



Economic Regulation Authority

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Your Ref: ERC0134 and GRC0011
Our Ref: D79042
Contact: Richard Begley

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

Dear Mr Pierce

Submission: Consolidated Rule Request – National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2011 and National Gas Amendment (Price and revenue regulation of gas services) Rule 2011

Thank you for providing the opportunity for the Economic Regulation Authority (**Authority**) to make a submission on the rule change proposals submitted by:

- the Australian Energy Regulator (**AER**) in relation to the economic regulation of electricity and gas transmission and distribution businesses; and
- the Energy Users' Committee (**EUC**) in relation to the methodology for the calculation of the return on the debt component of the rate of return allowance.

The Authority notes that it has a strong interest in the outcomes relating to these matters, as – like the AER – it is responsible for the economic regulation of electricity and gas networks.

The Authority has considered the matters set out in the proposed rule changes at a recent board meeting, and provides the following comments.

RULE CHANGES RELATING TO ELECTRICITY REGULATION

The Authority notes that the results of any rule changes to electricity regulation would not have any direct implications for the Authority's functions in electricity access – given that the regime in Western Australia has a different legislative basis to the national electricity rules.

However, the Authority provides the following comments in support of the AER's proposed rule changes:

- The Authority considers that the issues in relation to the capital expenditure and operating expenditure framework warrant examination. In particular, the Authority notes that the criteria in the rules to ensure prudent and efficient capital expenditure need to allow for a range of analyses, rather than just bottom up engineering approaches. On this basis, the Authority agrees that amendments to the rules – to remove restrictions that limit the AER's ability to determine an impartial forecast and to manage uncertainty – are likely to be necessary. That said, the Authority considers that the current arrangements under Western Australia's Electricity Networks Access Code – which allows for ex ante and ex post new facilities

investment tests to determine the efficiency of expenditure – is an approach which should be considered by the AEMC as a means to address the identified problem.

- The Authority supports any approach which delivers flexibility in the setting by regulators of the debt risk premium. This approach would allow the AER to action changes similar to those made by the Authority in recent determinations. These matters are discussed in more detail in the next section.
- The Authority considers that the proposed changes in relation to the regulatory decision making process have strong merit. In particular, the Authority believes that the ability of regulated entities to make submissions on their own revenue and regulatory proposals, and to make any information provided as part of those submissions confidential, frustrates the achievement of a transparent, efficient and timely regulatory process. There is a particular issue about ensuring stakeholders are able to receive timely information and to be able to comment. This problem was very apparent in the Authority's recent determination on the Dampier to Bunbury Natural Gas Pipeline.

In addition, the Authority provides the following observations in relation to the framework applying in Western Australia in relation to the weighted average cost of capital (**WACC**).

For electricity transmission and distribution in Western Australia, the *Electricity Networks Access Code 2004 (WA)* (the **Code**) is the applicable regulatory scheme. Under sections 6.64 (Calculating WACC) and 6.65 (Authority may make a determination of a methodology for calculation of WACC), the Code does not prescribe the methodology for the calculation of the WACC. The Code provides very general requirements for the WACC, such as that the determination of a WACC must:

- represent an effective means of achieving the Code objectives; and
- be based on an accepted financial model such as the Capital Asset Pricing Model.

As indicated above, the regulatory scheme in Western Australia makes provision for the Authority to make and publish a determination of the preferred methodology for calculating the WACC. The methodology must be used unless the service provider can demonstrate that an access arrangement containing an alternative methodology would better achieve the objectives set out in the Code.

After establishing an initial preferred WACC methodology, the Authority decided not to continue this practice as it found that there was little to be gained in undertaking a WACC review outside of the review of the access arrangement. Furthermore, there is currently only one covered network which is required to submit an access arrangement for approval, so any periodic review would effectively coincide with the access arrangement review (approximately every five years).

That said, the Authority is supportive of the AER's proposed changes in relation to the rate of return. These issues are considered in more detail in the next section, as the proposed changes have potential to change the approach to gas regulation in Western Australia.

