Financial Investor Group

Submission to the ERA's Draft Decision on Goldfields Gas Transmission's Proposed Revisions to the Access Arrangement for the Goldfields Gas Pipeline

The investor perspective

APA Group

PRIME INFRASTRUCTURE

DUET GROUP

December 2009

Contents

***Inherent Limitations**: This report has been prepared as outlined in Section 2 of this report. The report indicates the sources of the information used. Members of the FIG have not sought to independently verify those sources unless otherwise noted within the report.*

***Third Party Reliance**: Other than our responsibility to the Economic Regulation Authority, no FIG member undertakes responsibility arising in any way from reliance placed by a third party on this report. Any reliance placed is that party's sole responsibility.*

1 Executive summary

This report by the Financial Investor Group ("FIG") is submitted in response to the Economic Regulation Authority's ("ERA") Draft Decision on Goldfields Gas Transmission's Proposed Revisions to the Access Arrangement for the Goldfields Gas Pipeline, particularly as it relates to the cost of capital.

The FIG is an affiliation of eight major investors in Australian energy transmission and distribution networks. FIG members compete for ownership of infrastructure assets (including regulated energy networks), as well as for investors' funds that are, or may be, seeking exposure to this asset class. The three FIG members that this submission is made specifically on behalf of, own well over $3 billion of gas transmission and distribution assets in Western Australia.

The FIG has significant concerns with the ERA's Draft Decision given that it proposes returns that are simply inadequate to support private sector investment in regulated infrastructure in Western Australia. The FIG has previously compiled and provided market evidence to the ERA on the rates of return which are currently required by investors to provide equity, which demonstrate the disparity between what investors require and the return that the ERA has allowed.[1] This evidence, which has been updated in this submission, remains relevant for this submission.

Whilst this submission is intended to focus largely on our concerns with the adequacy of the overall rate of return proposed by the ERA for the GGP and the implications of it for investment, the FIG has also identified some issues relating to the ERA's choice of parameter values and the basis and transparency of the justification for the ERA's proposed values.

The FIG believes that the ERA needs to fundamentally revisit its Draft Decision in respect of the cost of capital.

While this submission makes some references to the AER's Final Decision on its review of WACC parameters for electricity transmission and distribution networks, this is done primarily to highlight the inconsistencies in the ERA's decision and decision-making process. For the avoidance of doubt, the FIG wishes to place it on the record that it remains of the view that the AER's Final Decision provides an inadequate regulated rate of return, as it is below that currently required by equity investors in regulated infrastructure assets.

[1] Financial Investor Group, Submission to the ERA's Draft Decision on Western Power's proposed revisions to the Access Arrangement for the South West Interconnected Network, The investor perspective, September 2009,

2 Introduction

2.1 The ERA's Draft Decision on Goldfields Gas Transmission's proposed revisions to the access arrangements for the Goldfields Gas Pipeline

The Goldfields Gas Pipeline ("GGP"), which is owned by Goldfields Gas Transmission Pty Ltd ("GGT"), runs the Dampier to Bunbury Natural Gas Pipeline at Yarraloola to Kalgoorlie via the East Pilbara and the North East Goldfields region. The GGP provides gas predominantly to the mining industries in the East Pilbara and the North East Goldfields region.

On 23 March 2009, GGT submitted proposed revisions to the GGP access arrangement and access arrangement information under the *National Third Party Access Code for Natural Gas Pipeline Systems* (Code). On 9 October 2009, the ERA issued its draft decision not to approve the revisions to the GGP access arrangement.

The ERA's draft decision rejected GGT's proposed nominal pre-tax rate of return of 13.5 per cent rate of return[2]. Instead, the draft decision requires GGT to adopt a nominal pre-tax rate of return of 10.28 per cent.

The ERA has requested submissions on the Draft Decision by 11 December 2009.

This report by the Financial Investor Group ("FIG") responds to the ERA's Draft Decision, particularly as it relates to the cost of capital.[3]

2.2 Who is the Financial Investor Group?

The FIG is an affiliation of eight major investors[4] in Australian energy transmission and distribution networks (refer Appendix A for more information on the members). FIG members compete for ownership of infrastructure assets (including regulated energy networks and transmission), as well as for investors' funds that are, or may be, seeking exposure to this asset class.

The eight FIG members have interests in well over $30 billion of Australian energy transmission and distribution assets, most of which are regulated. This accounts for a substantial proportion of the privately owned assets of this type in Australia, and over 40% of the total value of Australian regulated energy transmission and distribution assets.[5]

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[2] The current access arrangement for the GGP incorporates an approved nominal pre-tax WACC of 10.6 per cent.

