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**Economic Regulatory Authority's Draft Decision on Goldfield Gas Transmission's Proposed Access Arrangement Revisions October 2009**

To whom it may concern

The Australian Pipeline Industry Association (APIA) welcomes the opportunity to provide comment on the Economic Regulatory Authority's (ERA) Draft Decision on Goldfield Gas Transmission's Proposed Access Arrangement Revisions October 2009.

APIA has issues with five main areas of the Draft Decision:

- the treatment of previous Goldfields Gas Pipeline (GGP) expansions;
- the treatment of future GGP expansions;
- the treatment of the cost of capital;
- the treatment of asymmetric risk; and
- the treatment of operating cost.

In particular, APIA is concerned that the ERA has justified some of its decisions on the basis of consistency with decisions made for infrastructure under regulatory regimes other than the Gas Code.

Yours sincerely

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Chief Executive



## **The Australian Pipeline Industry Association's (APIA) Response to the ERA Draft Decision on Goldfield Gas Transmission's Proposed Access Arrangement Revisions October 2009**

### **1. Introduction**

The Australian Pipeline Industry Association (APIA) welcomes the opportunity to comment on the Economic Regulatory Authority's (ERA) October 2009 Draft Decision on Goldfield Gas Transmission's (GGT) Proposed Access Arrangement Revisions (the "Draft Decision").

APIA is the peak national body representing the interests of Australia's transmission pipeline sector. APIA's current membership is predominantly involved in high-pressure gas transmission. APIA's members include contractors, owners, operators, advisers and engineering companies and suppliers of products and services.

APIA is particularly concerned about five issues:

- the treatment of previous Goldfields Gas Pipeline (GGP) expansions;
- the treatment of future GGP expansions;
- the treatment of the cost of capital;
- the treatment of asymmetric risk; and
- the treatment of operating cost.

### **2. Comment on ERA Treatment of Previous GGT Expansions**

APIA is concerned that the ERA Draft Decision appears to propose de facto coverage of uncovered sections of the GGT pipeline. The effect of ERA's amendments 3, 10, 11, 12 and 13 is that the actual and forecast costs, revenue and volumes relating to the uncovered expanded capacity must be used in setting the regulated tariff. This approach appears to be a de facto coverage decision on the uncovered capacity of the pipeline.

Coverage decisions are the province of the National Competition Council rather than economic regulators. There is a clear and defined process for coverage to be achieved if it is appropriate for an asset. If this process is replaced by de facto coverage decisions made by economic regulators there will be an increase in uncertainty and risk. This would be likely to actively discourage investment in those jurisdictions where such practices are tolerated.

APIA has real doubt as to whether the ERA has the legal power to explicitly consider the capital costs of uncovered assets and the capacity of the uncovered pipeline for the purpose of determining reference tariffs for the covered pipeline.

APIA believes that GGT has acted appropriately in making a revised Access Arrangement proposal that relates only to the covered pipeline. APIA does not believe that the regulatory scheme of the Code supports the ERA's position that it is appropriate that costs and volumes associated with unregulated assets should be incorporated into regulatory decisions at the sole discretion of the ERA.

Overall APIA believes the ERA has misinterpreted the Code in seeking a de facto coverage of uncovered capacity and assets.

### **3. Comment on ERA Treatment of Future GGP Expansions**

APIA is also concerned that the Draft Decision appears to propose mandatory coverage of future expansions and extensions of the GGT pipeline.

APIA has real doubt as to whether the ERA has the legal power to explicitly mandate that future expansions and extensions of the GGT pipeline be covered. APIA believes that the Code requires that the service provider provide a mechanism for the treatment of extensions and expansions, but this mechanism does not require automatic coverage.

APIA believes that section 3.16 of the Code gives the service provider discretion on the content of the extensions and expansions policy, and the only issue for the ERA is to assess whether the service provider's proposal complies with the Code.

APIA believes that the ERA's amendment requiring a revised extensions and expansions policy does not align with the Code as the proposed extensions and expansions policy was already consistent with the Code.

### **4. Comment on ERA Requirement for a Trigger Event**

The Draft Decision requires GGT to include a trigger mechanism linked to pipeline capacity expansion. APIA has concerns with the inclusion of this mechanism for several reasons, in particular the trigger mechanism seems linked to the larger issue of the treatment of current and future expansions and whether these expansions should be covered.

GGT has submitted a Code-compliant extensions and expansions policy which allows GGT to elect whether or not a capacity expansion is covered. The extensions and expansions policy is the appropriate place to deal with coverage of expansions. As such, a trigger mechanism regarding expansions is superfluous.

