based on a proposed debt margin incorporating a 0.25 per cent estimate of debt issuance costs would be inconsistent with the Gas Code.

5. Timeliness of ERA Draft Decision

The ENA notes that the draft decision on AlintaGas Networks' proposed Access Arrangement revisions has been substantially delayed.

Proposed revisions to the current Access Arrangement were forwarded to the Authority on 31 March 2004 for its consideration, in accordance with the revisions date specified in the existing Access Arrangement. Following this, the Authority was able to release a timely Issues Paper to assist stakeholders in assessing proposed revisions. A consultation process was conducted following the release of this paper, with a deadline for submissions in mid-May 2004.

Under the provisions of the National Gas Code, the regulator is required to issue a final decision on approval of an Access Arrangement within six months.¹⁶ Section 2.44 of the Code also provides the discretion to the Authority to extend this period by periods of up to two months on one or more occasions provided notice is provided.

The ERA has so far issued three notices under Section 2.44, extending the period for its consideration of the proposed revisions. Without these extensions, under the normal requirements of Section 2.43, the Authority would have been obliged to issue a final decision by 30 September 2004. Given that the Authority's draft decision has been released in late February 2005, it would appear that there is a substantial possibility either that:

- the Authority's final decision will not be issued more than 12 months after the lodging of initial proposed revisions to the Access Arrangement

¹⁴ ERA (February 2005) [para 334]

¹⁵ ERA (February 2005) [para 335]

¹⁶ National Gas Code, Section 2.43

- there will be a shortened period of consideration and consultation between the publication of the Authority's draft and final decision
- further Section 2.44 notices of extensions of time will be required.

So far, the ENA is unaware of any formal statement by the Authority on the causes for the substantial delays in the assessment of the proposed Access Arrangement revisions. The average time taken by other regulatory authorities to approve proposed Access Arrangement revisions has been approximately 11 months. The ENA considers that greater clarity could have been provided by the Authority in the draft decision on the proposed timeline for a final decision which incorporates an adequate opportunity for the Authority to take into account stakeholder consultation on the draft decision.

The Energy Networks Association
18 March 2005