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Mr John Pierce
Chairman,
Australian Energy Market Commission
PO Box A2449,
Sydney South NSW, 1235

BY EMAIL: www.aemc.gov.au

Dear Mr Pierce

Re: Directions Paper – National Electricity and Gas Amendment Rule 2012

United Energy (UE) and Multinet Gas (MG) welcome the opportunity to provide a joint response to your Directions Paper. We note that the Energy Networks Association (ENA) has also provided a response to the same paper. UE and MG support that submission and provide the following response to the issues raised.

If you have any queries in relation to this response please contact me on (03) 8846 9860.

Yours sincerely

Andrew Schille
General Manager, Regulation

Response to specific Issues:

Q1.	Is the Commission's assessment approach, as set out in Chapter 2 and Appendix B, appropriate? Are there other factors that should be taken into account in assessing the rule change?

UE and MG have no comment on this issue.

Q2.	The Commission seeks further evidence on the drivers for increases in network costs, and in particular on the link between capex and opex allowances under the NER and such increases in network costs.

In UE and MG's view the rules do not constrain the AER from setting appropriate prices. For example in UE's recent price determination the AER was able to reduce the forecast capital expenditure by approximately 9%. For operating and maintenance costs the AER reduced the company's forecast by 15%. These are significant cuts by any standard.

UE's price increase in 2011 was negligible in 2011 (less than 1%) and 15% over the forthcoming period. This is largely driven by higher debt costs as a result of the global financial crisis, the continued growth in peak demand, and safety related matters (including state based levies). These factors are not constraints imposed on the AER under the rules but simply a reflection of the changed business conditions experienced by UE.

Q3.	Would it be appropriate for the wording of the NER to be clarified to better reflect the policy intent?

In UE and MG's view there is no need to clarify the wording of the NER to better reflect the policy intent. The wording deliberately reflects the policy intent to provide businesses with improved certainty and predictability of regulatory outcomes.

Businesses are best placed to make their submission and the regulator correctly required to asses those submissions. There is a requirement for the AER to accept reasonable forecasts. The AER does not have the detailed knowledge or expertise to be able to simply substitute company forecasts with their own without first assessing submissions, and the circumstances of the business.

In UE's experience (for capex at least) the AER performed a line by line review of the forecasts, required the company to provide additional information and then set forecasts based on the information available. There were no ranges contemplated, rather a review of projects and in some cases the AER determined that they could be deferred to another period. For safety related matters the AER sought assistance from Energy Safe Victoria (ESV) to determine the safety requirements and made adjustments to the forecasts based on advice received from ESV.

Q4.	What circumstances of the NSP should the AER be required to take into account when benchmarking?

UE and MG rely on the ENA submission.

Q5.	Would it be appropriate for the capex objectives to be clarified to better reflect jurisdictional reliability standards?

It would be appropriate for the capex objectives to reflect jurisdictional reliability standards.

Q6.	What factors of features of the approaches of other regulators should be taken into account when reviewing other regimes to confirm the best practice approach to economic regulation?

UE and MG rely on the ENA submission.

Q7.	In what circumstances would an NSP need to spend more than its allowance under the NER?

Incurring expenditure more than the allowance set by the regulator under the NER will always be a last option for UE and MG. The first option will always seek to reprioritise projects or activities so that the companies stay within the allowance. Although not under the NER MG has recently experienced circumstances where it was required to over spend the operating and maintenance allowances.

In MG's view the over run in operating costs was due to an incorrect benchmark established at the previous review and was unable to re-prioritise enough activities to stay within the allowance set by the regulator. Despite the overspend MG's actual costs remain one of the most efficient in the country.

Other reasons why companies more generally might spend more than the allowance include:

- Forecasting errors
- Installing additional capital to capitalise on STPIS rewards or minimise penalties
- Price inputs larger than inflation
- Unforeseen safety related matters that require urgent attention
- Unforeseen asset based failure require urgent attention
- Significant storms/natural disasters
- Unexpected growth
- Introduction of obligations within period

In all cases it is too simplistic to simply assess over spend as being inefficient or look to penalise the business. It is more important to assess whether the business has been efficient. To simply not include expenditure into the RAB because it is over a regulatory allowance will produce inefficient outcomes in the long run.

Q8.	What is the best option for dealing with the capex incentive issues identifies in this paper?

UE and MG rely on the ENA submission.

Q9.	How does using actual or forecast depreciation to determine the RAB affect a NSP's behaviour?

