Australian Pipeline Limited ACN 091 344 704
Level 19, 580 George Street, Sydney NSW 2000
PO Box R41, Royal Exchange NSW 1225
P: +61 2 9693 0000 | F: +61 2 9693 0093
APA Group | apa.com.au

COAG Energy Council Secretariat
CANBERRA ACT

By e-mail: energycouncil@environment.gov.au

APA submission on draft Statutes Amendment (National Energy Laws) (Binding Rate of Return Instrument) Bill 2018

APA Group (APA), an owner and operator of gas transmission pipelines, and of electricity transmission lines, expects to be affected by proposed changes to the national energy laws relating to the rate of return on capital and the value of imputation credits to be used in economic regulatory decisions. As a major stakeholder, APA appreciates the opportunity to comment on a draft of legislation which, if accepted by Energy Ministers, would implement the proposed changes.

APA has four principal concerns with the draft legislation. They are:

- limited recognition is given to stakeholders other than consumers
- independent review of the rate of return instrument is highly desirable, but the legislation should provide more specific guidance on review panel membership
- the AER should publish the reasons for its decision that a rate of return instrument achieves the national electricity objective, or the national gas objective, to the greatest degree, but whether the instrument achieves the relevant objective should not be a matter for the regulator
- there is no clear evidence supporting the same rate of return for all regulated electricity network service providers and covered pipeline service providers; the focus of the instrument should be the way in which the rate of return is to be calculated, and not a single rate of return to be applied in all circumstances.

Limited recognition of stakeholders other than consumers

Participation by consumers, through an appropriately constituted consumer reference group, is desirable given the statutory objective, in both the National Electricity Law (NEL) and the National Gas law (NGL), of outcomes which are in the long term interests of consumers. However, the long term interests of consumers will be achieved only if service providers can finance the electricity transmission and distribution networks, and the gas pipeline systems, which deliver electricity and gas to those consumers.

Sections 18L and 30G of the draft legislation should explicitly require the AER to have regard to the advice, recommendations and submissions made by asset owners, equity investors, and providers of debt, when making the rate of return instrument.

Independent review

The rate of return instrument will be an instrument made by the AER having regard to a large amount of relatively complex material, taking into account the views of stakeholders and experts on that material, and exercising its regulatory judgement. Review of a draft instrument, by an independent panel, is, in these circumstances, highly desirable.

The draft legislation, in sections 18P and 30K, provides for the AER's appointment of panel members. To ensure their independence, sections 18P and 30K should provide more specific guidance on panel membership.

APA is of the view that the legislation should provide for asset owners, and other key stakeholders, to nominate individuals with relevant finance, economics and regulatory expertise for membership of the independent panel.

The AER should publish the reasons for its decisions, but whether the rate of return instrument achieves the relevant national energy objective should not be a matter for the regulator

Section 18J(1) of the draft legislation requires that the rate of return instrument state a rate of return or value of imputation credits, or the way to calculate the rate of return or value of imputation credits, that the AER is satisfied will, or is most likely to, contribute to the achievement of the national electricity objective to the greatest degree. Section 30E(1) is the similar proposed change to the NGL (and refers to the national gas objective).

Sections 18J(1) and 30E(1) are key to the proposals of the draft legislation. They link the regulatory rate of return, and the value of imputation credits, with the objectives of the economic regulatory regimes of the NEL and the NGL. The requirement that a stated rate of return or value of imputation credits, or way of calculation of the rate or of the credits, achieve the relevant objective (national electricity objective or nation gas objective) to the greatest degree should be absolute. The national energy objectives will cease to have standing as over-arching objectives for the national energy access and regulatory regimes if it is sufficient that the AER be satisfied that the relevant objective is achieved to the greatest degree.

The words "the AER is satisfied" should, APA believes, be removed from section 18J(1) and from section 30E(1).

APA is of the view that the explanatory information which the AER is required to publish (sections 18Q and 30L in the draft legislation) should:

- explain the alternatives the AER has considered before stating a rate of return or value of imputation credits, or before setting out calculation methods
- set out the AER's reasons for finding that among the alternatives, the stated rate or value of credits, or the calculation methods which have been set out, will, or are most likely to, contribute to the achievement of the national electricity objective, or the national gas objective, whichever is appropriate, to the greatest degree.

If the alternatives considered and the AER's reasoning are not explained, there is no basis for concluding that a rate of return instrument contributes to achievement of the stated objectives of the regulatory regimes of the NEL and the NGL. The effect of sections 18R and 30M of the draft

legislation would be to give effect to an instrument when there has been no demonstration that it is capable of achieving the relevant statutory objectives. That would be poor public policymaking.

APA is of the view that sections 18R and 30M should be removed from the legislation.

Inclusion of a requirement for an explanation of the alternatives considered, and of the reasoning which has led the AER to conclude that the national electricity objective, or the national gas objective, has been achieved to the greatest degree, is important for two reasons:

- the first is that the requirement is likely to lead to better decisions on rates of return and values of imputation credits
- the second lies in the intended removal of the guidance which the National Electricity Rules (NER) and the National Gas Rules (NGR) currently provide on rate of return determination.

The guidance on rate of return determination in rules 6.5.2(b) – (l) and 6A.6.2(b) – (l) of the NER, and in rules 87(3) – (12) in the NGR, is detailed and specific to the task of determining the rate or return. Its detail is such that the matters it addresses may not be considered when assessing whether the national electricity objective, or the national gas objective, has been achieved to the greatest degree. The meanings of those objectives are far from precise. This imprecision allows matters of detail, such as those relevant to rate of return determination, to be overlooked.

