Government of **Western Australia**
Office of **Energy**

Our ref: RSM/0071

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Dear Paul

PROPOSED RULE CHANGE – NATIONAL GAS RULES – RATE OF RETURN

The Office of Energy (**OOE**) has considered the rule change proposal submitted by the Australian Energy Regulator (**AER**) in September 2011. The OOE submits that it does not support any of the amendments proposed by the AER for the reasons set out below.

Five yearly WACC review

The AER proposes that rule 87 of the National Gas Rules (**NGR**) be amended to prescribe that a Weighted Average Cost of Capital (**WACC**) decision be based on a 5 yearly review by the regulator. This amendment will align the NGR with the National Electricity Rules (**NER**). The AER has submitted that it anticipates the proposed rule change will reduce the administrative burden associated with conducting a WACC review for each gas network access arrangement in addition to the electricity network access arrangements for which it must also make a WACC decision. The AER proposes that a 5 yearly WACC decision will provide more certainty to service providers who are subject to regulatory decisions and greater certainty for investors as the rate of return on all assets will be streamlined. The AER also submits that it anticipates that the proposed rule change will reduce the number of merits review on the subject matter of WACC under the National Gas Law (**NGL**).

The OOE does not support the AER's rule change proposal. The OOE submits that the reduced administrative burdens anticipated by the AER relate only to the eastern states and submits increased efficiencies will not be reflected in Western Australia due to the fact that the Economic Regulation Authority (**ERA**) only administers 4 gas pipelines, and does not administer any electricity networks under the NER. The OOE submits that the AER's proposed rule changes ignore the administration of the national gas regime by the ERA.

The OOE is concerned that the AER's rule change proposal does not provided conclusive evidence that a 5 yearly review will provide greater certainty to the regulatory regime. A 5 yearly WACC decision in our view would inhibit the ability of the regulator to make regulatory decisions which reflect the volatility of financial markets. The OOE believes regulatory decisions made in relation to WACC which do not reflect the prevailing conditions at the time the decision potentially distort efficient costs of capital and adversely affect incentives to invest.

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The OOE notes that the provisions governing rate of return in the National Third Party Access Code for Natural Gas Pipeline Systems (the predecessor to the NGR) were intentionally left unchanged when the regulatory framework was transferred to the NGR in 2008. This was done to ensure the regime was not unnecessarily restrictive. The OOE is of the view that even though the WACC provisions have been the subject of many merits review applications under the NGL, this should not be construed to mean that the provisions are flawed but that litigation is the result of service provider's establishing the limitations of discretionary powers of the regulator under the new access regime.

Post-tax nominal WACC

The AER has proposed the NGR be amended to prescribe a nominal post tax framework for determining the rate of return. This is a departure from the current position where a service provider is able to submit an access arrangement under any recognised taxation framework.

The AER has justified its proposed amendment on the basis that a nominal post tax framework has been consistently applied by the AER as the preferred approach in gas regulatory decisions. The AER is of the view that a streamlined access arrangement review process will provide certainty for stakeholders and reduce the regulatory burden of converting pre-tax to post tax frameworks and thus eliminating the potential for overcompensation during the conversion process.

The OOE submits that codification of a nominal post-tax framework restricts regulators and service providers unnecessarily. The OOE submits that both pre-tax and post-tax frameworks produce equivalent outcomes (provided the effective company tax rate is accurately calculated) and therefore the only benefit from such an amendment would be to reduce the AER's administration of regulatory decisions. The OOE does not consider decreasing the administrative burden of the AER as a legitimate reason to amend the NGR.

The OOE submits that the ERA has not developed the same consistency as the AER in assessing gas access arrangements on a nominal post-tax model. To implement the preference of the AER into the national gas regime matter would disregard the ERA's role as an independent regulator in Western Australia.

Codification of CAPM

The CAPM model is currently prescribed by the NGR as an example of a 'well accepted model' to use when determining the cost of equity.

The AER has proposed that the CAPM model be prescribed as the only model to be used to calculate the cost of equity. The AER has justified its proposal on the basis that the CAPM model is robust and has been applied by the AER in all of their gas determinations to date.

The OOE holds a strong view that there would be no benefit from amending the NGR in relation to CAPM as proposed by the AER. The OOE is of the view that the NGR works well in its current form and that codification of the CAPM model is restrictive and could potentially result in further amendments in the future should the CAPM model fall out of favour as the preferred method to calculate the cost of equity.

Western Australia

Section 74 of the NGL provides the AEMC the power to decide in which jurisdiction a rule change applies. To date, changes to the NGR have predominantly concerned matters which have not affected the interests of Western Australian service providers, like the eastern states short term trading market. The OOE is concerned that in relation to WACC, a subject matter which is so fundamental to the pricing principles under the NGL, that should the AEMC decide to implement changes in the eastern states and not in Western Australia there would be a discrepancy on a fundamental level between the regimes. The OOE is of the view that such a discrepancy would upset the notion of a national gas regime. The OOE also submits that a discrepancy between regimes could increase regulatory burdens for companies operating nationally as they would have to administer two different regimes on a fundamental level.

The OOE is also concerned about the potential uncertainty that could result from the review of two different regimes by the Australian Competition Tribunal (**ACT**). The concern lies in the fact that the ACT will review two fundamentally different provisions in relation to WACC, one which reflects the prevailing market conditions and the other which is reviewed on a 5 yearly basis. The discrepancy between the regimes may not only negatively affect the ERA's independence as a regulator but also affect the Western Australian regulated assets by increasing uncertainty for service providers and investors.

The OOE advocates the notion of a national gas regime and does not support the changes proposed by the AER be implemented either in Western Australia or the eastern states. The OOE does not agree that decreased administrative burden is a sufficient reason to change any of the three regulatory principles noted above.

Should you wish to discuss any of the point made by the OOE in greater detail, please do not hesitate to contact Natalie Mogridge or Arianwyn Lowe on 94205660.

Yours sincerely

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A / COORDINATOR FOR ENERGY