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Australian Energy Market Commission
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Submission to AEMC draft Determination: National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012 and National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012

The APA Group welcomes the opportunity to respond to the AEMC's draft Determination on the AER Cost of Capital Rule Change proposals.

The APA Group (APA) is a major ASX-listed gas transportation business with interests in energy infrastructure across Australia, including over 12,800 km of natural gas pipelines, gas storage facilities and a wind farm. APA is Australia's largest transporter of natural gas, delivering about half of Australia's annual gas use through its infrastructure. APA owns and manages a diverse portfolio of energy infrastructure assets across Australia, with a value of approximately $9 billion. These assets include investments in two interstate electricity interconnectors which operate in the National Electricity Market.

APA therefore has a keen interest in ensuring that the gas and electricity regulatory regimes deliver outcomes that not only foster efficient new investment in energy infrastructure, but safeguard the business interests of existing investors in energy assets.

APA's focus in this review process is as a long term investor in infrastructure assets. In this regard, APA has also participated in this review as part of the Financial Investors Group (FIG) in responding to the draft Determination.

APA's primary focus is with the gas regulatory regime. To this end, APA's comments will focus mainly on the Rule Change proposal as it relates to the *National Gas Rules* (NGR) rather than the *National Electricity Rules*. In this regard, APA's focus will be primarily on the Rate of Return related issues, rather than the "electricity only" procedural and other issues. APA has coordinated with the Australian Pipeline Industry Association (APIA) in preparing a response to the draft Determination.

Summary

APA Group applauds the policy intent of the AEMC's proposed Rule change, importantly in respect that the AEMC expresses a clear intention to require the regulator to take into account a wider range of methods, models, data and other evidence in its decision-making.

The AEMC's intentions in its Draft Determination on proposed changes to the National Electricity Rules (NER) and NGR are highlighted in its executive summary. The AEMC states:[1]

> *The Commission proposes to amend the rate of return provisions in the NER and NGR to provide for a common framework that enables the regulator to make the best possible estimate of the rate of return at the time a regulatory determination is made. When making the estimate the regulator must take into account the market circumstances, estimation methods, financial models and other relevant information.*

In particular, the AEMC notes that an important motivation for having regard to a wide range of evidence is that:[2]

> *A framework that eliminates any relevant evidence from consideration is unlikely to produce robust and reliable estimates, and consequently is unlikely to best meet the NEO, the NGO and the RPP.*

APA also notes that the AEMC is unequivocal that the allowed rate of return must be estimated having regard to prevailing market conditions:[3]

> *A robust and effective rate of return framework must be capable of responding to changes in market conditions. If the allowed rate of return is not determined with regard to the prevailing market conditions, it will either be above or below the return that is required by capital market investors at the time of the determination. Neither of these outcomes are efficient and neither is it in the long term interest of energy consumers.*

APA applauds these initiatives.

APA Group has participated in and supports the submissions made by the Financial Investors Group (FIG) and the Australian Pipeline Industry Association (APIA). APA supports those submissions.

There are, however, a few areas of interest that may benefit from some clarification, as discussed below.

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1 AEMC Draft Determination, p. ii

2 AEMC Draft Determination, p. 48

3 AEMC Draft Determination, p. 49

Content of the AER Guideline

APA is of the view that the regulator's Guideline should focus on principles, approaches and methodologies, but ideally should not specify parameter values.

Including specific values in the Guideline introduces an element of rigidity to the Guideline, which is a key identified failing of the current SORI regime. Such rigidity would make it difficult for the regulator to adequately reflect the cost of capital commensurate with prevailing conditions in the market.

Trailing average approach to cost of debt

In the proposed draft Rule, the AEMC's drafting provides that Rule 87(5) requires the regulator to estimate a return on equity taking into account the prevailing conditions in the market for equity funds, and Rule 87(6) separately addresses considerations relating to the cost of debt. This drafting recognises that the use of the "trailing average" approach to estimating the cost of debt will result in a composite cost of capital that cannot always be expected to be commensurate with the cost of funds in the marketplace.