[3] The FIG has been assisted by KPMG in preparing this submission. The views expressed remain those of the FIG and are not necessarily those of KPMG. KPMG has prepared an independent report for Western Power and some of the material in this submission draws from that report.

[4] The FIG members are the APA Group, Babcock and Brown Infrastructure, Cheung Kong Infrastructure, the DUET Group, Hastings Funds Management, Hongkong Electric, Singapore Power International and Spark Infrastructure.

[5] This is based on AER data. See, AER, *State of the Energy Market Report*, 2008. It relies on RAB values for regulated and actual cost for non-regulated assets, but excludes recent capex for certain assets due to information constraints. By value the vast majority of these assets are subject to formal economic regulation. The other major owner is Envestra, but APA and CKI have a 30.6% and 18.5% ownership interest in Envestra respectively.

This submission is supported by all eight members of the FIG and is made specifically on behalf of three members of the Group: the APA Group, Prime Infrastructure and the DUET Group. These three FIG members own well over $3 billion of gas transmission and distribution assets in Western Australia, including ownership interests in the following assets:

- the Dampier to Bunbury Natural Gas Pipeline;
- the Goldfields Gas Pipeline;
- the Mid-West and South-West Gas Distribution Systems; and
- various other pipelines mostly in the mid-west and north-west regions of Western Australia. These other assets include: the Midwest Pipeline, the Telfer Pipeline, the Pilbara Energy Pipeline, the Burrup Energy Pipeline and the Kalgoorlie-Kambalda Pipeline.

The FIG therefore has a significant interest in how energy infrastructure in Australia and Western Australia is regulated, both directly and on behalf of their investors. The regulated cost of capital is a critical component of investment decisions, given that it typically accounts for at least 30% of regulated revenues in electricity networks and typically accounts for well over 50% of revenue on pipelines.[6] Moreover, given regulation typically seeks to ensure that any changes to regulatory depreciation are revenue neutral in net present value terms, in practice the regulated cost of capital generally accounts for over 60% of revenues in electricity networks and more again in pipelines.

2.3 Why is the Financial Investor Group making a submission?

The FIG was originally drawn together by concerns about the Australian Energy Regulator's ("AER's") first periodic review of certain WACC parameters as prescribed by the National Electricity Rules.[7] That review has formal application only to electricity determinations[8] in the eastern States.

Specifically, the FIG's concerns related to the nature and direction of the WACC review, which, in estimating parameter values, focussed almost exclusively on technical matters and gave little regard to market conditions, particularly in light of the Global Financial Crisis ("GFC"). The FIG believed that the AER had lost sight of the commercial importance of the cost of capital and the role that it plays in the investment decisions made by private sector infrastructure investors operating in a competitive and particularly challenging capital market, where private investors have many alternative investment opportunities available.

The FIG believes that setting a regulated cost of capital must ultimately be guided by commercial and practical considerations, as this is the perspective that investors will take when

[6] Except where those revenues are subject to pre-existing contractual arrangements.
[7] FIG, Submission to the AER's WACC parameter review: The investor perspective: January 2009 http://www.aer.gov.au/content/item.phtml?itemId=726833&nodeId=1f5b147a6952ac4b1152f668ef9e4495&fn=Financial%20Investor%20Group%20submission%20on%20explanatory%20statement%20(29%20January%202009).pdf
[8] The AER states that the decision "has no direct or formal applicability to gas access arrangements". See AER, Electricity transmission and distribution network service providers Review of the weighted average cost of capital (WACC) parameters: Final decision, May 2009, page 6.

making investment decisions, as it believes has been recognised in the National Gas Law and the National Electricity Law.[9] Failure to do so will result in much-needed capital for energy network and transmission investment being shifted to other investment opportunities.

While this submission makes some references to the AER's Final Decision, this is done primarily to highlight the inconsistencies in the ERA's decision and decision-making process. For the avoidance of doubt, the FIG wishes to place it on the record that it remains of the view that the AER's Final Decision provides an inadequate regulated rate of return, as it is below that currently required by equity investors in regulated infrastructure assets.

The FIG has similar concerns relating to the ERA's Draft Decision on the Goldfields Gas Pipeline given that it also proposes returns that are simply inadequate to support private sector investment in regulated infrastructure in Western Australia.

FIG members believe that, if anything, higher returns are required for certain infrastructure assets in WA (as the ERA has previously recognised), for reasons outlined in this submission.

