the australian PIPELINE industry association Ltd

Economic Regulation of Network Service Providers

Response the AEMC Draft Determination on Rule Change Proposal GRC0011

4 October 2012

Executive Summary

The Australian Energy Market Commission released its Draft Rule Determination on Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas on 23 August 2012. The Determination included, *inter alia*, draft Rules for gas, principally a new Rule 87. The Determination set out a set of features that the Commission is seeking to achieve.

APIA is strongly supportive of the features that the Commission is seeking to achieve. However, in APIA's view as drafted the Draft Rule will fall short of the Commission's intent and achievement of the National Gas Objective (NGO) and the Revenue and Pricing Principles. In reaching this conclusion APIA has been advised by Johnson Winter and Slattery (JWS) lawyers and CEG economists. JWS has provided proposed drafting changes for the Commissions consideration.

The key aspects of the draft Rule that APIA believes require reconsideration are:

- The reinstatement of the requirement that the rate of return be "commensurate with the prevailing conditions in the market for funds as part of the overarching objective for the rate of return in Rule 87(2); and
- That the requirement for the regulator to consider all relevant methods, financial models, data and evidence be clarified so that it is understood that multiple methods, models etc are to be weighed up in determining the best estimate for the rate of return.

Other important aspects of the draft Rule that also need reconsideration are:

- Clarification of the terms in Rule "efficient financing cost" and "benchmark efficient entity" neither of which have an agreed clear meaning;
- The rate of return objective require that the allowed rate of return "correspond to" the "best estimate of " the benchmark efficient entity's efficient financing costs, so that the precision implied by the words "corresponds to" are tempered by the recognition of the uncertainty associated with estimating the rate of return;
- Enhancements be made to the process for the development of rate of return guidelines;
- In the event that the Commission decides against APIA's proposed changes to Rule 87(2) that the decision about the cost of debt methodology at very least be a limited discretion decision; and
- There should be transitional provisions for businesses that have had a basis other than a post tax nominal basis for the rate of return that would avoid the confiscation of value associated with the change in basis.

APIA commends these and the more detailed proposals set out in this submission to the Commission for its consideration.

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1. Introduction

The Australian Pipeline Industry Association (APIA) welcomes the opportunity to respond to the Commission's Draft Rule Determination released on 23 August 2012 (**Draft Determination**) setting out draft Rules and the rationale behind its response to the Rule Change proposals made by the AER and the EURCC.

APIA is the peak industry body representing Australian gas transmission industry. The views expressed in this submission are the agreed position of the owners of regulated gas transmission infrastructure in Australia.

APIA acknowledges the assistance of Mr Chris Harvey of Chris Harvey Consulting in preparing this submission and Tom Hird of CEG and Roxanne Smith of Johnson Winter and Slattery (JWS) in preparing the supporting report at Attachments 1 and 2.

As in its previous submissions APIA recognises that, in addition to dealing with the regulated rate of return, these Rule change proposals cover matters surrounding capex incentives, capex and opex forecast and regulatory processes. While APIA is interested in the non rate of return matters, because of the potential to flow on to the NGR, it notes that the Commission has not indicated in the Draft Determination a preference to change any of the provisions in the NGR relating to the non rate of return matters.

Accordingly, this submission will focus on the matters directly related to the NGR, namely the rate of return.

2. Does the draft Rule best reflect the key features?

A common framework

The Commission has determined that there should be a common rate of return framework across gas and electricity transmission and distribution. As indicated in its response to the Directions Paper, APIA considers this to be preferable. APIA has demonstrated that the existing arrangements of the highly prescriptive framework applicable to electricity have had the effect of overriding the flexibility and responsiveness of the gas framework. This appears to be largely because the AER has appeared to feel bound to have all of its decisions on rate of return for energy service providers use the same approach. Inherently the flexible system conforms to the inflexible system. Clearly then, creating a common framework that has flexible features, such as those currently in the NGR, means that the sort of flexible and responsive features that are more likely to result in a reliable rate of return estimate will apply, avoiding the current problems of the NER rate of return provisions in constraining the operation of the NGR.

APIA also notes and endorses the Commission's confirmation of the desirable features of a rate of return framework at 6.3.4 of the Draft Determination. The following is APIA's assessment of the draft Rule in achieving the features, subject to drafting refinements suggested in this submission.

Feature of the Rate of Return Framework	Achievement of the Feature
Estimating a RoR for benchmark efficient service provider	**Largely achieved.** APIA agrees with the adoption of a "model" efficient service provider as the basis for determining the appropriate regulated return. It should not be the return of an actual company and in order to be consistent with the NGO should be the cost of capital a company operating efficiently and raising finance effectively and efficiently. The overarching criterion for the rate of return requires [Rule 87(2)] "the allowed rate of return to correspond to the efficient **financing costs of a benchmark efficient entity**". To the extent that the meaning of the terms "efficient financing" and "benchmark efficient entity" are clear this feature is achieved. A more detailed explanation of this concern is provided in section 4.1 below.
Methodologies driven by principles and reflecting current best practice	**Potentially achieved.** Consistent with its earlier submissions APIA considers this an essential feature. The current NER prevent such an approach and it is desirable that the Rules provide an environment in which the breadth of methodologies, models data and approaches are considered on the basis of sound economic and analytical principles. The allowed rate of return is to be determined [Rule 87 (2)(c)] "taking into account relevant estimation methods, financial models, market data and other evidence. Rule 87 (7) suggests cost of debt methodologies, but does not limit them. Rule 87(10) – (16) requiring a rate of return guideline provides for a wide consideration of methodologies for the estimation of the rate of return. Together these Rules contribute to an environment where there is wide consideration of methodologies, principles and best practice. The effectiveness of these Rules will depend on the quality of submissions and contributions by participants to the guideline consultation and the willingness of the regulators to fully consider the material put before them and undertake research of their own. This Rule is designed to require the regulators to take a broader view in determining the rate of return than has historically been the case. This approach is considerably different to that required in the current NER Chapter 6 and Chapter 6A. However, as discussed in section 4.2 below, despite the Commission's intent the drafting of the Rules does not preclude the regulators restricting their ultimate consideration to

Feature of the Rate of Return Framework	Achievement of the Feature
	the Sharpe-Lintner CAPM alone.
Flexibility to deal with changing market conditions and new evidence	**Largely achieved.** Similarly in its previous submissions APIA argued for the need for decisions about the regulated rate of return to be made using market evidence available and applicable at the time of the regulatory review. The draft Rule provides that the decision on the rate of return is made as part of each regulatory review. No parameters or methods are locked in by the Rules by a periodic WACC review. In theory this should allow for changing market conditions and new evidence. However, the strong role of the rate of return guideline will create considerable inertia, because the regulator is obliged to explain any departure from the guideline. While not required to adhere to the guideline the regulator can be expected to prefer to adhere the guideline outcome rather than depart from it. So while there is flexibility to respond to changes and new evidence, APIA expects that there will be inertia on the part of the regulators in responding to them.
Inter-relationships between parameter values	**Achieved.** In order to achieve a reliable estimate of the cost of capital it is essential that models and approaches are internally consistent. This requires that inter-relationships between parameter values are properly recognised and taken into account. Rule 87(4) specifically deals to the issue of internal consistency and inter-relationships
Accountability for both the regulator and the service provider	**Achieved.** APIA has also argued about the need for accountability of all participants in a regulatory review, whether the service provider, the regulator or other parties making submissions to regulatory review. The role of the regulator and the service provider is clearly established in the Rules. The Rule provides the criteria for determining the rate of return, the matters that must be taken into account and the role of the guidelines. The role of merits review is critical to achieving regulatory accountability. This has been achieved by move away from the approach under Chapter 6A, and to a lesser extent Chapter 6, of the NER.
Regulatory certainty	**Somewhat achieved.** The aspect of regulatory certainty, which APIA sees as being needed, is that the Rules provide a framework where

Feature of the Rate of Return Framework	Achievement of the Feature
	by the best estimate of the rate of return can be and is likely to be made. APIA is not keen to see the sort of regulatory certainty where the rate of return outcome can be predicted but the outcome is not an accurate estimate of the rate of return. Regulatory certainty is provided in the draft Rule 87 through providing clarity to a number of key matters in the regulator's decision making process and through the issuing of the rate of return guideline with its accompanying consultation process providing investors with a strong indication of how the regulator will determine the rate of return. However, there are two uncertainties in the draft Rule that may not be easily resolved. These arise from the apparently intended broad level of discretion given to the regulator in how it will undertake the development of the rate of return guideline and how it will take into account relevant estimation methods, financial models market data and other evidence. There is considerable scope for thorough, rigorous and transparent analysis and decision-making. However, there is scope for something considerably less, as explained in section 4.2 and 4.3 below.
More effective customer participation	**Achieved.** APIA sees the main benefit of customer participation is that customers will better understand process and outcomes of a regulatory review and, in particular, the way in which the regulated rate of return is determined. The inclusion of the rate of return guideline with its consultation process provides a more accessible forum for customer participation. This is an additional benefit of the requirement for a guideline.

3. Head Line Issues

3.1 The Allowed Rate of Return Objective (Rule 87(2))

Consistent with its earlier submissions, APIA is highly supportive of the inclusion of a rate of return objective that is to be used by the service provider and the regulator to test whether a rate of return determined by applying the other elements of Rule 87 is of necessary quality. It contains significant principles and criteria:

- That the rate of return correspond to the costs of efficient financing practice;
- That the rate of return should relate to a benchmark entity rather actual entity;
- That the benchmark entity be an efficiently run business; and
- That the benchmark company have similar nature and degree of risk as the regulated service provider.

The only element APIA considers missing is the requirement that the rate of return correspond to the prevailing conditions in the market for funds. A more detailed discussion of our concerns on the treatment of this matter is detailed below.

While APIA is supportive of the Commission's Rate of Return objective, we have concerns about the meaning of two particular terms in Rule 87(2): "efficient financing" and "benchmark efficient entity".

"Efficient financing"

APIA is concerned that this term is new to the regulatory arena and does not have readily recognised meaning in the context of economic regulation. APIA also notes that the proposed words leave considerable room for interpretation about the meaning of the individual words "efficient " and "financing" and how they should be interpreted together.

"Efficient" is not a term used in financial theory and practice in respect of a company's financing practices. Efficiency is normally applied to markets and investment portfolios.

"Financing" is probably clearer in meaning and should naturally be understood to be the provision of funds or finance necessary for a company to operate and invest and would include a number of sources of funds, but would typically be through debt and equity.

APIA assumes the intent behind the words "efficient financing cost" is the lowest sustainable cost for obtaining debt and equity necessary for the business to operate efficiently in the sense of economic efficiency. It is likely that the Commission has in mind inclusion of the benchmark level of gearing for businesses of similar type and risk as the service provider. APIA suggests that clarity would substantially reduce the potential for disputes arising from uncertainty in respect of the term.

"Benchmark efficient entity"

The term "benchmark efficient entity" is found in the NER Chapter 6[1] and Chapter 6A[2]. Despite its use in the NER, in APIA's view the meaning of this phrase is not precise and the intent behind has not been precisely articulated in this context. The Draft Determination does not provide an explanation of the Commission's intent, presumably because it considers the meaning is common ground. It is not clear to APIA that it is common ground. APIA's understanding is that the intended meaning of the words is a notional corporate entity that acts as a benchmark and is assumed to be operating at the lowest sustainable cost in terms of investment and operation and financial arrangements. However, it is important that the Commission clarifies the meaning of the phrase.

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[1] National Electricity Rules, Rule 6.5.2, various references

[2] National Electricity Rules, Rule 6A.6.2,various references

APIA suggests the following words provided by JWS[3], which are based on those in the current Rule 87(2)(ii) "the costs capital for debt and equity using a financing structure that meets benchmark standards as to gearing and other financial parameters for an entity that meets benchmark levels of efficiency" be applied in Rule 87(3)(a) to bring clarity to the phrases "efficient financing costs of a benchmark efficient entity".

"Correspond to"

APIA's legal advice from JWS[4] is that while the meaning of "correspond to" can vary, depending on its context and the legislative purpose, in the case of the proposed Rule 87 (2) that phrase means the determination of a rate of return that is the best equivalent of what is experienced by the benchmark entity. That is, there must be a strong alignment between the rate of return determined and those estimated for an efficiently financed benchmark entity.

Importantly, JWS highlights the mismatch between the intended level of precision of the words "correspond to" and the imprecision associated with the task of estimating the rate of return. JWS recommend the addition of the words "best estimate" to proposed Rule 87(2) to better achieve the Commission's intent.

"Prevailing conditions in the market for funds"

APIA notes that the draft Rule has not included a key element of the current Rule 87(1), which establishes the primary objective in setting the rate of return. In APIA's view, the phrase "prevailing conditions in the market for funds" is of key importance in establishing the regulated rate of return, and it is essential that it remain part of the allowable rate of return objective. APIA's rationale relates to the components of the phrase:

- **The market for funds:** this emphasises that cost of capital finance are to be determined from actual market information, not from theoretical sources.
- **Prevailing conditions:** this phrase highlights the fact that costs of debt and equity must be those prevailing at the time of the Access Arrangement review. It is essential to a service provider's capacity to raise funds that the rate of return fully reflect the cost of raising those funds at the time that the Access Arrangement Decision is made and does not relate to earlier periods. This was one of the major problems with the Statement of Regulatory Intent process in Chapter 6 of the NER and the Statement of the Cost of Capital in Chapter 6A.

The Commission itself notes the importance of this point in the draft Rule where it says,

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[3] Memorandum from JWS to APIA, 3 October 2012, page 4

[4] Memorandum from JWS to APIA, 3 October 2012, page 3

> *"If the allowed rate of return is not determined with regard to the prevailing market conditions, it will either be above or below the return that is required by capital market investors at the time of the determination".*

CEG supports this view[5]:

> *"To the extent that it [the term prevailing conditions in the market for funds] as part of the objective and not simply a requirement to achieve when estimating the rate of return, gives primacy to the need to estimate a prevailing rate of return (rather than this being one of a range f potentially conflicting objectives we consider that it is more likely to achieve the NGO".*

APIA observes that the draft Rule includes this phrase in proposed Rule 87(5)(b) in relation to the cost of equity, although it is noted that the regulator is required to take into account the prevailing conditions in the market for equity funds for the cost of equity. JWS points out that this is not as strong a requirement as under the current Rule 87 and proposes that if the prevailing conditions in the market for funds is not added to proposed Rule 87(2) then it is essential that the words "take into account" should be replaced with stronger words from the existing Rule 87 "be commensurate with".

APIA also observes that the draft Rule does not apply the phrase "prevailing conditions in the market for funds" in respect of the cost of debt. APIA assumes that this is because the Commission has formed the view that the trailing average methodology to the cost of debt is not consistent with the use of the phrase "commensurate with the prevailing conditions in the market for funds" and the Commissions wishes to ensure that the Rule 87 allows the use of the training average methodology.

Consistent with its previous submissions APIA does not consider the trailing average methodology to the cost of debt to be relevant or applicable to its members. However, it does consider that it is essential that the allowable rate of return objective includes the requirement that the rate of return be commensurate with the prevailing conditions in the market for funds. The logical consequence is that if the trailing average methodology is precluded that those provisions of draft Rule 87 that have been designed to facilitate the trailing average approach become redundant.

