ATCO Gas Australia Pty Ltd
ACN 089 531 975
12-14 The Esplanade
Perth WA 6000
Locked Bag 2507
Perth BC WA 6849
p. 08 6218 1700
f. 08 6218 1703
w. www.atcogas.com.au

ATCO Gas AUSTRALIA

By email

Australian Energy Market Commission

RE: Project Reference Code GRC0011 – Proposed Changes to the Rate of Return for Gas Networks under the National Gas Rules

ATCO Gas Australia (**"ATCO"**) welcomes the opportunity to be part of the consultation process being undertaken by the Australian Energy Market Commission (**"AEMC"**) with respect to its proposed amendments (in response to rule change requests by the Australian Energy Regulator and Energy Rule Change Committee) in its draft rule determination[1] published on 23 August 2012.

We are pleased to submit our response to the issues raised in the draft rule determination insofar as they concern the determination of the rate of return under the National Gas Rules (**"NGR"**).

ATCO welcomes and strongly supports the AEMC's proposed changes to the NGR to clarify how proposed rule 87 should be implemented. ATCO agrees that rate of return determinations should be based squarely on the National Gas Objective and the Revenue and Pricing Principles, and not on a mechanical application of any particular model. ATCO agrees that the central requirement is to tailor the rate of return to the individual network service provider, and to the regulatory and commercial risks faced by that particular NSP in providing the relevant reference services.

The matters raised in the **enclosed** submission address some concerns we have with respect to the implementation of the above policy.

ATCO will make separate submissions on transitional matters.[2]

Should you have any questions, please feel to contact me on 08 6218 1718 or Deborah Evans on 08 6218 1722.

Yours sincerely

Brian R. Hahn
President
ATCO Gas Australia

4 October 2012

[1] AEMC 2012, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Draft Rule Determinations, 23 August 2012, Sydney
[2] Outlined in AEMC 2012, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Consultation Paper on Savings and Transitional Arrangements, 14 September 2012, Sydney

Attachment

Submission on AEMC's Draft Rule Change on Economic Regulation of Network Service Providers (NGR 87 Rule Change)

1. Executive Summary

ATCO welcomes and strongly supports the AEMC's proposed changes to the NGR to clarify how rule 87 should be implemented. ATCO agrees that rate of return determinations should be based squarely on the National Gas Objective (**"NGO"**) and the Revenue and Pricing Principles (**"RPPs"**), and not on a mechanical application of any particular model. ATCO agrees that the central requirement is to tailor the rate of return to the individual network service provider (**"NSP"**), and to the regulatory and commercial risks faced by that particular NSP in providing the relevant reference services.

Section 3 of this submission deals with the rate of return itself. ATCO submits that the allowed rate of return objective (**"ARORO"**) should be expressed as a mandatory requirement, not an "objective" which may be misinterpreted as merely an aspirational goal. The ARORO should also be more specific – it should refer to "regulatory and commercial" risks, and should link those risks to the specific reference services under consideration, as is done in s24(5) of the NGL.

The concept of the benchmark efficient entity can be useful but must not be misused. It should be clarified that the benchmark entity is a hypothetical construct, operating efficiently but facing the same (not similar) risks. Benchmarking should not be used to 'assume away' risks the NSP cannot control, or to incentivise the NSP in respect of such risks, because in both cases the NSP has no way of responding and the resulting rate of return is likely to be inappropriately low. Some things should not be benchmarked, including credit ratings and whether funds are sourced nationally or internationally. Benchmarking should not be used to ignore market realities.

ATCO does not support the rules mandating an inflexible use of the post-tax nominal approach. While that approach may be appropriate for many NSPs, and may avoid some problems in poorly-implemented pre-tax models, the NGO and RPPs require the rules to leave room for flexibility if the circumstances justify it.

The proposed rule dealing with the use of multiple sources and models needs to be strengthened, to expressly require regulators to consider more than one model, to consider the weaknesses of each model used, and to give reasons for how models are used and weighted. The AEMC's reference to "consistency" needs to be clarified to mean only internal consistency within a given access arrangement and access arrangement period.

ATCO has concerns about the "have regard to" factors for return on debt set out in proposed rule 87(8), and has suggested several specific refinements.

Section 4 comments on the use of guidelines. Although these can bring definite benefits, they also create a number of risks. Foremost among these is the risk that the regulator may err when setting the guidelines, and that the presumptive force given to the guidelines may make it hard for an NSP to later challenge the erroneous guideline. Second is the risk that the guideline process may result in an entrenching of regulators' positions, which would be contrary to the AEMC's emphasis on flexibility in order to ensure that the rate of return is optimised for a given (efficient) NSP.

Schedule 2 to this submission sets out ATCO's suggested amendments to the proposed new rule, based on the comments in this submission.

2. Preliminary

2.1 Background

ATCO owns and operates the Mid West and South West Gas Distribution System which is a covered pipeline located in Western Australia, serving an area from Geraldton to Busselton (including the greater Perth metropolitan area) together with two separate non-covered gas distribution systems in the regional centres of Kalgoorlie and Albany.

2.2 Suggested amendments to proposed rule 87

Schedule 2 to this submission sets out ATCO's suggested amendments to the proposed new rule.

3. Detailed submissions on the rate of return

3.1 The allowed rate of return objective ("ARORO")

(a) ATCO supports flexibility and emphasis on NGO and RPPs

The NGO and RPPs are paramount. ATCO agrees that regulators must take a flexible approach to rate of return regulation if the NGO and RPPs are to be achieved. The NGR should make it clear that a mechanical application of a given model or methodology is unlikely to achieve the NGO or comply with the RPPs.

The NGO and RPPs direct the regulator to look at the specific risks of an individual NSP. ATCO welcomes the AEMC's clarification that the rate of return process should be flexible in the sense of being tailored to (an efficient analogue of)[3] the individual NSP and its particular circumstances. ATCO returns to this point below, because it is concerned that further clarification

[3] In this submission, ATCO uses the expression "efficient analogue of" an individual NSP to acknowledge that neither the NGO, RPPs nor the ARORO require the rate of return to compensate the individual NSP for its own inefficiencies.

might be needed to ensure that regulators and the Australian Competition Tribunal (**"ACT"**) are indeed directed onto a new path.

