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Mr Sebastian Roberts
General Manager, Transmission and Gas
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Sebastian

Draft Financial Reporting Guideline for Light Regulation Pipelines Services

Jemena appreciates the opportunity to respond to this consultation by the Australian Energy Regulator (AER) to develop Final Reporting Guideline for Light Regulation Pipelines ("Draft Light Regulation Reporting Guideline").

We own and manage some of Australia's most significant gas assets. Our gas investments in the East Coast include:

- Scheme pipelines that are covered and under full regulation - the Jemena Gas Networks servicing 1.4 million customers around NSW
- Non-scheme gas transmission pipelines that are subject to Part 23 of the National Gas Rules (NGR) including:
    - the Eastern Gas Pipeline (**EGP**) which delivers gas from Victoria's Gippsland basin to the ACT, Sydney and regional NSW
    - the VicHub, located at Longford Victoria linking the Declared Wholesale Gas Market and the EGP
    - the Darling Downs Pipeline Network in south-east Queensland supplying Darling Downs Power Station and APLNG's export pipeline.
    - the Queensland Gas Pipeline (**QGP**) which supplies Gladstone and Rockhampton.

  Our non-scheme pipelines are subject to separate AER's Financial Guideline for Non-Scheme Pipelines ("Non-scheme Reporting Guideline").

We acknowledge the AER's implementation objectives for the Draft Light Regulation Reporting Guidelines—which is an outcome of the Australian Energy Markets Commission (AEMC) rule change resulting from the review of Part 8-12 of the NGR—to ensure that light regulation pipelines are subject to many of the same obligations as non-scheme pipelines under Part 23 of the NGR.

In particular, greater disclosure, robust basis of preparation and further guidance on cost allocation will improve confidence in the information required for all stakeholders.

Although Jemena's pipelines are not subject to light regulation, given the relationship between the two financial reporting guidelines, we remain an interested stakeholder in the future regulation that applies to light regulation.

Our interest remains primarily in ensuring that there is no creeping over-regulation of non-scheme pipelines from on-going reassessment of light regulation, and that there remains a clear distinction in the extent and form of regulation applied to light and non-scheme pipelines.

This response from Jemena focuses on three overarching lines of enquiry:

- through the Draft Light Regulation Reporting Guideline, the AER proposes to apply a Recovered Capital Method (RCM) for any covered pipeline that did not have a previously establish regulatory capital base. For any covered (light) regulation pipeline that meets this criteria, this valuation methodology will be adopting a new concept of depreciation under the NGR. Without an accompanying Explanatory Statement to the Guideline, such changes to depreciation appear arbitrary, retrospective in nature, and thus likely to affect the stability of the regulatory framework and undermines investment certainty.
- this consultation is taking place at a time of impending review and potential reassessment of the suitability of the regulatory framework for non-scheme pipelines. Thus, great care should be taken to avoid any unintended consequences of the iterative reviews that swing from re-examination of non-scheme pipelines regulation, to necessary flow on impacts on light regulation, and the cycle continuing again thereafter. This risk a move towards *de facto* full regulation of all gas transmission pipelines.
- there is a risk of blurring of rate of returns between fully regulated pipelines and those to be applied for light or non-scheme pipelines. We believe that the construct of Parts 8-12 of the NGR for covered pipelines, whether it be for full or light regulation, must be distinct from commercial returns expected under Part 23 of the NGR.

Retrospective application of return of capital under RCM for covered pipelines risks stability of the regulatory regime

The AER is proposing to establish the basis the regulatory asset base under a number of circumstances that described in Table 4.1 of the Light Regulation Reporting Guideline and explained further in Section 5.

Where no RAB has been established for a covered pipeline, the AER needs to determine one. An obligation is imposed in the Guideline (section 5) requiring the use of RCM in this circumstance.

Jemena considers that the use of RCM in the form it adopted as Part 23 reporting guideline for non-scheme pipelines and in the context of Part 23 of the NGR that operates under the construct of a workably competitive market, should not be revised to reflect the form that has been specified under the draft Light Regulation Reporting Guidelines. This is because the RCM proposed under these Guidelines does not distinguish the return on capital required by businesses that face different market conditions and different financial risks. Moreover it imposes past regulations on businesses that have not been adequately consulted by the AER in developing those regulations.