JWS has developed drafting to reflect the inclusion of the phrase "commensurate with the prevailing conditions in the market or funds" in the allowable rate of return objective[6]. In APIA's view, while drastic and clearly not the Commission's intention, inclusion of the phrase "prevailing conditions in the market for funds" are so important as to consider such a change to the draft Rule as necessary.

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[5] Proposed AEMC changes to the National Gas Rule 87, CEG, page 13

[6] Memorandum from JWS to APIA, 3 October 2012, Attachment 1

However, if the Commission considers that the use of the trailing averages methodology to the cost of debt must be included in the Rule (thereby requiring it not be included in the allowable rate of return objective) then as identified in section 4.5 below, it is essential that the service provider be given discretion about the methodology to be applied to the cost of debt. Ideally this would be at the sole discretion of the service provider, but if this is not acceptable to the Commission APIA submits sub-Rules (6) and (7) at least be limited discretion decisions under Rule 40. JWS has also prepared drafting[7] consistent with this approach also.

3.2 Use of a range of methodologies, models, market data and other evidence

APIA notes the Commission's consideration of the Australian Competition Tribunal's decisions in respect of ATCO Gas and DBP's applications for merits review. In particular, the Tribunal's interpretation of Rule 87 that led to it accepting the ERA's exclusive consideration of the CAPM in determining the cost of equity. In particular, APIA notes and agrees with the Commission in saying,

> *"that requiring the regulator to have regard for more relevant information methods, financial models and other market data and allowing the regulator more capacity to achieve the overall objective, combined with a strengthen emphasis on achieving this objective, is more likely to achieve the NEO and the NGO that current approaches[8]."*

The Commission has given effect to this intent in proposed Rule 87 (3)(c) requiring that,

> *"the allowed rate of return …… is to be determined: …..(c) taking into account relevant estimation methods, financial models, market data and other evidence".*

As identified above this Rule provides the opportunity for the Service Provider and the regulator to rigorously and thoroughly consider a broad range of theory, research, practice, data and analysis to inform a rate of return estimate. Consistent with APIA's submission in response to the Directions Paper this is a highly desirable outcome.

APIA is concerned that in providing such broad discretion through the words "taking into account relevant" there is scope not only for thorough and rigorous assessment of the various estimation methods, financial models, market data and other evidence, but also scope for valid and relevant information to be discounted or its importance diminished or for non-rigorous methods of assessment to be applied. That is, the requirement to take into account a broad range of relevant material does not give certainty about whether the

[7] Memorandum from JWS to APIA, 3 October 2012, Attachment 2

[8] Draft Rule Determinations, Draft National Gas Amendment (Price and Revenue Regulation of Gas Services) Rue 2012, 23 August, AEMC, page 56

appropriate weight will be given to any particular piece of evidence. In particular, the regulator could consider all of the relevant material and decide to adopt a single model for example in the case of the cost of equity, the Sharpe Lintner CAP{M.

Advice from JWS[9] is that the Rule as currently drafted[10]

> *"could result in the Regulator considering other estimation methods, financial models, etc, but then putting to one to the side and continuing to estimate the cost of debt and the cost of equity using its preferred approach (ie the Sharpe Lintner CAPM), which would appear to be contrary to the objective of the rule change."*

CEG confirms APIA's view that the potential adoption of s single model is problematic its report[11].

> *We stated at section 3.2 of our previous report that approaches that rely on a single methodology will not meet the NGO. Accepted use of financial models has evolved over time with experience and research and this evolution continues. There remains a great deal of disagreement in the finance literature over which models best explain risk-adjusted returns. "Locking in" a particular implementation of just one model and assuming that only the output of this model is relevant to assessing the rate of return or cost of equity, cannot give rise to the best and most reliable estimates of the rate of return and will not meet the NGO>"*

APIA recognises that the latter outcome is not what the Commission intends, and that care must be taken in any revision of proposed Rule 87(3)(c) to avoid undesirable consequences through significantly greater prescription. APIA considers that there are two actions that the Commission can take to help avoid the possibility of too narrow a consideration of the range of methods, models data etc described above. Firstly, the Final Determination can make it abundantly clear that "relevant" is intended to be a low threshold for consideration and that a rigorous assessment of the various estimation methods, financial models market data, and other evidence is to be applied, by both the service provider and the regulator. Secondly, APIA proposes the following words developed by JWS be added to proposed Rule 87(3)(c)[12] to assist:

> *based on relevant estimation methods, financial models, market data and other evidence. <u>The allowed rate of return should be estimated using multiple relevant estimation methods, financial models, market data and evidence.</u>*

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[9] Memorandum from JWS to APIA, 3 October 2012, page 5, 6

[10] Memorandum from JWS to APIA, 3 October 2012, page 6

[11] Proposed AEMC changes to the National Gas Rule 87, CEG, page 4

[12] Memorandum from JWS to APIA, 3 October 2012, Attachment 1 and 2

CEG confirms the desirability of adding second sentence[13]:

> *"We believe this clarification does assist the AEMC's objective by ensuring that the status quo of sole reliance on a single implementation of the CAPM cannot continue to be the basis of future decision making."*

3.3 Guidelines

APIA can see value in the regulator issuing guidelines. It will provide an opportunity for a thorough consideration of the breadth of rate of return issues outside of the specific focus of an Access Arrangement. It will also provide investors with a clear picture of how the regulators intend to assess the regulated rate of return. There are however, some features of the proposed guidelines and the consultation process to achieve them that need adjustment.

Consultation Timetable and Process

APIA is of the view that the proposed timetable for the first set of guidelines is too short. Given the introductory nature of the first guideline and the fact that the matters to be considered under the new guidelines are by intention much broader than that under the SOCC/SORI process in the NER, more time should be provided to allow for undertaking the research, data gathering and analysis to allow the full range of estimation methods, financial models, market data and other evidence to be considered properly.

In addition, the process of consultation and evaluation required for the guidelines has not been undertaken under the NGR or the Gas Code. To the extent that there has been a broader consideration of different models, methods, data and other evidence, it has arguably been a cursory consideration and not the broad ranging and thorough consideration contemplated by the Commission. This is arguably true of the SORI and SOCC processes which were truncated by the narrow and prescriptive provisions of Chapter 6 and 6A of the NER.

APIA is sympathetic the need to minimise the need for and extent of deferrals of regulatory processes under the proposed transitional arrangements. APIA understands that these are designed to minimise delay in the application that the new Rule 87 to regulated energy infrastructure businesses. APIA considers the addition of one month in order avoid compromise in the development of high quality guidelines is to be preferred.

APIA suggests the following periods for the first guideline consultation:

- Proposed Rule 87(13)(b) – period to be 40 business days instead of 30 business days

[13] Proposed AEMC changes to the National Gas Rule 87, CEG, page 13

- Proposed Rule 87(13)(d) – period to be 40 business days instead of 30 business days

The dates in proposed Rule 87 (13) would need to be amended to take account of these changes.

APIA also wishes to raise one concern about the Guideline Process in Rule 9B. That is the absence of a consultation step before the regulator issues its draft revised Guidelines. The absence of this step truncates the process. In almost all regulatory processes there is an opportunity for airing of issues before a draft decision is made. This is the case in an Access Arrangement decision; it is the case in Revenue and a price Determinations for electricity. It is also the case in the Rule change process, most notably the Commission provided additional consultation on the initial Rule change proposal through the Directions Paper before arriving at its Draft Determination. In the light of the breadth and complexity of issues around the rate of return APIA considers such a process step as essential. In fact it is particularly so, because there is no process for review or appeal of the guideline by a third party.

This is also important for the regulators. It is well understood that a Draft decision by a regulator is one from which it will not quickly depart and will typically feel compelled to only make fine tuning changes in arriving at a final decision. APIA considers inclusion of a consultation step, before the regulator starts to formula clear views, to be significantly more conducive to an open consideration of the issues and a healthier, less adversarial debate. APIA commends the addition of a step as in Rule 87(13)(a) into Rule 9B.

Focus on estimation methods, financial models, market data and other evidence

The Draft Determination conveys the clear intent that the guidelines to be developed by the AER/ERA should focus on the financial models, methodologies, estimation techniques, information the AER/ERA will have regard to, guidance on how it will use, information models etc, weight to be given to various model estimates and data. It also indicates that the AER/ERA may provide current estimates of relevant parameters.

APIA notes in particular the Commission's comment in the Draft Determination:

> *The Commission anticipates that the guidelines would allow a service provider or stakeholder to make a reasonably good estimate of the rate of return that would be determined by the regulator if the guidelines were applied. In other words, the methodologies to be adopted and the information sources to be used should be sufficiently well explained such that they could be applied with a reasonable degree of accuracy*[14].

APIA endorses this intention and notes that while the Commission envisages that current estimates of parameters may be included to assist service providers and other stakeholders,

[14] Draft Rule Determinations, Draft National Gas Amendment (Price and Revenue Regulation of Gas Services) Rue 2012, 23 August, AEMC, page 60

it does not suggest that the guidelines should in anyway lock in parameter values as is currently done as part of the SOCC and SORI processes for electricity transmission and distribution. This is a crucial point for APIA. It is the locking in of parameter values that prevents a rate of return decision at the time of an Access Arrangement review being commensurate with the prevailing conditions in the market for funds.

While it seems clear to APIA that proposed Rule 87(11) only requires the guidelines to set out methodologies and the manner of their use, estimation methods, financial models, market data and other evidence and how these will be taken into account in estimating the cost of capital, they do not prevent the AER/ERA from going beyond this to establishing parameter values, that by virtue of proposed Rule 87(16) will implicitly be locked in. APIA does not think that this is what the Commission intends, but considers it a real possibility and an undesirable outcome.

To the extent possible, without introducing unnecessary prescription, it would be desirable to signal to the AER/ERA that the guidelines should not establish specific parameter values. This would mean that the inclusion of current estimates of relevant parameters would be indicative rather than prescriptive, which appears to be the Commission's intention.

Guidelines or de facto rules

While there are clear benefits of requiring the regulators to develop and consult on the rate of return guidelines, as alluded to in the previous section, the guidelines have the potential to lock in the various matters that the regulators must consider in developing the guidelines. As discuss above there are real benefits in the regulator considering the range of matters around methods, models, data etc and to set out how it will approach these matters. The problem arises in that in producing the guideline and having to explain any departure from it as required by Rule 87(16) the tendency will be for the regulators to adhere to the guidelines, even in the face of evidence for departure at the time of an Access Arrangement review.

Departure may be indicated because of a change of circumstances in either markets of in the development of new research or practice. However, it may also be because the regulator may have erred in developing the guidelines. In the event that there is an error in the guidelines, the service provider is burdened with demonstrating that the guideline was in error as well as making a case for correcting it. The fact that the regulator applied the guidelines in an Access Arrangement decision will make it harder to demonstrate error, if a party decides that recourse to merits review is warranted.

APIA is not aware of any clear remedy, other than the fact that the more the regulator addresses the issues of methodologies, models, data, weightings etc and avoids prescriptive setting out of parameter values and locking in the more detail elements of the rate of return, the less likely that these issues of inertia will arise.

Clarity about reasons

While the drafting of proposed Rule 87(11) requires that the guidelines are to set out the methodologies the regulator proposes to use in estimating the allowed rate of return and the methods, financial models, market data and other evidence the regulator proposes take into account in determining the rate of return. It would be appear to be implied that the regulator must give reasons for these decisions and for decisions about the weigh to be given to particular evidence and reasons why some evidence may not be considered relevant. However, APIA considers that it would be beneficial if the Rules also require the regulator to include reasons for its various decisions. This would be consistent with other places in the Rules where the regulator must give reasons. For example, Rule 59(4) and 62(4) requires the regulator to include a statement of reasons as part of its Access Arrangement Draft and Final Decisions.

In addition, it is important to both regulator and the service provider that in the event either of them decides to depart from the guidelines, at the time of an Access Arrangement Review, that the reasons for that departure can be clearly tied back to the reasoning that was the basis of the guidelines.

JWS has proposed a brief additional clause that would provide clarity about including reasons in the guidelines[15].

3.4 Transition to post-tax nominal basis

APIA's submission in response to the Directions Paper was that there was no need to prescribe the basis of the rate of return. That is it could be on a post –tax or pre-tax basis or a real or nominal basis and the Rules do not need to prescribe this matter. APIA accepts that the Commission has elected to adopt a consistent approach of a post tax nominal basis. However, APIA is concerned that, where businesses have had a pre-tax real basis applied to date there be an appropriate transition to the post-tax nominal arrangements.

It is likely that to simply apply the post tax nominal basis to the service providers Capital Base will create a discontinuity in the cashflows, because the implicit tax asset base under the pre-tax real calculations will not be the same as the Capital Base. The effect may be an immediate confiscation of business value from the particular service provider, simply through the transition from pre-tax real to post-tax nominal.

To avoid this transitional provisions need to be available for businesses that have had a pre-tax real rate of return applied, the regulators should be required to calculate the implicit tax asset base implied by the pre-tax real calculations and apply this for post tax modelling at the commencement of the next access arrangement period to be phased out over two access arrangement periods.

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[15] Memorandum from JWS to APIA, 3 October 2012, Attachment 1 and 2

It should also be made clear that the actual tax position of the service provider is not relevant for the purposes of calculating tax to be considered under Rule 87A.

3.5 Cost of debt methodology – Limited discretion decision

As discussed in section 4.1 above APIA is of the view that proposed Rule 87(2) should provide that the allowable rate of return should "be commensurate with the prevailing conditions in the market for funds. APIA also recognises that the Commission may view this as being inconsistent with allowing a trailing average methodology and therefore elect not to add the proposed words into proposed Rule 87(2). If this is the case APIA makes the following comments and suggested changes to proposed Rule 87(6) – (9).

Drafting matters

Proposed Rule 87(6)-(9) set out the requirements for the cost of debt and provide for some elections in proposed Rules 87(6) and (7) about the methodology for estimating the cost of debt. Rule 87(7) provides illustrative methodologies, which appear to be directed to

(a) the current methodology of applying the current cost of debt at the time of the Access Arrangement,

(b) a trailing average methodology, or

(c) a combination.

However, given the words "without limitation" in the preamble of Rule 87(7) the intention appears to be to allow other unspecified methodologies. JWS has identified some practical difficulties with achieving the Commission's intent. It has also identified a number of suggested refinements to the Rule 87(6) – (9)[16].

One element discussed by JWS[17], but not included in the drafting changes is the removal of Rule 87(8). JWS' advice is that the matters covered are duplicative of the requirements of the NGO and the RPP, creating potential ambiguity about how they should be applied or "double legislation" and therefore redundant. In either case the Rule would be enhanced by the removal of Rule 87(8). JWS has provided some drafting proposals that would go some way to removing some of the ambiguity/"double legislation" issues should the Commission consider it necessary to maintain Rule 87(8).

