Australian Gas Infrastructure Group

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Sherine Al Shallah
Australia Energy Markets Commission (AEMC)
via email sherine.alshallah@aemc.gov.au

Dear Sherine

Review into the scope of economic regulation applied to covered pipelines

This letter responds to the Draft Report of the Australian Energy Market Commission's (AEMC'S) review into the scope of economic regulation applied to covered gas pipelines. I thank the AEMC for the opportunity to comment on this report which provides with an important set of reforms to the current gas regulatory framework.

As you may be aware, Australian Gas Networks (AGN), Dampier Bunbury Pipeline and Multinet Gas have come together to create the Australian Gas Infrastructure Group (AGIG). AGIG combines the strengths of the three businesses to form one of the largest gas infrastructure businesses in Australia. AGIG has almost 2 million customers across every mainland state and the Northern Territory, 34,000 km of distribution networks, 3,500 km of gas transmission pipelines, and 42 PJ of gas storage capacity.

At AGIG, we believe the current framework for pipeline regulation is on the whole well designed to serve customers and meet the National Gas Objective (NGO).

We do however acknowledge that some improvements to the overarching framework are warranted. We particularly support recommendations that improve transparency (for example in Chapter 7) and those seeking to simplify the operation of the National Gas Rules (NGR) (for example recommendations 11 and 12).

We are generally supportive of the majority of draft recommendations made by the AEMC. We consider these changes, once implemented, will further promote the long term interests of our customers. We do however raise several issues in this submission that we think will further improve the operation of the NGR, and therefore ultimately better promote the NGO.

Coverage and form of regulation tests

Chapter 3 of the Draft Report raises a number of high-level issues about the framework and tests which determine the coverage and the form of regulation for pipelines. The Draft Report suggests that, with the introduction of Part 23, the current coverage tests "could lead to under-regulation (insufficiently addressing the market failure) or over-regulation (direct and indirect costs)" through the application of the "with-or-without regulation" test.

As the draft report acknowledges, "consideration of this issue is somewhat speculative" and "would involve significant changes" to the National Gas Law (NGL). We believe that consideration of the issue is premature. In our view, it is important that the recent reforms

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be given time to be put into practice by regulators, service providers and our customers before decisions are made on related parts of the regulatory framework.

We also note there has been significant review of the coverage test, including most recently by the Gas Market Reform Group in 2016. In all cases positions were reached that change to these parts of the framework are not required.

We would therefore encourage the AEMC to defer any further (and substantial) review of these parts of the regulatory framework until further information is available, including information that demonstrates the need for a further review in such a short time.

Reference services

Our primary concern with the AEMC's recommendations on reference services is that the proposed process seems to go beyond the stakeholder comments received by the AEMC. As noted in the Draft Report, stakeholder comments are concerned with only "material changes" to reference services and their non-tariff terms and conditions.

Based on these comments, a dedicated service setting process might only be warranted where a significant change is proposed to the reference services offered or their terms and conditions. Our own experience is that our reference services have remained stable for many years.

Limiting the proposed consultation process to circumstances where a significant change in references services is proposed would therefore result in a more fit-for-purpose (and hence lower cost) regulatory framework.

We are broadly supportive of recommendations 4 and 6, with only minor suggestions for improvement.

With regard to recommendation 4, the inclusion of pipeline services in Access Arrangements largely reflects current practice for AGIG. However, we caution against a broad requirement to include all "potential" reference services, largely on the basis that we cannot be in a position to understand all services the market may require. We also note that listing very low volume and/or unique service offerings is unlikely to be in the interest of our customers.

Regarding recommendation 6, we support the intention to include criteria by which a regulator would determine a pipeline service to be a reference service. We would however appreciate further information about how these criteria would be applied by regulators.

Arbitration

Our main reservations with the proposed recommendations regarding the operation of the arbitration mechanism concern the proposal for a fast-tracked dispute resolution process, to publish dispute information and to enable joint dispute resolution hearings (recommendations 30, 31 and 32). We consider the proposals will add to the complexity of the existing regime.

In particular, we believe the current process provides appropriate flexibility and breadth. The absence of time constraints means both parties to an access request are able to appropriately consider all aspects of the request and the technical requirements associated with the access request. At the same time the current triggers enable a broad range of aspects to be the subject of an access dispute.

