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

Dear Sir

DBP RESPONSE TO THE AEMC DIRECTIONS PAPER AER'S PROPOSED CHANGES TO THE RATE OF RETURN PROVISIONS IN THE NATIONAL GAS RULES (NGR)

1. Introduction

DBNGP (WA) Transmission Pty Ltd (**DBP**) thanks the AEMC for the opportunity to respond to the directions paper released on 2 March 2012 (**Directions Paper**).

As was the case in relation to the issues paper the AEMC released for the rate of return rule change proposal, DBP has worked with the Australian Pipeline Industry Association (APIA) in the development of a submission in response to the Directions Paper and fully supports the points made in the APIA submission. Accordingly, this submission focuses on matters relating to the rate of return rule change proposals that are specific to the circumstances of the DBNGP or which are confidential to DBP.

DBP notes that in relation to the three other rule change proposals addressed by the Directions Paper (being the capital and operating expenditure incentives, the capex and opex criteria and that regulatory process rule changes), the AEMC is not proposing to make changes to the relevant provisions of the National Gas Rules (**NGR**). As DBP's business is limited to operations that could be covered by the NGL, DBP has not made submissions on these other aspects of the Directions Paper. However, this does not mean that DBP would be supportive of similar rule change proposals being made

2. Key Points

DBP is encouraged by the AEMC's Directions Paper. Most importantly:

High level principles or objectives to set the rate of return - DBP supports the AEMC's current position that for a third party access regime to best promote the NGO and NEO:

- The rate of return framework in the regime must ensure that when regulators decide on the rate of return for a regulated business:
 - The criteria to be met for the rate of return must be a set of principles or objectives, rather than a prescriptive, detailed criteria; and
 - The regulator must have regard to all available evidence that points to what value meets the criteria, rather than a single, one size fits all, theoretical financial model.
- The rate of return must be set at the same time as tariffs are set, not through a separate process that is undertaken at quite a different time to the process of setting the tariffs.
- The regime must retain the right to Merits Review of regulatory decisions that have the ability to materially affect the financial performance of a business.

A regime that requires a regulator to set a rate of return by reference to a set of objectives or principles that are focused on matching prevailing market conditions and specific risks, having regard to all available evidence, rather than by following a prescriptive, theoretical formula recognises the fact that a rate of return is not directly observable nor is it capable of being precisely estimated down to a single precise value by reference to one theoretical financial model.

Rule 87(1) NGR contain an effective set of objectives - The most effective set of principles or objectives to be used as the criteria to be met for the setting of the rate of return are those presently in Rule 87(1) of the NGR – ie the rate of return must be commensurate with prevailing market conditions and the specific risks of a business.

Merits review should be retained to promote accountability - Retaining the right of all stakeholders to seek merits review best promotes accountability of regulatory decision making.

3. Why this rule change matters to DBP

DBP has invested over AUD \$3 billion in transmission pipeline assets in Western Australia. A reduction in the rate of return by 1% “costs” investors at least \$30 million annually. The rate of return used in setting regulated tariffs must reflect the realities of the commercial and financial markets in which DBP operates: Quite simply, DBP must be given the opportunity to recover its efficiently incurred costs.

Since the release of the Issues Paper, the ERA issued its Final Decision on the DBNGP Access Arrangement. In that decision, the ERA required that the rate of return be set based on a real pre-tax WACC approach and that the real pre-tax WACC be 5.74%.

This was despite:

- DBP proposing a real pre-tax WACC of 10.03%
- DBP submitting that the ERA should not have regard to regulatory precedent under the NER to justify its decision
- DBP submitting that the ERA is required to have regard to all available evidence that indicates what is the rate of return that is commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services
- DBP submitting detailed evidence, based on a variety of models and approaches and evidence of prevailing conditions in the market for funds which identified a range of outcomes for rate of return in excess of 9%.
- DBP’s owners indicating that if DBP was only allowed a maximum rate of return of 5.74%, it would not be prepared to invest further in pipelines or expansions or extensions of regulated pipelines.

In January 2012, DBP commenced an appeal of the ERA’s decision¹. Some of the grounds of the appeal relate to the regulator’s decision on rate of return. That appeal is presently being heard by the Australian Competition Tribunal.