[16] Memorandum from JWS to APIA, 3 October 2012, Attachment 1 and 2

[17] Memorandum from JWS to APIA, 3 October 2012, page 9

Discretion about cost of debt methodology

The election to move from the historic forward looking methodology is a significant step and has potentially significant ramifications for service providers, both in terms of the rate of return determined and in the incentives for debt management. The effect of this decision may have profound impact on the operation of the service provider's business. Depending on the nature of the service provider, its debt management policy may reflect one or other of the two identified cost of debt methodologies, or something else. It is therefore appropriate that the service provider has the right to choose the methodology that best reflects its business operation.

Moreover, the training average methodology has been likened to a treating the cost of debt as an operating cost, both by the Commission's consultant SFG and by CEG. If it was an operating expenditure it would be a limited discretion decision.

In the light if this APIA is of the firm view that the discretion about which debt estimation methodology is to be applied must be with the service provider, which is best placed to understand how the cost of debt methodology will best relate to its own debt management practices. In APIA's view there are arguments that this should be a "no discretion decision" as set out in Rule 40(1). However, if the Commission is of the view the regulator should have some discretion then at most it should be a "limited discretion decision" pursuant to Rule 40(2).

4. Consistency with the National Gas Objective and the Revenue and Pricing Principles

APIA has sought advice from economic consultants CEG about the extent to which the draft Rules are consistent with the National Gas Objective and the Revenue and Pricing Principles. CEG's advice is found in Attachment 2.

CEG is of the view that the drafting changes proposed by JWS are more likely to be consistent with the NGO and RRP, and also with the Commission's intent as articulated in the Draft Determination.

5. Drafting Issues

5.1 Tests of importance of factors

The Draft Rule applies a range of tests of importance of factors to be considered as follows:

- "correspond to" - Rule 87(2)
- "regard is to be had to" – Rule 87 (4), Rule 87(8)
- "taking into account" – Rule 87(3) (c), Rue 87(5)(b)
- "in a way that is consistent with" – Rule 87(5)(a), Rule 87(6)(a
- "reflecting" – Rule 87(7)

Each of these appears to have a different level to which the factor being considered is to apply and that the Commission has sought to apply a hierarchical structure of importance. Presumably this is because some factors may be in tension and those that have the strongest importance will be given the greatest weight in any decision making process. APIA agrees with this intention but is concerned about the number of apparent levels and whether the level of hierarchy intended will actually be achieved. APIA has obtained advice from JWS to ascertain how each of these terms may be interpreted and the impact on the interpretation an application of Rule 87. JWS's advice is contained in Attachment 1 to this submission. The following summarises that advice and raises issues that arise from it.

"Correspond to"

AS discussed above JWS's advice[18] is that while the meaning of "correspond to" can vary depending on its context and the legislative purpose, in the case of Rule 87 (2) that the phrase means that the determination of a rate of return that is the best equivalent of what is experienced by the benchmark entity. That is there must be a strong alignment between the rate of return determined and those estimated for an efficiently financed benchmark entity.

"Have regard to"

This phrase is often used in legislation and has been frequently interpreted. JWS considers[19] that a court would interpret the words "have regard to as the regulator is required to take the specified matters into account as fundamental elements in its determinations and that to fail to actively turn its mind to each of those factors would be an error.

"Taking into account"

JWS's advice[20] is that the phrase "taking into account" has the same meaning as "having regard to".

From this analysis it is clear that the top of the hierarchy of important is Rule 87(2) the rate of return objective. Accordingly, the use of the term "corresponds to" is appropriate. As identified in Section 4.1 above APIA's only misgiving is that the term suggests that the efficient financing costs of a benchmark efficient entity" can be known with precision. This is well known not to be the case. The implied expectation puts the regulator and the service provider in an position being required to determine a rate of return that corresponds precisely to an value that cannot known with precision.

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[18] Memorandum from JWS to APIA, 3 October 2012, page 3

[19] Memorandum from JWS to APIA, 3 October 2012, page 6

[20] Memorandum from JWS to APIA, 3 October 2012, page 5

APIA proposes that the addition of the words “the best estimate of” before the words “the efficient financing costs”. This would be consistent with Rule 74 and appropriately recognised that fact that the determination of the allowed rate of return is an estimation process of an imprecise parameter.

The terms “have regard to” and “taking into account” have the same meaning as a matter of legal precedent. However, the fact that the Commission has used both terms suggests that it considers them to be different. This leaves room for confusion. If the historic precedent were to be applied then a courts would consider them as having the same effect. If this is the case, it would be better to use one or the other term, but not both. Alternatively, a court may take the view that because the AEMC had chosen different terms it intended different meanings. However, legal precedent would be of no help in deciding the relative weights to be applied in the event of a conflict.

APIA suggests that the Commission review its use of these terms and either apply a single term where both have been applied or adopt another phrase in place of one or other that properly reflects its intended hierarchy of importance.

5.2 Other Drafting Proposals

As indicated above JWS has provided APIA advice on the drafting of the new Rule 87. The more significant elements of its advice has been referred to in sections above. The most significant of these revolves around the inclusion of the phrase “commensurate with the prevailing conditions in the market for funds”. This has resulted in two versions of proposed drafting. Version one (including the phrase in Rule 87(2)) is in Attachment 1 to JWS advice. Version 2 (not including the phrase in Rule 87(2)) is in Attachment 2 to JWS advice.

There are a number of minor suggested drafting changes proposed in JWS’ advice and included in the two versions of drafting proposals. APIA commends the whole of the JWS advice to the Commission for its consideration and the associated drafting proposals.

6. Conclusions

APIA is strongly supportive of the intention behind Commission’s proposed Rule change but has a number of reservations about the implementation in the Draft Rule 87. It has sought advice from lawyers JWS and economists CEG about the drafting and the likelihood that the draft Rule will achieve the Commission’s intent and, importantly, the NGO and RPP. Based on the advice from JWS and CEG APIA believes that the draft Rule needs to be modified to better meet both the Commission’s intent and the NGO and RPP.

APIA provides JWS’ drafting proposals and commends them to the Commission for its consideration.

Attachment 1 – Memorandum of Advice from Johnson Winter and Slattery

Memorandum

Date: 4 October 2012

To: Mr Steve Davies, Australian Pipeline Industry Association (**APIA**)

From: Roxanne Smith and Chris Beames

Subject: **Proposed AEMC changes to National Gas Rule 87**

Our Ref: A8302

On 23 August 2012, the Australian Energy Market Commission (**AEMC**) published Draft Rule Determinations with proposed changes to the National Electricity Rules and the National Gas Rules (**NGR** or **Rules**).

The proposed rule changes include proposed amendments to Rule 87 of the NGR relating to the rate of return to be calculated on the projected capital base. APIA has sought our advice on the interpretation of the new Rules and whether the proposed new Rules meet the objectives stated by the AEMC in the Draft Rule Determinations. Our advice on those matters is set out below.

We also set out in Attachments 1 and 2 to this memorandum suggested amendments to draft Rule 87, as discussed further below.

1 Executive summary

We have considered in detail the Draft Rule Determinations and the proposed new Rule 87. We understand your instructions to be that APIA is generally satisfied with the AEMC's overall approach and objectives. However, in a number of respects we consider the drafting of the new Rule 87 does not accurately reflect the discussion and objectives set out in the Draft Rule Determinations. In other cases, we consider the drafting can be clarified to avoid confusion or issues of interpretation. This is reflected in our suggested drafting alternatives in Attachments 1 and 2 and is explained in detail in this memorandum.

2 Rule 87(2) – Allowed rate of return objective

The proposed new Rule 87(2) requires that the allowed rate of return "*correspond to the efficient financing costs of a benchmark efficient entity with a similar nature and degree of risk as that which applies to the service provider in respect of the provision of reference services*". This is defined as the "*allowed rate of return objective*".

2.1 Change in priority

We note that the structure of the proposed new Rule 87 (and sub-Rule 87(2) in particular) reflects a subtle, though important, re-arrangement of the order of priority of different factors in the determination of the allowed rate of return as compared to the existing Rule 87.

In the proposed new Rule, the primary objective in the setting of the rate of return is set out in Rule 87(2) – i.e. that the rate of return is to correspond to the efficient financing costs of the benchmark efficient entity with a similar nature and degree of risk as applies to the service provider. The following sub-Rules then set out a number of specific requirements that are to be satisfied,[1] or factors to which regard is to be had or which are to be taken into account,[2] in determining a rate of return that meets the objective in sub-Rule (2).

In this sense, the "*allowed rate of return objective*" set out in sub-Rule (2) takes priority over the requirement in latter sub-Rules that regard be had to certain factors, or that certain factors be taken into account. These factors are to be considered or mobilised not as an end in themselves, but in the achievement of the allowed rate of return objective.

In the existing Rule 87 the primary objective in determining the rate of return is that it be "*commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services*" (Rule 87(1)).

Whilst consideration of the risks experienced by the service provider in the provision of the reference services remains a part of the primary objective in the proposed new Rule 87(2) (as the benchmark entity is required to exhibit a similar nature and degree of risk), the requirement that the rate of return be commensurate with prevailing conditions in the market for funds is no longer part of the primary rate of return objective. It only appears in the proposed new sub-Rule 87(5)(b) which requires that, when estimating the return on equity,[3] prevailing conditions in the market for equity funds are to be "*taken into account*".

On the current drafting, the overall rate of return is not required to reflect prevailing conditions in the market for funds. This appears to be inconsistent with the achievement of the national gas objective (**NGO**) and the revenue and pricing principles (**RPP**), insofar as it is an allowance that reflects prevailing conditions in the market that will incentivise investment funds being attracted to pipeline services.

The requirement that prevailing conditions in the market for equity funds be taken into account by the Regulator will mean that the Regulator is required to consider that requirement as a fundamental element in the estimation of the return on equity.[4] However, this consideration is now somewhat secondary to the primary objective in the proposed sub-Rule 87(2).

The AEMC in its Draft Rule Determinations reasons that a robust and effective rate of return framework must be capable of responding to changes in market conditions: "*If the allowed rate of return is not determined with regard to the prevailing market conditions, it will either be above or below the return that is required by capital market investors at the time of determination*".[5] The importance of a rate of return reflecting prevailing market conditions is acknowledged, however this is not reflected in the rate of return objective.

It appears from the Draft Rule Determinations that the reason the requirement that the cost of debt and overall rate of return reflect prevailing conditions in the market for funds has not been reflected in the rule changes, is to enable the use of trailing averages in respect of the

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1 E.g., sub-Rules (3)(a) and (b) which require the rate of return to be determined as a weighted average of the return on equity and return on debt and the use of a nominal post-tax basis.

2 E.g., sub-Rules (3)(c) and (4)(a) and (b).

3 There is no requirement in the proposed new Rule 87 to consider prevailing conditions in the debt market.

4 The meaning of "*taken into account*" is addressed further in section 4.1.

5 Page 49.

cost of debt. The AEMC seems to proceed on the basis that there are three options for estimating the cost of debt, namely what it calls the prevailing cost of funds approach, an historical trailing average approach or a combination of these two approaches.[6]

While the use of historical trailing average approaches may be appropriate for the purposes of estimating the cost of debt, it remains that the cost of debt is a forward looking estimate. You have instructed us that it will be just as important for the cost of debt to reflect prevailing conditions in debt markets expected over the relevant regulatory period as it will be for the cost of equity. In our view a submission could credibly be made that such an objective needs to be included in the allowed rate of return objective in order to ensure a rate of return that meets the NGO and RPP. Including a requirement to reflect prevailing conditions in the market for funds further aligns with the AEMC's objective of ensuring the rate of return is capable of responding to changes in market conditions and is consistent with the idea of estimating the rate of return using a broad range of estimation methods, financial models, market data and other evidence.

However, given the AEMC already has in its mind that a test of the prevailing conditions in the market for funds is not compatible with the trailing average approach, it may be difficult to have the AEMC accept the submission. There is no discord between APIA and the AEMC – at page 92 of the Draft Rule Determinations the AEMC speaks of "*the funding costs expected to be incurred by a benchmark efficient service provider over the regulatory period*". In other words, the AEMC accepts that the benchmark cost of debt is a forward looking concept. The difficulty is that such a concept has now become captured in the language of "*prevailing conditions in the market*", conditions which, based on the current drafting, the AEMC appears to believe are not reflected in a historical trailing average approach.

On the assumption that the AEMC will maintain its view that the use of a trailing average approach means the cost of debt and overall rate of return will not reflect prevailing conditions in the market for funds, we have prepared two alternative versions of the new Rule 87:

1 Attachment 1 to this memorandum includes a requirement in Rule 87(2) that the rate of return reflect prevailing conditions in the market for funds, but amends the cost of debt rules to reflect the AEMC's apparent view that it is not consistent with the use of historical trailing averages.

2 Attachment 2 maintains the current drafting of Rule 87(2) (except for slight wording changes) but, on your instructions, makes Rules 87(6) and (7) rules of limited discretion under Rule 40(2).

2.2 "Correspond to"

The authorities suggest that this phrase can have varying meanings depending upon its context and the legislative purpose – it can vary from "*exact likeness to broad similarity*" (*Samarkos*) – see the authorities extracted in Attachment 3 to this memorandum.

In the proposed new Rule 87(2), the allowed rate of return is to "***correspond** to the efficient financing costs of a benchmark efficient entity*" (emphasis added). This suggests that such a benchmark efficient entity can be identified (even if hypothetically) and its efficient costs determined. In our view, this suggests that a Court or Tribunal would apply a stricter

[6] Page 90.

interpretation of the phrase in this Rule; i.e. that the allowed rate of return must be equivalent to those efficient costs.

While, in practice, determining the efficient costs of a benchmark efficient entity is not going to be an exact science (because, for example, of the complexity in identifying such an entity and its efficient costs – see section 2.3 below), the phrase (in this context) seems to suggest more than just, for example, the determination of a rate of return that falls within a range, or is similar to a rate that might be experienced by the benchmark entity. Rather, the proposed Rule appears to envisage the determination of a rate of return that is the best equivalent of what would be experienced by the benchmark entity.

This view is to some extent supported by the Draft Rule Determinations in which the AEMC states several times[7] that the objective of this sub-Rule is to determine the "*best possible*" estimate of the rate of return and the benchmark efficient financing costs. Elsewhere, the AEMC refers to the objective that the rate of return "*best reflects*"[8] (although it also simply refers to "*reflects*"[9]) efficient financing costs. This gives some indication as to the AEMC's intention in Rule 87(2), although is likely to be of limited assistance to the Courts/Tribunal in interpreting the meaning of the words used in the actual Rule.

In circumstances where the AER is being given a wide discretion in the proposed new Rule 87, we consider a requirement to arrive at a rate of return which corresponds to the "*best estimate*" is appropriate, meets the AEMC's intention as noted above and is consistent with the requirement that already exists in Rule 74(2). The words "*correspond to*" could also be replaced simply with "*be*".

2.3 "Benchmark efficient entity"

There is no definition in the proposed Rules of the "*benchmark efficient entity*". Nor is there much discussion in the AEMC's Draft Rule Determinations about what this phrase is meant to mean, or how the benchmark efficient entity is to be identified.[10]

It is apparent that regard is intended to be had to a hypothetical entity other than the provider itself that exhibits benchmark efficiency but which also is subject to a "*similar nature and degree of risk as that which applies to the service provider in respect of the provision of reference services*".