The use of actual depreciation to determine the RAB provides a strong incentive to not only mange within the allowance set but also to manage within short-lived and long-lived assets. The companies will limit its investment in short-lived expenditure (including annual timing) to the regulator benchmarks. This has the potential for investment decisions will be driven by the regulatory allowances rather than the most efficient outcome. Therefore the price of regulatory or company forecasting error is higher under the use of actual depreciation.

Q10.	The Commission notes the comment by the ERAA on the need for a rigorous approach to assessing capex reopeners and contingent projects. The Commission seeks submissions from retailers on any other options for minimising the impact of capex reopeners and contingent projects on retailers.

UE and MG have no comment on this issue.

Q11.	More extensive use of the uncertainty regime means regulatory arrangements more closely resemble commercial contracts. Is this appropriate?

UE and MG rely on the ENA submission.

Q12.	To what extent would stronger capex incentives, through an EBSS for example, deal with incentives for a NSP to inefficiently change its capitalisation policy during a regulatory control period?

UE and MG rely on the ENA submission.

Q13.	How, and to what extent, does the incentive for a NSP to overspend or underspend vary depending on whether it uses a related party or not having regard to the other incentives for efficient capex, including the scope for the AER to determine efficient capex at the regulatory determination?

The AER's concern is that a related party with 100% common ownership currently has an incentive to charge inefficiently high margins to the regulated company. In its response to the AEMC's queries, the AER provided the following numerical example to explain its concerns, and proposed remedy.

Financial position of NSP's shareholders based on different regulatory treatment of an inefficient $10m related party margin paid in year 1 of the regulatory period (Net present value, millions)

Scenarios	Net payoff to NSP	Net payoff to related party	Net payoff to shareholders*
Scenario 1: Current rules. Margin excluded from forecast, but rolled into RAB at the end of the period	-$6.7m	$9.3m	$2.6m
Scenario 2: Sharing ratio only Margin is excluded from forecast, but rolled into RAB at the end of the period applying the 60:40 sharing ratio.	-$7.8m	$9.3m	$1.6m
Scenario 3: Sharing ratio and RAB adjustment Margin is excluded from the forecast, and also not rolled into the RAB and the end of the period (60:40 sharing ratio applied to remainder of capex overspend).	-$9.3m	$9.3m	$0m

Source: AER analysis (spreadsheet attached)
*Assumes NSP and related party are wholly owned by the same shareholders

UE and MG consider that the AER's concerns should be examined in two steps:

1. It should be determined whether the concern is a practical problem, rather than a purely theoretical one.

2. If there is a practical problem to be resolved, the most appropriate remedy should be adopted.

In relation to the first step, a key assumption in the AER's analysis is that the regulated entity and the outsourced service provider have 100% common ownership. Where this assumption does not apply, the imposition of inefficiently high charges by the outsourced service provider is unlikely to be feasible or sustainable in practice. In particular, where the related parties do not have 100% common ownership, the shareholder that benefits from providing outsourced services at inflated prices would need to compensate the remaining shareholders for the losses they incur as a result of agreeing to pay inflated contract prices.

For example, United Energy is owned 66% by DUET and 34% by SPIAA. SPIAA in turn owns 100% of Jemena Asset Management (JAM), which has a large contract with United Energy to provide capital and operating services. In these circumstances, DUET would incur a financial loss if it agreed to contract terms that were unduly favourable to JAM. DUET therefore has no incentive to enter into contracts that contain inefficient terms and conditions.

A further important consideration to be taken into account in assessing the validity *in practice* of the AER's concern is that the AER's approach to related party contracts has already provided a strong disincentive to enter into such arrangements. The AER has explained its approach in the following terms[1]:

> "Where an incentive on the service provider to accept non-arm's length terms exists, the AER stated that the means by which the contract price was determined becomes important. In the presence of such an incentive, the AER considered it should not presume the contract reflects efficient costs or the costs incurred by a prudent operator unless that contract has been subjected to a competitive open tender in a competitive market."

The AER's regulatory approach distrusts any contract costs incurred under a contract that has not been let in a competitive market. As outsourced operating and services agreements typically cover both operating and capital expenditure, it follows that competitively-let contracts will ensure that all expenditure is efficiently incurred. It is not possible to 'inflate' any component of a competitively let contract, and therefore the AER's concerns are highly unlikely to be valid in practice.

It is worth noting that UE and MG have both embarked on a competitive retendering of outsourced contracts in response to the commercial and regulatory risks associated with related party arrangements. The decisions made by UE and MG regarding the need to subject contracts to competitive tender is likely to be repeated by other network companies as legacy contracts expire.