The following outlines the sensitivity of changes in WACC parameter values on DBP’s regulated revenue

	Total Revenue \$m (2010)						5 year Total	% Change
	2011	2012	2013	2014	2015			
Final Decision	350.5942	395.6405	380.6455	378.2879	375.0203	1880.1885	N/A	
MRP - 6.5%	357.2567	402.5012	387.3478	384.8259	381.3929	1913.3245	1.76%	
Gamma - 0.2	353.4214	398.5518	383.4896	381.0623	377.7245	1894.2495	0.75%	
DRP - +50bps	360.2757	405.5585	390.3341	387.7384	384.2311	1928.1379	2.55%	
RFR - +50bps	368.6038	414.1327	398.7104	395.9093	392.1953	1969.5515	4.75%	

¹ Application 2 of 2012 by DBNGP (WA) Nominees Pty Ltd and DBNGP (WA) Transmission Pty Ltd

DBP considers that the reasoning of the ACT on the rate of return grounds of DBP's appeal may be very beneficial for the AEMC to have regard to as part of its deliberations on the rate of return rule change proposals for both:

- the issue of the proper interpretation of the NGR's rate of return provisions; and
- the issue of whether the existing provisions of the NGR provisions require the ERA to have regard to all available evidence that indicates what is the rate of return that is commensurate with prevailing conditions in the market for funds.

However, there is a further point that relates to the interface between the AEMC's assessment of the rate of return rule change proposals and the DBP appeal and which DBP requests that the AEMC take into account.

There is a real risk that if the AEMC decides, before the decision of the Tribunal in DBP's appeal, that the NGR should be changed, the Tribunal in DBP's appeal would be required to then base its decision on the changed version of NGR. This is so despite the fact that the parties would have arguments and submissions to the ACT based on the current version of the NGR and the ERA would have made its decision based on the current version of the NGR.

Were this to occur, this would create significant uncertainty for all parties involved in the appeal.²

4. The best framework for setting a rate of return is one based on the NGR

DBP agrees with the AEMC as to what are the attributes necessary to guide the Regulator on both the outcome to be achieved (ie the criteria) and the process to be followed by the Regulator in arriving at the rate of return that meets the attributes:

Outcomes attributes – the framework must deliver a rate of return which:

- is based around estimating a rate of return for benchmark efficient firms;
- allows methodologies for parameters to be driven by principles and reflect current best practice;
- allows flexibility to deal with changing market conditions;
- recognises the inter-relationships between some parameter values; and

Process attributes – in setting a rate of return, the regulator must follow an approach that:

- utilises all of the relevant data;
- creates a framework of accountability for both the regulator and the NSP/gas service provider in determining an appropriate rate of return.
- considers all relevant estimation methods;
- ensures internal consistency;
- is open and transparent;
- has been subject to scrutiny; and
- can be cross-checked for reasonableness

These attributes ensure the promotion of the NGO and the revenue and pricing principles (RPPs).

DBP submits that:

- The current rate of return framework in the NGR, when properly interpreted and applied, embodies all of these attributes, whereas the NER Chapter 6 is consistent with only two and Chapter 6A is inconsistent with only one.
- On a proper construction of the current rate of return provisions in the NGR:

² In appeal 2 of 2012 in the ACT, there are 7 parties involved in the appeal – two DBP parties, the ERA, the owner of a gas storage facility and 3 shipper entities (as interveners).

- a. Rule 87(1) sets out the criteria to be applied in determining the rate of return – ensuring a Rate of Return that is commensurate with prevailing market conditions and the specific risks of the service provider in providing services.
- b. Rule 87(1) requires the rate of return to meet key principles and Rule 74 requires the regulator to adopt current best practice.
- c. The requirement under the NGR for the rate of return to be set at the same time the tariffs are set in an access arrangement and for it to meet guiding principles of Rule 87(1) and the NGO and RPP, not only give the regulator the flexibility to deal with changing market conditions and the risks specific to a business, but it requires the Regulator to do so.
- d. Rule 87(2) requires the rate of return to be based around estimating a rate of return for benchmark efficient firms.
- e. The requirement for the Regulator to come up with best estimates arrived at on a reasonable basis (Rule 74) recognises the inter-relationships between some parameter values.
- f. Rule 87(2)(b) does not limit the Regulator to having regard to one estimation method. As the AEMC acknowledges, the estimation of the rate of return (including the cost of equity and the cost of debt) is not a precise science. The cost of equity is not directly observable. So, the NGR requires the use of all relevant data. The NGR recognises this by way of rule 74 (best estimates arrived at on a reasonable basis).
- g. The rules require the Service Provider to disclose the basis for its position in an access arrangement and for the regulator to outline its reasons for decision, thereby ensuring transparency.

