



Response to Australian Energy Regulator Draft Decision

Jemena Gas Networks Access Arrangement Proposal 2010-2015

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Energy Networks Association

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1. Executive summary

The Energy Networks Association (ENA) welcomes the opportunity to respond to the Australian Energy Regulator's (AER) Draft Decision on Access Arrangement revisions proposed by Jemena Gas Networks for its New South Wales gas distribution network.

The AER Draft Decision on the Jemena Gas Networks proposed revisions raise several issues of principle on the implementation of the 'fit-for-purpose' model in place in energy network revenue regulation, and core provisions of the National Gas Rules

ENA has significant concerns that the AER approaches and its interpretation of some elements of the National Gas Rules have the potential to undermine the clear, effective and intended operation of the gas access regime in three key areas. These areas are:

- the assessment framework for determining whether the Fama-French Model is 'well-accepted' and compliant with the Gas Rules;
- the application of the limited discretion rule for AER assessments of capital and operating expenditure forecasts; and
- network tariff approval and change processes.

ENA was a lead party in the policy discussions, rule negotiation and finalisation of the National Gas Rules and attaches significant importance to ensuring that the policy principles underpinning the operation of key clauses of the Gas Rules are adequately reflected in ongoing regulatory decision-making. To ensure the pending Final Decision is consistent with the intent and meaning of the Gas Rules, ENA invites the AER to reassess the approaches adopted in the Draft Decision taking full account of the issues raised.

2. Background

ENA is the peak national body for Australia's energy networks which provide the vital link between gas and electricity producers and consumers. ENA represents gas distribution and electricity network businesses on economic, technical and safety regulation and national energy policy issues.

Energy network businesses deliver electricity and gas to over 13.5 million customers, employ more than 40,000 people and contribute approximately 1.25 per cent to Australia's gross domestic product. Energy is delivered across Australia through approximately 48,000 km of transmission lines, 800,000 kilometres of electricity distribution lines and 81,000 kilometres of gas distribution pipelines. Energy network businesses are valued at over \$60 billion and annually undertake an average investment of approximately \$6 billion in network operations, reinforcement, expansions and greenfields extensions.

3. Choice of a rate of return model

The National Gas Rules clearly provide the flexibility for businesses to propose alternative means of deriving a benchmark rate of return. This flexibility was reaffirmed in 2008 by the decision by the Ministerial Council on Energy to retain all of the key conceptual elements of the equivalent provisions in the previous National Gas Code (s.8.30-8.31).

Given this policy decision, it is important that regulatory approaches give substantive effect to this flexibility, and that the AER's analytical framework to applying Rule 87 does not have the unintended effect of frustrating the policy goal underpinning the decision.

In the case of Rule 87, the policy goal is to enable rate of return estimates to be derived from well accepted models, outside of the traditional CAPM. This is in sharp distinction to the National Electricity Rules which mandate the use of a CAPM.

Jemena Gas Networks' Access Arrangement proposal represents the first time a service provider has sought to fully use the flexibility provided by the Gas Rules to utilise an alternative methodology for estimating a rate of return. This makes the decision-making framework and process undertaken by the AER on this issue of significant consequence for the entire energy network sector and consumers.

From the AER Draft Decision, however, it appears the AER has applied a framework of analysis which is inappropriate and inconsistent with the policy intent of the National Gas Rules and the *National Gas Law*. The principal concerns the network sector has in this regard are that the AER's approach:

- imports irrelevant requirements into applying the 'well accepted' test and other relevant parts of the Gas Rules; and
- fails to compare the CAPM and the Fama-French Model (FFM) proposed by Jemena Gas Networks in a balanced manner.

These issues are discussed in further detail below.

3.1 Interpretation imports irrelevant requirements into a 'well-accepted' test

A significant focus of the AER on the application of Rule 87 relates to the meaning of a "well-accepted" financial model. ENA has concerns that the approach adopted by the AER in relation to interpreting this term imports a range of irrelevant requirements into consideration of this issue. ENA acknowledges that application of regulatory rules inevitably involves a regulator developing practical interpretations of key terms employed. A touchstone for the reasonableness and workability of such interpretations, however, is that they do not import requirements or thresholds that have the practical effect of nullifying the key policy objectives directly evident in the terms of the provisions.

For example, there is no requirement in the relevant Gas Rule that the alternative model be well accepted by *regulators* seeking to establish a forward looking rate of return, although considerable weight appears to be attached by the AER to this matter. The Fama-French model is a well accepted model, understood and utilised for a range of theoretical and practical purposes by a range of relevant stakeholders, including finance academics and market practitioners.

In a similar way, there is no basis for limiting the choice of model according to a "relevant purpose", as the full range of asset pricing models available for application have as a common factor that there were not designed to provide forward looking estimates of the cost of equity in the context of Australian third party access pricing determinations.