Recommendation 27 would see a rigid mechanism imposed on parties to agree to an access request, with constrained time periods between receipt of an access request and the issue of an access proposal. These rigid timeframes are likely to be insufficient to enable a service provider to adequately assess the access request, including to request additional information wherever required.

For example, an assessment of an access request often involves various matters which require additional time for the pipeline service provider to assess. These include:

- creditworthiness checks;

- technical assessments; and
- bespoke requests.

Furthermore, the draft recommendation does not provide an expiry on the right of the prospective user to trigger the arbitration process. It is therefore conceivable that a pipeline service provider may have multiple access requests on foot at any point in time, each of which may be triggered to arbitration at any point in the future by a prospective user.

Notwithstanding our view that the current arbitration triggers are appropriate for scheme pipelines, were the AEMC's final report to include a new trigger process we consider the proposed timeframes to be overly restrictive. They would prevent adequate engagement on an access request and will likely result in unnecessary arbitration.

Financeability

Customers and regulated businesses have a shared interest in the ability of the regulatory regime to deliver cashflows consistent with the credit rating assumed in the making the regulator's decision. Continued access to the largest and lowest cost sources of debt finance is essential for maintaining investment in regulated assets, including to allow for businesses to deliver the expected work program contained within the regulatory decision.

We therefore have undertaken an examination of how a test of financeability could be added to the NGR. In short, we propose that a rule be introduced to require regulators to ascertain whether a benchmark efficient entity would pass a financeability test when making a regulatory decision. If the test was not passed, then the regulatory decision could be amended to address the financeability issue.

More detail on the issue and a potential approach is included in Attachment A, with the proposed draft rule in Attachment B. Most importantly, under our proposal customers would not bear the risk of a specific entity's inefficient financing decisions. Rather, the purpose is to ensure regulatory decisions deliver outcomes that are consistent with that assumed for the benchmark efficient entity (ie, to confirm that the regulatory decision is internally consistent).

Once again we would like to thank the AEMC for the opportunity to comment on the Draft Report. We look forward to working with the AEMC as it continues to progress the Review into the scope of economic regulation applied to pipelines. Should you require any additional information please contact Drew Pearman, Manager Policy and Government Relations on 08 9223 4341 or email drew.pearman@agig.com.au.

Yours sincerely

Craig de Laine
General Manager People and Strategy

Attachment A - Financeability

1. Overview

The term "financeability" is used here to refer to the capacity for a benchmark efficient business to be able to access sources of debt finance, at both the quantity and terms of debt required to underpin its required investments, consistent with that assumed by the regulator in making its decision.

We propose that a rule be introduced to require a regulator to test when making a regulatory determination whether the benchmark efficient entity for whom the decision is being made would pass a test of financeability in respect of the relevant credit metrics the decision would engender. If the test of financeability is not passed, then the regulatory determination should be altered to address the financeability issue.

It is envisaged that safeguards would be included to ensure that measures to address a near term financeability issue would not come at the expense of a larger, longer term problem. In addition, as the test would focus on the financeability of a benchmark efficient entity, customers would not bear the risk of a specific entity's inefficient financing decisions.

Rather, the objective would be to provide protection with respect to financeability in the face of events or factors that are outside the control of regulated firms.

Customers and regulated businesses have a shared interest in the regulatory regime facilitating the continued financeability of regulated businesses. Continued access to the largest and lowest cost sources of debt finance – including in the face of adverse events or factors – is essential for maintaining the incentive (and, indeed, potentially capacity) for investment, and for minimising the cost of provision and hence prices to customers.

AGIG considers the issue of financeability is likely to be more significant for gas pipelines than for electricity distribution and transmission assets. This is because electricity assets typically have a lower standard life (on average) than those of gas pipelines, which in turn results in gas pipelines having a slower rate of depreciation factored into revenue requirement calculations. This means that it is appropriate for a gas specific solution to be developed for this matter as part of this review into Part 8 to 12 of the National Gas Rules (NGR).

2. Financeability test promotes the NGO

AGIG considers the application of a finaceability test to regulatory decisions is consistent with good regulatory practice and therefore promotes the National Gas Objective (NGO). The focus of the NGO is on efficient investment in, and operation and use of, gas services in the long term interests of customers.