The application of RCM for regulated pipelines is a new application and major departure for any pipeline currently regulated under light regulation that does not have a regulated capital base. In particular, Jemena notes that the AEMC had considered that the capital base for light regulation mimic full regulation pipelines, with no reference to use of RCM as is the case for non-scheme pipelines:

"Require light regulation pipeline service providers to publish a financial [disclosure] and offer information, based on the requirements that apply to non-scheme pipeline service providers ***but adjusted so that the reported capital base is calculated in a manner consistent with the method applying to full regulation pipelines****.*[1] *(emphasis added)*

The RCM value requires calculation of "return of capital" or depreciation as the excess of:

- revenue less
- costs that include operating expenditures, a fair return on capital (and tax thereon) calculated back to the original construction of the asset. The return on capital under the Draft Guideline is a regulated WACC.

In simple terms, this return of capital is deducted from construction costs (plus net capital additions/disposals) to establish the initial regulated capital base. This means that all revenue, opex, and return on capital *since construction* are collectively deemed to equal depreciation rather than objectively assessed into what may be genuine excess return to investors or outperformance against operating costs. Such a crude application of RCM approach effectively assumes that businesses have had no incentives to lower their costs to maximise returns to their investors.

This by definition seem to be inconsistent with a workably competitive market framework where businesses have incentives to lower their costs and compete against other firms and also inconsistent with fully regulated framework where AER rewards businesses in excess of regulated rate of return for sustainable cost efficiencies.

What appears to be a retrospective regulatory change undermines confidence in the regulatory regime. A change of this magnitude to mandate use of RCM for covered pipelines would be better conducted via a separate consultation process focusing on asset valuation methodology for (light regulation) pipelines and ideally accompanied with an Explanatory Statement that provides the underlying rationale, options assessment, and how and why there is discretion being applied by the AER in the Draft Guideline.

Absent this, it reduces regulatory certainty and undermines investor confidence.

Timing of AER consultation in the context of upcoming regulatory reviews makes it difficult to engage in iterative regulatory reforms and risks full regulation of all pipelines

The reform process led by the GMRG and changes to Part 23 of the NGR resulted in the information disclosure and financial reporting regime that now applies to non-scheme pipelines, but the new regulation placed more intrusive obligations on non-scheme pipelines compared to regulation that applied to light regulation.

As a result, this issue was highlighted through the AEMC's review of Parts 8-12 of the NGR, with a recommendation for light regulation to be improved and strengthened:

"Firstly, consistent with the scope of this review, the Commission recommends that light regulation should be improved and strengthened, including by replicating certain aspects of the access regime for non-scheme pipelines (Part 23 of the NGR). This will reduce the regime's complexity and make the different forms of regulation successively more intrusive.[2]

Therefore, whilst the Draft Light Regulating Reporting Guideline modernises the regulatory framework and ensure a better balance of obligations between different forms of regulation,

[1] AEMC "*Review into the scope of economic regulation applied to covered pipelines*", Final Report, July 2018, page 21.

[2] AEMC "*Review into the scope of economic regulation applied to covered pipelines*", Final Report, July 2018, page 25.

there is an imminent further review of non-scheme pipeline regulation. This was already signalled by the AEMC in July 2018:

> *"…the Commission recommends that the COAG Energy Council request the AEMC undertake a review into the governance and processes of the framework for gas pipeline economic regulation in 2019, coincident with (or as part of) the scheduled review of the access regime for non-scheme pipelines.*[3]

More recently, the Terms of Reference (TOR) were published by COAG and we expect it now to incorporate how to consider the recommendations from the latest ACCC Gas Inquiry report .

Should the RIS process and implementation of ACCC recommendation lead to changes in the obligations and reporting for non-scheme pipelines, Jemena is concerned that the interdependency between the two financial reporting guidelines means that reform of non-scheme regulation will trigger further amendments to financial reporting for light regulation. This could yet again require a re-examination of non-scheme pipeline regulation.

This runs the real risk of a spiral of tighter regulation and de facto move to full regulation for all pipelines. This is despite the intention of the AEMC and the AER for the regulatory framework to provide different level of intrusiveness corresponding to the form of regulation.

A clear distinction must be maintained between rates of return applicable for non-scheme and light regulation pipelines

As noted earlier, one of the AEMC's intended objectives of the Part 8-12 review was to "*make the different forms of regulation more intrusive*." Jemena recognises that the AER also notes in section 1.1 (page 2) of the Draft Light Regulation Reporting Guideline that:

> *Given that light regulation pipelines are regulated assets, a regulatory WACC is to be used for reporting and calculating the RAB value and the RCM value.*

We would then draw some comfort from extending that logic—since non-scheme pipelines are not considered (covered) regulated assets, a regulatory WACC which uses regulated electricity businesses in its sample should not be used.

Part 23 is governed by commercial rate of return requirements that mean using regulatory based approaches to setting the WACC is not appropriate and this distinction between Part 23 and light regulation must continue to enable investment certainty and predictability.