Whilst it is obviously difficult to provide too much definition or prescription in the Rules as to how the "*benchmark efficient entity*" is to be identified, the use of such a concept is likely to lead to differences of opinion as to what the benchmark efficient entity is or what characteristics it possesses and, in practice, is likely to leave the Regulator with a broad discretion in determining whether the allowed rate of return objective has been satisfied (notwithstanding the stricter requirements introduced by the other language in sub-Rule (2) – see section 2.1 above).

Moreover, we consider that further clarity around the concept of the benchmark efficient entity could be achieved by linking the best estimate of the cost of capital to an entity that meets benchmark levels of efficiency, has a similar nature and degree of risk as the service provider, using a financing structure that meets benchmark standards as to gearing and other

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7 See, for example, pages 44 and 46.

8 See, for example, pages 51 and 55.

9 See, for example, page 55.

10 There is some discussion on pages 45-46, but it provides limited guidance as to how the AEMC envisages the benchmark entity is to be defined or identified.

financial parameters (concepts already picked up in the existing Rule 87(2)). We consider these concepts to be best captured in Rule 87(3)(c) as reflected in our proposed drafting change in Attachments 1 and 2.

It is also unclear what is meant by the "*efficient financing costs*" of a benchmark efficient entity and how they would be established. We have addressed these issues in our proposed drafting changes.

2.4 Proposed drafting

For the reasons outlined above we consider the current drafting of Rule 87(2) is difficult to interpret and does not reflect the intention of the AEMC to ensure the rate of return reflects prevailing conditions in the market for funds and is capable of responding to changes in market conditions. We have included alternative formulations of Rule 87(2) in Attachments 1 and 2.

3. Rule 87(3)(a)- weighted average

This sub-rule requires the allowed rate of return for a regulatory year to be determined as a weighted average of the return on equity and the return on debt for that regulatory year, where the weights applied reflect the relative proportions of equity and debt finance that would be "*employed and efficiently financed"* by a benchmark efficient entity with a similar nature and degree of risk as that which applies to the service provider in respect of the provision of reference services.

The difficulty with the drafting in this clause is that it is unclear what is meant by "*reflect the relative proportions of equity and debt finance that would be employed an* [sic] *efficiently financed by a benchmark efficient entity*". It appears to us to be introducing further uncertain concepts and discretion in the Regulator. Uncertainty as to the interpretation and application of the Rules would not be consistent with the achievement of the NGO and RPP and the desirability of regulatory certainty and transparency recognised by the AEMC.

We consider the clause can be more simply drafted requiring the weighted average using a financing structure which meets benchmark standards as to gearing and other financial parameters. We have included the proposed alternative drafting in Attachments 1 and 2.

4. Rule 87(3)(c) – "Relevant" methods, models, market data etc. to be "taken into account"

The proposed new Rule 87(3)(c) provides that the allowed rate of return for a regulatory year is to be determined "*taking into account relevant estimation methods, financial models, market data and other evidence*".

The AEMC's explanation surrounding this provision is that achieving the NGO and RPP requires the best possible estimate of the benchmark efficient financing costs. "*This can only be achieved by ensuring that the estimation process is of the highest possible quality. It means that a range of estimation methods, financial models, market data and other evidence should be considered, with the Regulator having discretion to give appropriate weight to all the evidence and analytical techniques considered*".[11]

[11] Draft Rule Determinations, page 46.

The AEMC further states that the estimation approach to equity and debt components should include "*consideration of available estimation methods, financial models, market data and other evidence to produce a robust estimate that meets the overall rate of return objective.*"[12] The premise for the rule change is the view that estimates are more robust and reliable if they are based on a range of estimation methods, financial models, market data and other evidence while giving the Regulator capacity to exercise regulatory judgment.[13]

4.1 "Taking into account"

The rule as currently drafted only requires the Regulator to "*take into account*" the relevant estimation methods, financial models, market data and other evidence.

In the context of new Rule 87(3)(c), it is likely that a Court/Tribunal will interpret the requirement to take into account the factors specified as a requirement in accordance with Mason J's formulation in *R v Hunt; ex parte Sean Investments*; i.e. that the Regulator is required to take the specified matters into account as fundamental elements in making its determination. The Regulator must actively turn its mind to each of the factors listed and would fall into error if it failed to do so.[14]

However, as long as the Regulator has taken into account the specified factors, it remains in the Regulator's discretion how those factors influence its decision. The practical application of this rule could result in the Regulator considering other estimation methods, financial models, etc. but then putting all but one to the side and continuing to estimate the cost of debt and cost of equity using its already stated preferred approach (ie the Sharpe Lintner CAPM), which would appear to be contrary to the objective of the rule change.[15]

4.2 "Relevant" methods, models, etc.

Rule 87(3)(c) requires the Regulator to take into account all "*relevant*" estimation methods, financial models, market data and other evidence. The Regulator will therefore fall into error if it fails to give proper consideration to any "*relevant*" evidence.

The Regulator is not required to consider all evidence put before it under Rule 87(3)(c). If evidence is "irrelevant", the Regulator will not fall into error by failing to "*take it into account*".

In practice, of course, this will require some form of value judgment by the Regulator about whether evidence put before it is relevant or not. This appears to be consistent with the very broad discretion envisaged by the AEMC in the Draft Rule Determinations

We consider the "relevance" test in this context to be a reasonably low threshold and appropriate in the circumstances.

4.3 Proposed drafting change

Given the possibility of an approach where the Regulator may "*take into account*" relevant estimation methods, financial models, market data and other evidence and then continue to

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12 Ibid, page 47.

13 Ibid, pages 48 and 49.

14 A more detailed explanation of the authorities supporting this view is set out in Attachment 3.

15 Note the AER's submission strongly rejecting any approach other than the CAPM referenced at page 47 of the Draft Rule Determinations.

apply the historical approach to the cost of equity and cost of debt, we have suggested some possible drafting changes to Rule 87(3)(c) to better reflect the objective stated by the AEMC, to ensure the most robust and best estimate of the rate of return is achieved through consideration of a broad range of information. The proposed drafting change is set out in Attachments 1 and 2.

5 Rule 87(4) – "Regard to be had" to certain factors

The proposed new Rule 87(4) requires "*regard to be had*" to certain factors in the determination of the allowed rate of return (in addition to the information in sub-rule 87(3)(c)), being those factors listed in sub-paragraphs 87(4)(a) and (b).

5.1 "Have regard to"

The authorities suggest that in an administrative law context, this phrase has the same meaning as "*take into account*" (see Attachment 3). In the context of Rule 87(4), we think the Courts/Tribunal will interpret the requirement to have regard to the factors specified in a way that requires the Regulator to take the specified matters into account as fundamental elements in making its determination.

As noted above, the Regulator must actively turn its mind to each of those factors and would fall into error if it failed to do so. However, as long as the Regulator has regard to all of the factors, it remains in the Regulator's discretion how those factors influence its final decision.

It is unclear if the AEMC intends the term "*taking into account*" to have a different meaning to factors to which "*regard must be had*". In our view, introducing different language (with the same legal meaning) will lead to uncertainty and difficulty in application of the Rules. Consistent language should be used in the Rule (either "*having regard to*" or "*taking into account*") and this is reflected in our proposed drafting changes in Attachments 1 and 2.

6 Rule 87(5) – Return on equity

Pursuant to the proposed new Rule 87(5)(b), the return on equity for an access arrangement period is to be estimated in a way that is consistent with the allowed rate of return objective and "*taking into account the prevailing conditions in the market for equity funds*".

We consider that the words "*in a way that is consistent with*" can be more directly expressed as "*to achieve*".

In respect of the requirement to "*take into account*" the prevailing conditions in the market for equity funds, as noted above, the existing Rule 87(1) requires the rate of return "*to be commensurate*" with the prevailing conditions in the market for funds.

In our view the use of the words "*to be commensurate with*" is preferable to "*taking into account*". It requires the return on equity to be more directly equated with the prevailing conditions in the market for funds, not just to be taken into account as a factor. This wording better reflects the AEMC's reasons about the importance of a rate of return reflecting prevailing conditions in the market and being capable of responding to changes in market conditions. We do not consider that "*taking into account*" the prevailing conditions in the market for equity funds gives that requirement sufficient prominence in the estimation of the return on equity. We have suggested a drafting change to this sub-rule in Attachments 1 and 2.

7 Rule 87(6) and (7) – Return on debt

Rule 87(6) requires the return on debt for a regulatory year to be estimated in a way that is consistent with the allowed rate of return objective and using a methodology that complies with paragraph (b) of the sub-Rule.

The proposed new Rule 87(7) provides that, subject to sub-Rule (6), "*the methodology adopted to estimate the return on debt may, without limitation, be designed to result in the return on debt reflecting*" two approaches set out in paragraphs (a) and (b) or some combination of the two (paragraph (c)).

7.1 Rule 87(6)(a)

This proposed new Rule presently requires the return on debt to be estimated "*in a way that is consistent with*" the allowed rate of return objective. We consider the requirement to meet the objective should be more strongly stated by using the words "*to achieve*" the allowed rate of return objective.

7.2 Rules 87(6)(b) and (9)

The proposed new Rule 87(6)(b) provides that the methodology used must be one under which:

> "*(i) the return on debt for each regulatory year in the access arrangement period is the same; or*
>
> *(ii) the return on debt for a regulatory year (other than the first regulatory year in the access arrangement period is estimated using a methodology which complies with subparagraph (i).*"

In the Draft Rule Determinations, the AEMC states that:[16]

> "*The proposed draft rule includes a provision to allow an annual adjustment to the allowed revenue for the service provider in circumstances where the regulator decides to estimate the return on debt using an approach that requires the return on debt to be updated periodically during the regulatory period. The formula for calculating the updated return on debt must be specified in the regulatory determination or access arrangement and must be capable of applying automatically.*"

In our view the drafting of both Rule 87(6)(b) and the related Rule 87(9) is nonsensical and circular and does not appear to reflect the above explanation of the AEMC. Given the policy intention and application of proposed new Rule 87(6)(b) is uncertain, there is a risk that a re-drafting of that clause by the AEMC will produce an outcome that is not satisfactory to APIA. We would suggest seeking clarification from the AEMC in respect of the intent of this provision.

7.3 Rule 87(7) – "Without limitation"

As noted above, this rule provides that the methodology adopted to estimate the return on debt may, without limitation, be designed to result in the return on debt reflecting the approaches set out in sub-rules (a) and (b) or a combination of the two.

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[16] Page 91.

Strictly speaking, the use of the words "*without limitation*" in Rule 87(7) is sufficient to allow the use of alternative methodologies that do not reflect the factors set out in paragraphs (a) to (c) of that sub-rule.

That said, the practical effect of such a prescription as set out in Rule 87(7) is that the Regulator may tend to adopt one of the prescribed methodologies as a matter of course, or may tend to prefer that prescribed methodology over another methodology proposed by a service provider, on the basis that the methodology prescribed in the Rule should be preferred in all but exceptional circumstances.

There is therefore a risk in practice (if not on the strict wording of the proposed Rule) that the proposed Rule will not achieve the result sought to be achieved by the AEMC (i.e. encouraging the consideration of a range of methodologies rather than being too prescriptive).

The AEMC appears to be suggesting that it does intend sub-rule 87(b)(7) to list three options "*to make it clear that all of them are available to the Regulator if it considers they best meet the overall allowed rate of return objective. The Commission accepts that it could also have chosen not to describe any approaches, but it considers that there is benefit of certainty in stating clearly the range of available options*".[17]

However, we consider the clause could be better drafted to reflect flexibility in the approach to the cost of debt by removing the reference to "*without limitation*" and providing an additional sub-paragraph enabling use of other methods derived from relevant debt management strategies that are consistent with the rate of return objective. This will avoid difficulties with the use of the words "*without limitation*" and the practical limitation imposed on the methods currently identified. This change is reflected in our proposed amendments in Attachment 2 to this memorandum.

7.4 Proposed Drafting change

We note that Attachment 1 proposes the deletion of subclause 87(7) as a result of the inclusion of the requirement to reflect prevailing conditions in the market for funds in Rule 87(2). Attachment 2 proposes the changes reflected in our comments above.

8 Rule 87(8)

Rule 87(8) provides further factors to which regard must be had in estimating the return on debt. The preamble to the Rule can be more directly expressed to ensure that in estimating a return on debt *to* "*achieve*" the allowed rate or return objective, regard must be had to the matters listed in the sub-Rules. We have reflected this proposed change in Attachments 1 and 2.

There are also some difficulties with the drafting in sub-rules (a) to (d). As an overall comment, it does not appear that the factors in (a) to (d) add anything to the requirements that already exist in the allowed rate of return objective and the NGO and RPP. The drafting of the sub-paragraphs raises the possibility of the clauses being interpreted as having some additional meaning or work to do in addition to the allowed rate of return objective and the NGO and RPP. More specifically :

1 Paragraph (a) simply picks up the heading to the discussion of this topic at page 92. As drafted it seems to contemplate a comparison of the benchmark cost of debt with

[17] Draft Rule Determinations, page 90.

the estimated cost of debt of the service provider. The discussion speaks of "*the extent to which the methodology matches the funding costs expected to be incurred by a benchmark service provider over the regulatory period*". The AEMC's intention is unclear and the reference to the matching to the funding costs of the benchmark service provider is already required by the Rule 87(2). The clause does not appear to add anything and it could be deleted. Alternatively, if this was not acceptable to the AEMC, the sub-Rule should more clearly state that the consideration is by reference to the benchmark efficient entity, not the actual cost of debt of the service provider.

2 Again, paragraph (b) simply picks up the heading to the discussion of this topic but the discussion focuses instead on either the increase or decrease in financing risk. Arguably the considerations sought to be captured by this sub-rule are already captured in the NGO and RPP and, on that basis, a submission could be made that this sub-clause is not necessary and creates confusion.

3 Again, paragraph (c) simply picks up the heading to the discussion of this topic but the application of the discussion about the mismatch between the regulatory allowance and the actual costs of debt is unclear. It is unclear what the consideration of incentive effects could add to the NGO.

4 Again, paragraph (d) simply picks up the heading to the discussion and would allow the AER in the exercise of discretion to consider a very broad range of topics. The discussion is more limited to the costs and confidence and the clause should be confined to the "investment incentives" identified in the discussion. The concepts appear to already be covered by the NGO and the RPP and the sub-clause does not appear to add anything.

Attachments 1 and 2 to the memorandum include suggested drafting changes to Rule 87(8) reflecting our comments above.

9 Rules 87(11)-(13) – Rate of return guidelines

The proposed new Rules 87(10) to (16) set out the requirement and process for the AER to issue "*rate of return guidelines*" at least every three years.

9.1 Rule 87(11) – Contents of guidelines

Rule 87(11) specifies the requirements for the contents of the guidelines, namely they are to set out:

> "*(a) the methodologies that the AER proposes to use in estimating the allowed rate of return, including how those methodologies are proposed to result in the determination of a return on equity and a return on debt in a way that is consistent with the allowed rate of return objective;*
>
> *(b) the estimation methods, financial models, market data and other evidence the AER proposes to take into account in estimating the return on equity, the return on debt and the value of imputation credits referred to in rule 87A.*"

It appears that the distinction between "*methodologies*" in paragraph (a) and "*estimation methods, financial models, market data and other evidence*" in paragraph (b) is deliberate. The Rules require the AER to identify the methods/models/data/evidence it proposes to take into account (paragraph (b)) and then to set out methodologies that describe how all of the

information is to be used to determine the rate of return (paragraph (a)). For example, it is conceivable the "methodology" could involve the calculation of a rate of return using the results from several different financial models, cross-checked against certain specified types of market data or evidence.

