DBNGP (WA) Transmission Pty Limited
ABN 69 081 609 190
Level 6, 12-14 The Esplanade
Perth WA 6000
Telephone: +61 8 9223 4300

Postal Address
PO Box Z5267
Perth St Georges Tce WA 6831
Facsimile: + 61 8 9223 4301

9 October 2012

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Sir

Consultation on Draft Determination on Rule Change GRC0011

DBNGP (WA) Transmission Pty Ltd (**DBP**) thanks the AEMC for the opportunity to respond to its Draft Determination on the applications from the Australian Energy Regulator (**AER**) and the Energy Users Rule Change Committee to modify the provisions in the NGR that relate to the determination of the rate of return to apply in full access arrangements under the National Gas Law (**NGL**).

DBP has worked with the Australian Pipeline Industry Association (**APIA**) in the development of a submission which was made on 4 October 2012 (APIA Submission) and fully supports the points made in the APIA Submission.

While DBP is generally supportive of a move to a common framework that is to apply to both regulated electricity and gas infrastructure businesses, there are four aspects of the Draft Determination that are specific to DBP or the circumstances applicable to Western Australia.

Accordingly, this submission focuses on these issues, which can be summarized below. To support DBP's submissions on the first three issues, attached is a letter from Linda Evans of Clayton Utz.

- **Scope of Guidelines** – DBP notes that the AEMC's intention, as expressed in the Draft Determination, is that the regulator should retain a fair degree of discretion on the precise contents of the Guidelines[1]. However, there are two guiding principles outlined by the AEMC in the Draft Determination which, DBP submits, requires the scope of the Guidelines to be limited in certain key respects. These principles are:
    - the requirement for the Guidelines to set out methodologies that are proposed to result in a [rate of return] that is ***consistent with the allowed rate of return objective***; and
    - the AEMC's stated intention that the allowed rate of return objective must be one that incorporates the consideration of the specific risks of a service provider operating in a regulated environment.

[1] Draft Determination at page 60.

Because of these principles, the scope of the Guidelines must be limited so as to not include values for parameters which subsequently restrict or limit the regulator from applying the circumstances of a benchmark efficient entity with a similar nature and degree of risk as that which applies to the service provider in the provision of reference services. This is particularly important for the regulated pipelines in Western Australia each of which has quite different risk profiles because of the different markets in which each operates.

- **Prevailing conditions in the market for funds –** like in the APIA Submission, DBP submits that the reference to "prevailing conditions in the market for funds" should be afforded a higher level of priority in the rate of return determination process by including it as part of the ***allowed rate of return objective*** in proposed Rule 87(2). This is as important for debt investors as it is for equity investors in regulated infrastructure.

- **Requirement to determine the rate of return "taking into account" relevant evidence –** DBP submits that it needs to be made abundantly clear in the new Rules that the regulator should use all relevant estimation methods, financial models, models, market data and other evidence in estimating the rate of return. DBP submits that the use of the phrase "taking into account" does not guarantee this will occur. DBP is particularly sensitive to this issue in light of the recent determinations of the Australian Competition Tribunal in both DBP's and ATCO's applications.

- **Concerns with the trailing average approach and associated costs –** DBP is concerned that the preferred Rule in the Draft Determination, which allows the Regulator to determine the cost of debt using the trailing average approach, has the potential to impose significant costs on service providers who have existing hedging arrangements that will need to be broken if the regulator requires a service provider to move to the trailing average approach. Moreover, DBP is concerned that requiring service providers to break existing hedging arrangements may also cause parties like DBP to be in breach of its financing covenants.

Following is a more detailed outline of DBP's position on each of these four issues.

1. Scope of Guidelines

It is noted in the Draft Determination that (at page 60), in the Guidelines the regulator would be expected to "*detail the financial models that it would take into account in its decision, and why it has chosen those models rather than other models. This would extend to outlining methodologies, estimation techniques and current estimates (where appropriate) of relevant parameters".*

However, it is also noted in the Draft Determination that there are two guiding principles outlined by the AEMC in the Draft Determination which, DBP submits, requires the scope of the Guidelines to be limited in certain key respects. These principles are:

- the requirement for the Guidelines to set out methodologies that are proposed to result in a [rate of return] that is ***consistent with the allowed rate of return objective***; and

- the AEMC's stated intention that the allowed rate of return objective must be one that incorporates the consideration of the specific risks of a service provider operating in a regulated environment.

