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21 June 2013

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Submission responding to AER Rate of Return Guidelines Consultation Paper

The APA Group (APA) appreciates the opportunity to comment on the Consultation Paper the Australian Energy Regulator (AER) has issued in its process of developing the rate of return guidelines now required under clauses 6.5.2(m) and 6A.6.2(m) of the National Electricity Rules (NER), and under rule 87(13) of the National Gas Rules (NGR).

APA is contributing to the AER's rate of return guidelines process through its participation in the Financial Investors Group (FIG) and through its membership of the Australian Pipeline Industry Association (APIA).

In making this submission in its own right, APA does not present views at variance with those of the FIG and APIA. Rather, APA takes the opportunity to give emphasis to a number of those views from its perspective as a major energy infrastructure investor which operates some 13,000 kilometres of gas transmission pipelines and associated gas storage facilities, and two transmission interconnectors serving the national electricity market.

APA has a keen interest in ensuring that the national electricity and gas regulatory regimes deliver new infrastructure investment in the long term interests of energy users while, at the same time, safeguard the interests of investors in that infrastructure.

The investors who finance APA's energy infrastructure have been concerned that the rates of return allowed in regulatory determinations under the NER and the NGR have been lower than the rates expected on investments in that infrastructure.

Those investors see the amendments to the rules governing rate of return determination in the NER and the NGR, amendments made by the Australian Energy Markets Commission (AEMC) in November 2012, as having the potential to change this perception by aligning expected and allowed rates of return.

The critical change has been the inclusion of the allowed rate of return objective in the rules. Rate of return determination is, as a result, now outcome-focused. It is focused on delivering the right outcome: an allowed rate of return which is commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of the provision of regulated services.



To ensure that the right outcome is achieved – to ensure that the allowed rate of return achieves the allowed rate of return objective – the AEMC’s amendments to the NER and the NGR also introduced flexibility into the process of rate of return determination by requiring that regard be had to relevant estimation methods, financial models, market data and other evidence.

APA is strongly of the view that this focus on the right outcome, and on the flexibility needed to ensure that the right outcome can be achieved, must be reflected in the rate of return guidelines which the AER is to make and publish.

Achieving the right outcome

Clauses 6.5.2(b) and 6A.6.2(b) of the NER, as they were before the AEMC’s November 2012 Rule Determination, required that the rate of return on equity be estimated as the return required by equity investors in a commercial enterprise with a similar nature and degree of non-diversifiable risk as that faced by a network service provider. This was the risk captured by the Sharpe-Lintner Capital Asset Pricing Model (CAPM). Use of the CAPM in estimating the rate of return on equity was mandated by clauses 6.5.2 and 6A.6.2.

Rule 87(2)(b) of the NGR, although not as prescriptive, similarly pointed to use of the CAPM and, by implication, to the non-diversifiable or systematic risk captured by the beta factor in that model as the only risk to which consideration was to be given in determining equity returns.

In the NER, the measurement of this risk was prescribed for transmission; beta was deemed to be 1.0. For electricity distribution, the basis on which beta was to be determined was less clear. In the NGR, the basis for beta estimation was left uncertain by requirements that, in determining the rate of return, the service provider was to be assumed to meet benchmark levels of efficiency, and to use a financing structure that met benchmark standards as to gearing and other financial parameters.

Rate of return determination under both the NER and the NGR took no account of the particular circumstances of the energy infrastructure business for which the rate of return was to be determined. The non-diversifiable risks for which investors were to be compensated through rates of return on equity were unrelated to the circumstances of the businesses in which those investors had invested.

The AEMC’s November 2012 rule changes changed this. However, as the AER noted in its Consultation Paper, the changes have made the consideration of risk, and of the way risk feeds in to the allowed rate of return, more complex matters.

The risk to which allowed rate of return objective refers is not, in APA’s view, the risk premium which is explained by the CAPM. It is a reference to variability in the returns of the service provider. If the AEMC had intended that the term risk, when it was used in the allowed rate of return objective, meant the risk premium in asset prices, in all likelihood that would have been made explicit in rule 87.

This is no mere point of legal drafting. It is fundamental to determination of the allowed rate of return. Irrespective of what financial models might be used, and of how those models reflect the risk premiums incorporated into the prices of financial assets, the application of



those models must be grounded in the circumstances of the service provider, albeit the circumstances of the efficient service provider. If the application of those models were not to be grounded in those circumstances, the requirements of the revenue and pricing principles of the National Electricity Law (NEL) and the National Gas Law (NGL) would not be satisfied:

- the service provider would not be provided with a reasonable opportunity to recover at least the efficient costs it incurs in providing regulated services; and
- a price or tariff determined using the allowed rate of return would not provide a return commensurate with the regulatory and commercial risks involved in providing the regulated service to which that price or tariff related.