RULE CHANGES RELATING TO GAS REGULATION

The Authority notes that if the National Gas Rules (**NGR**) were changed in line with the proposals, then there would be an impact on the way in which the Authority conducts its access arrangement determinations.¹

Accordingly, in what follows, the Authority comments on each of the proposed rule changes in turn.

Timing of review of WACC parameters

The Authority considers that the issue of the timing of review of the WACC parameters in Western Australia is less problematic than in the eastern states. This difference arises because there are only three covered gas pipelines in Western Australia, and because the timing of the access arrangement reviews in relation to the three covered gas pipelines are reasonably coincident. Hence, the Authority tends to review its WACC approach for the first determination that comes due, which then largely carries through to the two subsequent determinations, depending on considerations relating to the matters raised in submissions from the service providers and interested parties.

The Authority is concerned that any proposal to conduct WACC reviews outside of the period of access arrangement assessment processes would merely impose additional resource costs without significant efficiency gains in terms of the assessment process. This would particularly be the case where an inflexible timing of such reviews did not match the timing of determinations. For the Western Australian jurisdiction, the Authority considers that it is preferable to undertake targeted analysis of particular components of the WACC during the normal access arrangement assessment process and utilise the AER's reviews of particular parameters as appropriate.

That said, the Authority understands the benefits of an aligned, regular review by the AER for electricity and gas regulation. The Authority considers that such reviews would be an important benchmark for its own considerations for the rate of return to apply in its gas and electricity determinations. The Authority also notes the observation by the AER that such an aligned approach would not 'detract from the benefits of being able to consider whether there is a need for different parameters between different classes of energy networks (including gas service providers) as part of a single WACC review process'.² The Authority considers that the Australian Competition Tribunal's decisions would also continue to have a bearing on such deliberations.

The Authority is also cognisant of the restrictions imposed by the 'persuasive evidence' provisions in the current rules. The Authority considers that providing regulators with greater flexibility to take all relevant information into account at the time of any WACC review, and to avoid 'inertia', is likely to be more consistent with the objectives for regulation. The outcome could be to allow for smaller step changes in the rate of return to be implemented at each review.

¹ The NGR relating to the economic regulation of third party access, which are empowered under the NGA, automatically applies in Western Australia, but not any other NGR.

² Australian Energy Regulator 2011, *Rule change proposal: price and revenue regulation of gas distribution and transmission services: AER's proposed changes to the rate of return provisions of the National Gas Rules*, www.aer.gov.au, p3.

In conclusion, the Authority is supportive of the rule changes proposed by the AER – but with the caveat that the relevant regulator has discretion as to whether and when to undertake periodic WACC reviews.

Prescription of a post-tax nominal framework within the CAPM model

To date, the Authority has used a pre-tax real CAPM framework for its WACC determinations for gas pipelines, and for electricity networks. This aligns with the requirement that it use a well accepted financial model.

Nevertheless, the Authority is of the view that its use of the pre-tax real framework has become more problematic in recent years. Any regulatory determination will tend to comprise a range of ‘unders’ and ‘overs’ – which on balance may be viewed as delivering a ‘reasonable’ outcome overall that is in line with the regulatory objectives. However, with service providers increasingly seeking to dispute the ‘unders’ based on points of precision, it is important that the precision of any ‘overs’ also be addressed – to ensure that the overall return remains reasonable. In consequence, the Authority has been giving internal consideration to amending its approach to adopt the post-tax framework.

In this context, the Authority agrees with the AER that prescribing an approach in terms of a nominal post-tax CAPM framework could:

- address concerns regarding the inherent over-compensation arising from the pre-tax approach;
- reduce the distorting effect inherent in the potential for gas service providers to ‘cherry pick’ unfavourable elements in the WACC determination;
- generally reduce the administrative cost associated with reviewing the rate of return provisions; and
- allow for a consistent approach, thereby informing the relativity of returns among different regimes.

The Authority is therefore supportive of further detailed consideration of these issues by the AEMC.

