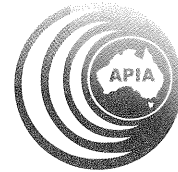
the australian
PIPELINE industry
association Ltd



18 December 2007

Mr Chris Pattas
General Manager
Network Regulation South Branch
Australian Competition and Consumer Commission
GPO Box 520
Melbourne VIC 3001

Email: gns@accc.gov.au

Submission by the Australian Pipeline Industry Association
on
ACCC Draft Decision for Revised Access Arrangement
Submitted by GasNet Australia Limited

The Australian Pipeline Industry Association (APIA) welcomes the opportunity to provide a submission on the Commission's Draft Decision for the GasNet Access Arrangement. This submission identifies two areas of concern:

1. The Commission's treatment of corporate synergies in approving non-capital costs. APIA is especially concerned that the Draft Decision does not appear to implement the accepted principle of incentive regulation which allows businesses to retain realised efficiencies for a period of time; and
2. Aspects of the Commission's decision on WACC parameters, which raises issues which APIA has addressed in other forums, such as the current Victorian Gas Access Arrangement Review.

Yours sincerely

CHERYL CARTWRIGHT
Chief Executive

AUSTRALIAN PIPELINE INDUSTRY ASSOCIATION LTD
ABN: 29 098 754 324 • ACN: 098 754 324
REGISTERED OFFICE: 1ST FLOOR, 7 NATIONAL CIRCUIT, BARTON ACT 2600
MAILING ADDRESS: PO BOX 5416, KINGSTON ACT 2604
T: 02 6273 0577 • F: 02 6273 0588
E: apia@apia.asn.au • W: www.apia.net.au

**Submission by the Australian Pipeline Industry Association
on
ACCC Draft Decision for Revised Access Arrangement
Submitted by GasNet Australia Limited**

1. GasNet Corporate Overheads/Synergies

The Draft Decision says:

> *This draft decision also accepts the majority of GasNet's proposed operating costs. However, the ACCC notes GasNet did not propose any reductions in corporate overheads resulting from cost savings expected from the APA Group's acquisition of GasNet in 2006. The ACCC proposes to reduce GasNet's corporate costs to reflect expected cost reductions.* (page iv)

The Draft Decision takes a position that cost savings are expected from the APA Group's acquisition of GasNet in 2006 and that these hypothetical savings should be incorporated into the corporate overhead costs proposed for the Victorian PTS. The ACCC estimates that the future reduction in GasNet's overheads could range from $2 million to $4 million per annum, and has settled on an estimate of $2 million per annum (page 116).

This position is unwarranted for the reasons outlined below.

Established regulatory principles relating to glide paths and incentives should be followed

APIA observes that the reductions in corporate overheads assumed by the Draft Decision have yet to be realised. When real synergies and efficiency gains are realised it is usual regulatory practice for these gains to be returned to pipeline shippers over time through an *ex post* benefit-sharing mechanism. These mechanisms provide an incentive for pipeliners to seek synergies, as the benefits of the synergies are retained by the pipeliner for a period of time.

Typically these mechanisms eventually return some, if not all, of the efficiencies, to pipeline shippers over time.

Thus, incentive mechanisms typically provide:

- An opportunity for infrastructure owners to first realise available efficiencies and economies of scale and scope;
- An opportunity for infrastructure owners to retain these benefits for a period of time;
- A defined method to shift these gains in subsequent regulatory periods to infrastructure shippers via a price/revenue path, an efficiency carryover mechanism or some other benefit-sharing mechanism.

Assuming that synergies are available in corporate amalgamations, whether for the APA Group or any other business, an *ex post* benefit sharing mechanism should be used by regulators. The efficiency gains should at least be realised and quantified before being shifted to pipeline shippers over time. This approach is consistent with sections 8.1(a), (b), (e) and (f) of the Gas Code.

