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## **Rule change proposal**

### **Economic regulation of transmission and distribution network service providers**

### **Proposed changes to the National Electricity Rules and National Gas Rules**

**October 2011**

**Assistance in preparing this rule change proposal by the Major Energy Users Inc (MEU) was provided by Headberry Partners Pty Ltd and Bob Lim & Co Pty Ltd.**

**The content and conclusions reached in this proposal are entirely the work of the MEU and its consultants.**

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## **The Proposed Rule Changes**

The AER has proposed some significant rule changes to network regulation for gas and electricity. In general, the Major Energy Users Inc. (MEU) strongly supports the AER's proposal as it addresses many of the key aspects of the rules on network regulation that have brought much discredit to the regime and, critically, resulted in substantial economic damage wrought on major industrial users and to residential users more generally.

The MEU shares the concerns with the regulatory regime expressed by the AER in its proposal. The MEU also shares the AER's concerns that its earlier expressed arguments (and the MEU's) that the new regime would not deliver efficient investment, and was unbalanced, were ignored by the AEMC when it developed the Chapter 6A Rules. For the public record, in the MEU's view, the new chapter 6A Rules developed by the AEMC (and which were subsequently basically integrated by the MCE into the revised Chapter 6 rules and to a lesser extent the Gas Rules) have caused so much damage to its members' operations, the economy and to consumers (especially low income consumers) in general, and more than reversed the benefit gained from energy reforms initiated since the mid 1990s.

The accompanying box articles (see appendix 1) summarise the concerns expressed by the MEU in 2006 with regard to the AEMC's Chapter 6A outcomes and the review process.

Despite its strong support for the changes proposed by the AER, MEU analysis indicates that there are some critical gaps in the AER proposals. The MEU therefore proposes a rule change to "fill in the gaps" left by the AER.

The proposed rule change by the MEU has the following principles. In developing the allowed revenue, consumers should not be required to pay for assets which are not used (ie the regulatory asset base should be optimised to only allow a return on assets that are actually used and not on assets that are underutilised or not used) and that fully depreciated assets are not automatically replaced by new assets if the existing assets are still "used and useful" and have a useful life beyond the period over which they have been depreciated.

The MEU considers that these changes will ensure the rules comply with the requirement of the National Electricity and National Gas Laws and should reflect both the stated Objectives and the six revenue and pricing principles embedded in both Laws (which were enacted after the Chapter 6A Rules were determined by the AEMC).

The following describe the essential elements the MEU considers need to be added to the rule changes proposed by the AER

## **1. Optimisation of assets**

When assessing the regulatory asset base, the regulator shall review the valuation of all assets to ensure that the value of the assets used in the building block approach reflects the minimum value necessary to ensure the provision of the services required.

## **2. Continued use of fully depreciated assets**

When approving a replacement for an asset that has been fully depreciated, the regulator must ensure that the asset to be replaced has passed its useful life and cannot be used productively for further service.

## 1. Introduction

As a result of a full cycle of network revenue regulation carried out by the AER over the past five years, the AER has proposed to the AEMC a number of changes to the NER and NGR which are intended to modify the approach used by the AER to address network revenue regulation, to ensure that the requirements of the Objectives and the stated revenue and pricing principles in the National Electricity Law and the National Gas Law are achieved.

In particular, the MEU notes that the AER has not addressed the issues to optimise the asset base or to retain fully depreciated used and useful assets within the asset base although they are related to the other issues the AER has included in its rule change proposal.

The MEU notes that there is no explicit requirement embedded in the Electricity Rules for these issues to be included in an AER revenue reset review nor is there an ability for the regulator to require a business to do so. The MEU also notes that, while the Gas Rules might be interpreted to allow the regulator to optimise the asset base and require the continued use of “used and useful” assets, this is not an explicit requirement.

On this basis the MEU proposes these as rule changes to be addressed concurrently with the process examining the AER rule changes.

### 1.1 Optimisation was historically applied

Under the National Electricity Code (NEC) a central element was that the assets provided by the service provider to deliver the service should be no larger than was necessary for the service provision. To achieve this, the NEC required that the valuation of assets be determined so that they did not exceed the Deprival Value of the assets<sup>1</sup>.