This also appears consistent with the AEMC's intention as set out in the Draft Rules Determinations. On page 59, the AEMC says the guidelines allow discussion about "*the choice of estimation methods, financial models, types of information that may be used*" (i.e. the methods, models, etc.) and "*how the regulator intends to apply them*" (i.e. the methodology). On page 60, it states that the regulator is expected to "*detail the financial models that it would take into account in its decision*" and "*detail any other information that it would expect to have regard to*" (i.e. the methods, models, etc.) and "*provide guidance on how it would use such models and information in reaching its decision, including matters such as... the relative weight... it would expect to place on various model estimates; and what market data (or similar) it would use to ascertain lower bounds and/or reasonableness checks on the estimates*" (i.e. the methodology).

However, there is still some uncertainty about what a "methodology" is for the purposes of paragraph (a). For example, its is unclear whether the AEMC, for example, intends that the use of a weighted average cost of capital (WACC) *approach* would constitute a "methodology" If something different is envisaged (for example, that the use of a WACC approach could be only part of some larger "methodology"), then this is not also not clear from the Rule as currently drafted.

9.2 Rules 87(12)-(13) – Initial guidelines

Under Rule 87(10), the first guidelines issued are to be made in accordance with the process set out in Rule 87(13), rather than the "*rate of return consultative procedure*" which is to be used for successive versions.

The proposed new Rule 87(13) sets out a timetable for issuing a consultation paper and draft guidelines (and making them available for comment), but does not refer to the timing for the finalisation of the guidelines. Rather, this is found in Rule 87(12) which requires the AER to "*make the first rate of return guidelines by [29 August 2013]*". We consider it would be preferable and more logical for this step to be included in the timetable set out in Rule 87(13).[18] We have addressed this issue in our proposed drafting changes.

10 Suggested amendments to Rule 87

Having regard to the matter discussed above, we set out in Attachments 1 and 2 some alternative amendments to the drafting of the proposed new Rule 87 (with the amendments marked-up).

Johnson Winter & Slattery

[18] Note this numbering has changed in our proposed drafting due to suggested deletion of other paragraphs.

ATTACHMENT 1

Rule 87 Rate of return

(1) The return on the projected capital base for each regulatory year of the *access arrangement period* is to be calculated by applying a rate of return that is determined in accordance with this rule 87 (the *allowed rate of return*).

(2) The *allowed rate of return* is to:

(a) correspond to the best estimate of the efficient financing costs of a benchmark efficient entity with a similar nature and degree of risk as that which applies to the service provider in respect of the provision of reference services; and

(b) be commensurate with prevailing conditions in the market in which a benchmark efficient entity competes for funds.

(the *allowed rate of return objective*).

(3) The *allowed rate of return* for a regulatory year is to be determined:

(a) as a weighted average of the return on equity for the *access arrangement period* (as estimated under subrule (5)) and the return on debt for that regulatory year (as estimated under subrule (6)) where the weights applied to compute the average reflect the relative proportions of equity and debt finance that would be employed and efficiently financed by a benchmark efficient entity with a similar nature and degree of risk as that which applies to the service provider in respect of the provision of reference services;

SUGGESTED ALTERNATIVE TO 87(3)(a)

(a) as a weighted average of the return on equity for the *access arrangement period* (as estimated under subrule (5) and the return on debt for that regulatory year (as estimated under subrule (6)) using a financing structure that would be employed by a benchmark efficient entity with a similar nature and degree of risk as that which applies to the service provider in respect of the provision of reference services and meets benchmarks standards as to gearing and other financial parameters;

(b) on a nominal post-tax basis that is consistent with the estimate of the value of imputation credits referred to in rule 87A; and

(c) taking into account relevant estimation methods, financial models, market data and other evidence.

SUGGESTED ALTERNATIVE TO 87(3)(C)

(c) based on relevant estimation methods, financial models, market data and other evidence. The *allowed rate of return* should be estimated using multiple relevant estimation methods, financial models, market data and evidence.

(4) In determining the *allowed rate of return*~~, regard is to be had to~~:

(a) ~~the desirability of using~~it is desirable that there be ~~an approach that leads to the~~ consistent application of ~~any~~ estimates of financial parameters ~~that are~~ relevant to the estimates of, and that are common to, the return on equity and the return on debt; and

(b) regard is to be had to any interrelationships between estimates of financial parameters ~~that are~~ relevant to the estimates of the return on equity and the return on debt.

Return on equity

(5) The return on equity for an access *arrangement period* is to be estimated:

(a) ~~in a way that is consistent with~~to achieve the *allowed rate of return objective*; and

(b) to be commensurate with ~~taking into account~~ the prevailing conditions in the market for equity funds.

Return on debt

(6) The return on debt for a regulatory year is to be estimated:

(a) ~~in a way that is consistent with~~to achieve the *allowed rate of return objective*; and;

(b) using a methodology under which the return on debt for each regulatory year in the access arrangement period is the same; or

~~(ii) the return on debt for a regulatory year (other than the first regulatory year in the access arrangement period) is estimated using a methodology which complies with subparagraph (i)~~

~~.~~(c) to reflect a return that would be required by debt investors in a benchmark efficient entity if it raised debt at the time or shortly before the time when the AER's decision on the access arrangement for that access arrangement period is made.

(7) ~~Subject to subrule (6), the methodology adopted to estimate the return on debt may, without limitation, be designed to result in the return on debt reflecting~~must result in an estimate of~~:~~

~~(a) the~~ a ~~return that would be required by debt investors in a benchmark efficient entity if it raised debt at the time or shortly before the time when the AER's decision on the access arrangement for that access arrangement period is made;~~

~~(b) the average return that would have been required by debt investors in a benchmark efficient entity if it raised debt over an historical~~a period prior to the time when the when the AER's decision on the access arrangement for that access arrangement period is made;~~a return on debt derived from or~~

~~(c) some combination of the returns referred to in subparagraphs (a) and (b).~~

(8) In estimating a return on debt to achieve the ~~determining whether the return on debt for a regulatory year is estimated in a way that is consistent with the~~ allowed rate of return objective, regard must be had to~~ the following factors~~:

(a) the likelihood of any significant differences between the costs of servicing debt of a benchmark efficient entity referred to in subrule (~~3~~2)(a) and the methodology used to estimate the return on debt over the access arrangement period;

(b) the impact on gas consumers, including due to any impact on the return on equity of a benchmark efficient entity referred to in subrule (3)(a);

(b~~e~~) the incentive effects of inefficiently delaying or bringing forward capital expenditure; and

(~~d~~c) the impact on investment incentives of changing the methodology for estimating the return on debt across access arrangement periods.

~~(9) A methodology referred to in subrule (6)(2)(ii) must provide for any change in total revenue for the regulatory year that would result from a change to the allowed rate of return for that~~

~~regulatory year, as a result of the return on debt for that regulatory year being different from that estimated under subrule (6), to be effected through the automatic application of a formula that is specified in the access arrangement~~.

Rate of return guidelines

(~~10~~9) The AER must, in accordance with the *rate of return consultative* procedure, make guidelines (the *rate of return guidelines*), except that the first *rate of return guidelines* are to be made in accordance with subrule (13) and not the *rate of return consultative procedure*.

(10~~1~~) The *rate of return guidelines* are to set out:

(a) the methodologies that the AER proposes to use in estimating the *allowed rate of return*, including how those methodologies are proposed to result in the determination of a return on equity and a return on debt in a way that is consistent with the *allowed rate of return objective*;

(b) the estimation methods, financial models, market data and other evidence the AER proposes to ~~take into account~~ have regard to in estimating the return on equity, the return on debt and the value of imputation credits referred to in rule 87A; and

(c) reasons for the AER's proposals in (a) and (b) above.~~.~~

~~(12) The AER must make the first *rate of return guidelines* by [29 August 2013] and there must be *rate of return guidelines* in force at all times after that date.~~

(11~~3~~) For the purposes of making the first *rate of return guidelines* the AER must:

(a) by no later than [29 March 2013], publish on its website a consultation paper that sets out its preliminary views on the material issues that are to be addressed by the *rate of return guidelines;*

(b) publish on its website an invitation for written submissions on the consultation paper, with such submissions to be made within the time specified in the invitation (which must not be earlier than 30 business days after the invitation for submissions is published);

(c) by no later than [31 July 2013], publish on its website a draft of the *rate of return guidelines*; and

(d) publish on its website an invitation for written submissions on the draft rate of return guidelines, with such submissions to be made within the time specified in the invitation (which

must not be earlier than 30 business days after the invitation for submissions is published).

(e) make the first rate of return guidelines by [29 August 2013] and there must be *rate of return guidelines* in force at all times after that date.

(124) The AER must, in accordance with the rate of return consultative procedure, review the *rate of return guidelines*:

(a) at intervals not exceeding three years, with the first interval starting from the date referred to in subrule (12); and

(b) at the same time as it reviews the *rate of return guidelines* under clauses 6.5.2 and 6A.6.2 of the National Electricity Rules.

(135) The AER may, from time to time and in accordance with the *rate of return consultative procedure*, amend or replace the *rate of return guidelines*.

(146) The *rate of return guidelines* are not mandatory (and so do not bind the AER or anyone else) but, if the AER makes a *decision* in relation to the rate of return (including in an access arrangement draft *decision* or an access arrangement final *decision*) that is not in accordance with them, the AER must state, in its reasons for the *decision*, the reasons for departing from the guidelines.

ATTACHMENT 2

Rule 87 Rate of return

(1) The return on the projected capital base for each regulatory year of the *access arrangement period* is to be calculated by applying a rate of return that is determined in accordance with this rule 87 (the *allowed rate of return*).

(3) The *allowed rate of return* is to correspond to the best estimate of the efficient financing costs of a benchmark efficient entity with a similar nature and degree of risk as that which applies to the service provider in respect of the provision of reference services;
(the *allowed rate of return objective*).

(3) The *allowed rate of return* for a regulatory year is to be determined:

(a) as a weighted average of the return on equity for the *access arrangement period* (as estimated under subrule (5)) and the return on debt for that regulatory year (as estimated under subrule (6)) where the weights applied to compute the average reflect the relative proportions of equity and debt finance that would be employed and efficiently financed by a benchmark efficient entity with a similar nature and degree of risk as that which applies to the service provider in respect of the provision of reference services;

SUGGESTED ALTERNATIVE TO 87(3)(a)

(a) as a weighted average of the return on equity for the *access arrangement period* (as estimated under subrule (5) and the return on debt for that regulatory year (as estimated under subrule (6)) using a financing structure that would be employed by a benchmark efficient entity with a similar nature and degree of risk as that which applies to the service provider in respect of the provision of reference services and meets benchmarks standards as to gearing and other financial parameters;

(b) on a nominal post-tax basis that is consistent with the estimate of the value of imputation credits referred to in rule 87A; and

(c) taking into account relevant estimation methods, financial models, market data and other evidence.

SUGGESTED ALTERNATIVE TO 87(3)(C)

(c) based on relevant estimation methods, financial models, market data and other evidence. The *allowed rate of return*

should be estimated using multiple relevant estimation methods, financial models, market data and evidence.

(4) In determining the *allowed rate of return*: ~~regard is to be had to:~~

(a) ~~the desirability of using~~ it is desirable that there be ~~an approach that leads to the~~ consistent application of ~~any~~ estimates of financial parameters ~~that are~~ relevant to the estimates of, and that are common to, the return on equity and the return on debt; and

(b) regard is to be had to any interrelationships between estimates of financial parameters ~~that are~~ relevant to the estimates of the return on equity and the return on debt.

Return on equity

(5) The return on equity for an access *arrangement period* is to be estimated:

(a) ~~in a way is consistent with~~ to achieve the *allowed rate of return objective*; and

(b) to be commensurate with ~~taking into account~~ the prevailing conditions in the market for equity funds.

Return on debt

(6) The return on debt for a regulatory year is to be estimated:

(a) ~~in a way that is consistent with~~ to achieve the *allowed rate of return objective*; and;

(b) using a methodology under which:

(i) the return on debt for each regulatory year in the access arrangement period is the same; or

(ii) the return on debt for a regulatory year (other than the first regulatory year in the access arrangement period) is estimated using a methodology which complies with subparagraph (i).

(7) Subject to subrule (6), the methodology adopted to estimate the return on debt ~~may, without limitation, be designed to result in the return on debt reflecting~~ must result in an estimate of:

(a) ~~the~~ a return that would be required by debt investors in a benchmark efficient entity if it raised debt at the time or shortly before the time when the AER's decision on the

access arrangement for that access arrangement period is made;

(b) the average return that would have been required by debt investors in a benchmark efficient entity if it raised debt over ~~an historical~~ a period prior to the time ~~when the~~ when the AER's decision on the access arrangement for that access arrangement period is made; or

(c) a return on debt derived from another relevant debt management strategy consistent with the *allowed rate of return objective*; or

(~~c~~d) some combination of the returns referred to in subparagraphs (a) and (b) and (c).

The AER's discretion under sub-rules (6) and (7) is limited.

(8) In estimating a return on debt to achieve the ~~determining whether the return on debt for a regulatory year is estimated in a way that is consistent with the~~ allowed rate of return objective, regard must be had to ~~the following factors~~:

(a) the likelihood of any significant differences between the costs of servicing debt of a benchmark efficient entity referred to in subrule (~~3~~2)(a) and the methodology used to estimate the return on debt over the access arrangement period;

(b) the impact on gas consumers, including due to any impact on the return on equity of a benchmark efficient entity referred to in subrule (3)(a);

(b) the incentive effects of inefficiently delaying or bringing forward capital expenditure; and

(c) the impact on investment incentives of changing the methodology for estimating the return on debt across access arrangement periods.

(9) A methodology referred to in subrule (6)(~~2~~b)(ii) must provide for any change in total revenue for the regulatory year that would result from a change to the allowed rate of return for that regulatory year, as a result of the return on debt for that regulatory year being different from that estimated under subrule (6), to be effected through the automatic application of a formula that is specified in the access arrangement.

Rate of return guidelines

(10) The AER must, in accordance with the *rate of return consultative* procedure, make guidelines (the *rate of return guidelines*), except that the first *rate of return guidelines* are to be made in accordance with subrule (13) and not the *rate of return consultative procedure*.

(11) The *rate of return guidelines* are to set out:

(a) the methodologies that the AER proposes to use in estimating the *allowed rate of return*, including how those methodologies are proposed to result in the determination of a return on equity and a return on debt in a way that is consistent with the *allowed rate of return objective*;

(b) the estimation methods, financial models, market data and other evidence the AER proposes to ~~take into account~~ have regard to in estimating the return on equity, the return on debt and the value of imputation credits referred to in rule 87A; and

(c) reasons for the AER's proposals in (a) and (b) above.

