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South32
108 St Georges Terrace
Perth WA 6000 Australia
T +61 8 9324 9000
F +61 8 9324 9200
south32.net

Jason Dignard
Economic Regulatory Authority
Level 4, Albert Facey House, 469 Wellington Street
PERTH WA 6000

Via email: publicsubmissions@erawa.com.au

Dear Jason,

Thank you for the opportunity to provide feedback to the ERA on the current gas instrument. Please find below feedback as requested in the Discussion Paper. South32 apologises for the late submission.

General Comments

South32 supports the ERA's working view that the 2022 gas instrument should maintain the use of a nominal vanilla WACC. And agree that this approach is: transparent, consistent with the estimation of gamma and consistent with the ERA's long-standing approach.

Broadly, gas markets in Western Australia and in the NEM have established very complicated and nuanced regulatory models that continue to use bespoke language that makes it almost impossible for a lay person to understand the workings of gas markets. Overly complicated regulatory models that require hundreds of pages of explanation should not be viewed as a successful outcome. These models simply create a barrier to entry for new entrants and promotes organisations' investing in game theory instead of delivering a reliable and efficient service for its customers.

Please see Table 1, below, in response to the discussion paper

Table 2: List of questions for the 2022 gas rate of return discussion paper

1 Do you agree with the use of a five-year term of estimates of the rate of return? If not, please explain why and your alternative approach.

5-year terms represent a good tradeoff between the long term nature of these assets and current market rates. 5 years also aligns with the Access Arrangement periods.

2 Do you agree with the standardised averaging period process? If not, please explain why and your alternative approach.

Yes

3 Do you support the use of a gearing level of 55 per cent for the 2022 gas instrument? If not, please explain why and your alternative approach.

Yes, benchmarking is the most effective way of confirming that the 55% remains. We expect that trends in debt:equity ratios will change with time and benchmarking across Australia provides the “fairest” way to determine what an “efficient benchmark entity” would do.

4 When determining gearing do you support the ERA adjusting debt and equity to recognise hybrid securities and what is a suitable method for allocating hybrid securities between debt and equity? If not, please explain why and your alternative approach.

Ultimately the ERA will need to determine how to treat hybrid securities which should be consistent with the original intention to determine the debt:equity. Where hybrid securities are more “equity” like or “debt like” they should be treated as such. We expect more hybrid securities to be developed and used going forward and so the ERA will need to establish some guidelines or protocols

5 Do you support the use of a hybrid trailing average approach for the cost of debt estimation? If not, please explain why and provide details of your alternative approach, including transitional arrangements.

Yes

6 Do you support the use of a benchmark credit rating of BBB+ for the 2022 gas instrument? If not, please explain why and your alternative approach.

Considering the increased amount of foreign ownership, it may be more appropriate to consider the rating of some similar companies in other countries of similar market structure to Australia. It would be inefficient to allow foreign owned entities to leverage the difference in their own credit rating with the rating assumed by the ERA. At the same time this mechanism should not discourage ownership by smaller Australian companies who would be at a disadvantage. However, the reality is that ownership of these types of infrastructure are going to be owned by large multinationals and investors and so the average of all entities in Australia should be considered.

7 Do you support the use of the revised bond yield approach for estimating the debt risk premium? If not, please explain why and your alternative approach.

Yes

8 When estimating the return on equity do you support the use of Commonwealth Government bonds as the risk free asset? If not, please explain why and your alternative approach.

Yes
9 When estimating the historical market risk premium do you support the use of sampling periods post-1958? If not, please explain why and your alternative approach.
Yes
10 When estimating the historical market premium do you support expanding the sampling periods to include a new period of 2000 to current? If not, please explain why and your alternative approach.
Yes
11 When estimating the historical market premium do you support the approach to only consider the Brailsford, Handley and Maheswaran (BHM) dataset? If not, please explain why and your alternative approach.
Yes
12 When estimating the historical market premium do you support the approach to calculate the historic market risk premium through the average of the arithmetic and geometric means? If not, please explain why and your alternative approach.
Yes
13 When estimating the market risk premium do you support the current approach of estimating and considering the market risk premium and the risk free rate independently from one another? If not, please explain why and your alternative approach. Specifically, the ERA is interested in:
a. The empirical relationship (magnitude and direction) between the ex ante market risk premium and the ex ante risk free rate in Australia and the conceptual logic underpinning such a relationship.
b. Whether the relationship is sufficiently stable and persistent (that is, not volatile and transitory) on an ex ante basis.
c. Ways in which the relationship can be implemented to estimate the market risk premium in a manner suitable for regulatory purposes.
Yes – the approach is supported
14 Do you support the continued use of domestic energy networks to estimate equity beta? If not, please explain why and your alternative approach.
No, the available firms is too small and once we interrogate the list of Australian firms it becomes clear that many of these firms are not comparable with the “benchmark firm”, as a significant share of their activity is not like a regulated infrastructure owner. Even APA is becoming progressively more of an integrated energy company providing exposure to long term energy agreements, gas processing facilities and with aspirations for expansion into North America.