APIA considers that the Draft Decision's premature shifting of efficiencies to shippers is not only inconsistent with the above sections of the Gas Code, it sets a very undesirable precedent that will remove any future incentive for infrastructure owners, such as pipeliners, to seek and realise efficiency benefits. Clearly, there should be rewards for the infrastructure owners to seek and realise efficiencies. The Draft Decision's approach removes these rewards, and hence removes the incentive for pipeliners to seek synergies.

The Draft Decision's approach is far closer to a cost-based regulation approach than incentive regulation. From a broader perspective, the Draft Decision also signals that otherwise desirable merger activity may not be worthwhile if any assumed economic benefits from mergers can be immediately appropriated by regulators.

Economic literature recognises the substantial benefits of regulators permitting businesses to retain merger efficiencies for a period of time. For example, Gordon and Olson (2006) observe:

> *The market for corporate control is a process by which a new management comes in and does what the old management did not do, perhaps by bringing to the table resources that the old management did not have access to. To successfully achieve merger savings, the new management team that takes charge of an acquired firm must generate maximal value for shareholders by realizing operating efficiencies.*
>
> *Success in achieving merger-enabled savings has potential to be a win-win situation for utility shareholders and customers alike. But ratemaking policies that penalize the combined utility by failing to provide a fair opportunity to share in the benefits of a merger will create perverse disincentives. Mergers and acquisitions can provide an effective way to reduce costs borne by consumers, and increase the value that they receive, by achieving economies of scale, scope, and learning.*
>
> *Given the potentially significant efficiency benefits that mergers can provide, ensuring that the combined utility's shareholders receive a share in the benefits of the merger is more than reasonable, it is an essential regulatory tool.*[1]

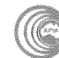
APIA observes that the above paper cites abundant US examples of regulatory approaches that allow sharing of net merger benefits between customers and shareholders (refer table 1 in the paper, page 55).

APIA also notes that the UK regulatory practice has established a more accommodating approach to mergers than is proposed in the Draft Decision. In 2002, Ofgem produced a policy statement on mergers in the electricity distribution sector which stated that regulation should not seek to inhibit companies from adopting corporate solutions, such as mergers, that promote greater efficiency. Ofgem also said:

> *For all mergers which take place following this policy statement, Ofgem's policy will be to identify savings from the merger as part of its work on*

---

[1] Dr. Kenneth Gordon and Wayne P. Olson: Removing Disincentives: State Regulatory Treatment of Merger Savings, *The Electricity Journal*, 15 October 2006. This is attached at the end of this submission.



operating and capital cost efficiency more generally. Savings from mergers will not be separately identified.[2]

APIA submits that this approach will produce more efficient corporate and capital market solutions than the approach of the Draft Decision, while providing an incentive to Service Providers to reduce costs and to develop the market for Reference and other Services.

Need to factor in the costs of achieving these benefits

The pre-emptive approach of the Draft Decision is further underscored by the fact that, while the Commission has assumed a level of benefits before they have been realised, it has made no specific allowance for the costs and risks that have been and will be incurred in realising any benefits. This is clearly an asymmetric approach to regulation: potential returns to the business are truncated, but the associated legitimate costs are not taken into account. Such an approach can only increase regulatory risk.

It is important for the ACCC to recognise that there is a level of risk that any merger may not achieve the level of synergies expected, resulting in costs to the merger parties but less actual benefit. This means that the potential net benefits must be sufficient to encourage the merger in the first place. Regulatory actions that remove expected benefits before the benefits or the full costs of acquisition and integration can be confirmed will not only reduce the forecast net benefit, but will create the potential for a greater net loss. Accordingly, such regulatory actions will discourage merger activity. A decision which has this effect is inconsistent with the requirement of section 8.1(d) of the Gas Code.

This reinforces APIA's view that the Commission should adopt an *ex post* approach to corporate synergies, and wait until the net ongoing benefits have been realised before sharing the benefits of mergers with customers through an appropriate benefit-sharing mechanism[3].