[9] The National Gas Objective is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas. The Rules require that the Rate of Return should reflect a return which is commensurate with prevailing conditions in the market for funds and the risk involved in delivering the Reference Service.

3 Our concerns with the ERA's proposals

3.1 The ERA's proposals

The ERA's Draft Decision has rejected GGT's proposed nominal pre-tax rate of return of 13.5 per cent and instead, proposed a nominal pre-tax cost of capital of 10.28 per cent. The ERA's proposed rate of return therefore represents a reduction of over 300 basis points on GGT's proposals. This decrease ignores the higher risk free rate of 5.52 percent which has been applied by the ERA (as compared with 4.27 per cent in GGT's proposal). When this is taken into account, the reduction being proposed by the ERA is well over 400 basis points. The ERA's proposal also represents a reduction of 0.32 per cent on the current regulated rate of return for the GGP which was set in 2005, notwithstanding the substantially more challenging capital market conditions that now exist.

In arriving at its conclusions, the ERA has proposed to adopt (amongst other things) the following parameter value ranges:

- a market risk premium between 5% and 7%;
- an equity beta in the range of 0.8 to 1.2; and
- an assumed value of between 57% and 81% in respect of imputation credits.

Along with its other proposed parameter values, the ERA's assumptions produce a feasible range for the nominal pre-tax WACC of 9.11% to 11.46%. This result has then been further adjusted to attain what the ERA regards as a reasonable range. The result, which is achieved by narrowing the feasible range to eliminate the top and bottom 10th percentile of values, is a range of 9.34% to 11.22%. The midpoint of this range – 10.28% - is the value proposed to be adopted in the ERA's Draft Decision.

3.2 The FIG's concerns

3.2.1 The adequacy of the overall rate of return

The FIG is highly concerned about the level of the overall WACC proposed by the ERA for the GGP and its implications for investment. As noted above, the proposed rate of return of 10.28 per cent represents a reduction of 0.32 per cent on the current regulated rate of return for the GGP. This result seems anomalous considering the economic and financial environment within which the GGP is currently operating, which is one that is considerably less stable than it was for a period prior to the GFC.

Whilst it is acknowledged that there are signs of an emerging economic recovery in recent months, the FIG considers that it is far too early to conclude that conditions have returned to "normal" or that further setbacks will not occur. Our views are reflected in the observations recently made by the Reserve Bank of Australia:

"…Given these developments, my theme today is one of cautious optimism about the global situation. We can't yet say that things are back to normal, and we still can't rule out further setbacks…

…the extreme risk aversion of late last year has been easing for some months now, and banks' access to wholesale funding markets has been improving. It's important to keep this in perspective: these market indicators are still, in some cases, a long way from pre-crisis levels, particularly for borrowing costs at longer maturities."[10]

The funding challenges facing the Australian power and utility sector have also been considered by Standard and Poor's:

"Financial markets may be thawing somewhat, but Australian utilities rated by Standard & Poor's Rating Services continue to face a bunch of major credit-related challenges. Debt refinancing is one of the biggest: the rated Australian utilities sector, whose assets range from power stations to gas pipelines, has about A$4.8 billion of publicly rated debt due in the next 12 months. With capital markets still effectively closed, funding options for Australian utilities remain invariably linked to the bank market, which has tightened terms and conditions, increased costs, and shortened the tenor of funding (mostly to three years). Indeed, for the next 12 months, we expect the refinancing process to be costlier and take a lot longer than expected."[11]

Given the current state of the economic and financial environment and their immediate outlook, there does not appear to be a strong case for adopting a regulated rate of return for the GGP which is lower than the current regulated rate of return. It is therefore difficult to reconcile the ERA's proposals within this context.