(b) Relationship between ARORO and the NGO and RPPs

The ARORO should be expressed as a mandatory requirement, and not a mere "objective" which arguably could be disregarded. The ARORO as currently expressed could be read simply as aspirational, such that a determination by the regulator could be lawful even if it did not meet the ARORO (for example on the grounds that a departure from the ARORO would be a better way of protecting the long term interests of consumers). ATCO submits that this is not the outcome the AEMC is or should be seeking to achieve. Rather, the ARORO is an essential step in achieving the NGO and RPPs, and as such regulators should be required to ensure that the ARORO is met. This approach would be consistent with the language in current NGR 87(1).

The ARORO should specifically refer to regulatory and commercial risks. The current drafting of the proposed rule does not indicate what form of "risk" should be considered. As with s24(5) of the NGL, the proposed rule should expressly state that these are "regulatory and commercial risks".

The ARORO should also be specifically linked to the particular reference services. Like the RPPs, the ARORO should be expressly linked to the NSP's particular circumstances. The best way of doing this would be to replicate the language of s24(5) of the NGL, by saying that the relevant risks are those involved in providing *the* reference services (ie. the reference services to which the relevant tariffs relate).

(c) The "benchmark efficient entity"

Overview: ATCO recognises that the concept of the "benchmark efficient entity" may be useful. Industry standards or benchmarks are important in incentive regulation schemes. However, ATCO has concerns about how benchmarking has been used in practice.

Incentivisation (whether through benchmarking or the rate of return generally) should target only matters within the NSP's control. It is appropriate that the collective effect of the ARORO and the benchmarking process incentivises the NSP to maximise efficiency. However the NGO and RPPs require that this incentivisation occurs within careful limits, which should be set by reference to matters that the NSP can control or manage. To impose a lower rate of return in order to "incentivise" the NSP to an outcome which is impossible in the particular circumstances of that NSP's business, is to de facto impose under-recovery of costs. This may bring a short term benefit for consumers, but is in breach of the NGO and the RPPs.

The proposed rule should expressly state that the benchmark efficient entity is a *hypothetical* construct. This does not necessarily follow from the word "benchmark" itself. It is difficult or impossible to find suitable real-world entities to use as benchmarks. As a result, there is a risk that a regulator may feel it necessary to compromise by choosing an entity with different regulatory and commercial risks from the NSP in question.

The word "similar" is an inappropriate dilution and should be avoided. The proposed ARORO requires the benchmark efficient entity to be formulated with "similar" risks to the NSP. This is a departure from the NGO and RPPs, which require the rate of return to consider the particular risks faced by (an efficient analogue of) the NSP in question, not some other NSP which faces "similar" but different, and possibly lower, risks.

Benchmarking should not diverge from the ARORO's focus on the regulatory and commercial risks facing the particular NSP in relation to the particular reference service, as required by the NGO and RPPs. The following paragraphs illustrate how benchmarking can diverge from this goal, and hence from the NGO and RPPs, which helps explain why ATCO believes that proposed rule 87(2) needs to be modified in the manner described in section 3.1(b) above:

- **The benchmarking process should not be used to ignore or 'assume away' risks.** ATCO agrees that the NSP should be given incentives to seek efficient financing. However, the search for efficiency and incentivisation should not result in an artificially low rate of return for the NSP, by benchmarking risks inappropriately, or by choosing a lower-risk entity as a benchmark.

- **The benchmarking process should not treat unlike businesses as though they are alike.** Not all regulated monopolies are the same. For example an NSP cannot choose the industries or sectors in which its users, or its users' customers, operate. Beyond ensuring that its contracting is in accordance with industry best practice, there are many commercial risks it cannot control by its long term sales contracts. The commercial risks faced by a gas transmission NSP will be quite different to those facing a gas distribution NSP which transports gas mainly to retailers supplying smaller commercial and residential end-users. The NGO and RPPs require the regulator to take these differences into account, and the benchmarking process must not hinder that outcome.

- **In general, credit ratings should not be benchmarked.** A specific example is the Australian regulatory practice of benchmarking an NSP's credit rating. Except in the particular and unusual instance where a credit rating is shown to be affected by the NSP's inefficiency, neither the NGO nor the RPPs are served by the regulator setting a rate of return by reference to a credit rating other than that which actually applies to the NSP concerned.

- **The benchmarking process should not be used to ignore market realities.** Benchmarking may be appropriate to ensure that the rate of return does not include a premium because an NSP is inefficient in its operations. Benchmarking may also assist to establish operating efficiency when efficiency is in doubt, or in setting the level of gearing. Beyond these benchmarking's role is likely limited. (For example, regulators have argued[4] that a benchmark efficient service provider will raise the funds it requires in the Australian capital market. Depending on the circumstances, this may be entirely unrealistic for

[4] eg. Application by DBNGP (WA) Transmission Pty Ltd (No 3) [2012] ACompT 14

those NSPs with larger asset bases, given the limited market capacity and lender preferences for risk exposures in particular sectors. The NGO and RPPs require that if, a particular NSP is compelled by the size of its capital needs to seek funds overseas, the benchmarking process should not ignore that reality.)

Summary – only benchmark things which can meaningfully be benchmarked, such as gearing. The benchmarking process can, if taken too far, 'assume away' risks that are required by the NGL to be included in the rate of return for the particular NSP and the particular reference service.

