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8 December 2011

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

John
Dear Mr Pierce



PROJECT REFERENCE CODE – GRC0011

Find attached a submission on the Consultation Paper for the National Gas Amendment (Price and revenue regulation of gas services) Rule 2011.

If you require further information on this submission, please contact me on 08 8418 1125.

Yours sincerely

A handwritten signature in black ink, appearing to read "a sh", followed by a horizontal line.

Andrew Staniford
Group Manager - Commercial



Submission to the National Gas Amendment
(Price and revenue regulation of gas services) Rule
2011

GRC0011

8 December 2011

Introduction

Envestra is pleased to have the opportunity to comment on the AEMC Consultation Paper on the National Gas Amendment (Price and revenue regulation of gas services) Rule 2011 released on 20 October 2011 (GRC0011).

The purpose of this submission is to provide insight to the Commission that reflects experience gained by Envestra as a regulated businesses pursuant to the National Gas Rules and its precedent, the National Third Party Access Code for Natural Gas Pipelines Systems (The Code), and to highlight issues raised by the proposed Rule Change that are significant to Envestra.

Envestra is also a participant in submissions prepared by the Energy Networks Association and the Financial Investors Group on behalf of regulated businesses.

About Envestra

Envestra is the largest listed specialist natural gas distribution company in Australia, owning over 22,000 kilometres of networks in Victoria, South Australia, Queensland, New South Wales and the Northern Territory. The Company delivers around 120 Petajoules of natural gas to over 1.1 million customers across its networks. Envestra listed on the ASX in 1997 and has extensive experience as a regulated business operating under both the Code (1998 to 2008) and more recently the National Gas Rules. Since 1998, the Company has participated in ten Access Arrangements reviews to either the Australian Energy Regulator or other jurisdictional regulators, including the Essential Services Commission of Victoria, the Essential Services Commission of South Australia, the Queensland Competition Authority, IPART and the ACCC.

This experience has provided Envestra with a very detailed understanding of both the theory and application of network regulation for gas distribution businesses.

AER Rule Change

The AER's proposed changes to the Gas Rules are summarised in Attachment A of its submission to the AEMC. The majority of the Rule changes relate to Rule 87 pertaining to the return on capital with minor consequential changes to other Rules that are necessary to implement the Rule 87 changes proposed by the AER. The effect of the Rule change is to reduce the amount of discretion the Regulator is able to exercise at the time of an Access Arrangement review when determining the appropriate rate of return. This is achieved by:

- Prescribing the CAPM model to forecast return on equity - Rule 87(1);
- Requiring the AER to undertake a review of prescribed rate of return parameters at least every five years with the outcomes being used to populate the rate of return model in Access Arrangement decisions – Rule 87A; and
- Prescribing how the cost of tax will be calculated – Rule 87B.

The Rule change proposed by the AER also has the effect of making any decision under the new Rule exempt from appeal. This is a significant departure from the existing Rules.

The Rule changes proposed by the AER effectively implements the current rules in chapter 6A of the *National Electricity Rules* (NER). The AER justify the proposed Rule change on the grounds that:

“the rate of return provisions of the NGR can be improved. Aligning certain provisions of the NGR with those of chapter 6A of the NER will improve those provisions.”¹

The AER posit four benefits from the proposed rule changes:

- It provides more certainty and stability on how the rate of return is to be determined;
- It strengthens the AER’s ability to approve an overall rate of return commensurate with the regulatory and commercial risks faced by service providers;
- It reduces administrative costs; and
- It provides a greater balance between the need for flexibility in the cost of capital framework over the longer term with greater certainty.

Overall Comment

Envestra strongly opposes the Rule change proposed by the AER. In our view, the AER has not made any case to change the methodology for determining rate of return in the NGR. No analysis or evidence is provided in the AER proposal that supports that conclusion. Envestra considers that the existing Rule 87 in the National Gas Rules remains appropriate.

Is there a problem with the current Rules?

The AER proposal claims that the existing Rules:

“produce a risk of higher than efficient rates of return”².