Under the Gas Code, the value of the Initial Capital Base was to be assessed within a range of values generally limited by the Depreciated Actual Cost and the Depreciated Optimised Replacement Cost. Subsequent investment leading to increases in the Capital Base were to be prudent, implying that imprudent investment would not be included in the capital Base

Assessing the Deprival Value is difficult and for the purposes of the NEC and the Gas Code the Depreciated Optimised Replacement Cost became the generally accepted method used for assessing the value of the assets used for providing the service.

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<sup>1</sup> See NEC clauses 6.2.3(d)(4)(iii) and 6.2.3(d)(4)(iv)A

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In 2004, there was a debate held under the auspices of the ACCC, looking at whether capex allowed in electricity regulatory decisions should be assessed on an ex ante basis rather than on the previously used deterministic approach where capex was allowed for specific projects. This followed the practice of a few jurisdictional regulators allowing actual capex into the asset base with little or no review. With the introduction of Chapter 6A electricity rules, the AEMC determined that actual capex would be accepted into the asset base without any ex post assessment. The combination of both these changes effectively resulted in there no longer being any pressure to ensure that capex only provided the optimal solution in sizing of assets to provide the service required.

Under the NGR, there is still a requirement for there to be prudence in investment in a pipeline, but there is a trend (especially in gas distribution system regulation) for actual capex to be rolled into the asset base without a review as to whether the actual capex reflects the optimal outcome for consumers. Whilst the NGR requires investments to be prudent, there is little effort made ex post to ensure this outcome occurred.

Effectively, the NER and NGR as operated, allows actual capex into the asset base with little or no review, and there is no requirement in the rules to assess whether the assets provided are appropriately sized for the service being provided. The outcome of this actual regulatory approach has been that there is no assessment that the assets are sized optimally for the service provided, and as a result consumers can be required to pay for assets which are too large for the service and thereby paying an excessive amount for the service provision. Further, in the absence of an explicit ex post review, there is no assessment made as to whether the planned capex for a project (on which the project was assessed to be prudent) was the actual cost of the project, despite the actual cost being rolled into the asset base.

### **1.2 The impact of using the building block approach, optimisation and asset replacement**

The AER uses the building block approach to set the allowed revenue for a regulated business. The building block is essentially based on recovery of costs with the return on equity providing the profits to the regulated firm. To generate a return on equity, the AER uses the capital asset pricing model (CAPM). The outcome of using the building block approach and the CAPM is that the profits earned by the firm are recovered in relation to the value of the assets included in the regulatory asset base. This provides an implicit incentive on a regulated business to maximise its asset base and thereby maximise its profit.

The lack of an optimisation approach to the asset provision provides an incentive to the regulated business to oversize its asset base. Similarly, the automatic replacement of fully depreciated assets is incentivised because there is no profit provided from fully depreciated asset whereas a new replacement asset maximises the profits for the firm.

Conversely, as long as the asset generates a profit from its continued operation, regardless if it is fully depreciated, a firm in a competitive environment will retain the asset as long as it is used and useful.

### **1.3 The impact of carbon emission constraints and optimisation**

With the drive from governments to reduce greenhouse gas emissions, there has been a significant increase in renewable and low emitting carbon generation, resulting in a significant increase in energy transport assets, partly because new connections at new locations are required, and because many renewable generation technologies are intermittent and therefore have low utilisation. The outcome of this is that there is significant capacity required which is often idle.

At the same time, heavy carbon emitting generation plants are under pressure to reduce output and in some cases, close. This will result in significant network assets becoming under-utilised and in the case of closures, complete redundancy. Under the current approach and the rules, these assets would remain in the asset base at their full depreciated value, and continue to receive a rate of return.

This means that unless there is a change to the rules, consumers will be required to pay rates of return (with the associated profit) to service providers for assets that are significantly under-utilised or not used at all, in addition to the new network assets connecting to new generators. This is not what is intended by the Objectives or by the revenue and pricing principles in the Laws.