Nonetheless, given the relationship between the Draft Light Regulation Guideline and the Financial Reporting Guideline for Non-Scheme Pipelines, and in the context of upcoming reviews of gas transmission regulation, there is risk that this distinction could be blurred.

To some extent, this risk has materialised in the ACCC's Gas Inquiry July 2019 report where in Section 6.3.7 the ACCC explains its views, and provides rebuttal to potential industry views, to put forward some reasons as to why there is no distinction between the WACC for a regulated gas transmission pipeline and an unregulated or non-scheme pipeline.

Our rationale for the risk profile of unregulated and regulated pipelines being different is provided in Box 1 overleaf.

[3] AEMC "*Review into the scope of economic regulation applied to covered pipelines*", Final Report, July 2018, page 25.

Box 1 – Unregulated pipelines have a different risk profile to regulated pipelines

Jemena considers that non scheme pipelines warrant a higher beta than regulated pipelines because they have a different risk profile.

A regulated asset provides a very high level of certainty that the investment will produce a return equal to the regulated return (at least over time). The AER regime for gas transmission is a "price cap" regime. Regulated entities are set an allowed aggregate revenue over the period (that will generate the return on capital) which is converted to a tariff so there is an exposure to volume risk and the credit risk of a customer. However:

- new volume forecasts are undertaken at each five yearly regulatory tariff reset so any mismatch is of limited duration;
- operators have a number of techniques to mitigate risk through their contracts (e.g. non-standard contracts with volume adjustments);
- some jurisdictions (e.g. Victoria) incorporate pass through adjustments for weather based impacts on volume; and
- regulated assets usually have a diversified base of customers and the billings are on a monthly basis. Any loss of volume post default will be readjusted at the next reset date.

In essence, the revenue and credit risk is different for a regulated business. There is some exposure to over/under performance against operating costs benchmarks but there is usually some scope to pass through some cost changes during a regulatory period and all costs can be reassessed through the (five yearly) tariff reset mechanism.

In contrast, with a non-scheme pipeline, the owner/operator is exposed to:

- credit risk of the individual customer. There is no ability to recover losses from other customers. A pipeline owner/operator is taking a real (sometimes long term) credit exposure with non-scheme pipelines and it is perfectly reasonable to price in credit risk given that a regulated asset essentially has minimal credit risk. Furthermore, in the case of non-scheme pipelines, the credit exposure might be highly concentrated.
- contracting risk. Not all new investments are contracted to their full capacity with foundation shippers. This is the case with Jemena's Northern Gas Pipeline (NGP). Given the need for greater investment to improve supply which may require greater risks being taken by pipeline owners, this contracting risk needs to be recognised in addition to recontracting risk
- volume risk, recontracting risk, or additional contracting risk. It is the case that contracts can be of shorter duration (say 1-5 years) reflecting:
  - the maturity of the pipelines themselves (it is usually only the foundation contracts that underpin construction that are necessarily long term); and
  - the high level of uncertainty as to security of supply that is afflicting the Australian gas market, at least on the East Coast.

If a maturing (or defaulting) contract cannot be replaced, the pipeline owner/operator bears the loss of volume. Going forward, the shorter term nature of contracts and the small number of potential customers accentuates this risk;

- price risk. At every recontracting event price is up for negotiation (with upside and downside risk);
- cost risk. Where there are longer term contracts, the absence of any reset means that the pipeline owner/operator has absolute exposure to unexpected changes (for better or worse) in operating costs (e.g. maintenance) and capital expenditure requirements. Over the course of, say, a 20 year contract such events are commonplace; and
- stranded asset risk. Many unregulated pipelines face the risk of closure because either:
  - they are designed to access a specific source of gas and that source becomes economically unviable; or
  - they supply an isolated project (e.g. power plant for a mine) that ceases to be economic.

In many cases, the original capital cost may be recovered through a long term (take or pay) contract but this is not always the case, and even if this is in place, there is a long term credit risk exposure to the counterparty. In addition, where the contract is long term the non-scheme pipeline operator is "locked into" the rate of return and, for example, could face a loss of (capital) value through the term if underlying market interest rates were to rise materially. In contrast, regulated assets (and unregulated asses with shorter term contracts) have the opportunity to reset their rate or return periodically (e.g. every five years).

Separately, it is also important to stress that the level of prescription on the WACC in the Draft Light Regulation Reporting Guideline is extremely complex and overly-prescriptive. Moreover, without the benefit of accompanying Explanatory Statements—that are referenced in the Draft Guideline but as yet not published—it remains difficult to provide feedback in a meaningful way.