3.2 The overarching requirements for setting the rate of return – proposed rules 87(3) and (4)

(a) The nominal post-tax approach- proposed rule 87(3)(b)

Flexibility is important. As stated above, ATCO supports the AEMC's emphasis on flexibility, recognising the individual circumstances of the NSP, and giving primacy to the NGO, RPPs and the ARORO, in order to achieve rate of return outcomes that are tailored to the individual risks and circumstances of (an efficient analogue of) the NSP. The AEMC has stated correctly that seeking these tailored outcomes is more important than simplicity and certainty.[5]

Mandating a nominal post-tax methodology is inconsistent with a flexible approach. Contrary to this emphasis on flexibility, the AEMC proposes in rule 87(3)(b) to prescriptively mandate a nominal post-tax methodology. ATCO does not support this approach.

Convergence, streamlining and predictability are secondary objectives at best. The AEMC proposes to prescribe a post-tax nominal approach in order to seek convergence,[6] streamlining and predictability.[7] These goals have value, but none is expressly required by the NGO or the RPPs, and so they cannot be placed above the need for flexibility, as the AEMC has made clear elsewhere in the Draft Determination. Not all NSPs are the same or experience the same circumstances. Moreover an NSP's circumstances can change over time, as can market conditions.

Common use does not require a narrow, prescriptive approach. The AEMC has noted that nominal post-tax is already widely used for TNSPs and DNSPs. This may be a good thing for those NSPs and it may be quite appropriate for that to continue. However, the fact that this outcome has been, and perhaps even should continue to be, used for one group of NSPs under the NEL does not in any way require that the NGR should prescriptively exclude all other options. To do so seems quite inconsistent with the AEMC's own reading of the NGO and RPPs.

Nor does the risk of overcompensation in the pre-tax methodology require a narrow, prescriptive approach. It is true that the pre-tax model, if implemented incorrectly, can overcompensate an NSP. However, this too

[5] Draft Determination p. 55 and elsewhere
[6] Draft Determination p. 53
[7] Draft Determination p. 54

does not mean that the NGR must inflexibly prohibit the pre-tax approach. As with other elements of the rate of return process, the proposed rule should leave it to the NSP and the regulator to settle on the best methodology, consistent with the NGL and NGR. If that can include a suitably-corrected pre-tax model, the NGR should permit it.

A more flexible approach is appropriate. ATCO submits that proposed rule 87 should be amended to allow a more flexible approach, subject to the NGO and RPPs. Indeed, ATCO submits that the proposed rule should expressly leave it entirely to the regulator and NSP to choose between pre- and post-tax, between nominal and real, and between the various approaches which can be taken within each of these categories.

Treatment of imputation credits. If ATCO's submission is accepted, and the rules remain flexible as to the choice of pre-tax versus post-tax, then proposed rule 87(3)(b) (insofar as it refers to rule 87A) and proposed rule 87A should be deleted. Alternatively, if retained, they should be limited to apply only when a post-tax model is adopted.

(b) The multiple sources approach - proposed rule 87(3)(c)

Overview: This is a critical rule, going to the heart of the WA Economic Regulation Authority (**"ERA"**)'s and ACT's previous approach in applying former rule 87, in which they mechanistically applied the Sharpe-Lintner CAPM under rule 87(2) rather than giving emphasis to the policy aspirations in rule 87(1). For this reason ATCO submits that the proposed new rule requires special attention and emphasis, and that proposed rule 87(3)(c) is not expressed strongly enough in several respects.

Proposed rule 87(3)(c) should expressly apply to both return on equity and return on debt. ATCO submits that proposed rule 87(3)(c) should be expressly referenced in each of proposed rules 87(5) and 87(6).

The proposed rule should expressly direct regulators to use more than one model. ATCO agrees with the AEMC that no one single model should be used. Presumably the use of the plural in the words "methods" and "models" in proposed rule 87(3)(c) is intended to encourage this result. However, this requirement deserves express emphasis.

The proposed rule should expressly direct regulators to consider the limitations of any models or methods used. One of the problems in regulators' historical approaches to this area is that they have been unwilling to adjust the regulated rate of return in order to correct for the limitations of the models being used. This has resulted in allowed rates of return which are inconsistent with the NGO or RPPs. The fact that proposed rule 87 no longer requires models to be "well accepted" should significantly mitigate this problem. However, ATCO submits that the proposed rule should go further and expressly require regulators to consider, and adjust for, the limitations of any models used.

The proposed rule should expressly direct regulators to state their reasons for selecting and preferring any model. This should include reasons for choosing any weights to be applied to models' outputs.

Setting a rate of return is a two stage process. The proper outcome from proposed rule 87 should be that the output of any model, or even the collective output of several models, is only the first step in setting the rate of return. The NGO and RPPs require the regulator to apply independent discretionary judgment to these outputs, in order to ensure that the NSP is allowed a return commensurate with the regulatory and commercial risks involved in providing the relevant reference services. In light of past regulatory and ACT decisions, ATCO believes that this two-stage process should be made express.

[Drafting point] The word "relevant", if necessary, is ambiguous. As a matter of grammar, it's not clear in proposed rule 87(3)(c) whether the word "relevant" qualifies only "estimation methods", or whether it also qualifies "financial models", "market data" and "other evidence". As a matter of administrative law, the regulator is in any event not permitted to consider irrelevant considerations, and is required to consider relevant considerations, so from one perspective it is unclear what the word "relevant" adds.

(c) Consistency - proposed rule 87(4)(a)

The word "consistent" could be misconstrued. Based on the AEMC's Draft Determination [8], the word appears intended to mean *internally* consistent, but even this concept needs clarification. ATCO understands the AEMC to mean internal consistency within a given NSP's access arrangement for a given access arrangement period. If so, ATCO supports this objective. It makes sense, for example, for a risk free rate used in setting the return on equity to be consistent with the risk free rate used in setting the return on debt. However, there are ways in which the word "consistent" might be open to misinterpretation:

- The word could be misconstrued as calling for consistency from one access arrangement period to the next. While some degree of predictability and stability is clearly desirable, placing too much emphasis on this type of consistency could lead regulators to a rigid outcome, or to overlook changed circumstances, or to reject regulatory innovations.