The lack of an ex-post review of past capex and the automatic rolling-in of actual capex spent over the past two regulatory periods will also mean that, especially in the case of the first previous regulatory period, actual capex overspend is likely to contain inefficient investments (as assessed by the AER) with regard to the situation in the second previous regulatory period. Absence of a rule to optimise the RAB means that inefficient investment in the first previous regulatory period will have inflated the asset base.

In the light of the Carbon Tax and the eRET scheme, there has been the on-going establishment of myriad wind farms; consumers are liable to pay very substantial amounts of new networks needed to allow these renewable generation facilities to operate effectively in the NEM. Unless there is optimisation of the RAB to remove under-utilised and un-utilized asset values from the RAB, consumers will be expected to pay considerably more for oversized networks.

### **1.4 Commercial pressures and the MEU rule change**

The basic intent of regulation is to provide surrogate competitive pressure on a regulated business to maximise efficiency. In the Australian context, where incentive

regulation is used, the intention is that the rules will apply incentives (both positive and negative) to achieve the goal of applying competition to the regulated business. To this end, the rate of return regulated businesses are awarded reflects the fact that these businesses are exposed to some risks in ensuring they provide the most efficient services to consumers.

Implicit in the return on equity, a regulated firm receives the average of the general equities market which mostly comprises businesses operating in a competitive environment. The Market Risk Premium (MRP) is the average return on all listed entities as measured by the difference between the risk free rate of return (the 10 year Commonwealth Bond yield and the compounding ASX Accumulation index averaged over a number of years. Because this equity return is related to the listed stocks in the market as a whole, then there is an expectation that the investors in a regulated firm would carry risks similar to those represented in the entire market.

If the return reflects that received by firms exposed to optimisation risks, then it is reasonable to expect regulated firms getting the same return to be exposed to the same risk.

#### **1.4.1 Optimisation**

One of the most significant elements of energy transport investment is that the current investment processes do not impose any requirement on the regulated business to ensure that the investment they make is well conceived and executed.

Although some investments are required to be demonstrably necessary by the need to carry out an investment test (TIT-T and RIT-D in the case of electricity transport or prudence test in the case of gas investments) there is no explicit requirement for an ex post assessment to ensure that the costings for the investment used as the basis of the net benefit test are the costs actually delivered when the investment is commissioned. In cases where there is no investment test, there is no demonstration at all that the costings used are replicated in the actual execution.

The structure of the current rules effectively requires (in cases where an investment test is required) a service provider to provide capital costings to demonstrate the investment is efficient. Once implemented the actual costs for the investment are rolled into the asset base with no further review. This approach allows the provider to avoid a number of constraints that apply to businesses operating in a competitive environment:

- If the actual cost of an investment exceeds the allowance used to demonstrate efficiency of the investment, the regulated business incurs no penalty because the actual cost is rolled into the asset base. This means there is an incentive for the regulated business to underestimate the cost of its preferred solution, knowing the actual cost will



be used for future revenue and therefore there is no penalty. Consumers pay the costs resulting from the in-built inefficiency.

- If the parameters on which the investment test were based are incorrect, and the investment becomes significantly under-utilised, there is no penalty on the regulated business because there is no ex post assessment or optimisation of the investment. Consumers pay the costs resulting from the inefficiency.
- Where there is no formal investment test, the capital allowance on which the approved capex was based can be exceeded without penalty. This means there is significantly reduced incentive on the regulated firm to ensure costs are contained to the allowance. Consumers pay the costs resulting from the inefficiency.
- The ex ante approach to setting the regulatory investment allowance has no ex post assessment, so a regulated business can use the capital allowance for any purpose at the discretion of the regulated business. A firm operating in a competitive environment must use its investment funds to maximise its profitability. A regulated business can use the investment funds for any purpose and incurs no penalty if the investment is inefficient.

None of these constraints applying to the competitive market are imposed on a regulated entity under the NEM rules, yet implicitly principles 4 and 5 in both the NEL and NGL, when combined, should apply such that the regulated firm should be exposed to the risk of optimisation.