Therefore, in order to give effect to these principles, DBP submits that the regulator will not be permitted to set out in the Guidelines:

- the values which are to be derived from the output of its chosen models; and
- the values for particular parameters which require an assessment of risks that are specific to either a service provider or a market in which a service provider operates.

Legal advice obtained by DBP (a copy of which is attached as **Attachment 1**), confirms this view.

As outlined in further detail in the attached advice, this may lead the Regulator to producing bespoke guidelines for each service provider ensuring that the nature and degree of risk as that which applies to the service provider in respect of the provision of reference services are specifically address to be complaint with the objective. Alternatively, failing to recognise the requirements in the allowed rate of return objective when settling the Guidelines will likely see the Regulator apply a "one-size fits all" approach across all service providers. However, this is clearly not the AEMC's intent.

In light of this, DBP submits that the AEMC needs to be clearer in either the Final Determination or its final Rule as to the content/scope of the Guidelines, particularly if they are to give effect to the above principles.

2. Prevailing conditions in the market for funds

It is essential to service providers that they have the capacity to raise funds to either fund future growth in the pipeline or to enable existing funds to be refinanced. To enable that to occur, the rate of return must fully reflect the cost of raising those funds (in both equity and debt markets) at the time of the access arrangement decision is made and does not relate to earlier periods. This concept is fundamental to the National Gas Objective and Revenue and Pricing Principles. DBP's concern is that the proposed draft Rule has made "prevailing conditions in the market for funds" a secondary order requirement when the AEMC established a hierarchy within its proposed drafting – it elevates the allowed rate of return objective over the remainder of the factors and considerations outlined in the Rule. This is confirmed by DBP's legal advice provided as **Attachment 1**.

This is important to DBP in circumstances where it is constantly having to refinance its debt because of the debt market's limited appetite to offer longer term debt to single asset businesses like DBP. This will become even more important in circumstances where the Guidelines are being reassessed every three years at least and the Guidelines are required to set out methodologies that are proposed to result in a [rate of return] that are ***consistent with the allowed rate of return objective***. Financiers will be likely to place as much reliance on the Guidlelines process as with the Access Arrangement approvals process in deciding whether to invest or to re-invest in regulated businesses.

DBP submits that the allowed rate of return objective should include the prevailing conditions in the market for funds requirement. The requirement should not only be for equity but be applicable to the determination of cost of debt and therefore the overall determination of the rate of return.

DBP refers the AEMC to the APIA Submission on this point and fully supports the APIA's recommended drafting addressing this concern.

3. Requirement to determine the rate of return "taking into account" relevant evidence

Draft Rule 87(3)(c) requires the regulator to determine the allowed rate of return *"taking into account relevant estimation methods, financial models, market data and other evidence".* DBP's legal advice suggests that the phrase 'take into account' allows the possibility that the Regulator could examine models, data and other evidence but afford them no weight. Such an approach would not be consistent with the AEMC's stated intentions from both the Directions Paper and the Draft Determination.

Both DBP's and the APIA's legal advisors have recommended the adoption of the term "using", rather than "taking into account", the relevant estimation methods, financial models, market data and other evidence. It is DBP' submission that this is likely to promote greater transparency in the regulatory decision making process and will minimize the risk of regulators adopting a single, formulaic approach to the calculation of rate of return.

DBP also submits that the adoption of "using" will overcome a tension that may exist with the current draft preferred rule, where the regulator is required to take into account the evidence but is required to arrive at the best estimate. As currently drafted, the regulators may be inclined to use only the best methodology, which may cause all but one model and piece of evidence to be not used in the calculation of the rate of return.

4. Concerns with the trailing average approach and associated costs

DBP's view is consistent with those provided by APIA which is essentially that that cost of debt should not depart from using a forward looking cost of capital. The rate of return is forward looking for three reasons:

- because economically efficient investment is served by determining a rate of return, including the return on debt, that best reflects the cost of capital at the time when the investment will occur and not that which applied in the past;

- because the regulatory process is concerned with setting prices for the next five (or more) years. This means by nature, every cost determined by an access arrangement review or a pricing and revenue determination is a forecast. Therefore all of the variables including the rate of return are a forecast for the next five years. A historical trailing average cannot substitute as a better forecast than market derived forecast evidenced by the yield curves for appropriately graded debt; and

- investors require a forward looking rate of return that includes a forward looking return on debt.