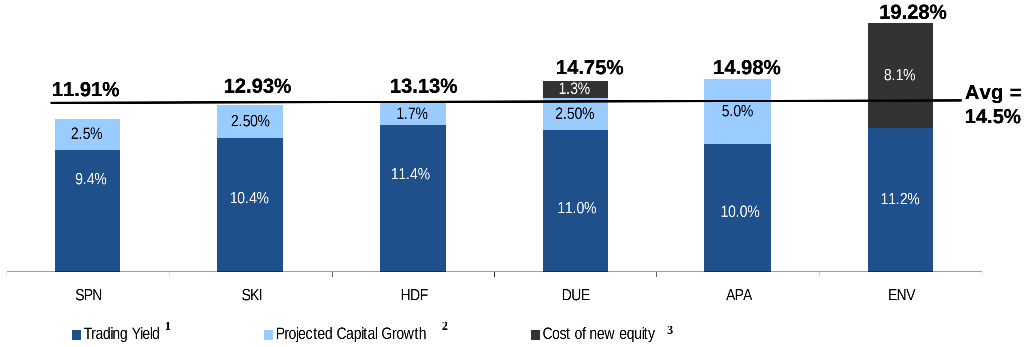
The FIG has previously compiled and presented market-based evidence to the ERA in relation to its draft decision on Western Power's South West Interconnected Network ("SWIN"), which demonstrates the extent of the disparity between the ERA's proposed rate of return on that asset with the prevailing rates of returns required by investors in Australian infrastructure assets. We have updated this data based on market statistics on 1 December 2009 and as shown in the charts below, this information indicates that investors are – on average - currently requiring a (pre-tax) return on equity of 14.5%. By contrast, the ERA's proposal implies a <u>pre-tax</u> return on equity of 13.04%, which is well short of investor requirements.[12]

[10] Edey, M. "The evolving financial situation", Speech delivered at the Finsia Financial Services Conference, 28 October 2009

[11] Standard & Poor's, "*Industry Report Card: For Australian Utilities, The Challenge Remains to Manage Refinancing and Balance Sheets*", 7 May 2009

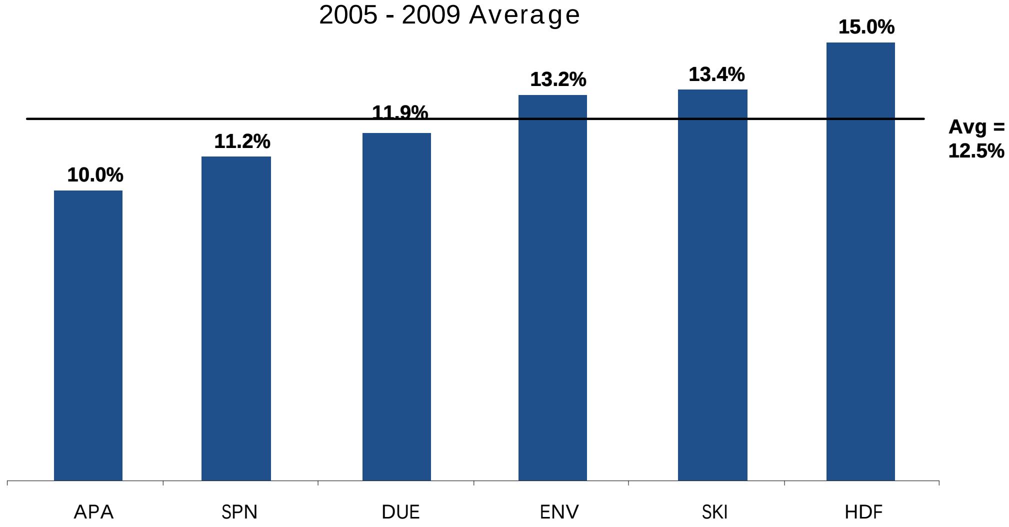
[12] The ERA's unadjusted range for the pre-tax return on equity is 10.10% to 15.98%, based on a risk free rate of 5.52%, a MRP of 6% and an equity beta in the range of 0.8 to 1.0. Removing the top and bottom 10% of values results in a range of 10.69% to 15.39%. The midpoint of this latter range is 13.04%.

Current Cost of Equity
(% pa, pre-tax nominal ROE)
1st Dec 2009



1 Source: Bloomberg and ASX company announcements (forecast dividend over market price at 1st December 2009)
2 Source: RBS (projected 3 year DPS growth)
3 Source: Bloomberg and ASX company announcements

Historical Prospective Trading Yields
(dividend guidance/quarterly VWAP)
2005 - 2009 Average



Source: Bloomberg and ASX company announcements

The FIG also notes that the ERA's own consultant, Frontier Economics, has expressed the view that *"…the required return on equity is presently high relative to past required returns."*[13] The report by Frontier Economics provides evidence that this is the case based on:

- analysis of dividend yields and debt spreads which indicates that both dividend yields and debt spreads were high relative to long term historical average levels. Frontier Economics observes that "*…the relevant finance literature establishes that required returns on equity are, on average, higher when trailing dividend yields and debt spreads are higher. At present, both of these measures are substantially higher than their average levels. This would imply that required returns on equity are presently higher than average."*[14]