Overall, APIA believes that GGT has proposed a Code compliant approach to tariff determination in the event of a capacity expansion. The ERA cannot disallow the approach. It is inappropriate for the ERA to require a trigger event of the nature required in the Draft Decision.

## **5. Comment on ERA treatment of Cost of Capital**

APIA is concerned that the current cost of capital allowed in the Draft Decision does not adequately reflect the cost of capital observed in the market, and consequently is inadequate to support private sector investment in regulated pipelines in Western Australia. Additionally, APIA is concerned that the ERA has reduced the cost of capital at a period when financial markets are experiencing high and prolonged levels of uncertainty that directly impact on the availability and cost of capital required by service providers.

APIA's concerns are exacerbated by the fact that the Draft Decision, in establishing values for cost of capital parameters, appears to place regulatory consistency, in particular consistency with the ERA's recent electricity networks draft decision, above determining a cost of capital that would fairly represent the risks in providing a reference service on the GGP.

The issue of consistency is highlighted by the fact that the ERA chooses to reject its own consultants recommended values for certain cost of capital parameters in order to pursue consistency with other ERA draft decisions. This demonstrates that the ERA is less interested in determining the correct cost of capital than it is with ensuring consistency.

It is also concerning that the ERA seeks to justify cost of capital parameter values based on regulatory precedent when the "precedent" values were set under regulatory regimes which are different to the Gas Code, and as such are of marginal relevance to the pipeline under consideration.

Further to the issue of cost of capital APIA has specific concerns related to the estimation of individual parameters used in the calculation of the cost of capital. These concerns are outlined in the sections below.

### ***Market Risk Premium (MRP)***

The Draft Decision considers that a reasonable range of estimates for the market risk premium is 5.0% to 7.0%. The Draft Decision does not provide any details or discussion to support estimates below 6%, other than referring to regulatory precedent and recent analysis undertaken in relation to the AER May 2009 Final Decision on Electricity Transmission and Distribution Network Service Providers Review of WACC Parameters.

APIA believes the justification put forward by the ERA is flawed as:

1. the regulatory precedent referred to relates to regulatory decisions prior to the current global financial crisis; and
2. the AER decision referred to arrived at an MRP point estimate of 6.5%, well over the ERA point estimate of 6%.

Given the global financial crisis, investors require a premium to commit equity capital in the current environment. Thus the current actual forward looking MRP may well exceed 6.5%.

APIA believes that a value of 6.5% or above remains an appropriate estimate for the long-term MRP.

## **Gamma**

The Draft Decision values gamma at 57% - 81%. This Draft Decision values appear to be based on the gamma value of 65% set in the AER May 2009 Final Decision on Electricity Transmission and Distribution Network Service Providers Review of WACC Parameters.

The process surrounding this AER Decision demonstrated that there is a broad diversity of conflicting views on gamma ranging from no value (0%) to full value (100%).

APIA has fundamental concerns with the AER's decision. Several key concerns are outlined below.

First, APIA is concerned that the AER's use of only two studies ignores a number of recent, reputable studies that suggest that the value of gamma is below 0.5 (and in some cases, zero). While APIA notes that the AER considered these studies, the AER's grounds for dismissing them are not considered compelling.

Second, significant problems have been identified with the results of the single study that has been relied upon to estimate the value of franking credits from market data, the Beggs and Skeels study. These problems were identified in two consultants' reports submitted to the AER by the Joint Industry Associations.<sup>1</sup> Further, one of these studies (being the report by SFG Consulting), sought to simply extend Beggs and Skeels' sample period to September 2006 – making no other changes to the methodology or assumptions they applied – and arrived at a very different estimate for the value of franking credits (0.37).

Third, tax statistics analysis is not an accepted method for valuing gamma. Taxation statistics measure the quantum of corporate taxation, the amount of credits distributed and the amount of credits claimed. The amount of credits claimed is not the value of those credits. It does not take into consideration the risk that shareholders bear in earning the dividends and credits. Therefore it merely establishes a hypothetical upper bound for theta (as the value must then be \$1 per \$1 of credits) which is higher than the 'true' upper bound. APIA considers that this study should not have been given such significant weight by the AER.

Fourth, another assumption that has proven particularly controversial is a 100% distribution rate, which differs from Hathaway and Officer's estimated market average of 71%<sup>2</sup>, which is widely applied in practice.

The AER suggests that while the valuation of gamma has been contentious in the past, the evidence it has relied upon is sufficiently robust to enable a more definitive estimate to be made:

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<sup>1</sup> SFG Consulting (2009), The Value of Imputation Credits as Implied by the Methodology of Beggs and Skeels (2006), Report Prepared for ENA, APIA and Grid Australia, February; Synergies Economic Consulting (2009), Peer Review of SFG Consulting Reports on Gamma, A Report to the ENA, APIA and Grid Australia, January.

