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

(*Lodged Electronically – Ref: GRC0011*)

PUBLIC VERSION

Dear Sir

AER'S PROPOSED CHANGES TO THE RATE OF RETURN PROVISIONS IN THE NATIONAL GAS RULES (NGR)

1. Introduction

DBNGP (WA) Transmission Pty Ltd (**DBP**) is the operator of the Dampier to Bunbury Natural Gas Pipeline (**DBNGP**), Australia's largest gas transmission pipeline and Western Australia's most important piece of energy infrastructure.

The DBNGP stretches almost 1,600 kilometres and links the gas fields located in the Carnarvon Basin off the Pilbara coast with population centres and industry in the south-west of the State

DBP is a privately owned company whose shareholders are the DUET Group (80%) and Alcoa (20%).

DUET Group is an ASX-listed owner of energy utility assets in Australia. DUET is managed jointly by AMP Capital Investors Limited and Macquarie Capital Group Limited. Alcoa operates the world's largest integrated bauxite mining, alumina refining, aluminium smelting and rolling system in Australia including bauxite mines and three alumina refineries in Western Australia.

DBP is an interested stakeholder in the AEMC's process to consider a proposal from the Australian Energy Regulator (**AER**) 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**) (**AER Proposal**).

DBP has worked with the Australian Pipeline Industry Association (APIA) in the development of a submission and fully supports the points made in the APIA submission. Accordingly, this submission focuses on matters that are specific to the circumstances of the DBNGP or which are confidential to DBP.

The information contained in this letter and its attachments are confidential and of a commercially sensitive nature. Accordingly, DBP requests that the AEMC not place this submission on the public register until a redacted version is provided for public release.

2. Key Points

Investors in gas pipeline infrastructure require that the rates of return allowed by regulators under the law are reflective of current market conditions for debt and equity funding and address the risks specific to each business in providing service to their customers. The current version of the NGR mandates this. So too do the revenue and pricing principles and the gas objective of the NGL. The AER Proposal does not.

It is critical for the NGR to continue to mandate these as outcomes because financial markets have changed dramatically in the past few years, and we believe are likely to be volatile for years to come. The NGR currently provides a means of dealing with volatility and change. The AER Proposal does not.

Additionally, the markets in which gas pipelines operate are diverse and differ significantly from electricity markets. There are also material differences between the different gas transmission businesses. We do not believe that the AER's proposed approach to the calculation of rate of return will benefit owners, financiers or ultimately customers of these gas transmission businesses.

DBP and its owners have invested $1.8billion in expanding the capacity of the DBNGP over the last five years, facilitating significant growth in the Western Australian economy during this time. However, this has been done outside of the regulatory framework under contracts negotiated with its customers. This would not have been possible under a regime that allows regulators to determine rates of return by reference to a "one size fits all", formulaic (and prescriptive) approach that is not only unnecessary, but is unable to matched the market realities and the risks of the specific business.

From 2016, the regulatory framework will play a much greater role in DBP's business. A framework which is increasingly formulaic and prescriptive, and which does not deal with market realities and business specific risks, will not facilitate the making of further investment on this scale.

With gas being recognized by governments as the transitional fuel in the move to a clean energy future, additional gas pipeline capacity will be required. However, if the law does not require regulators to set rates of return that match market realities at the time tariffs are set and that appropriately recognize the different risks of each business, there is an increased risk that it will not create the right incentives for this investment. The current provisions of the NGR do provide a framework that can encourage future investment. The AER Proposal does not.

In addition to these problems with the AER Proposal:

- The AER Proposal is being made at a time when the NGR has only been in operation for less than two years in Western Australia and when only one transmission pipeline has been assessed under the regime in Western Australia and only one other in the rest of Australia. The NGR in its current form needs to have time to work as it was intended.

- DBP's investors understand the NGR as it currently stands. They have confidence in how it should be applied. To change now creates uncertainty. Moreover, to change to an alternative that does not require the rate of return to match market realities and business specific risks creates even more uncertainty and therefore increases the perceived risk of investing in DBP. More risk means:

    - a higher cost of capital (across both debt and equity funding sources);
    - heightened debt refinancing risk, with additional restrictive financial covenants being required by financiers;
    - significantly reduced appetite for further investment in infrastructure; and
    - ultimately, higher tariffs for customers.

- There are serious questions about whether the AER would have the power under the NGR and NGL to make the decisions being proposed under the AER Proposal. This should be investigated by the AEMC as DBP has legal advice to the effect that the AER would be acting beyond its powers by applying the outcomes from the proposed statement of cost of capital to the access arrangement tariff determination. It would only lead to further uncertainty for DBP's investors if, the AER Proposal were accepted but it were to be subsequently found by a court that the AER did not in fact have statutory powers to make the Statement on the cost of capital (SOCC) decision or any access arrangement which incorporates the SOCC decision.