Regarding the cost of debt, the parallel to the "prevailing conditions in the market" is embodied in clause 87(7)(a), whereas the proposed "trailing average" approach is provided in clause 87(7)(b).

APA supports the optionality to apply a "prevailing conditions" or "trailing average" approach to estimating the cost of debt, as this can be structured to best reflect a particular business' underlying approach to managing its debt portfolio.

However, the current drafting of Rule 87(7) appears to give the regulator the discretion on which methodology to apply. APA is concerned that this may result in the regulator adopting an approach that does not reflect the business' approach to managing its debt portfolio.

In this regard, APA is of the view that the discretion on which methodology to apply should rest with the Service Provider; that is, the Service Provider should elect which methodology to adopt. Moreover, APA submits that this provision should be a Limited Discretion Rule.

As identified in the proposed drafting submitted by APIA, this can be achieved by simply adding a new clause to Rule 87(7) as follows:

> *The AER's discretion under sub-rules (6) and (7) is limited.*

Transitional provisions

Acknowledging the scope for a separate submission on transitional provisions, APA provides the following comments at a high level.

Discussions with the AEMC at an officer level clearly indicated a strong preference that the cost of capital Guideline be available, at least in draft form, to allow a business to prepare its Regulatory Proposal or proposed Revisions to its Access Arrangement. APA supports this view.

It is important, under the provisions in proposed Rule 87(16), that the business be able to make a case, if appropriate, as to why the regulator should depart from the Guideline in reaching a decision on the cost of capital in assessing proposed Access Arrangement revisions for a particular business.

This is particularly important for gas transmission businesses. Gas pipelines are individually distinct in terms of the market they serve, their geography, and their exposure to particular industry sectors. A cost of capital developed for one pipeline may not be commensurate with the cost of capital appropriate for another pipeline. To the extent that the regulator's Guideline is to have broader applicability across industries and businesses, it will be important to assess the reasonableness of applying that Guideline to a particular pipeline business.

To the extent that any service provider's Access Arrangement revisions are assessed in parallel with the development of the regulator's Guideline, the business will be denied the opportunity to present evidence and argument as to why it would be appropriate to depart from the Guideline in its particular case.

In this respect, APA considers it important that the first Guideline be finalised before any business is required to submit Access Arrangement revisions under it. Importantly, as the submitting business needs time to develop its arguments and evidence in response to the Guideline, APA recommends that the earliest filing date for Access Arrangement Revisions should be no earlier than three months after the release of the final Guideline.

This will impact the ATCO Gas distribution network in Perth, and the Goldfields Gas Transmission pipeline in Western Australia. In this regard, APA considers that existing Rule 92(3) is capable of dealing with any resulting delay in the approval of revisions to the current Access Arrangements.

For the same reasons, this same transitional approach should apply to any other requirements to file revisions to an Access Arrangement, particularly in light of a trigger mechanism. Importantly, Access Arrangement revisions in response to a trigger mechanism must often be filed within tight deadlines. APA submits that a transitional Rule is required to provide that the filing deadline for any proposed revisions required pursuant to Rule 51 should be no earlier than three months following the completion of the regulator's cost of capital Guideline.

Merits review and reasons for decision

While not strictly part of this Rule Change, the AER's proposal, and the AEMC's draft Determination, has the consequential effect of removing access to merits review on cost of capital matters. This is because the regulator's issuance of a cost of capital Guideline would not be a "reviewable regulatory decision" under s71A of the *National Electricity Law* or s244 of the *National Gas Law*.

Rather, the scope for merits review of the regulator's conclusion on the cost of capital reflected in revisions to an Access Arrangement would hinge on the reasonableness of the regulator's decision to either depart or not depart from the Guideline.

In this regard, APA considers that it is critical that the regulator include fulsome reasons for its findings in the cost of capital Guideline. Only by addressing the regulator's reasons for its conclusions in the cost of capital Guideline can the service provider make it clear that there are sound reasons for departing (or not departing) from the Guideline in its particular circumstances.

APA would be pleased to discuss these comments, and its experience in the merits review process, in more detail with the Commission or the Secretariat. Please contact Scott Young on (02) 9275 0031 or scott.young@apa.com.au.

Yours faithfully

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