~~(12) The AER must make the first *rate of return guidelines* by [29 August 2013] and there must be *rate of return guidelines* in force at all times after that date.~~

(12~~3~~) For the purposes of making the first *rate of return guidelines* the AER must:

(a) by no later than [29 March 2013], publish on its website a consultation paper that sets out its preliminary views on the material issues that are to be addressed by the *rate of return guidelines;*

(b) publish on its website an invitation for written submissions on the consultation paper, with such submissions to be made within the time specified in the invitation (which must not be earlier than 30 business days after the invitation for submissions is published);

(c) by no later than [31 July 2013], publish on its website a draft of the *rate of return guidelines*; and

(d) publish on its website an invitation for written submissions on the draft rate of return guidelines, with such submissions to be made within the time specified in the invitation (which must not be earlier than 30 business days after the invitation for submissions is published).

(e) make the first rate of return guidelines by [29 August 2013] and there must be *rate of return guidelines* in force at all times after that date.

(134) The AER must, in accordance with the rate of return consultative procedure, review the *rate of return guidelines*:

(a) at intervals not exceeding three years, with the first interval starting from the date referred to in subrule (12); and

(b) at the same time as it reviews the *rate of return guidelines* under clauses 6.5.2 and 6A.6.2 of the National Electricity Rules.

(145) The AER may, from time to time and in accordance with the *rate of return consultative procedure*, amend or replace the *rate of return guidelines*.

(156) The *rate of return guidelines* are not mandatory (and so do not bind the AER or anyone else) but, if the AER makes a *decision* in relation to the rate of return (including in an access arrangement draft *decision* or an access arrangement final *decision*) that is not in accordance with them, the AER must state, in its reasons for the *decision*, the reasons for departing from the guidelines

ATTACHMENT 3 – EXTRACT FROM RELEVANT AUTHORITIES

"Correspond to"

- Per Asche CJ in *Samarkos v Commissioner for Corporate Affairs (NT)*:[19]

> *The Oxford English Dictionary gives various definitions of "correspond" such as "to be congruous or in harmony with"; "to be similar or analogous to". The Macquarie Dictionary defines it as "to be in agreement or conformity"; "to be similar or analogous". The range is from exact likeness to broad similarity.*

- Per Lord Cairns of the House of Lords In *Sackville-West v Viscount Holmesdale*:[20]

> *'To correspond' does not usually or properly mean 'to be identical with', but 'to harmonize with' or 'to be suitable to'.*

- In dissent in the same case, Lord Hatherly LC:

> *I cannot admit that the proper meaning of 'corresponding' is 'harmonizing with', or 'being suitable to'. I think such meaning is secondary only. A footmark 'corresponds' with the foot when it has been made by it. A copy of an instrument corresponds with the original when the wording and paging, and, if possible, the handwriting agree.*

- In the *Samarkos* case, Asche J preferred Lord Cairns' interpretation:

> *…the word may well in some contexts have the exactitude which [Lord Hatherly] suggests, I would be more inclined to the broader interpretation espoused by Lord Cairns, and (although this is no doubt somewhat subjective) I am confident that in common parlance the word is used more generally in what Lord Hatherly refers to as its secondary meaning. Furthermore, if the intent of s562a(1)(b) was to confine that sub-section to exact counterparts of s418(1), it would have been a simple exercise to use an expression such as "sub-section 418(1) or a provision in the same terms", and this has not been done.*

"Have regard to"

- Per Stone, Foster and Nicholas JJ in *Minister for Immigration and Citizenship v Khadgi* (emphasis added):[21]

> *Section 109(1)(c) of the Act obliges the Tribunal to "have regard to" the prescribed circumstances set out in reg 2.41. The consideration of those prescribed circumstances is thus a jurisdictional prerequisite to the exercise of the Ministerial discretion to cancel a visa under s109. In order to comply with that prerequisite, the decision-maker must* ***engage in what has been described as "an active intellectual process" in which each of the prescribed circumstances receives his or her "genuine" consideration****: Tickner at 462 (per Black CJ) and Minister for Immigration and*

[19] (1988) 12 ACLR 764, 772.

[20] (1870) LR 4 HL 543.

[21] (2010) 190 FCFR 248, [57]-[60].

Multicultural Affairs v Jia Legeng (2001) 205 CLR 507 at [105] (p 540) (per Gleeson CJ and Gummow J).

In the absence of any statutory or contextual indication of the weight to be given to factors to which a decision-maker must have regard, it is generally for him or her to determine the appropriate weight to be given to them*: Minister for Aboriginal Affairs v Peko-Wallsend Ltd (1986) 162 CLR 24 at 41 (per Mason J). The failure to give any weight to a factor to which a decision-maker is bound to have regard in circumstances where that factor is of great importance in the particular case may support an inference that the decision-maker did not have regard to that factor at all.*

Similarly, a decision-maker does not take into account a consideration that he or she must take into account if he or she simply dismisses it as irrelevant. On the other hand, it does not follow that a decision-maker who genuinely considers a factor only to dismiss it as having no application or significance in the circumstances of the particular case will have committed an error. A decision-maker is entitled to be brief in his or her consideration of a matter which has little or no practical relevance to the circumstances of a particular case. A court would not necessarily infer from the failure of a decision-maker to expressly refer to such a matter in its reasons for decision that the matter had been overlooked. But if it is apparent that the particular matter has been given cursory consideration only so that it may simply be cast aside, despite its apparent relevance, then it may be inferred that the matter has not in fact been taken into account in arriving at the relevant decision: Elias v Cmr of Taxation (2002) 123 FCR 499 at [62] (p 512) (per Hely J). Whether that inference should be drawn will depend on the circumstances of the particular case.

In some cases it may be apparent that amongst the factors to which a decision-maker is bound to have regard, there is one factor (or perhaps more than one) which is critical or fundamental to the making of the decision in question. This was true of the particular matter referred to by Mason J in R v Toohey; Ex Parte Meneling Station Pty Ltd (1982) 158 CLR 327 at 338. As his Honour's reasons in R v Hunt; Ex Parte Sean Investments Pty Ltd (1979) 180 CLR 322 at 329 show, ***the relevant statutory provisions may make clear that a particular factor is "a fundamental matter for consideration"****. But the converse is also true.* ***The relevant statutory provisions may show that a particular matter to which a decision-maker must have regard is not fundamental to the decision-making process*** *in the sense discussed by his Honour: see, for example, Singh v Minister for Immigration and Multicultural Affairs (2001) 109 FCR 152 at [57] (p 164) (per Sackville J).*

- Per Sackville J in *Singh v Minister for Immigration and Multicultural Affairs* (emphasis added):[22]

  …a statutory obligation to have regard to specified matters when making an administrative decision may require the decision-maker ***to take the matters into account and "give weight to them as a fundamental element in making his [or her] determination"****: R v Hunt; Ex parte Sean Investments Pty Ltd (1979) 180 CLR 322 at 329 per Mason J. Indeed, this is the meaning that was given to the predecessor of s 501(6)(c) of the Migration Act (relating to*

[22] (2001) 109 FCR 152, [57].

> *the character test): Minister for Immigration and Ethnic Affairs v Baker (1997) 73 FCR 187 at 194.* ***But the phrase "have regard to" can simply mean to give consideration to something*** *(Shorter Oxford English Dictionary). In this sense a direction to a decision-maker to have regard to certain factors may require him or her merely to consider them, rather than treat them as fundamental elements in the decision-making process.*

- Per Lindgren, Rares and Foster JJ in *Lafu v Minister for Immigration and Citizenship* (emphasis added):[23]

> *In circumstances where a decision-maker is required to have regard to several specified or prescribed mandatory considerations, he or she must* ***genuinely have regard to each and every one of those considerations and must engage actively and intellectually with each and every one of those considerations by thinking about each of them and by determining how and to what extent (if at all) each of those criteria might feed into the deliberative process and the ultimate decision****; and*

- Per Mansfield J in *Australian Competition and Consumer Commission v Leelee Pty Ltd* (emphasis added):[24]

> *The expression "have regard to" is a common one.* ***It means no more than to take into account or to consider****: The Macquarie Concise Dictionary, 2ed, 831. "A" v Pelekanakis [1999] FCA 236 concerned, inter alia, the obligation of the Minister for Immigration and Multicultural Affairs under s54 of the Migration Act 1966 (Cth) to have regard to all the information in the application for a visa when considering that application. Weinberg J said at para 58:*
>
> > *"****The expression "have regard to" must, in context, mean "take into account"****. It does not, of course, require the recipient of the information to accept it as true, to act upon it, or even ultimately to be influenced by it – Hoare v The Queen (1989) 167 CLR 348 at 365. It does, however,* ***require the recipient of the information to consider it properly in the context of performing the statutory duty imposed upon him****, and to which the information to be considered is directed, ..."*
>
> *That commonsense and practical approach is reflected in many decisions of the Court under that Act: see e.g. per Wilcox J in Lek v Minister for Immigration Local Government and Ethnic Affairs (1993) 43 FCR 418.*
>
> *The expression was also considered by O'Loughlin J in Reid v Vocational Registration Appeal Committee (1997) 73 FCR 43 at 53-54. His Honour said at 54:*
>
> > *"The expression "must have regard to", which is found in statutory instruments from time to time,* ***will always take its meaning from the context in which it appears****. Thus the matters to which a decision-maker, such as the Appeal Committee, "must have regard to" might be exhaustively listed: see, for example, Re BHP Petroleum Pty Ltd and Minister for Resources (1993) 30 ALD 173 at 180. Alternatively, the relevant provisions might be "so generally*

[23] (2009) 112 ALD 1, [47].

[24] [1999] FCA 1121, [81]-[84].

> *expressed that it is not possible to say that he is confined to these… considerations…": Re Hunt; Ex parte Sean Investments Pty Ltd (1979) 180 CLR 322 at 329 per Mason J. But whether the listed subject matters are or are not exhaustive, they are matters to which regard must be had by the decision-maker.* ***It is essential that the decision-maker, to adopt the words of Gibbs CJ in R v Toohey; Ex parte Meneling Station Pty Ltd (1982) 158 CLR 327 at 333, "give weight to them as a fundamental element" in coming to a conclusion.****"*

The issue in that case was the obligation imposed upon the decision maker by the use of the word "must", but his Honour's views also indicate that it is necessary to give weight to a matter if there is an obligation to have regard to it. O'Loughlin J expressed similar views in Fitti v Minister for Primary Industries (1993) 40 FCR 286 at 299. His Honour applied the words of Mason J in The Queen v Hunt; ex parte Sean Investments Pty Ltd (1979) 180 CLR 322 at 329 that the obligation to have regard to the matter obliges the decision maker

> *"…to take [that matter] into account and to give weight to [it] as a fundamental element in making his determination".*

"Take account of"

- Per Parker J (with whom Malcolm CJ and Anderson J agreed) *Re Michael; Ex parte Epic Energy (WA) Nominees Pty Ltd*, consider section 2.24 of the *National Third Party Access Code for Natural Gas Pipeline Systems*, which required the regulator to "take into account" a number of factors when assessing a proposed Access Arrangement (emphasis added):[25]

> *The submissions of the parties in this regard proceeded by analogy with legislative requirements such as "must have regard to" or "shall have regard to". The researches of counsel had not identified any decision in which the precise phrase used in s2.24 had been the subject of judicial consideration. In R v Hunt; Ex parte Sean Investments Pty Ltd (1979) 180 CLR 322 the question arose in the context of a statutory requirement that a departmental head "have regard to costs necessarily incurred" when determining the scale of fees. At 329 Mason J (Gibbs J concurring), said:*
>
> > *"When subs(7) directs the Permanent Head to 'have regard to' the costs, it requires him to take those costs into account and to give weight to them as a fundamental element in making his determination. There are two reasons for saying that the costs are a fundamental element in the making of the determination. First, they are the only matter explicitly mentioned as a matter to be taken into account. Secondly, the scheme of the provisions is that, once the premises of the proprietor are approved as a nursing home, he is bound by the conditions of approval not to exceed the scale of fees fixed by the Permanent Head… In the very nature of things, the costs necessarily incurred by the proprietor in providing nursing home care in the nursing home are a fundamental matter for consideration."*

[25] (2002) 25 WAR 511, [52]-[55].

In the R v Toohey & Anor; Ex parte Meneling Station Pty Ltd & Ors (supra) the issue arose in the context of s50 of the Aboriginal Land Rights (Northern Territory) Act 1976 (Cth) which, in subs(3), required that the Commissioner in making a report in connection with a traditional land claim "shall have regard to the strength or otherwise of the traditional attachment by the claimants to the land claimed, and shall comment on" each of a number of matters. At 333 Gibbs CJ observed:

> *"…the section draws a clear distinction between those matters to which the Commissioner 'shall have regard' and those upon which he 'shall comment'. When the section directs the Commissioner to 'have regard to' the strength or otherwise of the traditional attachment by the claimants to the land claimed… it requires him to take those matters into account and to give weight to them as a fundamental element in making his recommendation. (His Honour referred to R v Hunt). When the section directs him to comment on the matters mentioned in para(a) to para(d) of subs(3), it requires him to remark upon those matters and to express his views upon them. The change in language is so significant that notwithstanding the difficulties of the section I find it impossible to reach any conclusion other than that a significant change of meaning is intended, and that the matters which form the subject of the comment are not matters to which the Commissioner is bound to have regard in making his recommendation."*

However, as Sackville J observed in Singh v Minister for Immigration and Multicultural Affairs [2001] FCA 389 at [54] the expression "have regard to" is capable of different meanings, depending on its context, and

> *"…can simply mean to give consideration to something (Shorter Oxford English Dictionary). In this sense a direction to a decision-maker to have regard to certain factors may require him or her merely to consider them, rather than treat them as fundamental elements in the decision-making process."*

In that case, the learned Judge was persuaded that the requirement in s54(1) of the Migration Act 1958 (Cth) that the Minister, in determining a visa application, must have regard to all the information in the application, did not require the Minister to take into account the information in the application as a fundamental element in the decision-making process because at [57]:

> *"It could hardly have been contemplated by the drafters that every piece of information selected for mention by an applicant, no matter how marginal its relevance to the issues to be determined, must be treated by the decision-maker as a 'fundamental element' in making the determination."*

…It is clear that an expression such as "have regard to" is capable of conveying different meanings depending on its statutory context. In s2.24 the phrase "must take the following into account" is apt to convey as an ordinary matter of language that ***the Regulator must not fail to take into account each of the six matters stipulated in (a) to (f), and by (g) any other matter the Regulator considers relevant. If anything, "take into account" appears, as a matter of language, little different from "have regard to"****.*

Indeed, in R v Hunt the expression "have regard to" was understood as requiring that the specified matters be taken into account. The matters specified in (a) to (f) appear, by their nature, to be highly material to the task of assessing a proposed Access Arrangement, given the legislative purpose and objects of the Act and the Code in this regard. It is difficult to conceive that it could have been intended that the Regulator might decide to give no weight at all to one or more of the factors stipulated in s2.24(a) to s2.24(f). In my view, in the context of the Act and the Code, the Regulator is required by s2.24 to take the stipulated factors into account and to give them weight as fundamental elements in assessing a proposed Access Arrangement with a view to reaching a decision whether or not to approve it.