- analysis of the relationship between option implied volatilities and required returns on equity previously undertaken by Grundy (2009)[15], which indicates that current estimates of implied volatility for the ASX 200 index have risen sharply in recent times, and this points to a higher required return on equity[16]; and

- prevailing low price-earnings ratios observed in the Australian market which is likely to result from two factors – reduced investor expectations for future earnings and an increase in investors' required return for risk. On this issue, Frontier Economics concluded that:

  "The decline in the market's price-earnings ratio is consistent with the increase in the dividend yield (prices relative to trailing dividends), debt spreads and option implied volatilities, discussed above. These factors suggest that equity prices reflect investors' relatively high return requirements, given their perceptions of risk in the present market."[17]

As the ERA would be aware, GGT competes with other infrastructure businesses both in Australia and offshore in securing equity and debt funding for its assets. The GFC has made capital both more scarce and more expensive. At the same time, the array of investment opportunities which are available to infrastructure investors has not diminished and may have expanded.

The FIG's submission to the AER's review demonstrated this at some length. In summary, it stated:

> *"Appendix A shows that there is massive global demand for infrastructure investment and energy infrastructure investment. In particular, projections suggest that in the period to 2030, $109 trillion of investment is required in the road, rail, telecoms, electricity generation and water sector. The energy infrastructure sector will require $40 trillion over the same period, of which 25% will be spent on energy networks. At the same time, there is huge demand for Australian infrastructure investment across a range of sectors, including energy and energy networks. Over the next 10 years the*

[13] Frontier Economics, Review of Weighted Average Cost of Capital estimate proposed by Goldfields Gas Transmission, Final Draft report prepared for the Economic Regulation Authority, 6 August 2009, page 13.
[14] Frontier Economics, Review of Weighted Average Cost of Capital estimate proposed by Goldfields Gas Transmission, Final Draft report prepared for the Economic Regulation Authority, 6 August 2009
[15] Grundy, B, 2009, The WACC and the averaging period, Submission commissioned by TransGrid, 16 February 2009.
[16] Frontier Economics, ibid, pages 12-13.
[17] Frontier, Economics, ibid, page 15.

investment required in Australian infrastructure (both economic and social) is around $445-700 billion. The energy network expenditure component of this is around $40 billion."[18]

While some of that investment will be deferred or avoided in the light of the GFC, the infrastructure investment need will remain very considerable. For example, the Australian Financial Review recently noted that around $16bn of shelved mining projects, a number of which are in Western Australia have been revived. This investment will require supporting infrastructure. This shows that the investment need remains substantial, but this may be addressed by some improvement in capital market conditions, particularly with equity investment by Chinese companies.[19]

In Australia, there have been recent reports which indicate that superannuation funds, which were previously expected to be a major source of funding for local infrastructure, are now wary of investing in such assets due to uncertainties over regulatory arrangements and the risk / reward profile of assets[20]. This result should not be surprising since regulatory processes that are perceived to be inconsistent, opaque or arbitrary create substantial risks for investors, particularly in long-lived or illiquid assets. Such regulatory processes require investors to make highly subjective judgements about possible regulatory outcomes. In these circumstances, investors will either:

- choose not to invest because the regulatory regime is perceived to be too risky; or
- only invest where the expected returns compensate for the additional risks involved (which, for regulatory risk, will be valued conservatively since such risks are hard to quantify and thus value).

To the extent that superannuation funds choose to invest offshore rather than in Australian infrastructure assets, this will add to the funding challenges of Australian infrastructure companies which already exist due to the GFC.

Providing a competitive rate of return on investment in regulated infrastructure is therefore a necessary condition (but not, of itself, a sufficient condition) to encourage investment that is consistent with promoting economically efficient investment in gas infrastructure and thus customer needs. The regulatory regime also needs to be transparent, stable and predictable. In this regard, there a number of aspects of the ERA's Draft Decision which fail to meet this need.

3.2.2 Concerns with specific parameter values

Whilst this submission is intended to focus largely on our concerns with the adequacy of the overall rate of return proposed by the ERA for the GGP and the implications of this for investment, the FIG has also taken the opportunity to outline its concerns on the ERA's proposals with respect to the value of imputation credits, the market risk premium ("MRP"), and

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[18] FIG, Submission to the AER's WACC parameter review: The investor perspective, January 2009, page 18.

[19] Australian Financial Review, 'Miners revive $16bn shelved projects', 11 November 2009, page 1. It also notes that: "Across the country, miners are reviewing plans that were shelved in response to a freeze in project finance at the beginning of this year. It is tricky to arrange debt, so they are instead turning to equity markets and cashed-up Asian investors to fund new developments."