2. WACC Parameters

APIA welcomes several aspects of the Draft Decision's approach to quantifying the components of GasNet's cost of capital. These include:

- an equity beta of 1.0;
- recognition of the relative bias in Commonwealth Government securities (CGS); and
- allowing a BBB rating for the debt margin.

On the other hand, the Draft Decision:

- indicated that an equity beta of 1.0 may be conservative in the light of market evidence;
- reduced debt raising costs from 12.5 basis points (the most commonly used regulatory value to date) to 10.4 basis points;

[2] Ofgem, *Mergers in the electricity distribution sector, Policy statement*, May 2002 section 3.25. APIA recognises that Ofgem also introduced a policy of requiring distributors to pass a quantum of savings back to customers whether or not those savings had been incurred. This requirement was to compensate customers for the loss of comparators caused by a merger and for which Ofgem decided customers required compensation. APIA notes that while this regulatory approach may be appropriate in the UK it is irrelevant in the Australian context.

[3] APIA notes that a large part of section 5.1.5 of the Draft Decision is devoted to speculating on what should be, in the ACCC's view, APA's future corporate overhead policy in relation to GasNet.

- did not accept the absolute bias in CGS;
- forecast inflation to be 3.0 per cent rather than a more reasonable 2.5 to 2.6 percent.

APIA supports the general industry positions that have been put to regulators on the values of certain of these parameters, including:

- there is a persuasive case supporting the retention of a beta value of 1;
- there is unambiguous evidence for the existence of absolute bias in CGS;
- an appropriate estimate of future inflation is 2.5 to 2.6 per cent.

APIA responded to the recent Draft Decision by the Essential Services Commission of Victoria (ESC) in respect of the Gas Access Arrangement Review 2008-2012, and notes that several of the WACC issues raised in that decision are similar to those arising from the Commission's Draft Decision[4].

(a) Equity beta

The ACCC states that there is mounting evidence to suggest that an equity beta of 1.0 is conservative (and cites the ESC Draft Decision). For various reasons cited in its Draft Decision, the ACCC has, at this point of time, maintained a value of 1.0. At the same time, the Draft Decision states that the ACCC "*may place greater weight on contemporary market evidence in deriving a best estimate of the equity beta under section 8.2(e) of the Code, noting that this may lead to an equity beta of less than 1.0*" (page 85). APIA finds the ACCC's intent somewhat unclear from these statements, and is concerned that the statement could imply a value of less than 1.0 in the Final Decision.

In the Victorian Gas Access Arrangement Review, APIA commissioned an analysis by NERA of an appropriate equity beta for Victorian distributors, and economic consultants CECG and SFG prepared analyses for the gas distributors that was complementary to the NERA work. APIA submits that this weight of expert opinion strongly supports an equity beta of 1.0, and refutes assessments produced by the Allen Consulting Group for the ESC which may suggest applying a beta of less than 1.0.

(b) Absolute bias

GasNet formally requested the ACCC to consider the NERA view that the nominal and indexed CGS yields are biased downwards. However, the Draft Decision notes that the ACCC does not consider that NERA has, to date, demonstrated a conclusive case to justify a departure from the accepted approach of using nominal CGS yields to proxy the nominal risk-free rate.

APIA is concerned that the Draft Decision has not recognised the absolute bias in the CGS market. The absolute bias (attributable to a uniqueness premium in the yields on nominal CGS) was initially recognised by NERA as discussed in the Draft

---

[4] See APIA submission dated 29 October 2007 to Essential Services Commission Draft Decision on the 2007 Gas Access Arrangement Review 2008-2012. See also submissions from other infrastructure industry associations and submissions from the Victorian gas distributors (including attachments) on ESC website:
http://www.esc.vic.gov.au/public/Energy/Consultations/Gas+Access+Arrangement+Review+2008-2012/Gas+Access+Arrangement+Review+2008-2012.htm

Decision. It has since been the subject of further investigation by the consulting firm CECG. CECG[5] has updated research on the absolute bias using the latest market data and Victorian gas distributors have provided this to the ESC.