It is on this basis that DBP objects to the trailing average method being specifically referenced in the proposed draft Rule. However, if the AEMC is of a mind that this aspect of the proposed draft Rule is to be retained in its Final Determination and implementation of the Rule, DBP submits that there are two issues that may not have been properly considered in allowing regulators full discretion to choose between the trailing average approach and any other approach in estimating the cost of debt.

They are the following:

- there may be many service providers like DBP who are required under their financing covenants, to hedge a minimum percentage of their debt. This can be an amount near 90%. However, if hedges are required to be broken in order to align with the new

methodology, then businesses run the risk of being in default of their financial covenants, which could have unintended consequences of default.

- there are likely to be significant transitional costs (such as the payment of break costs for any ineffective hedges) for service providers who will not have the opportunity to align their debt portfolio to match a decision by a regulator to:
    - move to a trailing average approach
    - change the assumptions in any trailing average approach; or
    - move from the trailing average approach in one re-set to a more traditional cost of debt approach in a subsequent re-set.

DBP submits APIA's proposal for this aspect of the Rule to only allow for the Regulator to have limited discretion may in part address this issue.

I would be more than happy to discuss any other concerns included in this letter with you or your staff in more detail as we work toward the conclusion of the rule change assessment process.

Yours sincerely

Anthony Cribb
General Manager Corporate Services

Mr Anthony Cribb
General Manager Corporate Services /
Company Secretary
DBNGP (WA) Nominees Pty Ltd
Level 6
12 - 14 The Esplanade
PERTH WA 6000

9 October 2012

Our ref 217/13193/80137266

Dear Mr Cribb

AEMC : Draft National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012

You have sought our advice in relation to three discrete issues arising from the Draft National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012 (**Draft Rules**) released by the Australian Energy Market Commission (**AEMC**), as follows:

1. ***Whether the current drafting of the initial rate of return guideline rules is such that the regulator is precluded from setting out in the guidelines values for either or both parameters into models or outputs from such models***

1.1 We consider that the rate of return guidelines contemplated in draft rule 87(10) to (16) (**Guidelines**) are not intended to preclude the regulator from setting out indicative, non-binding, values of particular parameters which may be used in financial models which the regulator intends to use in determining service providers' allowed rate of return. However, there are limitations on the regulator's ability to do so. The Guidelines could not, in our view, set out parameters in a way which restricted or limited the regulator from applying the circumstances of a benchmark efficient entity with a similar nature and degree of risk as that which applies to the service provider in the provision of reference services.

1.2 In our opinion, the regulator is not permitted to set out in the Guidelines (even on an indicative, non-binding basis) the values which are to be derived from the output of its chosen models. Such levels of prescription are not contemplated by the Draft Rule Determinations delivered by the AEMC on 23 August 2012 (**Draft Determination**) and may be inconsistent with the "rate of return objective" set out in rule 87(2).

1.3 Draft rule 87(11) provides:

> *"(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 and a return on debt in a way that is consistent with the **allowed rate of return objective**; and*
>
> *(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."

1.4 On its face, draft rule 87(11) makes no express reference to, and does not necessarily contemplate, the regulator making Guidelines which set out the values to be used to arrive at the allowed rate of return (as opposed to the "methodologies" the regulator will use to calculate the allowed rate of return and the "estimation methods" and "financial models"). However, it is arguable that, in setting out the particular methodology, estimation method or financial model to be used, the regulator is not precluded from choosing values to be used in such models. Such a conclusion is supported by the reference in draft rule 87(11)(b) to the "market data" and "other evidence" which it will take into account in estimating the return on equity, return on debt and the value of imputation credits.

1.5 Such a conclusion is also supported by the Draft Determination. First, the regulator retains a "fair degree of discretion on the precise contents of the Guidelines".[1] More specifically, at page 60 of the Draft Determination, the AEMC states that in the Guidelines the regulator would be expected to "*detail the financial models that it would take into account in its decision, and why it has chosen those models rather than other models. This would extend to outlining methodologies, estimation techniques and current estimates (where appropriate) of relevant parameters;*" (our emphasis). Clearly, the reference to "current estimates" means the estimated values of such parameters.

