



Major Energy Users Inc.

Australian Energy Markets Commission

**Optimisation of Regulatory Asset Base and
Use of Fully Depreciated Assets**

Comments on the Consultation Paper

Submission by

The Major Energy Users Inc

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1. Introduction

The Major Energy Users Inc (MEU) is a strong supporter of the need to change the network regulation rules to ensure that they are better balanced between the interests of the network providers and consumers who pay for the networks. The MEU notes that there have been a number of reviews in the past 12 months¹ that unequivocally concluded that there is a need for major changes to the rules to ensure such an outcome is achieved. These reviews identified that the current rules provide the basis for over-incentivisation of investment in energy transportation networks, resulting in an escalation of network changes, and that the rules need to be changed to address the imbalance.

Because of this broad recognition for a need for change, the AER has introduced a series of rule change proposals for the regulation of electricity transmission, electricity distribution and gas transportation. These proposals are generally wide reaching, but the MEU noted that there were some gaps in the AER's proposals which should be included in the overall review of the network rules. The rule change proposals that are the focus of this AEMC consultation paper were intended to "fill in" these gaps. Because of this, the MEU considers that the proposed changes should be seen in conjunction with the proposals made by the AER.

In its rule change proposal, the MEU provided the rationale behind the proposals and this submission is not intended to restate these. This submission is primarily focused on responding to the questions raised by the AEMC in its consultation paper on the MEU proposed rule changes and to highlight any aspects where the consultation paper has not adequately (in the view of MEU) and accurately reflected fully the intentions of the MEU in developing its proposals

¹ For example, Garnaut update #8, Parry/Duffy and IPART

2. Responses to the specific questions raised by the AEMC

Question 1 What would the impact on investment be with the rule change requests? Would this have a positive or negative impact?

MEU Response:

The key outcome of the proposals will be an incentivisation of efficient investment and a disincentivisation of over-investment, gold-plating and inflated costings. Consumers currently bear all the risks of over-investment and gold plating of network investments. With respect to existing investments, when market circumstances change, for example, when major demand loads become non-existent or demand is dramatically reduced, remaining consumers are expected to pay for redundant or under-utilised network assets – i.e. each remaining consumer will have to carry additional costs. Unit prices will rise as consumers pay for the inefficient costs of the networks. Prices based on inefficient costs have deadweight loss effects for the economy as a whole. With the MEU proposal existing investments will be efficiently costed resulting in encouraging downstream investments, which in turn will encourage demand for energy and hence a need for new efficient investments. A virtuous circle will eventuate. In fact, there will be productive, allocative and efficiency gains arising from the MEU proposal.

The issue of the need for “certainty” for network businesses should also be commented on. No business – whether regulated or non-regulated – should be able to demand “certainty” in a fast changing and dynamic economy, such as Australia’s. Consumers – such as large energy using industrial companies – have not been able to claim “certainty” from the effects of major structural changes in the economy, whether caused by market development (such as the \$A revaluation) or government policies (such as the imposition of the renewable energy targets and carbon pricing). Assets are written down as they are affected by such developments and efficiencies are sought in order to maintain profitability levels. Customers of such affected downstream entities are not required to underwrite the consequences of such developments!

The earlier access codes for both electricity and gas required that the efficient costs for providing the energy transportation service must pertain and, that consumers only pay for what they actually need – ie that the actual assets should be optimised to reflect the actual usage, and that assets oversized were adjusted to reflect the costs that related to the asset value needed for

the service provision. The move away from requiring the cost of the service not to be optimised was introduced with the introduction of Chapter 6A of the electricity rules. Prior to the current approach to setting the regulated asset value by the “roll over” method, at each reset, assets were revalued under the depreciated optimised replacement (DORC) or the deprival value methods, clearly implying that optimisation was an integral part of the development of asset values. The removal of the optimisation provision by the AEMC was part of the series of actions that resulted in such dramatically unbalanced rules.