<sup>2</sup> N. Hathaway & B. Officer (2004), The Value of Imputation Credits – Update 2004, Capital Research Pty Ltd, November 2004.

*"In arriving at its final estimate the AER acknowledges the considerable complexities associated with valuing gamma that have been recognised by market practitioners (and have also been the source of contention in previous regulatory debates). However, it is now of the view that...it is indeed possible to arrive at a reasonable empirical estimate of the value of imputation credits taking into account all the available evidence."*<sup>3</sup>

However, APIA also observes that the report provided to the AER by its own consultant, Associate Professor Handley, concluded that a reasonable estimate for gamma is within the range of '0.3 to 0.7'.<sup>4</sup> This clearly does not support the notion that a definitive value for gamma can now be determined, nor does it support a range that lies above the mid-point of the range of possible values for gamma (being between zero and one). As noted above, a number of recent reputable studies suggest that the value of gamma is zero and this evidence has been dismissed by the AER in favour to two single studies.

Further reinforcing this issue is the fact that the ERA's own consultant on this issue, Frontier economics, concluded that the value of gamma is in the range of 0% to 40%, well outside the range being used by the ERA.

The ERA does not justify why its gamma value differs by such a large margin from the value put forward by its adviser. APIA is of the view that the evidence relied upon by the ERA does not support the proposed value for gamma. The ERA should provide an adequate explanation as to how it arrived at its value for gamma.

APIA's view is that a reasonable estimate for gamma is less than 50%.

Overall the cost of capital proposed by the ERA is less than the cost of capital currently required in the financial market. As such investment in pipeline infrastructure is at jeopardy. APIA believes the level of the cost of capital needs to be increased if the ERA wishes to ensure ongoing investment in pipeline infrastructure in Western Australia.

### **Comment on ERA Treatment of Asymmetric Risk**

Regulated entities face asymmetric risk and returns as the distribution of expected returns are truncated at the upper end by regulation. The returns of regulated infrastructure are generally not allowed to exceed the regulated rate of return while the asset remains exposed to under-performance. Consequently, the regulated asset requires compensation for bearing these risks which it cannot avoid.

GGT proposed to allow for the cost of asymmetric risk. This was rejected by the ERA on the grounds that it has not previously approved a cost allowance for asymmetric risk, and that in any event, the cost allowance for asymmetric risk did not meet the requirements of the Code.

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<sup>3</sup> Australian Energy Regulator (2009), Final Decision: Electricity Transmission and Distribution Network Service Providers - Review of the Weighted Average Cost of Capital (WACC) Parameters, May, p.410.

<sup>4</sup> Handley, J. (2009), Further Comments on the Valuation of Imputation Credits, Report Prepared by the Australian Energy Regulator, 15 April, p.41.

APIA believes that issues relating to non capital costs should be considered on their merits rather than by reference to previous regulatory decisions and approaches. Furthermore, APIA believes that the proposal to recover asymmetric risk is consistent with Code principles, as the costs associated with the risk are borne by efficient and prudent service providers as the costs result from the regulatory system itself and are not under the control of the regulated pipeliner.

Overall, APIA believes that GGP should be allowed to recover an amount for asymmetric risk.

### **Comment on ERA Treatment of Shared Corporate Costs**

The Draft Decision has rejected GGT's submission on shared corporate costs on several grounds, including that it does not believe that a full range of corporate overhead costs are costs that meet the prudent service provider test under the Code.

APIA believes that shared corporate costs would be incurred by a prudent service provider. Such costs are related to meeting legal obligations and engaging in general management, financial management, IT, human resources and other shared corporate activities. These shared corporate activities are required to be performed and some reasonable allowance must be made for these costs.

Furthermore, APIA is concerned that different regulators seek to allocate shared costs using different methodologies. Inconsistent application of cost allocation methodologies raises the potential for the under-recovery of shared costs

### **Conclusion**

APIA believes that the ERA Final Decision should revise the following areas of the Draft Decision:

- The coverage status of previous GGP expansions should be at the election of the GGP;
- The coverage status of future GGP expansions should be at the election of the GGP;
- The trigger event is not required and should be removed;
- The cost of capital should be increased to levels which allow ongoing investment in pipeline infrastructure in Western Australia;
- The cost of asymmetric risk is a valid cost under the Code and should be allowed; and
- The cost of corporate shared services, as proposed by GGT, are valid costs under the Code and should be allowed.