- The word could be misconstrued as calling for consistency with the outcomes determined for other NSPs, or across gas and electricity. Although consistency in approach and methodology may be desirable, the NGO and RPPs call for an individualistic assessment of each NSP's circumstances. The comments made above about the need to use benchmarking carefully, apply equally here to any consistency requirement.

- Finally, the word could be misconstrued as calling for consistency in rate of return outcomes before and after rule 87 is changed. Clearly, this could frustrate the rule change objectives.

To address these concerns, ATCO submits that the proposed rule should expressly state that the consistency sought is internal consistency within a given NSP's access arrangement for a given access arrangement period, and

[8] Draft Determination pp 46 and 57

that the goal of consistency must not detract from the NGO, RPPs or the ARORO.

Clarifying a statement in the Draft Determination. In this context, ATCO notes that the AEMC's Draft Determination states at p. 44:

> *"While achieving the best possible estimate of the rate of return is the primary requirement of the framework for achieving the NEO and the NGO, achieving a degree of regulatory certainty is an important secondary objective."*

ATCO is concerned that this statement opens the door for the word "consistency" to be misconstrued in the ways just described. ATCO suggests that in the Final Determination the AEMC could clarify this statement to read:

> *"Regulatory certainty is valuable and definitely a secondary objective, but getting the best possible estimate is paramount."*

(d) Interrelationships - proposed rule 87(4)(b)

ATCO supports this proposed rule. See comment in next paragraph.

3.3 Setting the return on equity – proposed rule 87(5)

"Market for equity funds" should be broadened to "financial markets". ATCO considers that once interrelationships are taken into account as required by proposed rule 87(4)(b), the assessment in proposed rule 87(5)(b) will need to expand from "the market for equity funds" to "financial markets" recognising that capital moves freely between debt and equity markets.

3.4 Setting the return on debt – proposed rules 87(6) to (9)

(a) General comments on proposed rules 87(6) to (9)

The proposed rules for return on debt should oblige the regulator to avoid asymmetric regulatory risk. Rate of return regulation incentivises NSPs to source debt efficiently, but in practice it exposes an NSP to asymmetric regulatory risk. Regulators are able to *reduce* the rate of return to capture for consumers the benefits of an NSP's lower-than-benchmark cost of debt. However, regulators are generally reluctant in practice to *increase* the rate of return above so-called "benchmark" levels in order to reflect any above-benchmark cost of debt for an NSP, even if the NSP is being as efficient as possible in its particular circumstances. This asymmetry disincentivises the NSP from seeking debt funding efficiencies, and also can lead to a rate of return being set which does not fairly reflect the NSP's actual efficient cost of debt. ATCO submits that the proposed rule should expressly caution regulators to consider, and avoid, this asymmetric risk.

(b) Drafting of proposed rule 87(8)

Proposed rule 87(8) seems either too broad or is unnecessary, and could be misconstrued. ATCO's concerns are as follows:

- **Proposed rule 87(8)(a) creates asymmetric regulatory risk.** The ARORO requires that the rate of return be set by reference to a benchmark efficient entity. However proposed rule 87(8)(a) appears to call for this assessment to then be adjusted by reference to the NSP's actual cost of debt. In theory this could work either for or against the NSP. In practice it presents the NSP with an asymmetric regulatory risk as discussed in the preceding section.

- **Proposed rule 87(8)(b) is broader than the NGO and RPPs.** This mandatory "have regard to" rule could be misconstrued in a way that imposes an arbitrary reduction in return on debt, regardless of the NSP's actual efficient cost of debt, in order to provide a short-term benefit to consumers in the form of lower tariffs. Proposed rule 87(8)(b) as drafted does not contain the limitations expressed in the NGO, that the consumer's interests be assessed in the long term, and be assessed not only against price, but also against quality, safety, reliability and security of supply.

- **Proposed rule 87(8)(c) is unclear.** ATCO submits that the proposed rule is intended to refer to inefficient incentives created by the return on debt mechanism, such that the inefficient delaying or bringing forward of capital expenditure are the consequences, not the incentives.

- **Proposed rule 87(8)(d) is potentially too broad.** This proposed subrule could be misconstrued, if it were read as suggesting that stability must be maintained between access arrangement periods even if there are good grounds under the NGO, RPPs and ARORO to change the return on debt mechanism, eg. to reflect changed circumstances. A rule such as this potentially places too much emphasis on consistency, stability, precedent and predictability, and not enough emphasis on ensuring that the NSP is given an opportunity to earn a suitable rate of return in accordance with the NGO and RPPs.

- **Proposed rule 87(8) has the potential to conflict with the ARORO**. It may even be held to prevail on the basis that it is a specific rule which should prevail over the general provision in proposed rule 87(2).

To remedy the above problems:

- **Make it clear that proposed rules 87(8)(a), (c) and (d) are subject to the NGO, RPPs and ARORO.** ATCO considers that (subject to the general comments below) these three paragraphs appear directed to appropriate matters in accordance with the NGL, and could be retained if clarified along the lines suggested.

- **Delete proposed rule 87(8)(b)**. For the reasons given, ATCO submits that proposed rule 87(8)(b) should be deleted because it is

too open to misinterpretation and hence to the imposition of inappropriately low rates of return, and also because it is already incorporated into the NGO.

Why does proposed rule 87(8)(b) refer to return on equity? It is unclear what this proposed rule is intending to achieve. ATCO accepts that there can be interrelationships between return on debt and return on equity, but the proposed rule is not clear on how these interrelationships are to be addressed, or what it adds to proposed rule 87(4)(b). If the rule is not deleted as ATCO has suggested, its purpose needs to be clarified.

Why no equivalent for return on equity? ATCO has submitted above that proposed rule 87(8) needs to be re-examined and possibly removed. It is also unclear why this proposed rule is necessary for return on debt, but there is no equivalent for return on equity. Might this lead to asymmetries in how the rate of return is calculated, and how the ARORO is applied to return on debt versus return on equity? The rules should make it clear that the inclusion of proposed rule 87(8) in return on debt does not preclude equivalent issues from being considered in relation to the return on equity (subject always to the primacy of the NGO, RPPs and ARORO).