If the application of models for estimation of the rate of return on equity and the rate of return on debt is not grounded in the circumstances of the efficient service provider, a price or tariff determined using the allowed rate of return will not provide a return which promotes efficient investment in, and efficient operation and use of, energy services for the long term interests of consumers. The price or tariff will not achieve, as appropriate, the national electricity objective or the national gas objective.

The allowed rate of return objective in effect provides the service provider with a reasonable opportunity to recover at least the efficient costs it incurs in providing regulated services, and leads to prices or tariffs commensurate with the regulatory and commercial risks involved in providing those regulated services, by grounding the determination of the rate of return in the specific circumstances of an efficient services provider. This is achieved by requiring that the allowed rate of return be commensurate with the efficient financing costs of the benchmark entity. That entity is to be efficient, and it is to have a degree of risk similar to the risk of the service provider in respect of its provision of regulated services.

Benchmark efficient entity

The starting point for the proper application of clauses 6.5.2 and 6A.6.2 of the NER, and of rule 87 of the NGR, is, in APA's view, the characterisation of the risk of the service provider in the provision of regulated services. Once the risk of the service provider in the provision of those services has been characterised, a benchmark with similar degree of risk can be established.

This characterisation of risk should extend well beyond the "regulatory and commercial risks" of the revenue and pricing principles of the NEL and the NGL. The list of risk factors in the report which Frontier Economics has prepared for the AER is a useful start (although other aspects of that report are less useful). Risk factors relevant to characterisation of the risk of the service provider are likely to include:



Business risks

Demand risk
Engineering and design risk
Construction risk
Operational risk
Input price risk
Supplier risk
Inflation risk
Competition risk
Asset stranding risk
Political risk

Financial risks

Default risk
Counterparty risk
Illiquidity risk
Refinancing risk
Interest rate reset risk

Establishing the benchmark efficient entity will be a significant undertaking in its own right, and a task which must be undertaken for each regulatory determination. How it is to be undertaken must be set out in the guidelines.

The benchmark efficient entity need not be an actual entity. Like the benchmark previously used in determining the rate of return, it might be a hypothetical entity with characteristics drawn from the set of data for those actual entities which meet the criteria for consideration as the benchmark (an efficient entity with a degree of risk similar to that which applies to the service provider in respect of the provision of regulated services).

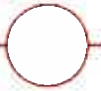
Once a benchmark efficient entity has been established for a particular regulatory determination, data for that benchmark should be used to estimate the rate of return on equity (and the rate of return on debt) for the regulated service provider.

APA notes that, although the benchmark efficient entity must have a degree of risk similar to that of the service provider, the benchmark will not necessarily reflect the specific circumstances of the service provider at a particular regulatory determination. In consequence, the allowed rate of return is unlikely to be the rate of return for the service provider itself.

APA does not discount the practical problems inherent in establishing the benchmark efficient entity at each regulatory determination. Only a small number of entities is likely to meet the test of being a pure play regulated network business operating within Australia and currently providing the same scale and scope of regulated services to the same customer base as the service provider. There will be even fewer of those businesses which have risk characteristics similar to those of the service provider for which the rate of return is to be determined. There may, as a result, be insufficient data pertaining to the benchmark to allow subsequent estimation of the rate of return on equity and the rate of return on debt.

In these circumstances, the AER could choose to use as the benchmark the set of businesses which it used prior to the AEMC's November 2012 Rule Determination. The earlier benchmark comprised those businesses which were thought to approximate the notional pure play regulated network business operating within Australia without parental ownership and currently providing the same scale and scope of regulated services.

If this were the case, the regulator would, in APA's view, need to give explicit consideration to how the data for that set of businesses, and the estimates obtained from their use, were to be adjusted so that they were for an efficient entity with a degree of risk similar to that of the



service provider in respect of the provision of regulated services. This may require careful analysis and argument akin to the risk positioning undertaken by North American regulators.¹

If that careful analysis is not carried out – if there is only the previous “casual” assessment and conclusion that there is no material difference between the broadly similar entities which might comprise the benchmark – then the service provider for which the rate of return has been determined will be entitled to claim that it has not been provided with a reasonable opportunity to recover at least the efficient costs it incurs in providing regulated services, and that the prices or tariffs determined using that rate of return do not allow for a return commensurate with the regulatory and commercial risks involved in providing those regulated services. The allowed rate of return will not, then, promote efficient investment in, and efficient operation and use of, energy services for the long term interests of energy consumers.

In these circumstances, the AER’s rate of return guidelines should explain:

- how candidates for the benchmark entity are to be identified as entities with degrees of risk similar to that of the service provider in respect of the provision of regulated services;
- how the efficiency of those candidates for the benchmark is to be assessed;
- how the benchmark is to be constructed from the efficient candidates;
- how the rate of return on equity, the rate of return on debt and the gearing are to be estimated from data pertaining to the benchmark; and
- the way in which any adjustments are to be carried out in circumstances where insufficient data are available and the requirement for a benchmark with degree of risk similar to that of the service provider in respect of the provision of regulated services must be relaxed.