Indeed, the rule making test to be applied by the AEMC requires that any rule promote the NGO, and where the rule is related to matters of economic regulation, that regard is had to the revenue and pricing principles contained in section 24 of the National Gas Laws (NGL).

The revenue and pricing principles are concerned with matters such as the recovery of efficient costs, regard to the economic costs and risks for under or over investment and utilisation of the pipeline, incentives to promote efficiencies, and that prices should reflect returns commensurate with the risks involved in providing services.

Ensuring that the service provider (by reference to the benchmark efficient entity) can access efficient sources of debt finance, and therefore ensure it can invest in the network efficiently, is in the long term interest of customers. Further, we consider a check that a regulatory decision is internally consistent is also good regulatory practice.

The remainder of this section discusses in more detail how the rule making test is met by introducing a requirement to test financeability.

2.1 Regulated businesses' financing activity

A key activity of regulated utility businesses is to incur substantial capital costs in financing necessary investment and then recover those capital costs from their customers over an extended time frame. The substantial financing task thus created makes it necessary – and efficient – for regulated utility businesses to raise and periodically refinance high levels of debt finance.

Access to the most efficient sources of debt finance – in terms of their cost and the supply of funds available – require a business to have an investment grade credit rating (which means a credit rating that is BBB-/Baa3 or better). The supply of debt finance for firms with an investment grade credit rating is substantially greater than the available supply for lower ratings (especially for corporate bonds), and particularly at the term to maturity of the debt (10 years or more) that is efficient. This outcome is driven in large part by the investment mandates of the providers of debt finance.

In contrast, the supply of funds (and available terms) for the sub investment grade debt – typically referred to as "speculative debt" or "junk bonds" – varies substantially over time, and the supply of which tends to dissipate quickly when adverse economic events occur.

Given the need to raise and maintain high levels of long term debt finance, and the fact that the most cost effective and reliable supply requires an investment grade credit rating, it is efficient for regulated firms to target and maintain and investment grade credit rating, and indeed to target a safety margin above the lowest level to allow for the possibility of unexpected, adverse events.

In addition, as the value of bond holders' debt instruments will be affected by changes in credit ratings (i.e., an adverse credit rating change would typically result in a capital loss), firms will also typically seek to avoid material changes to their credit rating over time (and particularly adverse changes). Avoiding adverse impacts on existing debt providers will maximise the likelihood that new finance on attractive terms will be available when required.

2.2 Customer benefit

Providing a framework in which gas pipelines have a reasonable opportunity to be financeable promotes the NGO as well as the revenue and pricing principles by removing a potential impediment to efficient investment. Thus, the outcome is to encourage gas pipeline owners to invest to deliver the quality, safety, reliability and security of supply to a level that is desired by customers.

A financeability test would ensure that there is internal consistency across all of the interlinked aspects of the determination made by a regulator. Regulators currently applying the NGR derive the cost of debt for the benchmark regulated entity to reflect an assumed credit rating for a benchmark efficient firm. However, the cash flows are not tested to determine whether the cash flows provided by the regulatory determination are consistent with that assumed credit rating.

There is a benefit to customers from a regulatory regime that generates a revenue stream that allows the benchmark efficient entity to be able to obtain – and maintain – an investment grade credit rating. If the efficient firm were unable to maintain an investment-grade credit rating due to the out-workings of the relevant regulatory decision, then this would be reflected in much higher and less stable debt financing costs, which is not in the long-term interests of customers.

Additionally, it could not be assumed that the efficient firm would be able to raise the amount of debt required to meet the regulatory determination. The consequence of this is that a firm's capacity to invest may be substantially reduced compared to the assumptions made elsewhere in the regulatory determination.

Importantly, our proposal is that the test of financeability be applied to the context of a benchmark efficient businesses. The most significant aspect of this would be that the analysis of financial ratios would be based on the level of debt and interest rate payable for the benchmark efficient entity, rather than that of the actual firm. Applying the test in this manner would ensure that customers are not exposed to the inefficient financing decisions, which outcome reduces the price to customers.

2.3 A totex framework

Frontier Economics' recent report to the AEMC on a totex regulatory framework identified that a financeability test would be needed if such an approach was introduced in Australia. Under a totex approach there is discretion as to how much expenditure is treated as capital and how much as operating expenditure. As such, there is a risk that if too much of allowed totex is capitalised the business may have insufficient cash to meet its operational and financing needs.