1.6 However, the words "where appropriate" in the passage of the Draft Determination quoted above are equally significant. The ability to choose values of parameters as part of the Guidelines process cannot detract from the overall rate of return objective which requires the regulator to focus on the specific circumstances of the service provider (by reference to the nature and degree of risk which a benchmark efficient entity in that position would face). There are some parameters which do not require the specific circumstances of the provision of the services to be considered. These can readily be included in the Guidelines.

1.7 There is, however, significant risk if the Guidelines were to move to include parameters for matters which will vary depending upon the circumstances of the provision of the reference services. In our view, in order to ensure that the Guidelines meet the requirements of Rule 87(11)(a), the appropriate course would be to limit the Guidelines to parameters which do not vary with the circumstances of a benchmark efficient entity with a similar nature and degree of risk as that which applies to the service provider.

1.8 Further, whilst the regulator may have the discretion to indicate the values of certain parameters in models, there is no suggestion in the Draft Determination that a regulator could use the Guidelines to nominate a value which may be derived from the output or application of a model. This is hardly surprising. The purpose of the Guidelines is in part to safeguard the framework against the problems of an overly rigid prescriptive approach that cannot accommodate changes in the market conditions.[2] It is difficult to see how that purpose would be served by the nomination of a series of generic values from models which would necessarily be derived without

[1] Draft Determination at page 60.

[2] Draft Determination at page 52.

regard to the circumstances of any particular service provider. For that reason, the methodologies endorsed by such Guidelines would not assist in arriving at a determination of a return on equity and debt in a way that is consistent with the allowed rate of return objective, as required by draft rule 87(11)(a).

2. ***Whether the reference to "prevailing conditions in the market for funds" should be afforded a higher level of priority in the determination process by including it as part of the rate of return objective***

2.1 Rule 87(1) of the current National Gas Rules states that *"The rate of return on capital is to be commensurate with the prevailing conditions in the market for funds and the risks involved in providing reference services"*.

2.2 By contrast:

(a) the allowed rate of return objective set out in (the new) draft rule 87(2) states that "*The allowed rate of return is to correspond to the efficient financing costs of a benchmark efficient entity with a similar nature and degree of risk as that which applies to the service provider in respect of the provision of reference services*";

(b) draft rule 87(5) provides that the return on equity is to be estimated in a way that is consistent with the allowed rate of return objective (87(5)(a)) and "*taking into account the prevailing conditions in the market for equity funds*" (87(5)(b)).

2.3 On a proper interpretation, draft rule 87 emphasises the primacy of the allowed rate of return objective in draft rule 87(2) over the rest of the draft rule, which merely prescribes a series of requirements to which the regulator must have regard in arriving at an allowed rate of return which is consistent with the stated objective. This interpretation is supported by the Draft Determination, which describes these other requirements as "secondary requirements".[3] These secondary requirements include the requirement in draft 87(5)(b) to take into account the prevailing conditions in the market for equity funds.

2.4 It is unclear whether or how the requirement that the allowed rate of return is to correspond to the efficient financing costs of the benchmark efficient entity with a similar degree of risk to the service provider could diverge from or conflict with the requirement that the return on equity is to be estimated taking into account the prevailing conditions in the market for funds. We consider that the review bodies would endeavour to read the provisions as operating harmoniously with each other, such that the efficiency of the benchmark efficient service provider's (equity) financing costs must still be assessed having regard to the conditions as they exist in the market for equity funds at the time of the determination.