At this point we note that there are several key differences between the AER's proposed approach for light regulation versus non-scheme financial reporting. We suggest that level of prescription between light regulation and non-scheme reporting guideline is maintained and better reflects the extent of regulation. For example, under the draft light regulation guideline there is a prohibition on the use of trailing average cost of debt. This is curious as trailing average more closely reflects what would be the efficient financing practice of service providers. The non-scheme pipeline guideline does not include this prohibition and we consider it should not.

The rest of this response focuses on why regulated WACCs are a starting point but not the end point for estimating returns for non-scheme pipelines.

The regulatory framework for estimating WACC for non-scheme pipelines reflects a commercial rate of return

Jemena's published basis of preparation for non-scheme pipelines clearly state that we rely on regulatory precedents to inform our estimates but also where we depart from regulatory decisions. Our basis of preparation also provides further explanation and underlying sources to support this.

Rule 569(3)(a) of the NGR requires that, in the context of arbitration:

> *…the price for access to a pipeline service on a non-scheme pipeline should reflect the cost of providing that service, including a commercial rate of return that is commensurate with the prevailing conditions in the market for funds and reflects the risks the service provider faces in providing the pipeline service…*

These requirements appear to be consistent with those specified in the guideline. The guideline refers to the rate of return in similar terms as section 569(3)(a) of the NGR but omits the term 'commercial rate of return' in its description:

> *…the rate of return to be applied to the closing value of the capital base from the immediately preceding year, which should be determined for each year and should be commensurate with the prevailing conditions in the market for funds and reflect the risks the service provider faces in providing pipeline services.*

However, the explanatory statement accompanying the guideline adds additional words to this statement, to the effect that the rate of return is 'based on a commercial rate of return'.

Trailing average is an appropriate commercial method for estimating the Cost of Debt

We estimate the cost of debt in each year as a prevailing cost of debt across the capital base. We calculate this under the assumptions that:

- the service provider aims to achieve a debt portfolio that is 'staggered' so that debt falls due in relatively equal amounts on a year to year basis, limiting refinancing risk; and
- the service provider aims to achieve a debt portfolio with an average term to maturity from issuance of 10 years.

We consider that these assumptions are reasonable, and that they reflect normal and desirable commercial practice. Staggered debt raising is an approach that is expected to limit refinancing risk and is a prudent practice that is applied by almost all companies with large enough debt raising requirements to have a treasury function.

The preference for a 10 year term is consistent with the approach taken by most Australian economic regulators to the cost of debt, reflecting the long lives of the underlying assets over which services are provided.

Furthermore, the calculation of a prevailing cost of debt on this basis is consistent with the emphasis of the economically written down value (EWD), as implemented via the RCM for non-scheme pipelines, of a pipeline operator's historical costs, since these assumptions more closely reflect actual costs than an alternative which does not take into account actual or likely debt raising behaviour.

The effect of these assumptions is that we estimate the cost of debt associated with capital expenditure, in the year of that expenditure, as the average of market debt yields in that year with terms ranging from one to 10 years.

Return on Equity for non-scheme pipelines must reflect differences in returns between unregulated and regulated gas transmission pipelines

In estimating the commercial return expected for equity holders, Jemena maintains that there are genuine reasons for using regulated market risk premium (MRP) and beta but then adjusting for differences between regulated and unregulated pipelines:

- *MRP*—In the S-L CAPM formula, the MRP measures the extent to which the expected return on the market portfolio of equities exceeds the risk free rate. The MRP is therefore the premium that investors require for the risk involved in holding the market portfolio.
    - Our basis for preparation cite the Credit Suisse Global Investment Returns Yearbook, prepared by Dimson, Marsh and Staunton, which is s a well-accepted source of estimates for average excess returns.
- *Beta*—In the S-L CAPM formula, equity beta measures the exposure of a firm to 'market' or 'systematic' risk, ie, risk that even diversified investors are unable to avoid. Economic theory suggests that firms undertaking unregulated activities tend to be more exposed to systematic risk than those undertaking mostly regulated activities. We surmise that this is due to:
    - nature of activities that tend to be regulated, typically being essential services, for which one might expect the sensitivity of demand for these services to remain more robust during adverse market conditions than for average firms; and
    - the nature of the process of regulation, which may act to shield a regulated business from the effects that adverse market circumstances might otherwise be expected to have on its returns. For example, regulated pipelines are able to make a case to the AER for cost pass throughs unlike unregulated pipelines.
    - Our approach is to estimate range of betas f which draws from regulated WACC decisions but adjusts for the additional risks of operating unregulated gas pipelines.

If you have any questions or would like to discuss any aspect of this proposal, please contact me on (02) 9867 7483 or at usman.saadat@jemena.com.au.

Yours sincerely

Usman Saadat

General Manger Regulation