The ENA is also concerned that the AER introduces an additional threshold that to be compliant with Rule 87, a model must pass a test of statistical robustness.¹ Notwithstanding that it is a contested issue as to whether the traditional CAPM would meet such a requirement, there is no basis in the Rule 87 or 74 for this requirement to be applied in relation to whether a model is 'well accepted' or reasonable to use in the circumstances. The test of statistical robustness may well be relevant to the application of Rule 74 to *other* elements of an Access Arrangement proposal which are readily and unambiguously amenable to statistical analysis and quantification. The terms of Rule 74, however, clearly recognise that across a range of Access Arrangement parameters and assumptions, varying levels of quantification and statistical testing will be reasonable.²

A broad industry concern with the analytical framework adopted by the AER and in particular on the matters raised above is that under the AER's proposed approach it is unlikely *any* alternative model would be adopted outside of the traditional CAPM. This is not a reasonable outcome taking into account the policy intent of Rule 87. A logical consequence of this interpretation of Rule 87 would be to deny any potential for regulatory innovation around cost of capital estimation methodologies occurring in the Australian regulated energy sector, and to cast doubt on the legitimacy of any AER methodological approach in relation to CAPM which did not have a range of supporting international precedents.

3.2 Fails to compare the CAPM and FFM in a balanced manner

ENA is also concerned that the analytic approach and reasoning adopted by the AER fails to adequately discharge the task of assessing whether FFM meets the requirements of Rule 87.

Broadly, the AER's approach is to seek to compare CAPM and FFM in a manner which suggests that CAPM is a 'default' or *de facto* requirement of the Gas Rules, a privilege which is not suggested by the terms of the relevant Rule, that merely provide for CAPM as one approach that *may* be applied.

The critique in the Draft Decision of the FFM highlights an unbalanced approach. Many of the findings about the Fama-French Model that the AER uses to support its rejection of the approach apply equally to the traditional CAPM which the AER requires Jemena Gas Networks to adopt.³ For example:

- the CAPM can be, and is, used for a range of purposes, however, this does not invalidate its use for access pricing functions;
- the CAPM is also used in a way different to its original specification and assumptions, yet is not deemed invalid to be applied by the AER;
- the CAPM also relies on empirical variables whose significance varies across different studies and timeframes;
- the CAPM was also developed in the US using US data sets;
- the CAPM was developed to explain how assets are priced, across a full market portfolio, just as FFM was developed for different purpose; and

¹ AER *Draft Decision – Jemena Access arrangement proposal for NSW gas networks*, February 2010, p.120

² See National Gas Rules, Cl. 74 (2)

³ See AER *Draft Decision* (February 2010) ,p.102-111

- the CAPM was also developed in context of portfolio selection, just as FFM was.

ENA does not consider it is consistent with sound evidence-based regulatory decision-making for the AER to maintain that the FFM is non-compliant with the Gas Rules on the basis of factors which also apply with equal force to the traditional CAPM.

4. Application of limited discretion under the National Gas Rules

A strong area of concern for the energy network sector arising from the Draft Decision is that elements of the AER's decision-making appear inconsistent with the operation of a 'fit-for-purpose' regulatory model adopted by the Ministerial Council on Energy for the sector.

The AER has limited discretion in its assessment of proposed capital and operating expenditures. This means that the AER cannot reject an element of an Access Arrangement which complies with relevant provisions and is consistent criteria set out in the Law and Rules.⁴ Where the AER exercises its discretion to substitute preferred values or parameters, it has a duty to provide reasoning and evidence to support its substituted values of parameters.

ENA considers that two areas of the AER Draft Decision particularly demonstrate strong tensions with the constrained discretion provided to the regulator under the Gas Rules. These are the AER's approach to:

- determining an efficient forward capital expenditure estimate; and
- setting to zero proposed cost escalation factors impacting on capital expenditure forecasts.

In addition, the energy network sector considers that the AER's proposal that Jemena Gas Networks be required to maintain a 'statement of costs' specified by the regulator through the Access Arrangement revisions process is outside of the intended discretionary powers provided to the regulator for approving reference access terms and conditions. These matters are discussed in further detail below.

4.1 Approach to 'balancing' historical and forward capital expenditure

The AER states that in relation to capital expenditure that it 'strikes a balance' in the level of approved expenditure between that which is 'reasonably required' and the level of projects Jemena Gas Networks has delivered historically. Its reasoning is that historical expenditure demonstrates the level of expenditure that can be delivered in compliance with Rule 79 in the future Access Arrangement period.