[20] The Australian, "Superannuation funds spurn local infrastructure investment", 23 November 2009.

the equity beta. These concerns relate not only to the ERA's choice of parameter values, but also on the basis and transparency of the justification for the ERA's proposals.

The ERA has ignored the advice of its consultant in relation to the value proposed for imputation credits but accepted its advice in relation to the value for the equity beta

The ERA has proposed to adopt a value for imputation credits between 57% and 81%, and a value in the range of 0.8 to 1.2 for the equity beta. The FIG notes that in arriving at these proposals, the ERA has chosen to:

1 ignore the advice of its consultant Frontier Economics, preferring instead to adopt a range consistent with that adopted in its draft decision on the SWIN, which was justified on the basis of consistency with the AER's WACC decision; and

2 accept the advice of Frontier Economics in relation to the value for the equity beta.

The FIG has major concerns with the way in which the ERA appears to have selectively considered the advice of its consultant.

The FIG notes that Frontier Economics reached the following conclusion in relation to the value of imputation credits:

> *"Consequently, we consider the estimated value for imputation credits of 0.2 by GGT to be appropriate and that a reasonable range for this parameter, based on all of the evidence and analysis that is now available, is 0 to 0.4."*[21]

In arriving at this conclusion, Frontier Economics also stated that:

"Our conclusion is that the AER analysis in relation to gamma is fundamentally flawed and should receive no weight for a number of reasons:

(a) The AER's estimate of gamma is based on an assumed dividend payout policy that bears no resemblance to that which we actually observe from Australian companies;

(b) The AER's estimate of gamma is inconsistent with the observed practice of Australian firms and independent expert valuation professionals; and

(c) The two studies relied upon by the AER to measure theta actually measure different concepts. The study by Beggs and Skeels produces estimates that are conditional on dividends being valued at 80% of face value whereas the CAPM-WACC framework requires estimates that are conditional on dividends being fully valued. The study by Handley and Maheswaran provides evidence that around three-quarters of distributed imputation credits are redeemed, and therefore received by Australian investors. It does not provide any information whatsoever about how much imputation credit value is reflected in market prices."[22]

By contrast, the Authority's assessment:

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[21] Frontier Economics, Review of Weighted Average Cost of Capital estimate proposed by Goldfields Gas Transmission, Final Draft Report prepared for the Economic Regulation Authority, 6 August 2009, page 23.
[22] Frontier Economics, ibid, page 22.

1 refers to its draft decision on the SWIN, which noted that regulatory decisions in Australia provides precedent support for a value of 50% and that the AER has also recently considered this issue; and

2 concludes that the ERA is adopting the same approach for the GGP draft decision as that for the SWIN.

No reasons were offered for the ERA's decision to disregard the advice of its consultant, and to adopt a range or values which is so materially different.

The process which the ERA has taken to arrive at its conclusions on the value of the equity beta is quite different. For this parameter, the draft decision clearly outlines that the ERA has chosen to place a strong degree of reliance on the advice of Frontier Economics and has concurred with all aspects of Frontier's analysis.

> *"473. The Authority notes that Frontier has concluded that a reasonable range of values for the equity beta for the GGP is 0.8 to 1.2. In summary, the reasons outlined by Frontier supporting this range were as follows (Frontier's Draft WACC report, Page 32-33):*
>
> *(a) The midpoint estimate for any equity beta is 1.0, the beta for the average firm. One would only adopt an estimate different from 1.0 to the extent supported by reliable empirical analysis.*
>
> *(b) The ACCC has consistently adopted an equity beta of 1.0 for gas pipeline businesses.*
>
> *(c) The ERA has previously used a range of 0.8 to 1.33 for the GGP and we are unaware of any reason why its systematic risk is any higher or lower than it was previously.*
>
> *(d) After considering a range of equity beta estimates for the available "comparable" firms, the AER has adopted an equity beta estimate of 0.8 for electricity transmission and distribution firms (also with 60% gearing).*
>
> *(e) The GGT submission on this point notes that there are some aspects suggesting that the pipeline's systematic risk is higher than that faced by the average pipeline business and some evidence that systematic risk is below average. There is no compelling evidence to suggest which of these effects might dominate the other.*
>
> *(f) Even if the approach that was submitted by GGT was adopted application of the beta estimates using the ERA's favoured approach for re-levering betas produces an equity beta estimate of 1.23. There is no empirical evidence to support an equity beta higher than this.*
>
> *474 The Authority accepts Frontier's advice that a reasonable equity beta range for the GGP is 0.8 to 1.2."*[23]

The FIG is extremely concerned about the process by which the ERA has arrived at its decision on both of these parameters. Whilst we accept that it may be open to the ERA to accept or reject the advice of its consultant, we would also expect that proper process would dictate that

[23] ERA Draft Decision, page 85-86.

the ERA's reasons for rejecting the advice for its consultant be made fully transparent. This is necessary part of the assessment process which gives the market confidence that an open and unbiased assessment has in fact been undertaken and adds credibility to the decision.