The list in proposed rule 87(8) must not be closed. ATCO submits that the proposed rule should expressly state that other factors may be considered.

4. The use of guidelines

(a) ATCO supports the concept of guidelines

Flexibility is paramount to achieve the NGO and RPPs. As stated above ATCO supports the AEMC's emphasis on flexibility.

Subject to the NGO and RPPs, it is appropriate for the rate of return regime to pursue other objectives. The AEMC has expressed other goals as well: certainty, transparency, and saving consumers from having to participate in every access reset. These additional goals are not expressly legislated in the NGO and RPPs and so must be regarded as secondary. ATCO does not oppose these secondary goals provided that they are clearly made subordinate to the statutory NGO and RPPs. The currently-proposed guideline mechanism risks outcomes that are not consistent with the NGL.

(b) The guideline mechanism has problems

The rules need to deal with the possibility of regulatory error during the guideline-setting process. For example, what if a proposed guideline is inconsistent with the NGL? This is a major concern for ATCO.

The rules should not entrench regulatory inertia. There are clearly efficiency benefits to be gained by following regulatory precedent, but this should not displace a thorough assessment of the NSP's individual position as required by the NGO and RPPs. ATCO is concerned that the guideline mechanism may undermine the need for flexibility in three ways:

- First, when setting guidelines, regulators will by definition be removed from NSPs' individual circumstances, and so will of necessity be more likely to adopt purely theoretical positions (for example adopting benchmarking criteria that, when applied to an NSP, are insufficiently flexible to reflect the NSP's particular circumstances).

- Second, in attempting to develop a one-size-fits-all guideline, regulators may find it difficult not to simply recycle previous regulatory precedents, for example in relation to the use of CAPM.

- Third, proposed rule 87(16) expressly encourages inertia, by apparently requiring some additional level of justification for the regulator to move away from the guidelines. This is clearly the AEMC's intention,[9] but ATCO submits that a scheme which says guidelines should be followed unless there is evidence to depart from them, would only be justified if the AEMC is confident that the guidelines will not contain errors or otherwise inappropriately limit the regime's flexibility.

There is insufficient clarity on what should or should not be included in the guidelines. In addition to the risk of a guideline not being consistent with the NGO, RPPs and ARORO[10], there is also a risk that a guideline might seek inappropriately to constrain the flexibility of subsequent access arrangement reviews, for example by prescribing the type of evidence that must be put forward to justify a departure. The difficulty here is that neither the AEMC nor the proposed rules give any indication of what sort of things should and should not be included as guidelines. To illustrate this with rather extreme examples, it is not clear whether or not the following guidelines would be permitted:

- *"Vanilla CAPM is to be used unless the NSP can demonstrate convincingly that an alternative model is well accepted."*

- "*The outputs of models are to be weighted, with a 99% weighting for vanilla CAPM and a 1% weighting for all other models*".

- Or even *"A benchmark efficient entity will be assumed to have an equity beta of 0.3%."*

ATCO would hope that no regulator would seek to include such guidelines. The examples are given to illustrate the fact that there's nothing in the proposed rule to indicate that such guidelines would be inappropriate. ATCO submits they clearly are inappropriate, because otherwise much of the AEMC's work in amending rule 87 might be undone. ATCO therefore submits that the proposed rules need to provide *binding* guidance to regulators in this area.

The guideline review process is underdeveloped. There does not seem to be a mechanism for any person other than the regulator to propose

[9] For example Draft Determination p. 53 states "service providers would need to explain … why they are proposing a different approach to the regulator's guidelines …. This would not, of course, limit a service provider's ability to submit that there was a change in evidence or circumstances that required a variation …".
[10] ATCO submits in section 3.1(b) above that the ARORO should be a mandatory requirement rather than an objective.

amendments. There is no minimum period for review of the guidelines – in theory a regulator could revise the guidelines sufficiently frequently to ensure that they were updated before each NSP's access arrangement revisions were lodged.

Timing in WA. How will proposed subrule (14)(b) be adapted for the ERA in WA?

(c) The guidelines may be non-mandatory, but they clearly have presumptive force

Stating that the guidelines are not mandatory does not render them harmless. Clearly the guidelines are intended to have some force.[11] This is implied by proposed rule 87(16), when it requires the AER to give reasons for departing from the guidelines. Even without this requirement, the very fact that the rules include the guidelines mechanism would imply that the guidelines, binding or not, were intended to shape the regulatory playing field.

It is not completely clear that the guidelines are open to question on a merits review. Does the AEMC intend that an access arrangement decision which implements, or is influenced by, a guideline, can be challenged on grounds which include an assertion that the guideline itself was erroneous (ie. was inconsistent with the NGL, including NGO, RPPs or ARORO)? ATCO submits that this must be the case, because otherwise the guidelines could inadvertently become a way of entrenching non-reviewable errors. However, without clear statements from the AEMC on this subject, and clear provisions in the NGR, ATCO is concerned that a regulatory decision which relied on an erroneous guideline may be difficult to impeach under s246(1)(a) to (d) of the NGL.

(d) Possible solutions to these problems

These are important problems. ATCO urges the AEMC to give these issues serious attention, because if the guidelines are implemented poorly, much of the policy intention of the proposed rule 87 changes may be lost. However, there are a number of possible solutions.

Merits review of the guidelines, during access arrangement revision.[12] For the reasons discussed in the preceding section, if an access arrangement decision implements, or is influenced by, a guideline, there should be no doubt that the decision can be challenged on grounds which include an assertion that the guideline was incorrect or inconsistent with the NGL including the NGO, RPPs or ARORO. The proposed rules should not be silent on this. There are however some practical difficulties.

[11] The AEMC has stated that "the appeal body [is] to have significant regard to [the guidelines] as a starting point": Draft Determination, p. 59. See also the passage quoted at footnote 9 above.