This 'balancing' test has no clear basis in the actual provisions of the Gas Rules. Historical information about the scale of projects delivered in the past may be relevant to an assessment of whether a service provider is likely to be able to deliver a set of projected capital projects, but it is by no means a determinative factor of such weight that it should be 'balanced off' against projects that are reasonably required.⁵ Such an approach fails to give substantive meaning and effect to the criteria for conforming capital expenditure which emphasises the expenditure that a prudent service provider, acting efficiently, in accordance with good industry practice would incur in order

⁴ See National Gas Rules, Cl.40

⁵ This phrase too has no analogue in the Gas Rules, and it appears to be a nugatory reference to the capital expenditure decision criteria under the *National Electricity Rules* Schedule 2, S6.2.1. (e) (8) (i)

to achieve the lowest sustainable cost of providing services.⁶ The AER's 'balancing' approach would also appear to give undue weight to one of many factors relevant to assessing forward expenditure estimates, an approach which the AER has recognised as incomplete in recent electricity distribution determination processes.⁷

ENA considers that based on the capital expenditure criteria in Rule 79 an assessment of the deliverability of a future program of capital expenditure should take into account the likely capacities of the service provider over the regulatory period in question (taking into account the integrated nature of proposed operating and capital expenditures), and include an initial presumption that the business will be able to operationally manage variations in its proposed expenditure programs in a manner consistent with firms operating in a competitive market.

This approach is also consistent with the benchmark efficient firm presumption applied across other areas of building blocks approach, which avoids placing the AER in the untenable position of making operational and commercial decisions for which it lack sufficient relevant information

4.2 Obligation to evidence best estimates

A second matter for concern is that in a number of areas in the Draft Decision, in particular cost escalators, the AER rejects proposed cost escalation factors applied to materials, and applies a 'zero' factor in its place with no explanatory reasoning.

Where the AER has limited discretion, and has rejected a service provider proposed value or parameter supporting a cost estimate, the AER has an obligation to provide clear and detailed reasoning regarding how it considers its substituted value complies with the relevant rules. In the case of cost escalation factors, for example, this would include setting out the reasoning to support an estimate of zero has the best estimate derived on a reasonable basis.

This requirement is important for a number of reasons. First, it demonstrates to stakeholders a clear basis for proposed decisions. Secondly, it maximises the capacity for the service provider and other stakeholders to provide relevant empirical and theoretical information to enable the Final Decision to incorporate evidence of the best available quality. Third, where such reasoning ultimately underpins forward Access Arrangement terms and conditions, it provides transparency for the service provider and users on the basis of regulated tariffs.

4.3 Proposal to require a statement of costs

A final matter of concern for ENA in relation to regulatory discretion is a proposal in the Draft Decision to impose a detailed information collection template, styled as a 'statement of costs' through the Access Arrangement approval process.

To the extent that this proposed instrument would require the collection and maintenance of information required for the exercise of the AER's functions, ENA is of the view that direct information collection powers provided for this purpose under the *National Gas Law* should be utilised. In its recent final decision with respect to the ActewAGL gas network Access Arrangement revisions the AER has reassessed a similar initial request for a detailed cost information template to form part of the revised Access Arrangement, in a positive recognition that information collection issues should be addressed separate to the role of the Access Arrangement in setting reference

⁶ See National Gas Rules, Cl.79

⁷ See for example, *Minutes of the Queensland Public Forum on Energex's and Ergon Energy's regulatory proposals (1 July 2010 to 30 June 2015)*, p.2 <<http://www.aer.gov.au/content/index.phtml/itemId/730109>>

terms and conditions of third party access. ENA considers that for the same substantive reasons a consistent outcome should apply in this case.

5. Approach to gas network tariff change and approval processes

5.1 Flexibility to introduce new tariffs

ENA understands that the AER is proposing that the introduction of new tariffs through the next regulatory period will only be able to be effected by Jemena Gas Networks seeking a re-opening of its Access Arrangement.

This approach would appear to deny Jemena Gas Networks a capacity, at a time of significant market changes to flexibly redesign, retire, and create new tariffs within the requirements of its proposed Access Arrangement. This appears to be inconsistent with the broad role of the Access Arrangement to provide an overarching framework for revenue and overall price paths over five year period, rather than an Access Arrangement representing a specific commitment to a particular tariff design or structure.

5.2 Annual ex-ante certainty on tariffs

Related to the points raised above, the AER has also proposed a mechanism under which it appears possible for Jemena Gas Networks to undergo annual tariff approval processes, yet still be subject to ongoing potential uncertainty going forward around the revenue recovered by these regulator approved tariffs. It is uncertain under which provision of the Gas Rules this requirement is made.

To have meaning and net benefit, annual tariff approval processes must provide *ex ante* certainty to service providers that, barring any material mathematical or methodological errors, the tariffs approved may be charged without tariff revenue being 'clawed back' into the future. ENA seeks clarification from the AER of the intended operation of this mechanism.

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