Frontier Economics noted that under the UK's totex regime regulators have found that financeability tests are a useful tool to check if the rate of capitalisation of totex within the RAB is appropriate.[1] AGIG therefore considers that the justification for the use of financeability tests in the UK identified by Frontier Economics is also valid in the current Australian context.

[1] Frontier Economics, 'Total expenditure frameworks', December 2017, p. 107.

3. Concerns with undertaking a financeability test

Concerns that are sometimes raised in response to the prospect of regulators being required to assess and – if a problem exists – to attempt to remedy a financeability issue. Some of these concerns include that:

- it is not the role of the regulator to guarantee the credit rating of the regulated entity, rather the business should manage financeability itself rather than relying on regulatory measures;
- credit ratings are substantially influenced by qualitative factors, and so a focus on expected credit metrics from a regulatory determination is artificial and inappropriate;
- addressing a financeability concern for the near term will most likely create a larger problem;
- addressing financeability through a change to asset lives (and hence the depreciation rate) will lead to a disconnect between the depreciation allowances and asset lives, and
- measures to address financeability will raise near-term revenues, which will create allocative inefficiency.

We however consider that these concerns are either not warranted or may be addressed through the design of the mechanism.

In terms of the first of these concerns, and as advised above, we agree that regulated businesses should be responsible for the efficiency of their financing decisions, and that customers should not be exposed to poor decision making by businesses. This principal has been central to how infrastructure firms have been regulated in Australia since the implementation of the various sectoral reforms together with the National Competition Policy in the 1990s.

Our proposal is entirely consistent with this principle – that is, for the regulator to test the financeability of a benchmark efficient entity, not that of the actual business. Rather than to protect regulated firms against inefficiency in their own decisions, our proposal seeks to provide for a regulatory decision that is internally consistent and provides for the business to deliver on the scope of works set out in the regulatory decision.

In terms of the approach of credit rating agencies, while ratings agencies do have regard to a number of qualitative factors when determining the credit rating for the debt of a particular firm, the assessment of the quantitative financial metrics typically result in a base position from which adjustments for such qualitative factors may be made. This is the case for the process applied by Standard & Poor's, which is summarised in the Box below.

Thus, by making neutral (benchmark) assumptions about the qualitative factors, a direct link is established between the financial metrics for a benchmark efficient entity and its likely credit rating. Moreover, as the report to the AEMC from Frontier Economics points out, there is substantial precedent for regulators drawing such a mechanistic link between financial metrics and the likely credit rating.

Box 1: Standard & Poor's credit rating method

The method that Standard & Poor's (S&P) employs to determine a credit rating comprises a number of steps,[2] which are as follows.

First, an "anchor credit rating" is calculated, which is the product of an assessment of the firm's "business risk profile" and its "financial risk profile".

The "business risk profile" is expressed as a score from 1 to 6, ranging from "excellent" to "vulnerable". This assessment is based on an assessment of country risk (score of 1 to 6, although this is irrelevant for low levels of country risk) and the risk of the industry in which the firm operates (score of 1 to 6), as well as an assessment of the competitive position of the firm in question.

The "financial risk profile" is determined, which also comprises a score of 1 to 6, ranging from "minimal" to "highly leveraged". The financial risk profile is established from a consideration of financial indicators. There is an interaction between the determination of the financial risk profile and business risk profile because a lesser threshold for financial ratios is imposed for firms that operate in a less risky industry.

A matrix is then applied (shown below), which determines the anchor credit rating that is derived for a given combination of "business risk profile" and "financial risk profile".

Secondly, factors that may affect the rating from the "anchor" are then considered, which include such factors as diversification, quality of capital structure, financial policy, liquidity, management and governance. These factors may cause the rating to be raised, lowered or left unchanged. An overall check is then applied (with the opportunity for an overall judgement to be exercised), which may result in a rating being increased or decreased. The product of this assessment is the stand-alone credit rating.

Thirdly, where the firm exists as part of a wider group, then the effects of being part of the group are considered. This may cause the rating to be raised (for example, for firms with a government owner), or reduced (for example, if the parent has a lower rating than the issuer's stand-alone rating).