#### **1.4.2 Used and useful assets**

Under the network revenue rules, the network owner is to propose depreciation schedules for each asset class. The AER has the ability to ensure that the proposed depreciation schedules reasonably reflect the technical life of the asset class but it may agree to accelerated depreciation under certain circumstances.

If an asset, for whatever reason, can no longer be used, the asset can be disposed of and written off out of the asset base with recovery of the unrecovered depreciation added to the allowed revenue.

However the opposite does not apply. Where an asset is still used and useful, but is fully depreciated, there is no requirement that the asset should be retained by the regulated business, even though there is no revenue derived from it<sup>2</sup>. Therefore from the regulated business viewpoint, it provides no benefit to its revenue stream and no profit contribution to the business.

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<sup>2</sup> Under the building block approach to setting the allowed revenue, if an asset has zero residual value (ie is fully depreciated) then the revenue from it is zero as value (= zero) x WACC = zero revenue. Other elements of the building block are recovered at cost, providing no revenue for the fully depreciated asset.

If this fully depreciated asset is replaced, the business receives a profit contribution because the WACC includes the profit contribution to the business (see point 1.2 above). This means there is an incentive to the business to replace fully depreciated assets, regardless of their ability to contribute to providing the regulated service. This is in marked contrast to businesses in the competitive sector.

The MEU has noticed in the last regulatory period, that NSPs have sought to retire some assets early, with the AER providing approval for this to occur. This practice can also be incentivised if the regulated WACC is higher than that determined for the retired assets. The risks are, therefore, directed to consumers for early retirement of assets. Some offsetting measures are required to limit the risks exposure of consumers from such practices.

A firm operating in a competitive business is incentivised to retain fully depreciated assets in its asset base, because the financial cost imposed by a fully depreciated asset is zero and, as the fully depreciated asset still generates a return for its output, the profitability to the firm is higher than from a partly depreciated asset. Firms operating in a competitive environment actively seek to retain fully depreciated assets within their asset base for this very reason.

A firm in a competitive environment will replace assets when the cost to maintain the asset in working condition exceeds the benefit from retaining the asset in the production processes (ie when the cost to maintain it reaches a significant proportion of the cost of its replacement (commonly  $\frac{1}{2}$  or  $\frac{1}{3}^{\text{rd}}$ ) or the cost to operate it exceeds the profits generated from its continued operation.

## 1.5 Conclusion

Regulation is intended to be a surrogate for applying the outcomes that competition would impose.

A firm operating in a competitive environment will ensure that any asset it invests in maximises its return by ensuring that the asset is sized to its needs. Where an asset has been provided but is not returning its expected return, the firm will suffer a loss. Where such a firm has an asset which is fully depreciated, the asset is not disposed of until the costs of maintaining it exceed the cost of its replacement or when the asset no longer contributes to the firm's profitability.

In contrast, a regulated business receives a return on an asset that does not contribute to providing the service and has an incentive to replace assets which are fully depreciated.

In summary, the basis of the MEU views on optimisation and replacement can be tabulated as follows:

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<b>Asset issue</b>	<b>Regulated business</b>	<b>Competitive business</b>
Over investment	Incentivised	Penalised
Inefficient investment	Profit provided	Penalised
Replacement	Incentivised to replace	Incentivised to retain

These concerns are overcome by a requirement to optimise the asset base and to require a regulated business to retain used and useful assets.

## **2. How the proposed rules contribute to the NEO and the six revenue and pricing principles**

### **2.1 The National Electricity Law**

The National Electricity Objective, section 7A in the National Electricity Law states:

“The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to—

- (a) price, quality, safety, reliability and security of supply of electricity; and
- (b) the reliability, safety and security of the national electricity system”.