[12] ATCO does not propose that the guideline-making process itself should be reviewable by the ACT. Although this would be one way of protecting against both regulatory error and excessive inertia, it would not be an attractive option. Any such review would likely become very cumbersome and expensive if all interested parties sought to be joined. Also, it would be hard for the ACT to make a determination given that, at that stage, the question would be an abstract one without reference to any specific NSP's circumstances. Putting this another way, the easiest time to show that the guidelines err, will be when they are applied to a particular NSP's circumstances and produce a result inconsistent with the NGL or NGR (including the NGO, RPPs and ARORO).

- First, the proposed rules cannot modify the NGL provisions dealing with merits review. The solution to this is to structure the amendments to rule 87 to ensure that a regulatory decision based on the guidelines is reviewable, if the guidelines do not comply with the NGO, RPPs or ARORO. ATCO suggests wording in Schedule 2 which could achieve this.

- Second, it may be necessary to modify the proposed rules to limit other NSPs' ability to intervene, or to deal equitably with costs should they do so.

Reasons should be required for *following* the guidelines. ATCO submits that if the NSP has proposed a *departure* from the guidelines, the proposed rules should expressly require the regulator to state its reasons for *following* the guidelines.

Alternatively, AEMC should consider limiting the regulator's discretion if NSP proposes a departure from the guidelines. One solution to the risk of excessive regulatory inertia would be to limit the regulator's discretion under rule 40, if the NSP makes a credible case (based on the NGO, RPPs and ARORO) for departing from the guidelines. The guidelines would still play a very important role in establishing a common starting point and providing a common framework within which to analyse differences between NSPs' access arrangements.

Perhaps the guidelines should be limited only to matters of process. This may mitigate some of the identified risks.

(e) Conclusion – The guidelines should be step 1 in a two step process

The proposed rules should expressly emphasise the two-step process. The ATCO and DBP appeals contended that current rule 87 called for a two-step process. The first step was the arithmetical procedures in rule 87(2), but there then should be a second step in which the regulator exercised a broad discretion, informed by the NGO and RPPs, to consider whether the output from step 1 was appropriate to the particular NSP. It would be ironic if the proposed rule changes, having endorsed this interpretation, then undermined it by creating an environment in which regulators became entrenched in the guidelines (step 1) and refused or felt unable to make the overall discretionary evaluation taking into account the NSP's particular circumstances, the NGO, the RPPs and the ARORO (step 2). This is a real risk, and therefore the proposed rules should expressly state that the rate of return process involves two steps of which the first is a consideration of the guidelines and their merits, and the second is a broad discretionary assessment of the rate of return against the NGO, RPPs and ARORO. Merely saying that the guidelines are non-binding is not sufficient to ensure that the regulators take this second step.

5. Typographical etc comments

ATCO notes the following minor typographical issues:

Rule 87(3)(a): The words *"… an efficiently financed by a benchmark efficient entity…"* should read:

> *"by an efficiently financed benchmark efficient entity"*

Rule 87(6)(b)(ii): ATCO believes that a bracket should be inserted after "period" in the second line and that the reference to subparagraph (i) should be a reference to subrule (9): Subrule 87(6)(b)(ii) should thus read:

> *"the return on debt for a regulatory year (other than the first regulatory year in the access arrangement period) is estimated using a methodology which complies with subrule (9)".*

Rule 87(7)(b): The words "when the" are repeated.

Rule 87(8)(c): ATCO queries whether the word "of" should be replaced with "on" so that it reads:

> *"the incentive effects on inefficiently delaying or bringing forward capital expenditure; and"*

Rule 87(9): The reference to subrule (6)(2)(ii) should be a reference to subrule (6)(b)(ii).

Schedule 1

Glossary/Abbreviations

ACT	Australian Competition Tribunal
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
ARORO	Allowed Rate of Return Objective
ATCO	ATCO Gas Australia Pty Ltd
CAPM	Capital Asset Pricing Model
DBP	Dampier to Bunbury Pipeline Pty Ltd
DNSP	Distribution Network Service Provider
ERA	Economic Regulation Authority
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
NSP	Network Service Provider
RPP's	Revenue and Pricing Principles
Regulator	See ERA and AER
TNSP	Transmission Network Service Provider

Schedule 2

ATCO's suggested amendments to proposed rule 87

[5] Rule 87 Rate of return

Omit rule 87 and substitute:

(1) The return on the projected capital base for each regulatory year of the *access arrangement period* is to be calculated by applying a rate of return that is determined in accordance with this rule 87 (the *allowed rate of return*).

(2) The *allowed rate of return* ~~is to~~must[13] correspond to the efficient financing costs of a hypothetical[14] benchmark efficient entity with ~~a similar~~ the same[15] nature and degree of regulatory and commercial[16] risk as that which applies to the service provider in respect of the provision of the[17] reference services ~~*(the allowed rate of return objective)*~~[18].

(3) The *allowed rate of return* for a regulatory year: ~~is to be determined:~~[19]

(a) is to be determined[20] as a weighted average of the return on equity for the *access arrangement period* (as estimated under subrule (5)) and the return on debt for that regulatory year (as estimated under subrule (6)) where the weights applied to compute the average reflect the relative proportions of equity and debt finance that would be employed by an efficiently financed ~~by a~~[21] hypothetical[22] benchmark efficient entity with ~~a similar~~ the same[23] nature and degree of regulatory and commercial[24] risk as that which applies to the service provider in respect of the provision of the[25] reference services;

(aa) subject to subclauses (2) and (3A), and to the *national gas objective* and the *revenue and pricing principles* — may be determined on either a nominal or real basis, and on either a pre-tax or post-tax basis, and using any methodology within each of those permutations;[26] and

[13] See section 3.1(b) above. Converting the ARORO from an objective to a mandatory requirement.
[14] See section 3.1(c) above. "Benchmark" does not necessarily connote hypothetical, but that's what's needed here.
[15] See section 3.1(c) above. "similar" risks is not the test in the RPPs.
[16] See section 3.1(b) above. Linking to the RPP in s24(5) NGL.
[17] See section 3.1(b) above. Linking to the specific references services as per the RPP in s24(5) NGL.
[18] See section 3.1(b) above. Converting the ARORO from an objective to a mandatory requirement.
[19] Consequential upon inserting new (aA) below.
[20] Consequential upon inserting new (aA) above.
[21] Typo
[22] See section 3.1(c) above. As per footnote 14.
[23] See section 3.1(c) above. "similar" risks is not the test in the RPPs.
[24] See section 3.1(b) above. Linking to the RPP in s24(5) NGL.
[25] See section 3.1(b) above. Linking to the specific references services as per the RPP in s24(5) NGL.
[26] See section 3.2(a) above. The rules should not prescribe only a nominal post-tax approach.