The allowed rate of return objective in NER rules 6.5.2(c) and 6A.6.2(c), and in NGR rule 87(3), establishes a requirement that the rate of return be commensurate with the efficient financing costs of a benchmark efficient entity with a degree of risk similar to that which applies to the service provider in respect of regulated service provision. This requirement guides the regulator away from many – possibly infinitely many – possible rates of return to a much more limited set of possibilities which is directly relevant to the specific context in which the rate of return is being determined. This much more limited set is the set of rates commensurate with the efficient financing costs of a relevant benchmark efficient entity.

The national energy objectives may require efficiency in investment, operation and use of electricity and gas services, but the requirement to achieve efficiency in these dimensions of service provision is not sufficiently precise to guide the AER to a rate of return which is directly relevant to the specific context of the NEL and the NER, or of the NGL and the NGR. Removal of the allowed rate of return objective, of rules 6.5.2(d) – (l) and 6A.6.2(d) – (l) of the NER, and of rules 87(4) – (12) of the NGR, will have the effect of removing the guidance which directs the regulator to a rate of return appropriate to the regulatory regime for which it is being determined. It will remove any requirement that the rate of return reflect the efficient costs of financing electricity transmission and distribution networks, and gas pipeline systems. It will remove the requirement that the rate of return be a weighted average of those financing costs.

The substance of NER rules 6.5.2(b) – (l) and 6A.6.2(b) – (l), and NGR rules 87(3) – (12), should, in APA's view, be retained in the legislation governing the binding rate of return instrument.

In the absence of clear evidence supporting the same rate of return for all regulated electricity network service providers and covered pipeline service providers, the focus of the instrument should be the way in which the rate of return is to be calculated

If an instrument states a rate of return on capital or a value of imputation credits, then Section 18J(2) of the draft legislation requires a single rate or value of credits, which is to apply to all regulated network service providers. Section 30E(2) similarly requires that a stated rate or value of credits is to apply to all covered pipeline service providers. Sections 18W and 30R go further: they authorise the AER to make one rate of return instrument for the purposes of both the NEL and the NGL.

These provisions have the effect of reducing administrative complexity in the making of rate of return instruments. However, they may not lead to instruments which contribute to achievement of the national energy objectives to the greatest degree. No objective empirical evidence has previously been advanced, by policymakers or by the AER, which supports a single rate of return for all regulated network service providers. No objective empirical evidence has previously been advanced which supports a single rate of return for all covered pipeline service providers.

Not all covered pipelines have the same cost of capital, and there is no case for mandating a single rate of return for those pipelines.

Unlike gas distribution pipeline systems, transmission pipelines are often constructed for one or a small number of users. Those users may be gas fired power generators, large industrial users of gas, or mining and minerals processing operations. Through their contracts with these users, pipeline owners are exposed to volatility in downstream markets – the national electricity market, domestic and international product markets, and commodity markets. Pipeline owners face the risks associated with volatile electricity prices, or with product and commodity price downturns, which have the effect of significantly reducing requirements for gas. They face the very real prospect of the closure of downstream operations in adverse market conditions.

Although they face the risks of reduced gas requirements and downstream plant closure, transmission pipeline owners have few opportunities to mitigate these risks by diversifying their user bases. Furthermore, these risks are not reduced by regulation which, in the event of prolonged downturn or plant closure, allows pipeline costs to be recovered from remaining users. Regulatory regimes which increase the tariffs payable by remaining users simply increase the risk of further closures.

The risks of service provision vary across transmission pipelines with differences in the composition of user bases and different contractual arrangement with users. The risks of service provision using transmission pipelines are different from those of distribution pipelines with their extensive, and usually diversified, end-user populations. The costs of financing pipeline investment are therefore different across transmission pipelines, and between transmission pipelines and gas distribution pipeline systems. There is no evidence which supports the draft legislation authorising a single rate of return for all covered pipeline service providers.

Even if there were evidence which lent support to a view that all covered pipelines had similar costs of capital, there is no evidence which supports single rate of return applicable to both electricity and gas.

Sections 30E(1) of the draft legislation can accommodate differences in risk, which lead to different financing costs across gas transmission pipelines, between transmission pipelines and distribution pipeline systems, and between electricity and gas, through their provision for the rate of return instrument to state the way in which the rate of return on capital is to be calculated. Similar flexibility is available, in the context of electricity networks, in section 18J(1).

Those sections would be more effective in delivering rate of return instruments which contribute to the national energy objectives if they were to refer only to methods – to the way in which the rate of return is to be calculated – and not to statement of rates of return. The potentially better outcome would be assisted by removing from the legislation sections 18J(2) and 18E(3), and sections 30E(2) and 30E(3). With these changes, sections 18W and 30R would be unnecessary.

APA agrees that the proposed changes to the way rates of return and values of imputation credits are to be calculated should reduce the burden on stakeholders in terms of the time and costs involved in debating complex issues. But, as the AER's recent concurrent expert evidence sessions have clearly demonstrated, there is diversity of opinion, even among experts, on how these calculations should be made. Implementation of the proposed changes may enhance regulatory certainty for regulated businesses, and for the regulator, but at the expense of imposing rates of return on service providers which become increasingly divorced from the costs of financing network and pipeline investment. APA doubts that the mechanistic approach of a rate of return instrument which is binding over a long period (for some service providers, as long as nine years) will lead to outcomes which are in the long term interests of consumers.

APA would be pleased to elaborate on the views in this submission.

Ross Gersbach
Chief Executive Strategy and Development

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