The six revenue and pricing principles in the National Electricity Law (section 7A—Revenue and pricing principles) states:

- (1) A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in—
  - (a) providing direct control network services; and
  - (b) complying with a regulatory obligation or requirement or making a regulatory payment.
- (2) A regulated network service provider should be provided with effective incentives in order to promote economic efficiency with respect to direct control network services the operator provides. The economic efficiency that should be promoted includes—
  - (a) efficient investment in a distribution system or transmission system with which the operator provides direct control network services; and
  - (b) the efficient provision of electricity network services; and
  - (c) the efficient use of the distribution system or transmission system with which the operator provides direct control network services.
- (3) Regard should be had to the regulatory asset base with respect to a distribution system or transmission system adopted—
  - (a) in any previous—
    - (i) as the case requires, distribution determination or transmission determination; or
    - (ii) determination or decision under the National Electricity Code or jurisdictional electricity legislation regulating the revenue earned, or prices charged, by a person providing services by means of that distribution system or transmission system; or
  - (b) in the Rules.
- (4) A price or charge for the provision of a direct control network service should allow for a return commensurate with the regulatory and commercial risks involved in providing the direct control network service to which that price or charge relates.

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(5) Regard should be had to the economic costs and risks of the potential for under and over investment by a regulated network service provider in, as the case requires, a distribution system or transmission system with which the operator provides direct control network services.

(6) Regard should be had to the economic costs and risks of the potential for under and over utilisation of a distribution system or transmission system with which a regulated network service provider provides direct control network services.

### 2.2 The National Gas Law

The National Gas Objective, section 23 in the National Gas Law states:

“The objective of this Law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.”

The six revenue and pricing principles in the National Gas Law (section 24—Revenue and pricing principles) state:

- (1) A service provider should be provided with a reasonable opportunity to recover at least the efficient costs the service provider incurs in—
  - (a) providing reference services; and
  - (b) complying with a regulatory obligation or requirement or making a regulatory payment.
- (2) A service provider should be provided with effective incentives in order to promote economic efficiency with respect to reference services the service provider provides. The economic efficiency that should be promoted includes—
  - (a) efficient investment in, or in connection with, a pipeline with which the service provider provides reference services; and
  - (b) the efficient provision of pipeline services; and
  - (c) the efficient use of the pipeline.
- (3) Regard should be had to the capital base with respect to a pipeline adopted—
  - (a) in any previous—
    - (i) full access arrangement decision; or
    - (ii) decision of a relevant Regulator under section 2 of the Gas Code;
  - (b) in the Rules.
- (4) A reference tariff should allow for a return commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff relates.
- (5) Regard should be had to the economic costs and risks of the potential for under and over investment by a service provider in a pipeline with which the service provider provides pipeline services.

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(6) Regard should be had to the economic costs and risks of the potential for under and over utilisation of a pipeline with which a service provider provides pipeline services.

### **2.3 The proposed rule changes and the Objectives.**

There is significant commonality between the Electricity and Gas Objectives and the six revenue and pricing principles embedded in the two Laws. A review of the second reading speeches for the Electricity Laws in 2005 and 2007 and the gas Law in 2008 when each of the Laws was presented highlight that this is the basic aim of these energy laws.

In relation to this rule change proposal, the second reading speeches regarding both the Gas and Electricity Objectives explicitly seek that the detailed rules are to provide the lowest long term price for consumers. This is interpreted to be that both the gas and electricity markets should be efficient in economic terms.

It is clearly inefficient for consumers to pay for assets which are significantly under-utilised, clearly implying that consumers should not be required to pay for assets that they do not use, or use to significantly less than their capacity. Imposition of this requirement would provide an incentive to service providers not to over invest in the assets. Equally it is accepted that it may be more efficient to build an oversized asset if there is a strong expectation that in the next few years the spare capacity will be utilised. But there should be a test or checks undertaken to ensure that this is so.

It is also inefficient to replace assets which, from a technical viewpoint, do not need to be replaced as they are still used and useful. The concern that consumers have is that there is an incentive for a service provider to replace assets which are economically depreciated, because under the building block approach, such assets do not provide any profit to the service provider, whereas replacements assets will provide a profit.

In relation to the six revenue and pricing principles in the Laws, principles 2, 5 and 6 have applicability in relation to this rule change proposal.