Finally, the AER Proposal does not contain the level of substantiation for the contentions in the proposal that the AEMC must have to enable it to accept the proposal. In fact, many of the AER's contentions are not only unsubstantiated, the AER has not identified key costs of the AER's Proposal.

Therefore on a proper consideration of these matters, we believe that the AER Proposal must be rejected.

3. DBP's experience in financial markets

DBP's experience in financial markets demonstrates why it is of paramount importance that the NGR maintain the requirement that the rate of return ***must be commensurate with prevailing conditions in the market for funds and the risks involved in providing the reference services***. .

1. DBP has obtained the following credit ratings from the following credit ratings agencies:

   - Standard and Poors – BBB- (stable outlook)
   - Moodys – Baa3 (stable outlook)

   This places DBP at a lower rating than other regulated pipeline businesses.

2. A reduction in the allowable rate of return by 1% "costs" investors at least $30 million annually in reduced returns. To put this into perspective, DBP's total annual operating costs are approximately $70 million.

3. DBP and its owners have invested $1.8billion in expanding the capacity of the DBNGP over the last five years. However, this has been done outside of the regulatory framework under contracts negotiated with its customers.

4. DBP has over $2.7billion in commitments under senior debt facilities. While DBP's equity investors have invested over $300 million in new equity in the past three years to reduce gearing, the debt facilities will need to be refinanced on a continual basis. [redacted]:

   [redacted]

   - [redacted].

Note: The content of this section, which is subject to a claim of confidentiality by DBNGP (WA) Transmission Pty Ltd, has been omitted in accordance with section 24 of the *Australian Energy Market Commission Establishment Act 2004* (SA) and section 319 of the National Gas Law

5. Because of the need to approach new markets, DBP not only needs to understand what is a competitive price for debt in these markets, the prospective market needs to understand the risk profile of DBP. Accordingly, through its efforts to understand the US bond markets, DBP has focused on comparable organisations to understand whether these markets are offering competitive pricing. These have been companies with similar risks to those experienced by DBP. Accordingly, comparisons are made with large gas transmission businesses ideally with a single asset and a limited number of large industrial shippers linked to cyclical commodity markets.

6. A "one size fits all" approach to the cost of debt, relying on credit ratings to indicate default risk, as will effectively be implemented by the AER Proposal, will not work. Bond investors, especially in a post-GFC environment; do not rely solely on rating agencies for their analysis of risk and determination of yield requirements. Rather, they use a combination of bottom-up and top-down analysis, including (but not limited to):

- company profile;
- business risk (in that regard, see a description below);
- financial analysis;
- global assessment of comparables (as outlined above);
- economic fundamentals;
- credit cycle; and
- industry themes.

7. For a gas transmission company investors will also consider security of supply (remaining life in supplying gas fields), security of demand (creditworthiness and business outlook for major customers) and bypass risk (alternative routes to market).

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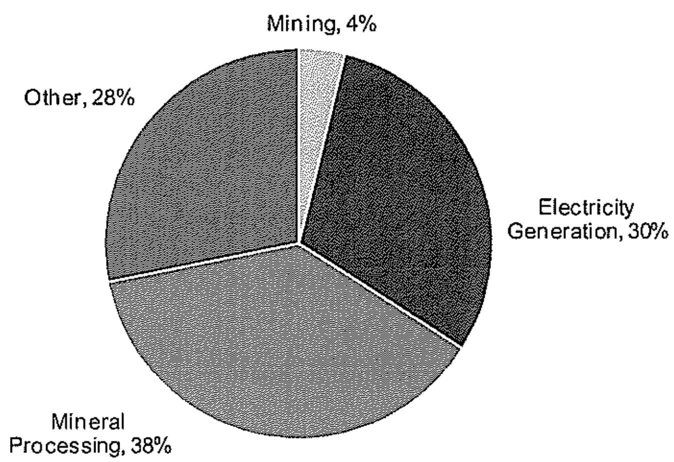
Equity investors and providers of debt view regulatory risk as a key risk. [redacted].