Envestra disagrees with this conclusion. The current Rule 87 is reproduced below:

“87 Rate of return

- (1) *The rate of return on capital is to be commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services.*
- (2) *In determining a rate of return on capital:*
 - (a) *it will be assumed that the service provider:*
 - (i) *meets benchmark levels of efficiency; and*
 - (ii) *uses a financing structure that meets benchmark standards as to gearing and other financial parameters for a going concern and reflects in other respects best practice; and*
 - (b) *a well accepted approach that incorporates the cost of equity and debt, such as the Weighted Average Cost of Capital, is to be used; and a well accepted financial model, such as the Capital Asset Pricing Model, is to be used.”*

¹ AER Rule Change Proposal, September 2011, page 1.

² AER Rule Change Proposal, September 2011, page 5.

Since the National Gas Rules have been in place, the AER has handed down six gas distribution decisions in which it has administered this Rule (Wagga, Jemena, APT Queensland, Envestra Queensland, Envestra SA and ActewAGL). However, there are another five businesses that have not yet been through an AER review under the National Gas Rules (Central Ranges, Envestra Victoria, Multinet, SP Ausnet and Albury Gas Company).

This suggests that at best there is only very limited experience in the application of this Rule to gas distribution businesses that can be used to provide evidence on whether the Rule has been effective or ineffective. Moreover, the AER has not pointed to any evidence from any of the previous reviews that have been undertaken where the Rules have contributed to incorrect outcomes.

Perhaps more importantly, Rule 87 is very similar to clauses 8.30 and 8.31 in the Code.

Rate of Return

- 8.30 *The Rate of Return used in determining a Reference Tariff should provide a return which is commensurate with prevailing conditions in the market for funds and the risk involved in delivering the Reference Service (as reflected in the terms and conditions on which the Reference Service is offered and any other risk associated with delivering the Reference Service).*
- 8.31 *By way of example, the Rate of Return may be set on the basis of a weighted average of the return applicable to each source of funds (equity, debt and any other relevant source of funds). Such returns may be determined on the basis of a well accepted financial model, such as the Capital Asset Pricing Model. In general, the weighted average of the return on funds should be calculated by reference to a financing structure that reflects standard industry structures for a going concern and best practice. However, other approaches may be adopted where the Relevant Regulator is satisfied that to do so would be consistent with the objectives contained in section 8.1.*

The Code was in effect from 1997 up until 2008 and has been used in numerous decisions over that time by state regulators and the ACCC. If there was a problem with the general approach to determining rate of return in the Code and the NGR, you would expect some evidence would have emerged to suggest that the method was producing biased results. No such evidence is presented in the Rule change proposal.

This suggests that no case has been made to support a change to Rule 87.

Will the AER Proposed Rule Generate Efficient Outcomes?

Envestra considers that the Rule change proposed by the AER is unlikely to produce correct forecasts of rate of return as required by the National Gas Objective and the Revenue and Pricing Principles of the National Gas Law. The National Gas Objective is:

“to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas”.

The most relevant Revenue and Pricing Principles is Clause 24(5) which requires that:

“A reference tariff should allow for a return commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff relates.”

In order to meet the National Gas Objective and the Revenue and Pricing Principles, it is necessary for the return approved by the regulator in an Access Arrangement review to be commensurate with prevailing conditions in the market for funds. If the approved rate of return differs from the prevailing market return, investment will be sub-optimal and customers will be disadvantaged. It is now well accepted that the extent to which customers are disadvantaged will be greater if the approved regulatory rate of return is lower than the actual cost of capital. This is reflected in the clause 24(2) of the Revenue and Pricing Principles where there is an obligation on the regulator to provide the regulated business with:

“a reasonable opportunity to recover at least the efficient costs the service provider incurs.”

In Envestra's view, setting the rate of return at the right level is the most critical task the regulator has to undertake. The rate of return accounts for about 60% of revenue able to be recovered by Envestra through Reference Tariffs³.

However, setting rate of return is a difficult task. It is well accepted that financial markets are dynamic, and that they change sometimes unpredictably and drastically, eg September 11, Global Financial Crisis. Changes in financial markets can materially alter the prevailing cost of capital. In setting the rate of return, regulators need to assess the impact of market conditions on the cost of capital to ensure that the return approved by the regulator is consistent with the prevailing market conditions. Failure to set an appropriate rate of return inevitably leads private sector companies such as Envestra to be constrained in sourcing new funding, whether debt or equity, from capital markets to support proposed capital expenditure programs, or to re-finance existing debt.