However, the draft decision provides no reason whatsoever for the ERA's decision to reject the advice of its consultant in relation to the value of imputation credits. The FIG contends that fact that the Authority has chosen to adopt a value that is so far removed from Frontier's recommendations creates even more imperative for appropriate justification to be provided. We do not consider that it is sufficient to offer an explanation which simply defers to the AER's conclusions, particularly when a critical conclusion of Frontier Economics was that the AER's analysis is fundamentally flawed. In the absence of a credible explanation, it is difficult to escape the impression that the ERA's views on the value for imputation credits were predetermined before considering the advice of its consultant.

The ERA has adopted a range for the market risk premium which is inconsistent with its consultant's recommended range of 6% to 7%.

The ERA has proposed to adopt a range for the MRP of 5% to 7% (which implies a midpoint of 6%), notwithstanding the advice of its consultant which recommended a range of 6% to 7% (which implies a midpoint of 6.5%).

The FIG notes that whilst the midpoint of the ERA's proposed range is 6%, Frontier Economics has explicitly stated that:

> *"… our view is that 6% is an appropriate lower bound for the reasonable range in the current circumstances."*[24]

Frontier Economics has also expressed the view that there would appear to be little disagreement on the point that at present, the market evidence "*…strongly points towards an increase in the market risk premium to a value above 6%."*[25]

In choosing to adopt a range of 5% to 7%, the ERA has therefore formed a significantly different view to its consultant, the AER, and apparently, the market at large. Given the ERA's position on this parameter, it is surprising that the Draft Decision does not attempt to reconcile the ERA's views with those of its consultant, except to note that in the Authority's recent draft decision on the SWIN, it was concluded that a range of 5% to 7% was appropriate for the MRP.

In a previous submission to the ERA on its draft decision on the SWIN, the FIG noted that it does not consider the ERA's assessment of the value for the MRP is appropriate[26]. This was because the ERA's analysis quite clearly failed to take into consideration the impact of the GFC.[27] We continue to hold these views in relation to the ERA's draft decision on the GGP.

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[24] Frontier Economics draft report, page 17.
[25] Frontier Economics, draft report, page 16.
[26] Financial Investor Group, Submission to the ERA's Draft Decision on Western Power's proposed revisions to the Access Arrangement for the South West Interconnected Network, The investor perspective, September 2009, page 15.
[27] The FIG submission on the SWIN also noted certain process issues which were of concern in arriving at the ERA's choice of values for the MRP.

The FIG accepts that estimating a reasonable value for the MRP involves a degree of judgment, given that the forward-looking MRP is not observable, and historical-based averages can only provide a guide to the forward-looking MRP. ETSA and the Victorian distributors have provided supporting evidence from Officer and Bishop[28], highlighting the disconnect between the current MRP and its long run mean through the use of a forward looking MRP. Concluding that it is appropriate to depart from the long term historical average used, estimating the current forward looking MRP to be 11%pa, regressing towards the long term historical average over a period of 3-5 years, producing a forward looking MRP for the 2011-15 period of 8%[29].

Consequently, the FIG considers that in the present economic environment, and given the market and academic evidence on the rates of returns required by investors, there is a strong case for the ERA to exercise its discretion to adopt a value for the MRP which is at the higher end of a reasonable range based on the historical evidence. Doing so would allow the Authority to set a rate of return which better reflects *"…a return which is commensurate with prevailing conditions in the market for funds…"* which is the criteria specified in the Code.

The FIG does not support the reduction of the range for the equity beta below the range of 0.8 to 1.33 in the current access arrangement

The FIG considers that the case for reducing the range for the equity beta below that which is currently adopted for the current access arrangement is weak. The GGP is a relatively unique regulated energy infrastructure by virtue of the fact that almost all of its throughput is supplied to the mining sector.