DBP also submits that the merits review regime in the NGL creates a framework of accountability for both the regulator and the NSP/gas service provider in determining an appropriate rate of return. It contains the following checks and balances:

- The service provider must meet a financial threshold to be able to appeal – ensures that there is discipline as to what gets challenged
- The prospect of an appeal should drive the regulator to accountability
- The enhanced rights of users and consumer groups to themselves appeal and intervene in others' appeals acts as a sound discipline against service providers making ambit claims or cherry picking.
- Under section 258 of the NGL, the Regulator can “open up” other areas that are not challenged by a service provider.

The decisions made to date under the NGR (and its predecessor the Gas Code) haven't reflected a proper application of these attributes. This is because electricity decisions have dominated the reasoning of regulators in NGR decisions and regulators have considered it more important to achieve consistency amongst their decisions without properly recognising that the NER and the NGR, to date, are quite different frameworks.

5. Can the NGR framework be improved

While the current framework in the NGR embodies all of the required attributes, there could be some fine tuning of it to better promote the NGO and RPPs. That fine tuning involves:

- Removing the requirement in Rule 87(2) to have regard to one theoretical financial model
- Making it clearer in Rule 87(2) that the regulator must have regard to all relevant evidence, including financial models, that indicates what is the rate of return that meets the key objectives in r.87, the NGO and RPP's

DBP would be concerned at having too many objectives in the NGR to guide the regulator. This will create uncertainty for regulators and potentially competing objectives. This in turn could negatively impact on investment incentives. The NGR framework was designed specifically to overcome these problems that existed in the Gas Code.

6. Should there be a regular, industry wide, review?

It is noted that neither the ERA nor WA service providers were supportive of a separate, industry wide review for rate of return.

Having a regular, industry wide, review is not necessary in circumstances where the AER makes eight regulatory decisions on average each year. Consultations on each regulatory decision are public and the AER's approach will be transparent, as will any new information and approaches developed by service providers. Being in "constant WACC review mode" is a healthier and more mature way to air developing knowledge about the determination of rate of return.

Further, an industry wide review that is undertaken at a different time to when tariffs are set for a business and which is binding on the regulator in the tariff setting process creates a real likelihood that the framework is not consistent with the NGO and RPPs. This was the subject of the legal opinion attached to the APIA submission in response to the Issues Paper.

However, if there is a desire for an industry wide review conducted at regular intervals, that review should be informative and not binding on a regulator when setting tariffs and could be focused on such things as:

- Considering what new evidence has come about that informs stakeholders as to what should be a rate of return that meets the criteria for rate of return (ie the objectives in Rule 87(1))
- Any developments in academic research on financial capital asset pricing models

A regular, industry wide review that seeks to achieve more than this and which binds the regulator in tariff setting processes runs the risk that any amended rule will not be valid.

7. The Solution

Suggested changes to the drafting of the NGR ROR provisions

- h. Amend r.87(2) (b) to read as follows –

In determining the rate of return for the purposes of Rule 87(1) [and to ensure the rate of return is of the highest quality], the regulator must use:

- (i) *the WACC approach; and*
- (ii) *all relevant financial models which inform compliance with r.87(1)*

DBP appreciates the opportunity it has had to date to engage with the AEMC in its consolidated rule change assessment process. If the AEMC wishes to make an queries regarding the issues raised in this submission of those within the APIA submission please contact myself or Trent Leach, Manager Regulatory & Government Policy on 0429 045 320 or via trent.leach@dpp.net.au

Yours sincerely

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