15 Do you support the use of a sample of domestic and international comparators to estimate equity beta? If not, please explain why and your alternative approach.

Yes, the ERA has indicated it has undertaken a broad review and narrowed down on firms that face similar risks to an Australian benchmark firm in a similar regulatory environment.

16 If an international sample is to be used for estimating equity beta, which jurisdictions and companies could be considered as part of the sample?

We would be cautious referring to some assets based in the USA as they can be operating in quite different markets to Australian businesses and so the risk profile can be significantly different. For example, some pipeline operators in the USA take on much more risk as to gas quality, gas balancing and the proportion of long term contracted positions versus short term contracts than companies in Australia. The inclusion of Canada, New Zealand and the UK looks reasonable.

Many of the firms listed in Canada, New Zealand and America are “diversified” in the energy sector – for example Vector is exposed to gas prices. In Canada ATCO is a diversified company which provides temporary structures and a range of other services.

In the Western Australian case ATCO Gas Australia and DBNGP are not exposed to gas prices, have no risk on gas quality (this is transferred to their customers) and are predominantly long term contracted with very high levels of fixed revenue (or take or pay costs). This should serve to discount the market premium as these companies carry significantly lower risk than the international companies the ERA has identified.

As countries in South America, Asia and potentially Africa progress their development and regulation of infrastructure assets in may be possible to expand the pool of potential comparators.

17 If an international sample is to be used for estimating equity beta, how should these international estimates be incorporated into the equity beta estimation method?

Similar to the approach to determining the market premium, the ERA could look at each of the jurisdictions to determine each market’s equity beta and then determine an average using a weighting more to Australian companies.

18 When considering equity beta should the ERA consider shocks such as COVID-19 and takeover announcements? If so, please explain why and how these events can be accounted for.

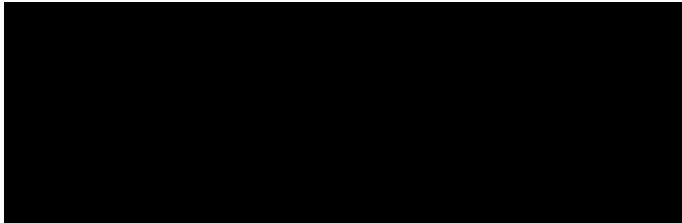
With regards to COVID-19 we saw the market respond and bounce back so quickly it is possible that the true impact of COVID-19 is still not yet evident in market indices and share prices.

Takeovers though may give us some insight if the Risk Premium is too high (or too low) and so should be examined to consider, why was this price achieved, how does this Takeover change the risk profile of the business, why is the Takeover proceeding, what is the strategic rationale.

<p>19 Do you support the ERA’s general approach and simplifications for estimating equity beta (regardless of any potential changes to the sample firms)? If not, please explain why and your alternative approach. Specifically, the ERA is interested in views on the following aspects of the method applied to estimate equity beta in this paper:</p>
<p>a. Use of a 5-year estimation window with weekly returns.</p>
<p>b. Use of the Bloomberg total return index for individual stocks and market indices.</p>
<p>c. Use of the Ordinary Least Squares estimator, with the Least Absolute Deviations method as a robust estimator.</p>
<p>Yes – the approach is supported</p>
<p>20 When estimating the expected rate of inflation do you support the use of Treasury bond implied inflation approach? If not, please explain why and your alternative approach.</p>
<p>Yes</p>
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Overall, South32 welcomes the opportunity to provide feedback to the ERA.

Yours sincerely



Michael Brooks
 Energy Principal
 South32