As demonstrated by the Frontier Economics' analysis, companies in the Australian mining sector typically exhibit relatively higher asset and equity betas, indicating that these businesses do have an inherently higher level of business risk. It is therefore likely that some of this risk will translate into higher risks for the GGP.

In the previous access arrangement review for the GGP, the ERA adopted an equity beta range of 0.8 to 1.33 to recognise that transmission pipelines in WA, particularly the GGP, may be exposed to a higher level of systematic risk as a result of their exposure to the mining and mineral processing sector. The risk characteristics of the GGP have not changed. What has changed is the price of risk and as a result, investors are now demanding higher rates of return for investing than they have in the past. Reducing the equity beta relative to what is currently being allowed is not logical within this context.

[28] Market Risk Premium for 2011-2015, Dr Steven Bishop and Professor Bob Officer

[29] Officer and Bishop's methodology employs the implied volatility (IV) of a three month call option issued against the ASA 200 Index for the longest time period available to them, i.e. since 1st January 1997. Implied volatility is derived from the only 'unknown' variable in the Black and Scholes call option pricing relationship arising from using the observed price of the option and the three other inputs, these being the risk free rate, time to maturity and exercise price. Put simply it is a forward looking estimate of market volatility. Officer and Bishop then regress the annualised 30 day moving average of the standard deviation of the ASX 200 Index plotted against the implied volatility derived from the option price of a 30 day option on the index. Despite the IV being a forward looking measure and the 30day average standard deviation being historical, Officer and Bishop found a correlation of 0.89. Officer and Bishop argue that due to this high degree of correlation between the two, the IV can be used to obtain an estimate of the forward MRP. Therefore given the evidence on increased market volatility, the underlying MRP has increased substantially, at least in the short term.

The FIG understands that further analysis on the equity beta is being provided to the ERA in a separate submission by GGT. FIG believes that, given the risk profile of the GGP, and in particular its exposure to the gold, nickel and iron ore industries, an equity beta substantially above 1.0 is appropriate for an asset such as the Goldfields Gas pipeline.

3.3 Conclusion

The range of market indicators reviewed in this submission support the view that investor risk aversion remains high at the present time and the rate of return proposed by the ERA falls short of the rates of returns currently required by investors. Such an outcome places the significant amounts of investment which is required in the GGP over the next regulatory period at risk of being deferred as investors shift their funds towards investments offering higher prospective returns for equivalent risk.

As this submission has noted, providing a competitive rate of return on investment in regulated infrastructure is a necessary condition (but not, of itself, a sufficient condition) to encourage investment that is consistent with promoting economically efficient investment in gas infrastructure and thus customer needs. Transparency and predictability are also important aspects of the regulatory process. The FIG believes that the way in which the ERA has disregarded the advice provided by its consultant is unsatisfactory and raises significant questions over the integrity of the ERA’s assessment process.

A The Financial Investor Group

The FIG is an affiliation of eight major investors in Australian energy transmission and distribution networks. It includes: the APA Group; Prime Infrastructure; Cheung Kong Infrastructure; the DUET Group, which is jointly managed by AMP Capital Investors and the Macquarie Group; Hastings Funds Management; Hongkong Electric; Singapore Power International; and Spark Infrastructure.

In addition to their energy interests, FIG members own significant other infrastructure interests, including in:

- non-regulated energy, transport, roads and water sectors; and
- infrastructure investments in Asia, New Zealand, North America, the United Kingdom, and elsewhere in Europe.

Table 1 provides some details on specific energy interests of the three members of the FIG who have contributed to this submission.

Table A1: Description of key assets of the members of the FIG making this submission

Investor	Description of key assets
The APA Group	Manager of a listed energy infrastructure vehicle with interests in more than 12,000 km of gas transmission infrastructure, a gas distribution network in Queensland, two high voltage direct current electricity interconnector systems, other energy related assets and a 30% stake in Envestra.
Prime Infrastructure	Listed energy and transport infrastructure vehicle with energy investments in the transmission and distribution sectors. Assets include interests in Western Australia Gas Networks, Dampier to Bunbury Natural Gas Pipeline, Multinet Gas Network, Tasmanian Gas Pipeline and Westnet Energy. It also holds interests in a number of offshore assets including Powerco and the Cross Sound Cable and the Natural Gas Pipeline Company of America.
DUET Group	Listed energy infrastructure vehicle which has interests in Western Australia Gas Networks, Dampier to Bunbury Natural Gas Pipeline, United Energy Distribution, and Multinet Gas. Also has an interest in Duquesne Light, an electricity transmission, distribution and supply business in Pittsburgh, USA.