The anchor credit rating that is implied for combinations of "business risk profile" and "financial risk profile" is shown below.[3]

		Financial risk profile					
		1 Minimal	2 Modest	3 Intermediate	4 Significant	5 Aggressive	6 Highly leveraged
Business risk profile	1 Excellent	AAA / AA+	AA	A+ / A	A-	BBB	BBB- / BB+
	2 Strong	AA / AA-	A+ / A	A- / BBB+	BBB	BB+	BB
	3 Satisfactory	A / A-	BBB+	BBB / BBB-	BBB- / BB+	BB	B+

The regulated gas distribution business in Australia are typically assessed as having an "excellent" business risk profile, and so the first row in the table above is relevant. This means that a BBB+ credit rating may be sustained with a "significant" financial risk profile, but not with an "aggressive" financial risk profile.

The thresholds for financial indicators that are applied to assess the "financial risk profile" of regulated gas distribution businesses in Australia are shown below.[4]

2 Standard & Poor's, 2013, Corporate Methodology, November, summarised on pp.4-6. See also Standard & Poor's, 2013, Key Credit Factors For The Regulated Utilities Industry, November.

3 This is a part of a table provided in Standard & Poor's, 2013, Corporate Methodology, November, p.8.

4 This is the "low volatility" table provide in Standard & Poor's, 2013, Corporate Methodology, November, p.35. For when the "low volatility" table is applied, see Standard & Poor's, 2013, Key Credit Factors For The Regulated Utilities Industry, November, pp.17-18.

	Core ratios				Supplementary coverage ratios				Supplementary payback ratios					
	FFO / debt (%)		Debt / EBITDA (x)		FFO / cash interest (x)		EBITDA / interest (x)		CFO / debt (%)		FOCF / debt (%)		DCF / debt (%)	
	From	*To*	*From*	*To*	*From*	*To*	*From*	*To*	*From*	*To*	*From*	*To*	*From*	*To*
[1] Minimal	35+		< 2		> 8		> 13		> 30		20+		11+	
[2] Modest	23	35	3	2	5	8	7	13	20	30	10	20	7	11
[3] Intermediate	13	23	4	3	3	5	4	7	12	20	4	10	3	7
[4] Significant	9	13	5	4	2	3	2.5	4	8	12	0	4	0	3
[5] Aggressive	6	9	6	5	1.5	2	1.5	2.5	5	8	-10	0	-20	0
[6] Highly leveraged	< 6		> 6		< 1.5		< 1.5		< 5		< -10		< -20	

This shows, for example, that a significant financial risk profile requires a ratio of FFO/debt (which is the ratio that is currently being given most weight by ratings agencies) of greater than 9 per cent.

A regulated utility whose financial risk profile is at the lower end of the "significant" classification would expect to have a one-notch reduction applied to its credit rating (that is, for a BBB+ to be applied, rather than A-).

In terms of the potential for measures to address near-term financeability only creating future problems, we note this that it is unclear to us how such a situation could arise. Further, we also note that our proposal would allow the regulator to moderate any proposed remedy if the remedy were to result in a greater future financeability issue.

In terms of the potential to create a disconnect between asset lives and the depreciation allowance, we note the following:

- For many energy network businesses, there is already a material disconnect between the depreciation allowance and the lives of individual assets due to the application of the weighted average remaining life approach (WARL); and

- Depreciation can be advanced without altering asset lives. For example, switching from straight line depreciation with inflation indexation to straight line depreciation without inflation indexation will increase near-term cash flows without changing asset lives.

In respect of allocative efficiency, it is not clear whether a given change in the allocation of costs amongst customers through time will be less or more efficient than any other; this would be a case-specific issue. Moreover, we note that the current approach to regulatory depreciation has the effect of pushing depreciation to future customers ie, more costs are allocated to them than would be the case if businesses were allowed to apply standard straight line depreciation.

4. Potential remedies to address financeability

Economic regulation provides a number of options to improve financeability. This may take a number of forms, and the appropriate remedy should be fit for purpose to the nature of the issue revealed by the failure of the regulatory decision to meet the financeability criteria.