With regard to the need for the retention for used and useful assets after they have been fully depreciated, this aspect has never been addressed in the access codes as such, but is very much the focus of the approach used to value assets under the deprival method of asset valuation. When assets were valued at each reset (prior to the rule changes made to value assets on the roll-over method), the use of the deprival value approach implicitly retains assets that are still used and useful

There was no lack of investment in networks when regulated under the original codes of access as service performance showed an actual improvement rather than a reduction which would have indicated a lack of investment. The MEU proposal will be consistent with the NER with respect to “efficient investment” in networks and in terms of the National Electricity Objective (“...in the long term interests of consumers...”). The proposal will not have any negative impact as it will not discourage / disincentivise efficient investment.

It must be recognised that the two proposals reflect the practices of commercial competitive enterprises.

In a business subject to competition, an asset that is not able to operate in a way that adds to the profitability of the business, is either closed down and written off or operated at a lesser output and the asset value written down to a level where the asset value reflects its value to the business. In both cases, the write off and write down is a cost to the business and results in a reduction of profit to the business. That this occurs is to ensure that the cost to customers does not include the retention of non-productive assets. The equivalent approach in a regulated business is that the asset base is optimised as would result from this rule change proposal.

In counterpoint to removing from the asset base those assets which do not add to the profitability of the business, a competitive business will continue to use assets which have been fully depreciated but which are still contributing to the profitability of the business (ie are still used and useful).

The MEU proposed rule changes reflect what actually occurs in normal commercial enterprises. As regulation is intended to replicate for a monopoly what occurs in the competitive environment, there is no reason to believe that the MEU proposal should create a disincentive for investment.

Question 2 Is it appropriate for the AER to determine and assess the age and condition of a regulated network business's asset?

MEU Response:

The AER, as the relevant economic regulator, is the appropriate body to determine and assess the age and condition of a regulated network business's asset. This is appropriately already undertaken at regulatory resets and by the AER's engineering consultants (when such information is provided in the access arrangement applications) who would be expected to be sufficiently expert to perform the tasks, when such information is provided in the access arrangement applications. Already the AER is required to assess the age and condition of the regulated assets as this is part of the AER assessments that have to be undertaken under the regulatory regime, and as the current activities of the AER already encompass a review of the assets provided, and their usage, the activity required by this rule change adds little to the AER work scope. The AER (or its consultants) is not expected to carry out physical examination of every one of the assets of the business when it allows new assets into the RAB, and a review of the existing assets should be carried out under a similar approach.

The AER (or its consultants) would continue the current practice of spot checks and monitoring of reports provided by the regulated business.

These tasks are not difficult as the data already is available from the network business's asset register. In addition, demand load data is available from the network business and AEMO (and by the AER consultants), and the relevant data matching can be readily undertaken to ascertain the age and condition of the assets and matched against changes in demand loads, occasioned by, for example, a closure of a brown coal generator or major industrial load.

Network businesses currently provide the relevant data (relating to fully depreciated assets, the age and condition of assets, the retirement of fully or partially depreciated assets). There is nothing new or onerous that will arise from the MEU proposal.

Question 3 Does the increase in administrative burden outweigh the benefits of the proposed rule?

MEU Response

It is questionable about the accuracy of the AEMC statement: “The proposed rule could place significant administrative burden on the AER and businesses” (AEMC pg 9).

The data is already available at regulatory resets. All network businesses must possess and update their asset registers, the life of the assets and the service levels each of the assets provides. To carry out its regulatory responsibilities, the AER and the businesses must have the data available now. The proposed rules do not require any more that what is expected now of the regulator and the businesses.

The AER is required to assess the need for assets at regulatory resets now, so there is no increased burden as such.

It is unfortunate that the AEMC makes an emphasis of “administrative burdens”. The outcome in all regulatory resets is to seek to have efficient investments, and efficient costs, and to be in the interests of consumers. The MEU proposals reflect past practice in relation to optimisation, so this requirement is no more than that applied prior to the introduction of Chapter 6A. Already the regulatory regime allows a regulated business to remove assets that are not fully depreciated but need replacing because of system needs. The issue of the retention of “used and useful” but fully depreciated assets is the mirror image of what is already allowed by the rules, current regulatory practice and is regularly applied by the regulated businesses.