Multiple models methodology

In APA’s view, the NER and the NGR now require the use of a multiple models methodology in the determination of the allowed rate of return. They require that, in the estimation of the rate of return on equity and the rate of return on debt, regard be had to relevant estimation methods, financial models, market data and other evidence.

As the AER notes in section 5.5 of the Consultation Paper, the use of such a methodology – the use of information from multiple sources – raises a key question: how is the relevant information to be combined; and how should it be distilled into a single point estimate?

Four broad approaches to the use of models are set out in the Consultation Paper to assist addressing this question. The AER asks: which of the four broad approaches to combining information to determine a return on equity is preferred and why?

¹ This risk positioning was described in section IV.D of the Brattle Group report which formed part of the APIA’s response to the AER’s Issues Paper on the rate of return guidelines.



Use of a single model, or of a primary model with reasonableness checks - the AER's approaches (1) and (2) - would not, in APA's view, be consistent with the requirements of the NER and the NGR, and would not be consistent with the AEMC's intentions. The AEMC amended the NER and the NGR with the express intention of having the regulator implement a multiple models methodology for rate of return determination.

APA would be concerned about the use of the reasonableness checks. When these checks have been used in the past, there has been no discrimination between the rate of return and other factors that might be contributing to the measures used for assessing "reasonableness". Before any reasonableness check could be used, the AER would have to demonstrate that the check was capable of yielding results which were consistent with achieving the allowed rate of return objective.

The simplicity and transparency of the AER's approach (3) would, APA believes, be largely illusory. Irrespective of the number of primary models, the fixed weights would be, at best, the outcome of a complex process of assessment of the significance to be attributed to each of those models (at worst, they would be arbitrary). Furthermore, use of a set of fixed weights, established in guidelines, would disregard the requirements of the NER and the NGR that prevailing conditions in the market for equity funds be taken into account at the time the rate of return on equity is estimated.

In APA's view, approach (4) - the use of multiple models and other information - is the only one of the AER's four approaches to the use of models consistent with the requirements of the NER and the NGR, and consistent with the intentions of the AEMC as they were explained in the November 2012 Rule Determination.

However, implementing approach (4) through the use of a primary model, with results from other financial models used informatively to assess the result obtained from the primary model, would not be consistent with the requirements of the NER and the NGR. There is no primary model upon which such an implementation could rely.

Multiple models cannot be mechanically applied and regulatory judgement will have to be exercised. In the Consultation Paper, the AER seems concerned that the exercise of regulatory judgement required in the application of a multiple models methodology will preclude transparency. APA sees no reason for this concern.

The use of multiple models will involve a process of assessment of the significance to be attributed to each of the models which draws on understandings of the models themselves, the circumstances in which they are applied, and other information relevant to estimating a rate of return on equity and a rate of return on debt which can contribute to achieving the allowed rate of return objective.

APA is of similar view to the AEMC. The previous relatively mechanistic approach to estimation of the rate of return no longer meets the requirements of the NER and the NGR. The AER must follow good administrative decision-making practice. It must provide rigorous, full and considered explanations for decisions. In each regulatory determination, the AER must clearly articulate how it has considered the factors to which it must have regard in making a decision on a rate of return that meets the allowed rate of return objective.



Rate of return on debt

In the Consultation Paper, much of the discussion on the use of multiple models is focused on the use of multiple models in the estimation of the rate of return on equity. The AER advises that its position, at this time, is that a single approach be used for estimating the rate of return on debt.

The discussion of issues arising in the estimation of the rate of return on debt is limited to those issues which might arise if estimation were to use an on-the-day approach, a trailing average portfolio approach, or a hybrid portfolio approach.

APA sees these three approaches as options now explicitly admitted by the rate of return provisions of the NGR and the NGR. Their admission does not limit the broader requirement of the rules to adopt a multiple models methodology. The NER and the NGR do not support the notion of a single approach to estimating the rate of return on debt.

Any estimate of the rate of return on debt to be used in determining the allowed rate of return must be an estimate made such that it contributes to the allowed rate of return objective. It must be an estimate which contributes to a rate of return commensurate with the efficient financing costs of the benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of the provision of reference services.

The question of the relative efficiency of the on-the-day, trailing average portfolio, and hybrid portfolio approaches arises only in the context of ensuring that, when any of them is used, it is used because it contributes to the efficient financing costs of the benchmark efficient entity.

APA is of the view that no single approach to measuring the cost of debt will be appropriate to all businesses subject to regulatory purview. In this regard, it is critical that the business be able to nominate the methodology which best suits their circumstances.

APA also notes that the AER and ERA appear to agree that a single methodology is appropriate, but appear to be leaning in opposite directions on the question of which methodology is best. APA is concerned that different approaches across jurisdictions could lead to distorted investment signals between jurisdictions.

APA Group would be pleased to discuss with the AER any issue arising from our response to the Consultation Paper. Please contact Scott Young on (02) 9275 0031 or scott.young@apa.com.au.

Yours faithfully

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