For example, one problem which can occur in regulatory determinations is one of cashflow mismatches; the regulatory determination provides enough revenues to meet the costs of the benchmark efficient entity over the life of the relevant assets, but this is back-ended to such an extent that the entity may have issues in meeting its near-term cash liabilities. In this instance, the need is not for an increase to total cash flows over the life of the assets, but rather a change to the allowed profile of cashflows through time.

This change to the profile of cashflows could be achieved by:

- Making an adjustment to the approach to depreciation. This approach would be straightforward to implement and is already contemplated in the NGR.[5] A change to depreciation need not imply a reduction in the assumed asset lives, instead it can simply be a change to the profile of depreciation such that more of the unrecovered investment is returned earlier and less is then recovered later.

- Treating a portion of capital expenditure as 'pay as you go' ie, a 'totex' framework. This approach requires treating a portion of capital expenditure as if it was operating expenditure and is the equivalent to setting the asset life for an investment to zero years. As such, the approach provides for an immediate return of the relevant portion of capital expenditure. It would be best applied where the financeability issue was arising due to material capital expenditure requirements.

[5] Clause 89(1)(e) of the NGR.

5. How to implement a financeability test

AGIG recommends that a rule change to introduce a "financeability objective" into revenue determinations would have the following components:

- First, a regulator would need to establish a target credit rating that is appropriate for a benchmark efficient entity that provides essential (utility) services. This must be consistent with any credit rating specified in the rate of return guidelines.

- Secondly, a regulator would be required to assess the likely credit rating that would be achieved by a benchmark efficient entity in the following regulatory period, consistent with the following:

  - To calculate the standard financial measures of credit worthiness that are applied by credit rating agencies and compare those values to the critical values that credit rating agencies apply in credit rating assessments.

  - In relation to the qualitative factors that are applied by ratings agencies, apply the assumption that the firm in question is a benchmark efficient entity conducting the activities of the relevant regulated business (i.e. not the actual firm).

If the test is not passed, the regulator would investigate why the test failed (what aspect of the decision left the benchmark efficient entity unable to meet the target credit rating) and then to apply a solution that best solves the problem identified and which will, or is likely to, contribute to the achievement of the NGO.

Attachment B – Draft Rule

FINANCEABILITY OBJECTIVE

1. Total revenue for an *access arrangement period* determined in accordance rule 76 must be assessed against the *financeability objective* in accordance with this rule.

2. The *financeability objective* is to ensure that total revenue of the service provider for the *access arrangement period* is commensurate with the *target credit rating* determined in accordance with sub-rule 3(a) below.

3. In assessing whether total revenue determined in accordance with rule 76 meets the *financeability objective*, the AER must:

   (a) Apply a credit rating consistent with any credit rating specified by the AER in the *rate of return guidelines*;

   (*the target credit rating*)

   (b) Assess whether the total revenue for the access arrangement period is commensurate with *the target credit rating* by applying the methods and assumptions employed by reputable credit ratings agencies to determine the likely credit rating that would be generated by the cash-flows derived from the total revenue.

4. If total revenue for the *access arrangement period* determined in accordance with rule 76 does not meet the *financeabililty objective*, then the AER must assess the cause of the *financeability* objective not being met and:

   (a) state in its reasons for the *decision* the reason why the *financeability objective* is not met;

   (b) make adjustments it is permitted to make under these rules to, insofar as is possible, ensure total revenue does meet the *financeability objective*. This may include, but is not limited to, calculating a portion of forecast capital expenditure which may be recovered in full in the year in which the capital expenditure is forecast to occur, which portion must be excluded from the opening regulatory asset base for the next *access arrangement* period determined in accordance with rule 77; and

   (c) In making any adjustments under sub-rule 4(b) the AER must:

      (i) make the adjustment which the AER is satisfied will or is likely to contribute to the achievement of the national gas objective to the greatest degree; and

      (ii) demonstrate how the adjustment addresses the reasons why total revenue, before the adjustment, did not met the *financeability objective;* and

      (iii) have regard to whether taking any step to meet the *financeability objective* in respect of the *access arrangement period*, would result in the *financeability objective* not being met in the next or subsequent *access arrangement period.*

DEPRECIATION CRITERIA

Add a new clause to the depreciation criteria as follows:

89 (1) The depreciation schedule should be designed:

…

(f) so as to allow, if required, for the total revenue for an *access arrangement period* to meet the *financeability objective*