The MEU considers that the proposed rule changes will not increase the regulatory burden but will impose necessary competitive disciplines.

Question 4 Does rule 85(1) of the NGR (capital redundancy) adequately address the proposed rule's objective to remove under-utilised assets from the RAB? Should rule 85(1) of the NGR be duplicated in the NER?

MEU Response

As acknowledged by the AEMC, Rule 85(1) of the NGR provides that a full access arrangement may include (and the AER may require it to include) a mechanism to ensure that assets that cease to contribute in any way to the delivery of pipeline services (redundant assets) are removed from the capital base.

But the provision is dependent on voluntary actions from both the network business and the AER. The MEU considers that network businesses are unlikely to volunteer such actions and the AER needs to seriously improve its regulatory responsibilities for its existing regulatory activities, as well as including the work implied by this rule change. In any case, the current provision applies only to redundant assets, and does not apply to under-utilised or gold plated assets.

Rule 85(1) is grossly inadequate in meeting the interests of consumers.

Question 5 The proposed rule requires the amount (to be determined by the AER) to reflect the difference between the actual depreciated value of assets provided and the depreciated replacement value of assets (to be deemed by the AER) required for provision of services. Does this provide the appropriate signals for efficient utilisation of assets? If not, is there a better alternative approach?

The AER rule change proposal does nothing for the efficient utilisation of assets. The MEU strongly considers that rule changes need to reflect changes in market structures and circumstances. In view of the very significant changes to the energy markets that have been introduced by governments (the carbon tax, renewable energy targets, etc) - which will result in, for example, displacement of high carbon emitting generators from the market, introduction of new gas-fired generators, emergence of new renewable energy sources, reduction in demand from major industrial loads, relocation of major industrial activities off shore or within Australia – many network assets are likely to become redundant or under-utilised. Consumers are thus faced with:-

- very significant escalation in unit network costs
- very significant escalation in new network costs

unless existing redundant and under-utilised assets are removed from the regulatory asset base. In addition, with respect to new network investment requirements, the MEU rule change will bring additional discipline to ensure there is “efficient investment” outcomes.

A voluntary rule provision, such as NGR 85(1) or the AER’s rule change (applying to new investment) will not achieve the basic aim of regulation (which is to ensure that investments are efficient) and therefore will not be in the interests of consumers.

Question 6 The proposed rule places a requirement that would disincentivise expenditure for replacement of a fully or partially depreciated asset from being included in the RAB. Does this ensure that fully or partially depreciated assets that are still in use and useful are not replaced? If not, is there a better alternative?

The MEU considers that its approach is one which will best achieve the goal of minimising the unnecessary replacement of depreciated assets which are still used and useful. Just as regulation is a second best solution to competition to ensure the long term interests of consumers is achieved, the MEU accepts that its solution provides an approach which is consistent with incentive regulation which is the basis for the regulation of networks, as opposed to intrusive regulation and/or no regulation.

Question 7 Should optimisation of the RAB be considered as an alternative to the “40/60 sharing factor” approach when the AEMC is considering the best capex incentive mechanism in response to the AER’s rule change request?

MEU Response

The AER proposed “40/60 sharing factor” is not an alternative to the MEU proposal. At best, the AER proposal is seen as an incentive to control over a

regulated business over-running its capex allowance in the final 1-2 years of the regulatory reset. The MEU is not convinced that the AER proposal will achieve the goal of reducing over-investments by the networks and has the potential for creating a lack of needed investment. The MEU is also concerned that the application of an automatic formula simply encourages new forms of “regulatory gaming”.

The MEU considers that the AER “40/60” proposal does not address the concerns the MEU has as it does not deal with existing investments or with under-utilised assets.

Question 8 When should any proposed rule commence?

MEU Response

The MEU proposal should commence with the first access arrangement review under the next round of regulatory reset.