2.5 Notwithstanding this, there is some merit to the suggestion that the requirement in draft rule 87(5)(b) should be elevated to, and included as part of, the allowed rate of return objective in draft rule 87(2). Clearly the requirement concerning the prevailing conditions in the market for equity funds is of continuing and undiminished significance, since it reflects the importance of estimating a return on equity that is sufficient to allow sufficient investment in, and efficient use

[3] Draft determination, page 57.

of, the relevant services.[4] As the AEMC has observed, if there is a failure to give due regard to the prevailing market conditions, the allowed rate of return will either be above or below the return required by capital market investors at the time of the determination, and neither of these outcomes are efficient or in the long term interests of energy consumers.[5]

2.6 One issue which arises with this approach is that it would be somewhat unusual as a matter of principle for the allowed rate of return objective to include a requirement that the return on equity reflect the prevailing conditions in the market for such funds and not also include reference to the return on debt. It would appear from the Draft Determination that the AEMC has formed the view that the trailing average of debt approach (which the regulator *may* use to estimate the return on debt), is inconsistent with (and mutually exclusive from) a requirement that the regulator must take into account the prevailing conditions in the market for debt funds. If that is correct, then the risk is that incorporation of only the return on equity will be seen to be an approach not based on a coherent issue of principle and one which creates a tension between the treatment of equity and debt.

2.7 You have instructed us that the position adopted by the Australian Pipeline Industry Association in response to the AEMC's Draft Rule, is that if the allowed rate of return objective in 87(2) is to include a requirement that the allowed rate of return must reflect the prevailing conditions in the market for funds (both debt and equity), the cost of debt rules should be amended by the deletion of the trailing average cost of debt approach. We agree with that approach.

3. ***Whether it suffices for the regulator to determine the allowed rate of return "taking into account" relevant estimation methods, financial models, market data and other evidence or whether some other requirement would be more appropriate***

3.1 Draft rule 87(3)(c) requires the regulator to demine the allowed rate of return "*taking into account relevant estimation methods, financial models, market data and other evidence*". Rule 87(3)(c) is fundamental to the flexible approach endorsed by the AEMC, designed to ensure that the allowed rate of return objective is achieved. Further, the use of a range of relevant models and methods is encouraged to ensure that the estimation process is of the highest possible quality and, consequentially, that the estimate meets the national gas objective (rule 23, National Gas Law) and is consistent with the revenue and pricing principles (rule 24, National Gas Law).[6]

3.2 Having regard to the significance of the intention behind draft rule 87(3)(c), it is critical to the process that the regulator is bound to give proper consideration to the relevant models (etc) which will ensure that the allowed rate of return objective is achieved.

3.3 The requirement, to take "take into account" a matter or matters is a common expression and one which is clearly capable of application.

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[4] Draft Determination, pages 58/59.

[5] Draft Determination, page 49.

[6] Draft Determination, pages 46 - 47; 48.

3.4 The authorities establish that where a decision maker is required to "take into account" or "have regard to" matters, the decision maker must give weight and genuine consideration to those matters. The question of how much weight or how much consideration depends on the natural meaning of the words and the subject matter, scope and purpose of the particular legislation: *Telstra Corporation v ACCC* (2008) 106 ALD 318. Whilst the better view is that the decision maker would likely be required to take the specified matters into account as fundamental elements in making the determination (*R v Hunt; Ex parte Sean Investments Pty Ltd (1979) 180 CLR 322*), it should not be assumed that that this will always be the applicable test. It is quite possible that based on the current drafting a regulator could examine a relevant model (etc) but then disregard it or give it no weight at all. This does not seem consistent with the Draft Determination.

3.5 With this in mind, a preferable formulation of the draft rule may be that the regulator determine the allowed rate of return "using", rather than "taking into account", the relevant estimation methods, financial models, market data and other evidence. This is likely to promote greater transparency in the regulatory decision making process, since it can be difficult for a service provider to determine whether a regulator has taken a particular model (etc) into account and, if so, to what extent. The requirement to use a relevant model (etc) would necessarily require a regulator to demonstrate how that model (etc) has been used and, where applicable, how much weight has been given to that model. Further, there are two important qualifications on the obligations which would be placed on a regulator by this amendment:

(a) first, the draft rule already (appropriately) limits the requirement to "relevant" methods, models, data and other evidence. As such, if a method (etc) is irrelevant, the regulator would not be required to use it;

(b) secondly, the requirement to use a relevant model (etc) would not in any way curtail the regulator's discretion. The regulator would still retain the discretion to give appropriate weight to all of the evidence and analytical techniques considered[7].

Yours sincerely

Linda Evans, Partner
+61 2 9426 4217
levans@claytonutz.com

Tim Owen, Senior Associate
+61 8 9426 8016
towen@claytonutz.com

[7] Draft Determination, page 48; 57