Calculation of the return on debt

The Authority considers that the issues raised by the EUC in relation to the calculation of the return on debt have merit, and that the options proposed by the EUC warrant thorough consideration.

The proposed changes by the EUC overlap in large part with changes adopted by the Authority as part of its recent cluster of WACC reviews for covered gas pipelines.

Given this overlap, the Authority makes the following observations in relation to the:

- methodology for estimating the debt risk premium;
- term to maturity for the nominal risk free rate; and
- differences between public and private ownership in the debt risk premium.

Methodology for estimating the debt risk premium

In its previous decisions, the Authority relied on the estimates of 10-year fair yield curves derived by Bloomberg and CBASpectrum. However, Bloomberg has in recent times progressively shortened its estimates of fair yields across credit ratings for Australian corporate bonds. Additionally, in September 2010, CBASpectrum ceased publishing its estimates of the fair yield curves across all credit ratings for Australian corporate bonds.

In response to these changes, the Authority developed a bond-yield approach to estimate the debt risk premium. With this approach, the previous practice of basing the debt risk premium on a 10-year corporate bond using Bloomberg's extrapolated data was discontinued in favour of an estimate based on: (i) a sample of bond yields of varying terms to maturity; and (ii) a sample excluding the Bloomberg's yield curves.

The Authority is of the view that the bond-yield approach, which relies on bond yields observed directly from the Australian financial market, is simple, transparent and replicable. The EUC proposal therefore is in accordance with the Authority's current practice of estimating the debt risk premium based on the observed yields for a sample of Australian corporate bonds.

The term to maturity of the nominal risk-free rate

The Authority is of the view that there should be consistency between the terms of the risk free rate and the debt risk premium. This view is based on the following considerations.

- First, the Authority notes that the possibility of over-compensation from the use of a term for the risk free rate that exceeds the length of the regulatory period, which is generally 5 years.
- Second, the Authority is of the view that there is no evidence to suggest that regulated businesses will seek to issue long term debt as a matter of preference. Instead, the Authority is aware that regulated businesses issue debts over a period of less than 5 years.
- Third, the Authority is aware that regulated businesses generally avoid the situation of having a significant proportion of their debt funding maturing in any one year.

Based on the above considerations, the Authority is of the view that there are strong grounds for matching the assumption of term to maturity with the regulatory period, which is generally five years.

The Authority also notes that matching the term of the risk free rate and the regulatory period is also a current practice adopted in New Zealand and the United Kingdom.

Accounting for differences arising from public and private ownership of service providers

The EUC is proposing that the debt risk premium should account for differences in ownership status. Specifically, the EUC state:³

³ Energy Users' Committee 2011, *Proposal to change the National Electricity Rules in respect of the calculation of the Return on Debt: Proposal by Amcor, Australian Paper, Rio Tinto, Simplot, Wesfarmers, Westfield and Woolworths*, www.aemc.gov.au, p6.

For government-owned NSPs, the Committee considers that it would be inconsistent to allow these NSPs to charge users for a cost of debt as if they were privately owned when they obviously are not. Such an approach – which currently applies – contravenes the Competition Principles Agreement. It is also unsupported by economic theory.

The Authority notes that there are no government owned gas monopoly network service providers in Western Australia that are subject to regulation by the Authority. However, the issue does have bearing on the Authority's upcoming deliberations in relation to Western Power's third access arrangement in electricity (**AA3**).

Overall, the Authority is of the view that the EUC has made a case for review of the approach to estimating the debt costs of State owned monopoly NSPs. The Authority supports consideration of this proposed rule change by the AEMC. The Authority will also need to consider this issue as part of its deliberations on the WACC applying to Western Power's AA3. The Authority's deliberation will necessarily need to consider all views from interested parties on this matter – the Authority has sought comment on this issue in its AA3 Issues Paper.⁴

Yours sincerely



LYNDON ROWE
CHAIRMAN

6/12/11

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Economic Regulation Authority 2011, *Issues Paper on Western Power's Proposed Revisions to the Access Arrangement for the Western Power Network*, www.erawa.com.au, p8.