(b) ~~on a nominal post-tax basis that is consistent with the estimate of the value of imputation credits referred to in rule 87A~~[27]; and

(3A) The return on equity and the return on debt are each to be determined:[28]

(~~c~~a) taking into account [relevant] estimation methods, [relevant] financial models, [relevant] market data and other [relevant] evidence;~~.~~[29] and

(b) recognising that no single method or model is likely to achieve the outcome required by subrule (2);[30] and

(c) having regard to, and adjusting for, the limitations of any method or model [or data or evidence] used,[31] and expressly stating the reasons for using it;[32] and

(d) if the results of more than one method or model are to be weighted, expressly stating the basis for selecting the weights used;[33] and

(e) without disregarding any regulatory or commercial risk faced by the service provider acting efficiently in providing the reference services;[34] and

(f) having regard to the possibility that asymmetric regulatory risk may produce an incorrectly low *approved rate of return*.[35]

(4) In determining the *allowed rate of return*, regard is to be had to:

(a) the desirability of using an approach that leads to ~~the~~ an internally consistent application (within the *access arrangement* and for the *access arrangement period*)[36] of any estimates of financial parameters that are relevant to the estimates of, and that are common to, the return on equity and the return on debt; and

(b) any interrelationships between estimates of financial parameters that are relevant to the estimates of the return on equity and the return on debt.

(4A) Determining the *allowed rate of return* must be undertaken as a two stage process, as follows:

(a) first, considering the *rate of return guidelines*, and any method or model referred to in subclause (3A); and

(b) second, weighing the result against subclauses (2) and (3A) and the *national gas objective*, and making any necessary

[27] See section 3.2(a) above. Alternatively, if this provision and proposed rule 87A are not deleted, this provision should be reworded to read "if it is to be determined on a post-tax basis, is to be determined on a basis that is consistent with the estimate of the value of imputation credits referred to in rule 87A".
[28] See section 3.2(b) above. Emphasising [what was] proposed rule 87(3)(c).
[29] See section 3.2(b) above. Clarifying or deleting the word "relevant".
[30] See section 3.2(b) above. Compelling regulators to use more than one model.
[31] See section 3.2(b) above. Compelling regulators to consider the deficiencies of any models etc used.
[32] See section 3.2(b) above. Compelling regulators to articulate their reasons for selecting any models etc used.
[33] See section 3.2(b) above.
[34] See section 3.1(c) above. Making sure risks do not get 'assumed away' by the benchmarking process. Recognising that each NSP is different.
[35] See section 3.4(a) above.
[36] See section 3.2(c) above. Ensuring the word "consistent" is not misconstrued.

adjustments in order to achieve the best possible estimate for the *allowed rate of return*.[37]

Return on equity

(5) The return on equity for an *access arrangement period* is to be estimated:

(a) in a way that ~~is consistent~~complies[38] with ~~the allowed rate of return objective~~ subrules (2)[39] and (3A)[40]; and

(b) taking into account the prevailing conditions in ~~the market for equity funds~~financial markets[41].

Return on debt

(6) The return on debt for a regulatory year is to be estimated:

(a) in a way that ~~is consistent~~complies[42] with ~~the allowed rate of return objective~~subrules (2)[43] and (3A)[44]; and~~;~~

(b) using a methodology under which:

(i) the return on debt for each regulatory year in the *access arrangement period* is the same; or

(ii) the return on debt for a regulatory year (other than the first regulatory year in the *access arrangement period*) is estimated using a methodology which complies with ~~subparagraph (i)~~subrule (9).[45]

(7) Subject to subrule (6), the methodology adopted to estimate the return on debt may, without limitation, be designed to result in the return on debt reflecting:

(a) the return that would be required by debt investors in a hypothetical[46] benchmark efficient entity if it raised debt at the time or shortly before the time when the AER's decision on the access arrangement for that access arrangement period is made;

(b) the average return that would have been required by debt investors in a hypothetical[47] benchmark efficient entity if it raised debt over an historical period prior to the time when the ~~when the~~ [48]AER's decision on the access arrangement for that access arrangement period is made; or

(c) some combination of the returns referred to in subparagraphs (a) and (b).

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[37] See section 3.2(b) above. Confirming that it is a 2 step process.
[38] See section 3.1(b) above. Converting the ARORO from an objective to a mandatory requirement.
[39] See section 3.1(b) above. Converting the ARORO from an objective to a mandatory requirement.
[40] See section 3.2(b) above. Emphasising [what was] proposed rule 87(3)(c), and making it apply specifically to subrule (5).
[41] See section 3.3 above.
[42] See section 3.1(b) above. Converting the ARORO from an objective to a mandatory requirement.
[43] See section 3.1(b) above. Converting the ARORO from an objective to a mandatory requirement.
[44] See section 3.2(b) above. Emphasising [what was] proposed rule 87(3)(c), and making it apply specifically to subrule (6).
[45] Typo
[46] See section 3.1(c) above. As per footnote 14.
[47] See section 3.1(c) above. As per footnote 14.
[48] Typo

(8) In determining whether the return on debt for a regulatory year is estimated in a way that ~~is consistent~~complies[49] with ~~the allowed rate of return objective~~ subrules (2)[50] and (3A), and without limiting the factors to which regard may be had,[51] regard must be had to the following factors:

(a) the likelihood of any significant differences between the costs of servicing debt of a hypothetical[52] benchmark efficient entity referred to in subrule (3)(a) and the return on debt over the access arrangement period;

(b) ~~the impact on gas consumers, including due to any impact on the return on equity of a benchmark efficient entity referred to in subrule (3)(a);~~[53]

(c) the incentive effects ~~of~~ on[54] inefficiently delaying or bringing forward capital expenditure; and

(d) the impact of changing the methodology for estimating the return on debt across access arrangement periods,

but nothing in this subrule (8) may result in an *allowed rate of return* which is not consistent with the *national gas objective*, the *revenue and pricing principles* and subrules (2) and (3A).[55] ~~.~~

(8A) Nothing in subrule (8) limits the matters which may be taken into account in determining the return on equity.[56]

(9) A methodology referred to in subrule (6)(~~2~~b)(ii)[57] must provide for any change in total revenue for the regulatory year that would result from a change to the allowed rate of return for that regulatory year, as a result of the return on debt for that regulatory year being different from that estimated under subrule (6), to be effected through the automatic application of a formula that is specified in the access arrangement.

Rate of return guidelines

(10) The AER must, in accordance with the *rate of return consultative procedure*, make guidelines (the *rate of return guidelines*), except that the first *rate of return guidelines* are to be made in accordance with subrule (13) and not the *rate of return consultative procedure*.

(11) The *rate of return guidelines* are to set out:

(a) the methodologies that the AER proposes to use in estimating the *allowed rate of return*, including how those methodologies are proposed to result in the determination of a return on equity

[49] See section 3.1(b) above. Converting the ARORO from an objective to a mandatory requirement.
[50] See section 3.1(b) above. Converting the ARORO from an objective to a mandatory requirement.
[51] See section 3.4(b) above. Ensuring the list is not closed.
[52] See section 3.1(c) above. As per footnote 14.
[53] See section 3.4(b) above. ATCO submits that this should be deleted because it is adequately (and differently) covered by the NGO. If retained, the word "hypothetical" should be added to "benchmark efficient entity".
[54] Typo
[55] See section 3.4(b) above. Ensuring these "have regard to" items are not misconstrued.
[56] See section 3.4(b) above. It seems odd that there is a "have regard to" list in subrule (8) for return on debt, and no equivalent list for return on equity.
[57] Typo

and a return on debt in a way that ~~is consistent~~complies[58] with ~~the allowed rate of return objective~~subrules (2)[59] and (3A);

(b) the estimation methods, financial models, market data and other evidence the AER proposes to take into account in estimating the return on equity, the return on debt and the value of imputation credits referred to in rule 87A.

(12) The AER must make the first *rate of return guidelines* by [29 August 2013] and there must be *rate of return guidelines* in force at all times after that date.

(13) For the purposes of making the first *rate of return guidelines* the AER must:

(a) by no later than [29 March 2013], publish on its website a consultation paper that sets out its preliminary views on the material issues that are to be addressed by the *rate of return guidelines*;

(b) publish on its website an invitation for written submissions on the consultation paper, with such submissions to be made within the time specified in the invitation (which must not be earlier than 30 business days after the invitation for submissions is published);

(c) by no later than [31 July 2013], publish on its website a draft of the *rate of return guidelines*; and

(d) publish on its website an invitation for written submissions on the draft *rate of return guidelines*, with such submissions to be made within the time specified in the invitation (which must not be earlier than 30 business days after the invitation for submissions is published).

(14) The AER must, in accordance with the rate of return *consultative procedure*, review[60] the *rate of return guidelines*:

(a) at intervals not exceeding three years,[61] with the first interval starting from the date referred to in subrule (12); and

(b) at the same time as it reviews the *rate of return guidelines* under clauses 6.5.2 and 6A.6.2 of the National Electricity Rules.[62]

(15) The AER may, from time to time and in accordance with the *rate of return consultative procedure*, amend or replace the *rate of return guidelines*.

(16) The *rate of return guidelines* are not mandatory (and so do not bind the AER or anyone else) but (subject to subrule 18), if the AER makes a *decision* in relation to the rate of return (including in an access arrangement draft *decision* or an access arrangement final *decision*) that is not in accordance with them, the AER must state, in its reasons for the *decision*, the reasons for departing from the guidelines.

[58] See section 3.1(b) above. Converting the ARORO from an objective to a mandatory requirement.
[59] See section 3.1(b) above. Converting the ARORO from an objective to a mandatory requirement.
[60] ATCO has observed that there is no mechanism for other interested persons to commence a review or propose changes, see section 4(b) above.
[61] ATCO has observed that there is no minimum period, see section 4(b) above.
[62] ATCO has enquired how this will apply to the ERA, see section 4(b) above.

(17) If a service provider makes an *access arrangement proposal* which is not in accordance with the *rate of return guidelines*, then to the extent that the AER makes a decision (subject to subrule 18) to prefer the *rate of return guidelines* over the service provider's *access arrangement proposal*, the AER must state, in its reasons for the *decision*, the reasons for preferring the guidelines.

~~(17)~~(18) A *rate of return guideline* is of no force and effect, and may be disregarded for the purposes of this rule 87 in relation to an *access arrangement proposal*, to the extent that (in the context of the *access arrangement proposal)* the *rate of return guideline* is, or is capable of producing an outcome which is, inconsistent with the *national gas objective*, the *revenue and pricing principles* and subrules (2) and (3A).[63]

[Delete proposed rule 87A][64]

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[63] See section 4(d) above. The challenge is to ensure that errors in the guideline-setting process can be reviewed and remediated by the ACT, when we are only changing the NGR and not the NGL. The problem is also that a guideline may seem quite benign, until it is brought to bear on a particular NSP's circumstances. Hence we have linked it to the access arrangement proposal.

[64] See section 3.2(a) above. Alternatively, if proposed rule 87A is not deleted, it needs to be modified to apply only when the post-tax basis is used, as shown in footnote 27.