Investors understand, and make considerable efforts to understand, DBP's business circumstances, particularly where these are quite different from those of other pipelines in Australia and overseas, and different from those of other pipelines in Western Australia. Following is a short summary of the circumstances that are particular to DBP and the DBNGP:

a. All of DBP's contracted capacity is contracted with shippers under negotiated tariffs. All but one of these shippers are on the same contract – DBP's Standard Shipper Contract. Under this contract, the tariff payable by shippers is significantly higher than that set by the regulator (The tariff in the Standard Shipper Contract is $1.54/GJ compared with the tariff required by the regulator in the final decision of $1.15/GJ).

b. DBP has a relatively small number of customers (22) spread across a relatively small number of sectors in the industry. The following chart demonstrates DBP's customer base by industry sector



Source: DBP internal

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c. The economic fortunes of many of these sectors, particularly the commodity sector, are relatively cyclical. [redacted]

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d. While DBP is one of many transmission pipelines that will be required to pay the carbon tax under the new Clean Energy Act, its exposure will be significant because of the number of compressors installed on the pipeline. [redacted].

DBP submits therefore that, as a large borrower of funds, locking in a one-size-fits-all, formulaic and prescriptive approach to the calculation of the cost of debt which is undertaken up to five years before the regulatory tariffs are set cannot be consistent with requiring that the rate of return not only is commensurate with prevailing conditions but that it is commensurate with the specific circumstances of a business.

4. The Key aspects of the AER Proposal – do they contribute to the NGO and are they consistent with the revenue and pricing principles

DBP supports the APIA submissions on the key aspects of the AER Proposal being changes relating to:

- The process – i.e. the two staged process of setting a SOCC and then re-filing revisions to the access arrangement, sometimes, up to 5 years apart. Not only will this not contribute to the national gas objective nor is it consistent with the revenue and pricing principles of the NGL, it also gives rise to legality issues which are highlighted in the APIA submission.

- The methodology – locking in a one size fits all, formulaic (and prescriptive) methodology for the setting of key elements in the cost of capital calculation, including the requirement to use the Sharpe Lintner CAPM to establish the cost of equity. DBP is of the view that this will also not contribute to the national gas objective nor is it consistent with the revenue and pricing principles of the NGL.

- The criteria – removing the requirement that the rate of return must be commensurate with the prevailing conditions in the market for funds and the risks involved in providing the reference services and in its place listing a series of matters that the regulator must simply "have regard to". DBP is of the view that this will also not contribute to the national gas objective nor is it consistent with the revenue and pricing principles of the NGL.

- The removal of appeal rights in relation to rate of return decisions. Given that the regulator has full discretion in relation to rate of return under the NGL, it is necessary from good administrative decision making policy that there be an appeal regime in place to provide the appropriate check and balance.

5. Response to the AER's explanation of benefits and costs

It is DBP's view that the AER has not undertaken a complete analysis of the expected benefits and costs of its proposal, and of the potential impacts of the change on those likely to be affected. The AER has not identified many of the additional costs that the change would impose on business, and it has provided little or no quantitative evidence of the benefits.

In addition points contained in the APIA submission, DBP submits that there are additional costs that the AER Proposal does not identify:

- In Western Australia, the costs of the regulator are paid for by regulated businesses. Accordingly, the costs of the additional SOCC process are likely to be passed on to service providers. DBP presently pays for 50% of the ERA's portion of costs recovered from the gas pipeline industry.

- The ERA is likely to have to incur more costs in conducting a SOCC process as opposed to undertaking case by case assessments of each pipeline's rate of return. This is because presently, it is able to retain its own in house experts. By being required to conduct a SOCC process, it is likely that the ERA will not be able to retain these experts in house. This will therefore force the ERA to engage external consultants, which will be more expensive, with these costs being passed through to industry and ultimately to customers. This issue should be explored by the AEMC with the ERA.

- To the extent that the ERA conducts a separate SOCC process to the AER's SOCC process, DBP is will have to participate in both processes. This is particularly the case where one regulator relies on the other's SOCC decision in formulating their own SOCC. This will lead to more costs being incurred by DBP through the engagement of more staff and more external consultants to assist [redacted] While the costs of the access arrangement process should reduce somewhat (given the regulator is required to apply the parameters from the SOCC process consistently in the access arrangement), there is not expected to be a comparable reduction in the access arrangement budget.

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Any increase in administrative costs will compound the effect of higher costs caused by inappropriate rates of return being set by the regulators

- The real costs of change are the costs of inappropriate rates of return brought about by a loss of flexibility to deal with changes in market conditions; this flexibility is currently provided by Rule 87(1). Under the current provisions in WA, it is the Service provider who may seek to re-file if circumstances change. There are appropriate checks and balances in the regime that disincentivise the service provider from continually re-filing – not only does the regulator have a full discretion when it comes to assessing the rate of return, but DBP would have to pay for the regulator's costs each time it re-filed revisions to its access arrangement.

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

on behalf of:

Anthony Cribb
General Manager Corporate Services

Note: The content of Appendix 1, which is subject to a claim of confidentiality by DBNGP (WA) Transmission Pty Ltd, has been omitted in accordance with section 24 of the *Australian Energy Market Commission Establishment Act 2004*