Principle 2 implies that assets provided by the service provider are to be sufficient (but only just sufficient) for the provision of the service. It also highlights that there are to be incentives for the achievement of this goal. The reverse of providing an incentive for maximising efficiency, is that there should be a disincentive for allowing inefficiency. It is inefficient for assets to be larger than needed and to replace used and useful assets and so the rule change proposal reflects the implicit requirement to minimise inefficient provision of the service.

Principle 5 requires recognition that there are economic costs for under and over investment.

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Providing assets which exceed the requirements for providing the service can increase costs so requiring the provision of assets which are just sufficient for the service provision is the goal sought by the Laws.

Under the building block approach, all electricity assets provided are to be rolled into the asset base regardless of whether they are sized appropriately for the service they deliver. The rule change proposal would provide a limitation to ensure that only necessary assets, sized for the service, are included in the asset base.

Although it could be interpreted under the gas rules that only prudently provided assets should be rolled into the asset base, past regulatory practice has been to roll into the asset base, actual capital expenditure. This rule change seeks to make it an explicit requirement that only necessary assets, sized for the service, are included in the asset base.

In a similar vein, assets which do not need to be replaced, should not be withdrawn from service just because they have reached the end of their economic life, even if the service provider does not receive any return on them. The proposed rule change would limit the replacement of assets which are still used and useful, thereby limiting over investment.

Principle 6 requires recognition that there are economic costs for over and under utilisation. The rule change proposal aims to ensure that an asset which is not used or is under used, is included in the asset base at a value which reflects its utilisation needs, rather than at a value reflecting its full utilisation.

Both elements of the rule change proposal are supported by the Objective and the revenue and pricing principles in the Laws.

The first change ensures that there is an incentive to optimize the size and capacity of the assets used for providing the service so there is sufficient but not excess capacity provided where the unnecessary excess capacity would be paid for by consumers.

The second change ensures that there is not premature replacement of assets when they are still used and useful.

### **3. Expected costs and benefits and potential impact on those affected**

As with the proposed network revenue rule changes proposed by the AER, this proposal seeks to align the revenue rules with the revenue and pricing principles encapsulated in the NEL and NGL. The proposal replicates some of the pressures on firms operating in a competitive environment to ensure that their investments are well conceived and recognise the changing nature of the market as a whole.

In the case of the replacement of used and useful assets, and early retirement of assets, there is no cost impost on the regulated business but the AER will have to take steps to ensure that during a revenue reset the requirement will have to be assessed. The additional cost to the revenue reset costs will be minimal. There is no increased risk to the NSP by the imposition of this requirement but consumers will receive lower costs if used and useful assets are retained once they are fully depreciated.

In the case of optimisation, the requirement returns to the situation that applied under the National Gas and Electricity Codes. As the WACCs that applied under the Codes are no different to those applying under the Rules, the imposition of optimisation of assets does not increase costs or risks above those that applied under the Codes.

There will be increased risks to the NSPs by the re-imposition of optimisation as they risk having an imprudent investment optimised, but this risk is no less than that faced by a firm operating in a competitive environment. This will be in the long term interest of consumers as they would not need to pay for over-sized assets or under-utilized and redundant assets. Consumers need to have rules that claw back some of the excessive capex allowances provided to NSPs under the discredited old regime.

There is an increased risk for consumers in that an NSP might not invest in an asset where there is an expectation that a duplicate investment might be required in a short time after the initial investment is made. To overcome this, the AER should be empowered to approve an oversized investment when there is a reasonable expectation that the additional capacity will be required within a reasonable time of the first investment.

There will be a reduction in revenue to the regulated businesses if the proposed rule change on optimisation is implemented, but this reduction reflects the outcomes that the rules should have imposed to reflect the requirements of the Objective and the revenue and pricing principles.



## **4. Suggested wording for the proposed rules**

### **2.1 Electricity distribution**

In the case of distribution control services, schedule 6.2 of the NER chapter 6 should be amended to include a new clause S6.2.1(c)7A

#### **S6.2.1(c)7A**

The previous value of the regulatory asset base must be reduced by the amount determined by the AER reflecting the difference between the actual depreciated value of assets provided and the depreciated replacement value of assets deemed by the AER to be required to provide the services.