Attachment 2 – Advice on Proposed Rule Changes to National Gas Rule 87 by CEG

COMPETITION ECONOMISTS GROUP

Proposed AEMC changes to National Gas Rule 87

October 2012

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1 Introduction

1. The Australian Pipeline Industry Association (APIA) has asked CEG to assess whether the regulator's current application of a single model for determining the rate of return (in particular the cost of equity) will achieve the intent expressed by the AEMC in its Draft Determination or the best estimate of the rate of return of capital which is consistent with the National Gas Law (NGL), specifically the National Gas Objective (NGO) and revenue and pricing principles (RPP).

2. In answering this question, CEG has been asked to take into account legal advice obtained by APIA's legal advisors Johnson, Winter and Slattery (JWS) on how the AEMC's proposed revisions to NGR 87 would affect interpretation of this regulation, advice previously provided by CEG to APIA and recent regulatory precedent on these issues. CEG has also been asked to consider whether alternative drafting for NGR 87 prepared by JWS would, from an economic perspective, be more likely than the AEMC's drafting to achieve the NGO and the RPP.

3. The remainder of this report is set out as follows:

   - Section 2 draws from the Draft Determination in assessing what the objectives of the AEMC were in formulating the new Rules relating to the rate of return;
   - Section 3 briefly summarises the legal advice provided by JWS as it relates to these objectives;
   - Section 4 presents a case study demonstrating the problem with the implementation of the existing Rules that needs to be addressed; and
   - Section 5 assesses whether JWS's alternative drafting would be more likely to achieve the NGO and RPP than the AEMC's proposed drafting.

2 AEMC's objectives

4. The AEMC's intentions in its Draft Determination on proposed changes to the National Electricity Rules (NER) and NGR are highlighted in its executive summary. The AEMC states:[1]

> *The Commission proposes to amend the rate of return provisions in the NER and NGR to provide for a common framework that enables the regulator to make the best possible estimate of the rate of return at the time a regulatory determination is made. When making the estimate the regulator must take into account the market circumstances, estimation methods, financial models and other relevant information.*

5. Within this broad statement of intentions, there are two components to the AEMC's objectives. Firstly, it has amended both the NER and the NGR to ensure that the best estimate of the rate of return is made at the time of each regulatory determination. This reflects a movement away from current provisions of the NER where five-yearly WACC reviews can "lock in" certain parameters over many individual regulatory reviews. Secondly, the AEMC expresses a clear intention to require the regulator to take into account a wider range of methods, models, data and other evidence in its decision-making. This compares to the current situation where, for cost of equity, reliance is in essence placed solely on a particular implementation of the CAPM.

6. We consider these objectives in more detail below.

2.1 Objective to reflect prevailing conditions

7. The AEMC is unequivocal that the allowed rate of return must be estimated having regard to prevailing market conditions:[2]

> *A robust and effective rate of return framework must be capable of responding to changes in market conditions. If the allowed rate of return is not determined with regard to the prevailing market conditions, it will either be above or below the return that is required by capital market investors at the time of the determination. Neither of these outcomes are efficient and neither is it in the long term interest of energy consumers.*

8. We consider that this objective is sensible and it is appropriate that the AEMC expresses it in these terms. In order to achieve the NGO it is necessary that investors have an expectation that, on any capital supplied to the regulated business,

[1] AEMC Draft Determination, p. ii

[2] AEMC Draft Determination, p. 49

they will recover a cost of capital that is commensurate with the market return they can achieve elsewhere for exposure to similar risk. If this is not the case then investors will not willingly invest in the assets of the regulated business. In this respect that AEMC's conclusion is consistent with the advice we gave in our earlier report for APIA.[3]

9. Similar advice was provided by the AEMC's consultant, SFG, which noted that the first feature of a high quality WACC estimate was that it comes from a process that "reflects current market circumstances":[4]

> *By definition, the WACC is a forward-looking opportunity cost. It is an estimate of the expected return that investors would require in order to commit capital to the firm in the current environment. Since market circumstances vary over time, a firm's cost of capital will also vary over time. For this reason it is important that any WACC estimate properly reflects the current market circumstances. The current Rules recognise this where they refer to the need for the regulatory rate of return to be "a forward looking rate of return that is commensurate with prevailing conditions in the market for funds."*

2.2 Objective to take into account a range of approaches

10. The AEMC is also very clear that it intends to require the regulator to consider *"a range of estimation methods, financial models, market data and other evidence"* in coming to its estimate of the allowed rate of return. It considers that this is the only way of ensuring that *"the estimation process is of the highest possible quality"*.[5]

11. It expresses concern that the current Chapter 6 NER framework takes too prescriptive an approach, locking in the use of particular methodologies and parameters with no or limited scope for review. It rejects the prescription of 'formulaic' approaches to determining the cost of debt and cost of equity:[6]

> *An example of an estimation process that has become formulaic is the mandatory use of the CAPM under the NER and the view that appears to be adopted in practice that CAPM is the only "well accepted" model under the NGR, despite the flexibility to consider other models.*

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3 CEG, *Proposed changes to the National Gas Rules: A report for APIA*, December 2011, Section 3.1

4 SFG, *Preliminary analysis of rule change proposals: Report for AEMC*, 27 February 2012, p. 17

5 AEMC, Draft Determination, p. 46

6 AEMC, Draft Determination, p. 47

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12. In particular, the AEMC notes that an important motivation for having regard to a wide range of evidence is that:[7]

> *A framework that eliminates any relevant evidence from consideration is unlikely to produce robust and reliable estimates, and consequently is unlikely to best meet the NEO, the NGO and the RPP.*

13. We consider that the AEMC's concerns about reliance upon prescribed approaches are warranted. In our opinion, consistent with the views expressed in our earlier report for APIA, it is appropriate to be informed by all reliable information relevant to estimating the allowed rate of return. This provides the best possible opportunity to arrive at an accurate estimate of a rate of return.

14. We stated at section 3.2 of our previous report that approaches that rely upon a single methodology will not meet the NGO. Accepted use of financial models has evolved over time with experience and research and this evolution continues. There remains a great deal of disagreement in the finance literature over which models best explain risk-adjusted returns. "Locking in" in a particular implementation of just one model and assuming that only the output of this model is relevant to assessing the rate of return or cost of equity, cannot give rise to the best and most reliable estimates of the rate of return and will not meet the NGO.[8]

15. This advice is also consistent with the recommendations of SFG, which emphasises that the best estimate of the WACC requires utilisation of all relevant data and consideration of all relevant estimation methods.[9]

7 AEMC Draft Determination, p. 48

8 CEG, *Proposed changes to the National Gas Rules: A report for APIA*, December 2011, Section 3.2

9 SFG, *Preliminary analysis of rule change proposals: Report for AEMC*, 27 February 2012, p. 17

3 Interpretation of proposed Rule

16. APIA has provided us with legal advice given to it by JWS that indicates that the AEMC's proposed changes to the NGR may not give effect to the intentions that are summarised at section 2.

3.1 Objective to reflect prevailing conditions

17. JWS note that in the existing Rule 87, the rate of return is to be estimated "*commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services*".

18. By contrast, the proposed new drafting will require the rate of return to "*correspond to the efficient financing costs of a benchmark efficient entity with a similar nature and degree of risk as that which applies to the service provider in respect of the provision of reference services*". In the revised drafting the reference to a requirement for the estimate to be based on 'prevailing conditions' is no longer contained within the objective of the Rule but as one of the items that must be considered in its implementation. JWS advise that this in effect makes it secondary to the primary objective of Rule 87.[10]

19. JWS also observe that the new Rule 87(5)(b) requires the return on equity to be estimated in a way that *"is consistent with"* the allowed rate of return objective and "*taking into account the prevailing conditions in the market for equity funds*". In this construction, JWS advise that the requirement to "take into account" prevailing conditions does not reflect the prominence given by the AEMC to this factor in its Draft Determination. Furthermore, JWS note that the requirement for the rate of return estimated "to be consistent with" the rate of return objective could more directly be expressed as "to achieve" that objective.

20. Use of "to be consistent with" and "taking into account" prevailing conditions do not reflect the importance accorded by the AEMC to this factor. JWS state that "commensurate with" and "to achieve" is a more direct expression of the AEMC's intentions. [11]

3.2 Objective to take into account a range of approaches

21. The proposed new Rule 87(3)(c) provides that the allowed rate of return for a regulatory year is to be determined *"taking into account relevant estimation methods, financial models, market data and other evidence"*.

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[10] JWS, *Proposed changes to National Gas Rule 87*, 25 September 2012, pp. 1-2

[11] Op cit, pp. 5-6

22. JWS note that the requirement to "take into account" alternative models and approaches requires the regulator to give consideration to those matters but that does not require the regulator to rely upon or give weight to any one of them:[12]

> *However, as long as the Regulator has taken into account the specified factors, it remains in the Regulator's discretion how those factors influence its decision. The practical application of this rule could result in the Regulator considering other methodologies but continuing to estimate the cost of debt and cost of equity using traditional approaches (eg the Sharpe Lintner CAPM), which would appear to be contrary to the objective of the rule change.*

[12] Op cit, p. 5

4 RFR/MRP case study

23. A number of recent AER decisions, most specifically the AER's recent final decision for the Roma to Brisbane Pipeline (RBP), highlight the need for clear guidance in the Rules as to what is required of the regulator and what is within its discretion to do.

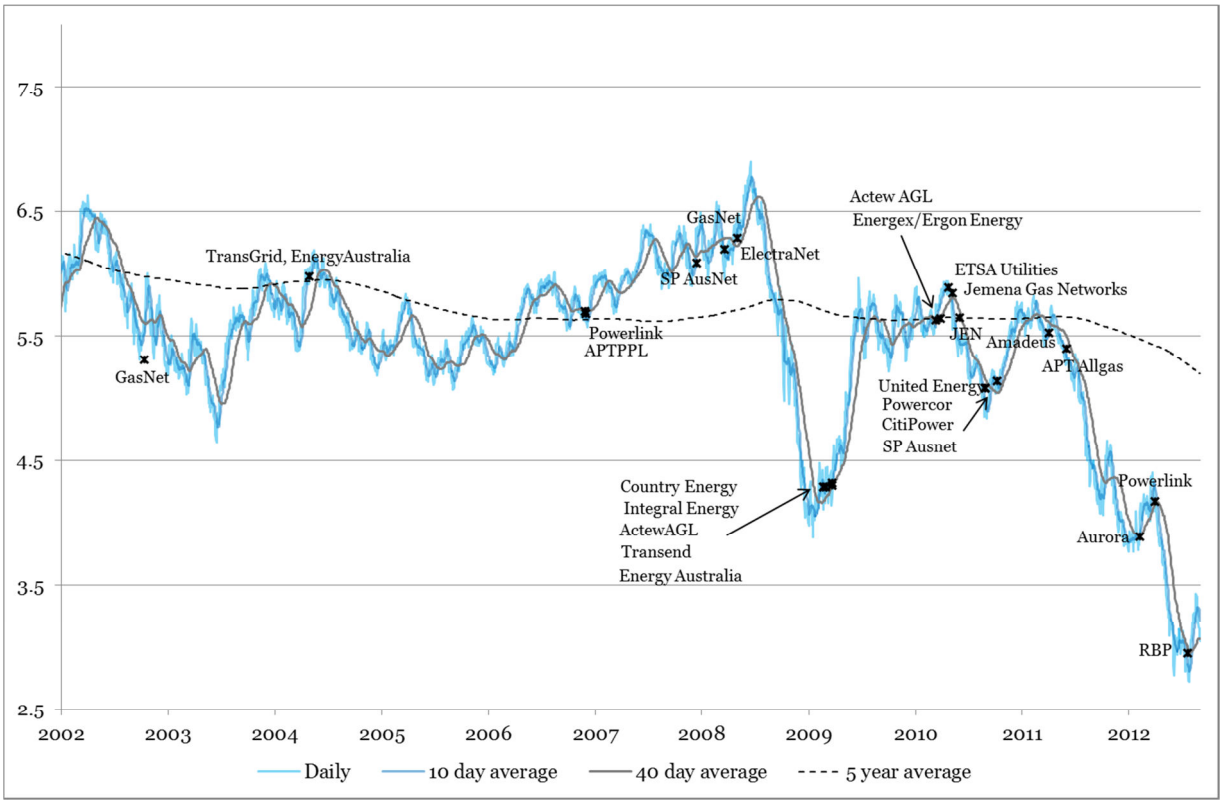
24. In particular the RBP decision demonstrates the possibility that requiring the regulator to have regard to a wide range of methods, models, data and other information may not be enough to ensure that it gives these matters due consideration. This is because ultimately the AEMC's proposed drafting leaves the regulator with the discretion to place little or no weight on these matters. In this respect, the proposed Rules may not result in an outcome any different to what has happened in recent decisions, such as the final decision on RBP.

25. In the RBP review, a specific area of disagreement between the pipeline owner APTPPL and the AER was the level of the MRP. APTPPL proposed an MRP of 8.5%, whereas the AER's final decision imposed a value of 6%. The value of the risk-free rate was agreed by both parties to be 2.95%, being the annualised yield on 10-year CGS.

4.1 Volatile risk free rate with fixed MRP

26. The 10 year Commonwealth Government Security (CGS) risk free rate proxy has been extremely volatile since the global financial crisis as is evidenced by the following figure which show a time series for this measure along with corresponding regulatory decisions marked on the same figure.