(c) Inflation

The Draft Decision accepted that the spread between yields on nominal and indexed CGS exhibits a relative bias that may make these yields currently unreliable inputs to the Fisher equation in order to estimate future inflation. The ACCC therefore decided to rely on monetary policy settings to form a view on inflation:

> *Where the RBA has a bias to tighten monetary policy, it would be reasonable to form the view that inflation will be at the top of the 2 to 3 per cent inflation target range. Where the RBA has a bias to relax monetary policy, inflation expectations will be taken to be at the lower end of the range. Where the RBA has a neutral position, inflation will be taken to be at the midpoint.* (page 80)

The Draft Decision noted that the current market sentiment is that inflationary pressures in the short to medium term may result in a tendency for the RBA to tighten monetary policy and therefore considered that an inflation forecast of 3 per cent per annum, which is at the upper end of the RBA's target range, provided the best estimate of the forecast inflation rate.

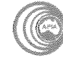
APIA notes that the Draft Decision's approach does not align the ACCC's assumed inflation forecast with the period over which the risk free bond rate is relevant. The Draft Decision should have used a long term inflation rate because it relied on using 10-year bonds for the risk free rate. Given that the Draft Decision has stated that w*here the RBA has a neutral position, inflation will be taken to be at the midpoint,* long term inflation should align with the middle of the RBA's range ie 2.5 per cent. This figure essentially balances (over the long term) periods of tighter and more relaxed policy settings. To assume that inflation will, for the long term be at the 3 per cent high point of the range suggests (on the ACCC's reasoning) that monetary policy will be in a tightening mode throughout that entire period. Not only is this scenario counter-intuitive, it may conflict with other elements of a submitted Access Arrangement, including volume and capital expenditure forecasts.

ESCV Draft Decision

APIA notes that the ESCV's Draft Decision for the Victorian Gas Access Arrangement Review proposed a forecast inflation rate of 3 per cent in order to derive a real risk free rate. Both NERA[6] and CECG[7] have since tested the validity of this assumption. Both NERA and CECG assessed that this value was incorrect and a more appropriate estimate of inflation for the purposes of deriving the real risk free rate would be 2.5 per cent to 2.6 per cent. APIA also notes that NERA expressed concern with the emphasis the ESCV had placed on the upper bound of the Reserve Bank of Australia's inflation target band when selecting the 3 per cent inflation rate forecast. NERA concluded:

---

[5] CECG, *Choosing a proxy for the nominal risk free rate*, October 2007.
[6] NERA, *ESC Draft Decision: Inflation Expectations*, October 2007.
[7] CECG, *A methodology for estimating expected inflation*, October 2007.



> *An inflation rate estimate of between 2.5% to 2.6% would accord with the current market expectations of the inflation rate that is expected to prevail over the next ten years and is consistent with the views of both the RBA and the Commonwealth Treasury*[8].

APIA submits that the WACC parameters should ensure that the WACC reflects an outcome which provides the service provider with the opportunity to earn a return which is commensurate with prevailing conditions in the market for funds and the risk involved in delivering the reference services.

3. Conclusion

APIA observes that the GasNet Draft Decision raises some important industry-wide issues of principle, especially concerning the treatment of synergies in corporate mergers. APIA urges the Commission to review its decision in this matter to one which accords with incentive regulation, accepted economic theory and the requirements of the Gas Code, as noted in this submission. Relevant overseas regulatory practice, as noted in this submission, should also be considered by the Commission.

APIA also submits that the Commission's Final Decision should reflect the latest research provided by APIA to the ESC in respect of the value of equity beta, absolute bias in the risk-free rate, and the forecast inflation rate.

Attach 1: Paper by Gordon and Olson
Attach 2: APIA ESCV Submission

---

[8] NERA op cit, page 14