In the case of distribution control services, an additional clause is to be added

#### **6.5.7(e)(11)**

If the proposed capital expenditure is intended to replace an asset which is still used and useful, the expenditure involved in replacing such an the asset (whether partly or wholly depreciated) is not permitted to be added to the regulatory asset base.

### **2.2 Electricity transmission**

In the case of prescribed electricity transmission services, schedule S6A.2.3(a) of the NER chapter 6A, replace the first paragraph:

“For the purposes of rolling forward the regulatory asset base for a transmission system as described in clause 6A.6.1 of the Rules and this schedule, the AER may only determine to remove, from the regulatory asset base for a transmission system, the value of an asset (or group of assets):”

with the following words:

“For the purposes of rolling forward the regulatory asset base for a transmission system as described in clause 6A.6.1 of the Rules and this schedule, the AER must reduce the regulatory asset base by the difference between the actual depreciated value of assets provided and the depreciated replacement value of assets deemed by the regulator to be required to provide the services.

In other cases, the AER may only determine to remove, from the regulatory asset base for a transmission system, the value of an asset (or group of assets):”

In the case of prescribed electricity transmission services, an additional clause is to be added.

#### 6A.6.7(e)(14)

If the proposed capital expenditure is intended to replace an asset which is still used and useful, the expenditure involved in replacing such an the asset (whether partly or wholly depreciated) is not permitted to be added to the regulatory asset base.

### 2.3 Gas services

In the case of gas services,

- clause 77(1)(iv) of the NGR is to be deleted and replaced with:
  - “(iv) the amount determined by the AER reflecting the difference between the actual depreciated value of assets provided and the depreciated replacement value of assets deemed by the AER to be required to provide the services; and
  - (v) the value of pipeline assets disposed of since the commissioning of the pipeline.”
- clause 77(2)(f) is to be deleted and replaced with:
  - “(f) the amount determined by the AER reflecting the difference between the actual depreciated value of assets provided and the depreciated replacement value of assets deemed by the AER to be required to provide the services; and
  - (g) the value of pipeline assets disposed of during the earlier access arrangement period.”
- clause 77(3)(d) is to be deleted and replaced with:
  - “(d) the amount determined by the AER reflecting the difference between the actual depreciated value of assets provided and the depreciated replacement value of assets deemed by the AER to be required to provide the services; and
  - (e) the value of pipeline assets disposed of since the relevant date.”
- Clause 79(2)(e) is to be added

If the proposed capital expenditure is not intended to replace an asset which is still used and useful. For the sake of clarity, expenditure involved in replacing a used and useful asset (whether partly or wholly depreciated) is not considered to be justifiable.

## Appendix 1

### MEU concerns with AEMC's Chapter 6A Outcomes and Process

#### Box Article 1:

#### Executive Summary

Despite clear evidence that Utilities as a class (including the electricity transmission businesses) are in the top quartile for profitability (as measured by the dividend yield) and have the lowest risk profile than every other sector of the market (as measured by equity beta), the AEMC has determined that this is insufficient, and that further increases in profitability for TNSPs are needed and that the risks they face need to be further reduced.

MEU suggested that a reason for the outperformance was due to high WACCs awarded by regulators for such low risk businesses. Unfortunately the AEMC has elected to ignore this fact, and has carried out no independent assessments to confirm that the MEU contention is soundly based. The MEU would have welcomed an open debate and indeed expected one for a review of such importance.

Overall, the AEMC is proposing a package which demonstrably requires consumers to pay more for what they use, predicated on an unproven assumption that more investment is needed in the transmission system than is currently provided.

Analysis of the Draft determination and its accompanying second draft Rules shows clearly that the AEMC has taken a view that the electricity transmission businesses (TNSPs) need to be given more freedom, less risk and a greater return on their funds than was the case under the old Rules.

The AEMC has taken a conceptual view (no doubt backed up by the unfounded protestations of the TNSPs that they need such encouragement) that by giving away more consumers' money to the TNSPs, there will be greater investment in the transmission networks. Unfortunately the AEMC has failed to carry out any independent review of its own, to demonstrate that such additional encouragement has any foundation at all.