Under the Rule change proposed by the AER, the five yearly review of Cost of Capital will almost always be undertaken prior to the time the regulator makes a decision on an Access Arrangement submitted in accordance with the NGR. Therefore, it would only be by pure chance that the rate of return determined through the five yearly Cost of Capital review would be consistent with prevailing conditions in the market for funds and the National Gas Objective and Revenue and Pricing Principles at the time a regulatory decision was handed down.

The deficiency of the AER Rule change proposal can be seen by reference to the current Chapter 6A rules in the NER. In this model, a Statement of Regulatory Intent was issued by the AER in May 2009 setting out various WACC parameters and the reasoning for those parameters. Those parameters were then codified in the Chapter 6A Rules in the NER.

The Statement of Regulatory Intent is now 2.5 years old – about half way through its foreshadowed life.

However, there is already evidence demonstrating that WACC parameters codified in the existing Chapter 6A Rules through the Statement of Regulatory Intent are inconsistent with prevailing market conditions. For example, Chapter 6A prescribes a gamma of 0.65 and MRP of 6.5. In relation to gamma, the Australian Competition Tribunal on 19 May 2011 handed down its decision on the appeals by the South Australian (ETSA Utilities) and Queensland electricity distribution network operators (Energex and Ergon Energy). The Tribunal found that gamma should have been set at 0.25, however, the Chapter 6A still binds the AER to use 0.65 for electricity transmission businesses.

Similarly, the AER in its recent decisions for Envestra and APT for gas and Aurora for electricity have proposed that the MRP should be 6.0 rather than the 6.5 codified in Chapter 6A. If the AER were correct in this view, the current Chapter 6A Rules would again be in error.

³ See for example, AER 2011, Final Decision for Envestra Ltd, Table 9.2.

This is a major deficiency with the Chapter 6A model on which the AER Rule change is based. The evidence after only 2.5 years experience with this model supports Envestra's contention that there is a high probability that the outcomes from the proposed Rule change, which seeks to concentrate decision making on rate of return parameters into one review every five years, will produce results that are inconsistent with prevailing market conditions at the time of an Access Arrangement review. If the rate of return is not consistent with prevailing market conditions, the regulatory decision will not comply with the National Gas Law. While consistency could be achieved through bringing forward the Cost of Capital review, the timelines associated with undertaking the review are such that it is unlikely that decisions will be made in timely manner for the purpose of individual Access Arrangement reviews.

In contrast, the existing Rule 87 provides flexibility to deal with changing market conditions.

Administrative Ease

The AER seem to have based their view that the current Rule needs to be modified on the grounds that it provides too many opportunities for gas businesses to lodge submissions with the AER on WACC.

This according to the AER results in:

- the AER being drawn into arguments on rate of return rather than looking at other aspects of the regulatory proposal;
- businesses being given multiple opportunities to lodge submissions on WACC; and
- stakeholders and the regulator finding it difficult to respond to businesses arguments.

The AER suggest that it would be administratively more efficient to have one WACC process in which all affected parties are able to effectively participate.

Envestra agrees with the AER that we should look at developing processes that maximise the efficiency of any debate around rate of return thereby reducing costs of regulation. However, we do not believe that administrative ease should be the main driver for a Rule change proposal. Given the importance of rate of return to the business and to consumers, consideration of rate of return issues should require an appropriate focus by all stakeholders including the regulator. For the reasons noted above, it is essential that the WACC rule delivers the right outcomes in relation to rate of return.

The effect of the AER proposed rule change is to minimise discussion of rate of return in regulatory decisions. In our view, this is unacceptable. It is not appropriate to simplify the rate of return Rule in a way that seeks to restrict or stifle discussion of what is the most important regulatory decision that needs to be made.

Part of the reason for the AER's view that there is "excessive" attention being placed on rate of return today is due to a divergence of opinions between the AER and businesses on what the rate of return should be, for which there has been no mechanism in the Rules to facilitate reconciliation. This partially reflects the fact that when the AER undertook its Statement of Regulatory Intent in 2009, the businesses were unable to appeal the decision. For example, the AER concluded in the Statement of Regulatory Intent that gamma should be 0.65. This was not accepted by the businesses at the time.