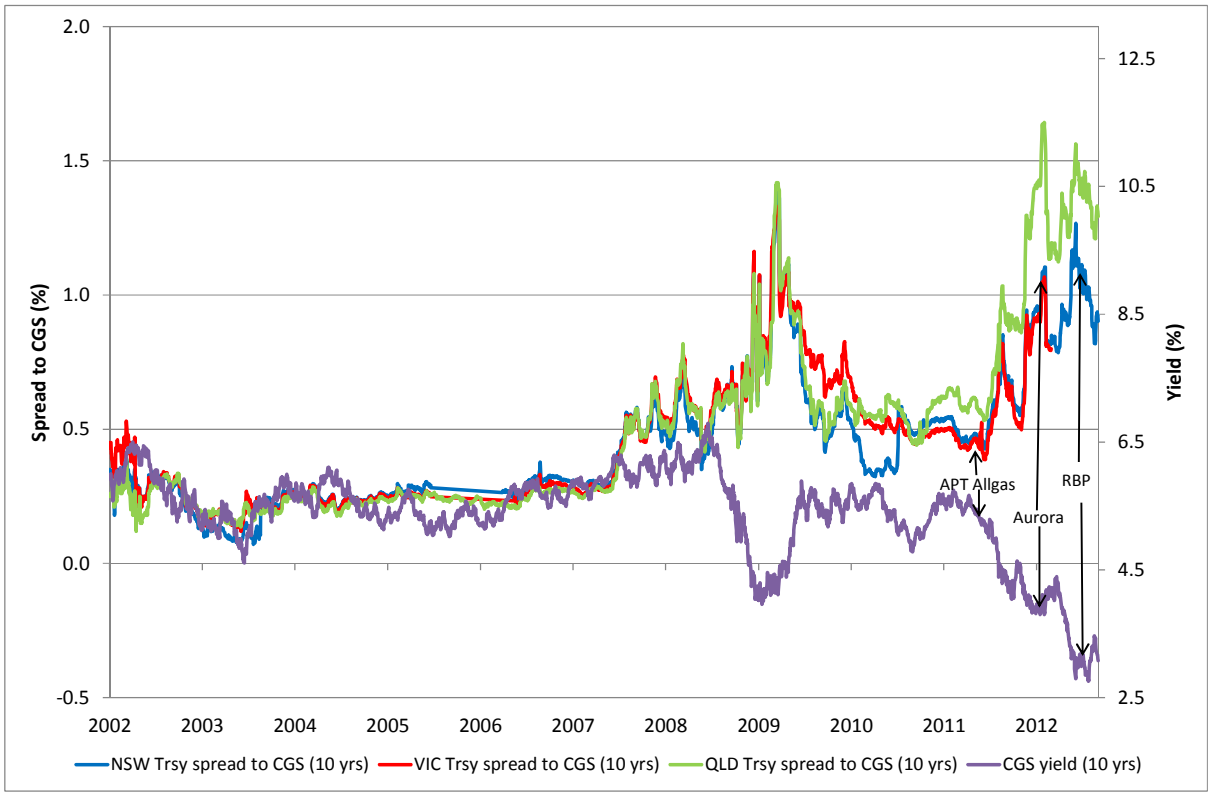
Figure 1: Risk free rate decisions for regulated energy businesses



Source: ACCC/AER decisions, CEG analysis

27. CEG has presented what we regard as compelling evidence that the MRP and risk free rate tend to be inversely related such that when the risk free rate is low the MRP tends to be high (and *vice versa*). This included, for example, evidence that spreads between CGS and other assets (even other AAA rated Government debt) tended to be highest when CGS was lowest (and *vice versa*). The following chart shows an updated version of a figure put before the AER prior to the RBP final decision (obviously the RBP final decision point and data was not in that chart).

Figure 2: Inverse relationship between risk premia on state Government debt and CGS yield

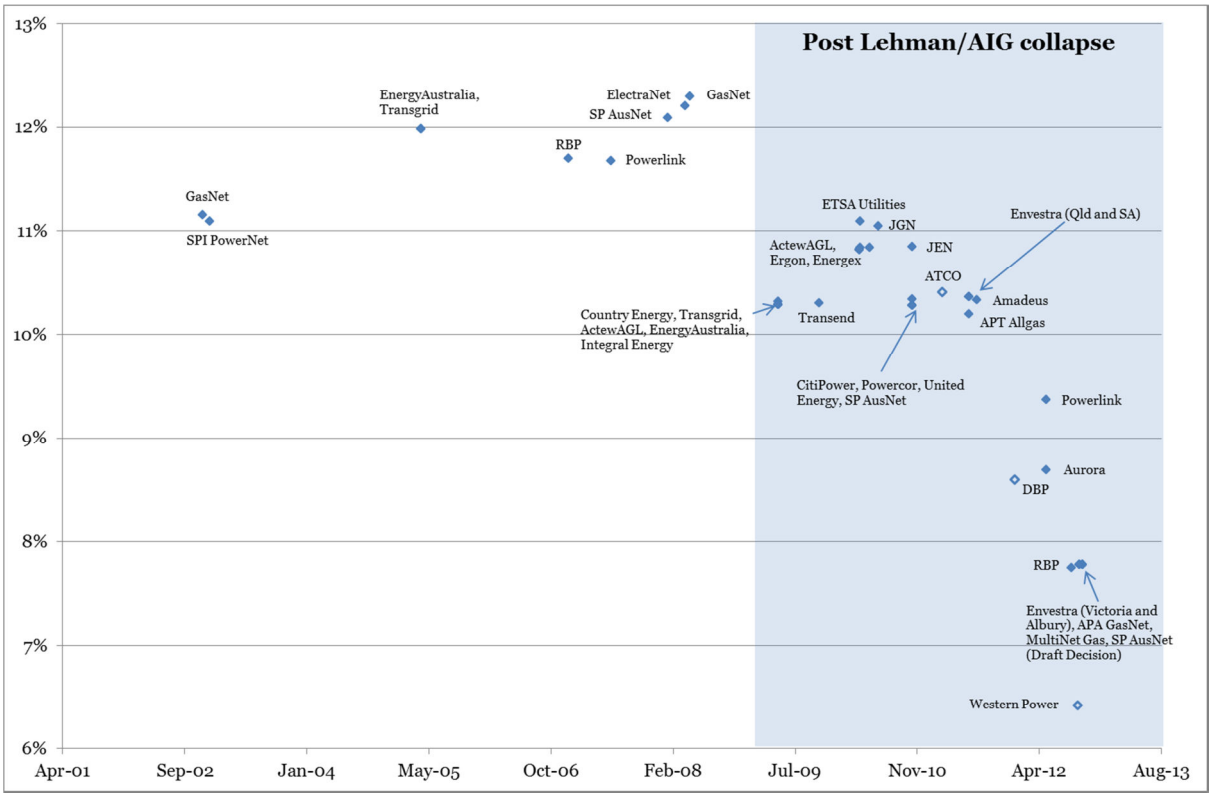


Source: CEG analysis, Bloomberg data

28. This evidence was put before the AER in the RBP process but was dismissed with the AER choosing to set a constant MRP in the face of a historically unprecedented (at least in the last 50 years) risk free rate. Indeed, the AER actually reduced the MRP from 6.5% to 6.0% in its Aurora decision just as risk free rates were plummeting and risk premiums rising (as evidenced by risk premiums on state Government debt).

29. The effect of this is that the AER has estimated that RBP's cost of equity is the lowest cost of equity for any energy business regulated by it. Similarly, for very similar reasons the ERA in Western Australia has estimated that Western Power has an even lower cost of equity (partly reflecting the ERA's choice of a 5 year CGS proxy for the risk free rate).

Figure 3: History of allowed cost of equity



Source: ACCC/AER/ERA decisions

30. APTPPL's proposed MRP of 8.5% was based upon advice prepared by CEG for the Victorian gas distributors, also submitted as part of APTPPL's revised access arrangement proposal. In that report we made a detailed survey of general conditions relevant to assessing the cost of equity and the MRP, and proposed two quantitative methodologies by which the cost of equity and MRP could be estimated based on dividend growth models (DGM).

31. We considered that a range of information in addition to the spreads to CGS on AAA rated state Government debt instruments described above. These all suggested that risk premiums in the general economy were elevated relative to historical averages. Moreover, the AER received advice from the RBA that confirmed this view of heightened risk premiums. Assistant Govenor Guy Debelle, when asked by the AER to review the CEG report, essentially agreed with CEG's core view when he stated:

> *As a result, there has been a widening in the spreads between CGS yields and those on other Australian dollar-denominated debt securities. This*

widening indeed confirms the market's assessment of the risk-free nature of CGS and reflects a general increase in risk premia on other assets.[13]

32. Our evidence was confirmed by our estimate of the current cost of equity for regulated energy network businesses. [14]

33. A key component of our advice was that the methodology that was being applied by the AER effectively combined a current estimate of the risk-free rate with an historically averaged estimate of the MRP. Given that measures of the risk-free rate were historically low, this combination resulted in a very low overall cost of equity that was not reflective of the prevailing conditions in financial markets.

4.2 AER final decision

34. Evidence that the AER had regard to in coming to its estimate of 6% included:

- historical excess returns;
- survey evidence;
- the practice of other Australian regulators and recent Tribunal decisions;
- DGM estimates; and
- other financial indicators, including:
  - credit spreads; and
  - dividend yields.

35. The AER's decision gives overwhelming weight to the evidence sourced from historical excess returns. The AER itself admits that these are not "strictly forward looking".[15] It is a contradiction in terms for the AER to refer to *"the best estimate of a 10 year forward looking MRP based on historical excess returns"*.[16] An additional assumption is required that future expectations of MRP are best measured by average historical measures, and not through direct estimates of the expected MRP such as DGM estimates.

[13] http://www.aer.gov.au/sites/default/files/RBA%20letter%20concerning%20the%20Commonwealth%20Government%20Securities%20Market%20-%2016%20July%202012.pdf

[14] CEG, *Internal consistency of risk free rate and MRP in the CAPM: Prepared for Envestra, SP AusNet, Multinet and APA*, March 2012

[15] AER, *Final Decision: APT Petroleum Pipeline Pty Ltd: Access arrangement final decision Roma to Brisbane Pipeline 2012–13 to 2016–17, August 2012*, p. 67

[16] Op cit, p. 69

36. By comparison, the AER states that DGM estimates "can provide some information" on the expected MRP. It immediately qualifies this view by casting doubt on the robustness of such estimates:[17]

> *However, the AER considers that the DGM based estimates of the return on equity and inferred estimates of the MRP are highly sensitive to the assumptions made. It is necessary that all assumptions made have a sound basis, otherwise estimated results from DGM analysis may be inaccurate and lead analysts into error.*

37. Of course, precisely the same is true of interpretations of any evidence – including historical evidence relied on by the AER.

38. The AER admits that DGM estimates currently give high estimates of the MRP. However, by setting the overall MRP at 6%, it clearly has chosen to give very little weight to this information. The AER disputes the reliability of other information that could be looked at to assess the level of volatility or risk premiums.[18]

39. The above discussion shows, in our view, that while a regulator may *have regard* or *take account of* a great deal of information, much of which may be very relevant to assessing a particular WACC parameter, it will not necessarily place significant weight on this information. In this sense, the AEMC's proposed Rule changes do not appear to require the regulator to do anything different from what it is currently doing and will not necessarily resolve its reliance on a single financial model

40. We understand that the AEMC's intention in drafting its proposed Rule changes was that the regulator would be required to have active regard and place appropriate weight on a variety of approaches to assessing the rate of return. However, if no words or framework are provided to allow a review body to assess whether the regulator has exercised its discretion reasonably then it is not clear that the proposed Rules will have the effect that was intended.

17 Op cit, pp. 74-75

18 Op cit, pp. 76-77

5 Alternative drafting

41. CEG has been asked to consider whether alternative drafting for NGR 87 prepared by JWS would, from an economic perspective, be more likely than the AEMC's drafting to achieve NGO and the RPP.

42. In this section we restrict our attention to the changes proposed by JWS which we believe have implications for economic interpretation of the requirements of the Rules.

43. In our view, the changes recommended herein will better achieve the NGO and the RPP for the reasons outlined in section 2 above.

5.1 87(2)

44. We consider that JWS's reinstatement of the words *"be commensurate with prevailing conditions in the market for Funds"* in the allowed rate of return objective at Rule 87(2) is more likely to achieve the NGO.

45. This is reflected in the opinions we expressed in our earlier report for APIA that in order to achieve the NGO it is necessary that investors have an expectation that, on any capital supplied to the regulated business, they will recover a cost of capital that is commensurate with the market return they can achieve elsewhere for exposure to similar risk. If this is not the case then investors will not willingly invest in the assets of the regulated business. [19]

46. To the extent that including it as part of the objective, and not simply a requirement to achieve when estimating the rate of return, gives primacy to the need to estimate a prevailing rate of return (rather than this being simply one of a range of potentially conflicting requirements) we consider that it is more likely to achieve the NGO.

5.2 87(3)

47. JWS provides a number of drafting alternatives, all of which clarify that the regulator is not just *required to take into account* a range of methods, models and data, but is *expected to utilise several* of these in support of its estimate. We believe that this clarification does assist the AEMC's objective by ensuring that the status quo of sole reliance on a single implementation of the CAPM cannot continue to be the basis of future decision making.

[19] CEG, *Proposed changes to the National Gas Rules: A report for APIA*, December 2011, Section 3.1

48. This is consistent with the observations of the AEMC, CEG and SFG summarised at section 3.2 above that wider regard to methods, models and data would result in an estimate that would be more likely to achieve the NGO.

5.3 87(5)

49. JWS's redrafting of the Rule 87(5) to guide estimation of the return on equity replaces:

    - *"to be consistent with"* the allowed rate of return objective with *"to achieve"* that objective; and
    - *"taking into account"* the prevailing conditions in the market for equity funds with *"to be commensurate with"* those conditions.

50. JWS's proposed revisions appear to provide clearer guidance to the importance of achieving the allowed rate of return objective, and place greater importance on reflecting the prevailing conditions in financial markets. Since reflecting prevailing conditions is important to achieving the NGO, as summarised at section 3.1, we consider that JWS's draft Rule would be more likely than the AEMC's proposed Rule to achieve the NGO.

5.4 87(b)

51. Consistent with the views of JWS it does not appear that there is any reasonable economic or logical interpretation for the proposed requirements of 87(6)(b).

the australian PIPELINE industry association Ltd

4 October 2012

Australian Energy Market Commission
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Submitted via web portal

Consultation on Draft Determination on Rule Change GRC0011

Dear Commissioners

The Australian Pipeline Industry Association (APIA) welcomes the opportunity to comment on the Commission's Draft Determination on the Economic Regulation of Service Providers rule change proposals. APIA's submission focuses on the rate of return changes proposed for the National Gas Rules (NGR), the rule change identified as GRC0011.

APIA is pleased that the Commission has formed a view that the more flexible approach to determining the rate of return embodied and intended under the current NGR has features consistent with those determined to be desirable by the Commission and should form the basis of a new framework. The need to ensure that the framework requires the regulators to use all available evidence and market data in estimating the rate of return, rather than adopting a formulaic approach that relies on a single model in that estimation process will not only ensure that the most accurate outcome is achieved, it will give the greatest confidence to investors that the national gas objective will be achieved. The features of a desirable framework set out by the Commission are strongly supported by APIA.

Notwithstanding this, APIA does have some concerns that there are aspects of the proposed preferred rule outlined by the Commission in the draft determination which may not accurately embody the key features identified by the Commission.

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The attached submission seeks to address these issues. We are also conscious that there is a relatively short timetable proposed to complete the rule change assessment process so as to not adversely impact on the pricing determination process that must be commenced by some regulated businesses in 2013.

Accordingly, APIA proposes the following:

- the attached submission contains specific re-drafting of the preferred rule for the Commission's consideration.
- as every word used in a rule can impact the meaning of a rule, APIA suggests that the Commission form a Drafting Committee, with representatives from key stakeholders, to review the final set of words decided upon by the Commission prior to the release of the Final Determination. This will provide an opportunity for a range of experts to review the final wording of the rules to ensure the Commission's intent is achieved as closely as possible.

The submission will also address APIA's concerns with aspects of the Guidelines process proposed in the Draft Determination. These concerns primarily focus on the timing and process of the first Guideline and ensuring that the Guideline does not become a more prescriptive than intended instrument a regulator feels bound to follow.

In terms of transitional issues, this submission will address only those that relate to transitioning to the mandatory use of a post-tax basis for estimating the rate of return. Transitional issues that relate to the timing of the next round of pricing approvals in access arrangements relative to the guidelines process will be addressed by APIA as part of the separate consultation process currently being conducted by the Commission.

If you would like any further information please contact me on (02) 6273 0577 or sdavies@apia.asn.au.

Yours sincerely

STEVE DAVIES
Policy Adviser