There are a number of clearly expounded views by AEMC where it has increased freedoms, increased returns and decreased risks.

#### **Less risk**

- The TNSPs face less risk as a result of the approach to automatically roll into the RAB capex actually incurred without any assessment that the amount to be included is demonstrably prudent and efficient
- The TNSPs face less risk as a result of the decision not to carryout assessments from ex post optimizations of the networks
- The TNSPs face less risk as a result of the reduction of the powers of the AER to assess on a holistic basis the entire revenue and performance package proposed by a TNSP.
- The TNSPs face less risk through the automatic pass through of costs from exogenous events
- The TNSP face less risk in achieving service performance outcomes as they can include “contingent projects” in the capex forecast and be permitted to vary the expenditure in the future, both with regard to timing and value

#### **Increased returns**

- The return on funds has been increased by reducing the debt credit rating to that actually achieved by the lowest rated and highest geared TNSP, despite its gearing being well in excess of that used for the notional TNSP
- The return on funds has been increased by using an equity beta of 1.0 despite the fact that most state based regulators have reduced the equity beta on electricity distribution businesses (which have a higher risk) and not recognizing that the AEMC has further reduced the risks faced by TNSPs

#### **Greater freedoms and incentives**

- TNSPs are to be given the freedom to set their own depreciation schedules, despite the fact the current regulatory approach overly compensates them already
- Under-runs in capex and opex will automatically result in a bonus to the TNSP, without any assessment whether these and other incentives included in the package will provide a driver for the TNSP to actively game the Rules.

**Source: Comments on the Revenue Requirements, Response to Draft Determination by The Major Energy Users Inc and Major Employers Group Tasmania, August 2006 Pages 4 & 5.**

## Box Article 2

**The following are key issues where the AEMC has failed to address let alone undertaken any alternative analysis if the views are contested:-**

- ❖ The MEU provided data that the costs of transmission (distribution) of electricity were rising significantly, well above the costs of inflation – the AEMC totally ignores this trend and the impacts it has on consumers, to the extent that it is not even addressed by the AEMC at all
- ❖ The MEU provided hard data that over the past five years the profitability of the utilities and the share prices for utility stock have greatly exceeded that of the market in general, to the extent that share prices for utilities have doubled the rate of price growth of the market in general and the associated market risk premium for utilities stock is twice that of the market in general – the AEMC has totally ignored this trend and the essential deduction from it that the utilities are being excessively rewarded for being monopolies and therefore need to be regulated
- ❖ The MEU provided hard data that the allocations of capex (needed for investment) by regulators generally matched the requests of the regulated businesses. That the regulated businesses did not always use this allowance (preferring to keep the return on the capex unspent) indicates that the businesses themselves had identified that there was no need for this expenditure – the AEMC has totally ignored this and insisted that a more relaxed regulatory environment will encourage more investment
- ❖ MEU provided feedback that in a number of cases the allocation of capex granted was constrained by the perceived inability of the regulated business to actually spend (and properly control) the funds granted in the time before next review – the AEMC has not even addressed this constraint.
- ❖ MEU provided data that utilities are so attractive an investment that they are being used by aggregators to provide excessive fees to financial engineers – the AEMC has not even addressed this concern, continuing to view the need for encouraging investment.
- ❖ The MEU observed that there has been no lack of investment under the

existing Rules (even to the extent that some regulated businesses actually exceeded their capex allowance) yet the AEMC persists in its view that conceptually investment needs to be encouraged and the way to do this requires a bias towards the regulated businesses.

- ❖ The MEU commented that the entire focus of the AEMC is towards the needs of the regulated businesses, yet the investments made by consumers of electricity (both in the residential and productive markets) far exceed the investments made by regulated businesses. That these consumer investments can be put at peril due to the rising costs imposed by these monopoly businesses with their burgeoning profitability has not been considered at all by the AEMC.

**Source: Comments on the Revenue Requirements, Response to Draft Determination by The Major Energy Users Inc and Major Employers Group Tasmania, August 2006 pages 8 & 9.**