However, there was no avenue for appeal. Consequently businesses had no opportunity to resolve the differences in view other than through individual Access Arrangement reviews and subsequent appeal. Now that this matter has been resolved by the Tribunal, Envestra would expect future submissions to the AER on gamma to be much shorter and refer to the work that has been done and now settled.

There are also a number of appeals that have been lodged on debt risk premium. As with gamma, Envestra would expect that once the Tribunal hands down its decision on this matter, there will be greater clarity for the AER, regulated businesses and stakeholders. This will avoid the need to spend an excessive amount of time on debt risk premium in future Access Arrangement reviews.

Reconciliation of issues of differences in this manner is preferable to imposing a rule change that provides the regulator with increased powers to impose its own value for rate of return parameters without appropriate academic and professional enquiry that ultimately should resolve these differences. The current Rule 87 provides a means of reconciling points of difference, finishing in an appeal to the Australian Competition Tribunal, if the parties cannot agree.

Alternative Approach

Envestra accepts that if the regulatory process can be made more efficient, we should do so. In this regard, we agree with the AER that there is merit in undertaking a five year review of Cost of Capital. However, rather than hard coding the outcomes of that review into the NGR, we consider that issues relating to how an administrative body intends to achieve its legislative obligations are most appropriately put in an industry guideline. We therefore suggest that the review should have the status of a regulatory guideline, leaving the opportunity to depart from parameters set out in the guideline at the time of an individual Access Arrangement review if market conditions warrant such a deviation. The NGR already provides the regulator with a power to issue guidelines (Rule 5).

Publication of a regulatory guideline on rate of return would meet a number of objectives including:

- provide a clear summary of the AER thinking on rate of return issues which will assist to provide certainty and stability around how the rate of return will be set;
- achieve administrative efficiencies by considering WACC from an industry perspective; and
- provides flexibility to deal with changing market circumstances.

Compulsory Use of the “CAPM” Model

The AER has also proposed that the regulatory WACC setting process should be restricted to use of the Capital Asset Pricing Model (CAPM). Whilst we acknowledge that the CAPM methodology has been used almost exclusively by Australian regulators over the course of more than a decade, we are also mindful that particularly in volatile market conditions, the CAPM approach has significant limitations and at least should be used only in conjunction with other methodologies.

The CAPM used by Australian regulators, including the AER, is a model first published in the early 1960's, some 50 years ago, and there has been considerable academic attention given to its development in subsequent years. The model adopted by Australian regulators is openly acknowledged to be based on assumptions that are inconsistent with commercial practice e.g. investors being able to borrow and lend at the risk-free rate, taxes and transaction costs being assumed away, etc. Uncritical adoption of the CAPM “arithmetic” in some market circumstances will result in unrealistic setting of the cost of equity. An example of this is the current market where the Government 10 year bond yield has reduced due to uncertainty in financial markets, with investors shifting money to government bonds – the so called “flight for quality”.

We do not suggest that the CAPM should be discarded, However, we do contend that its use in regulatory WACC setting should be carefully implemented, acknowledging the academic progress that has been applied over the years, and only adopted in a context of references to other available methodologies to assess equity and debt capital costs for the benchmark firm.

A strength of the current Rule 87 in the NGR is that the regulator is able to consider alternative models to CAPM assisting to build confidence that the rate of return approved by the regulator is in fact correct.

Summary

Rule 87 in NGR, which provides the regulator with discretion, coupled with appeal rights, provides the most effective mechanism for ensuring rate of return in Access Arrangements is correct and consistent with prevailing market conditions. We suggest that there is no need to change this rule now. Moreover, as around half of the gas distribution companies have not yet been through a regulatory review pursuant to the NGR, it is too early to even begin to consider changing Rule 87. We acknowledge that the implementation of Rule 87 could be assisted through release of a regulatory guideline setting out AER views on WACC parameters.

We consider that this approach (similar to the current model in the NGR) will more effectively meet the objectives of the National Gas Law and the benefits identified by the AER in Section 6 of their Rule Change Proposal:

- It will provide more certainty and stability on how the rate of return is to be determined;
- It will ensure that overall rate of return approved by the AER is commensurate with the regulatory and commercial risks faced by service providers;
- It will reduce administrative costs; and
- It will provide an appropriate balance between the need for flexibility in the cost of capital framework over the longer term with greater certainty in the short to medium term.