In summary, UE and MG consider that the AER's concerns are primarily theoretical, and are highly unlikely to be valid in practice. Where examples of related party contracts can be identified, the evidence suggests that these contracts will be renewed on a competitive basis, in response to the AER's regulatory approach to assessing the costs incurred under outsourced contracts.

In relation to the second step of the analysis described above, if the AEMC finds that a practical concern does exist, careful consideration must be given to how best to address such concerns. In broad terms, there are two choices available:

- Establish Rules that preclude related party margins from being included in the regulated asset base; or
- Establish incentive mechanisms that encourage network service providers to minimise capital expenditure.

The AER's approach is evidently focused on the former approach. However, as Professor Yarrow has explained, such approaches may lead to unintended consequences[2]:

> "I think it would be better to address the issue via a more general development of capex arrangements, which could consider and 'balance' incentive effects on a wider basis, than by writing very specific disallowances into the rules – a rigid and piecemeal approach that seems to me to greatly increase the risk of unintended consequences."

A possible unintended consequence from the AER's proposed approach arises because the AER will 'lock in' a decision on related party margins for the 5 years covering the next regulatory period.

1 AER, Victorian electricity distribution network service providers 2011-2015 price determination, Final Decision, October 2010, page 166.

2 Professor Yarrow, Preliminary Views for the AEMC, page 19.

Consequently, an existing contract cannot be renewed on terms that provide for a higher margin, even if the total expected costs are lower. Therefore, the AER's approach may inadvertently preclude network service providers from negotiating more favourable performance related contractual terms and conditions, which would ultimately deliver better outcomes for customers.

In contrast, developing appropriate incentive arrangements that encourage efficient capital expenditure will ensure that network service providers have flexibility to enter into contractual arrangements that deliver efficient outcomes. Contrary to the AER's suggestions, the Rules should provide incentives for regulated companies to deliver efficient outcomes, and should not empower the regulator to regulate contractual arrangements. UE and MG strongly support incentive regulation that is focused on incentivising efficient outcomes, rather than regulating inputs.

Q14.	To what degree would a parent company of an NSP be better off if related party margins, that are higher than those allowed for by the AER in the regulatory determination, are due to genuine higher costs?

As explained in answer to question 13, UE and MG consider that the best approach to addressing related party margins is to provide incentives for regulated entities to deliver efficient operating and capital expenditure. In practice, the AER's approach to assessing related party margins demands that outsourced contracts are subject to competitive tenders. An examination of margins, in isolation of the other contract terms and conditions, is likely to lead to regulatory error. For example, low margins may be warranted if the outsourced service provider is not exposed to any risk relating to cost recovery or performance. However, increased margins may be justified in a performance-related contract that delivers better outcomes for customers. UE and MG do not favour any regulation of contractual terms and conditions. It is better to focus regulation on the outcomes that customers value, not contractual inputs.

Q15.	Should the AER be given the power to develop and implement pilot or test incentive schemes within a controlled environment?

There is likely to be merit to allow the AER to introduce new schemes in a controlled environment. For example paper trials or limiting the incentives at risk allows both the businesses and the AER to review the scheme outcomes against the scheme intent.

Q16. What limits should be placed on the extent of these schemes?

See response to question 15 above.

Q17.	Should the concept of compensation for consumers for use of shared assets be applied to transmission, as well as distribution?

UE and MG rely on the companies' earlier submission on this issue.

Q18.	Stakeholders have suggested use of assets for alternative control services should be excluded from the uses for which consumers should receive compensation. Are there any other examples of such uses?

UE and MG rely on the companies' earlier submission on this issue.

Q19.	What are the appropriate guiding principles allocating compensation arising from sharing assets between regulated and unregulated services?

UE and MG rely on the companies' earlier submission on this issue.

Q20.	Are some WACC parameter values more stable that others, and sufficiently stable to be fixed with a high degree of confidence for a number of years into the future? Would it be practical for periodic WACC reviews to cover only some parameters that are considered relatively stable in value and requires others to be determined at the times of each regulatory determination?

UE and MG support the process of periodically reviewing the WACC parameters. It is arguable that some WACC parameters are less likely to change. For example, the benchmark level of gearing and the assumed credit rating are parameters that may be less likely to change compared to, for example, the market risk premium. However, experience has shown that the costs of fixing parameter values are unlikely to outweigh the benefits. For this reason, the key requirement is that the Rules should provide flexibility to consider the latest available evidence and circumstances that are likely to prevail in the relevant regulatory period.

Q21.	Would it be useful if the AER periodically published guidelines on its proposed methodologies on certain WACC parameters as opposed undertaking periodic WACC reviews that locks in parameter values for future revenue/pricing determinations?

UE and MG support a process under which the AER periodically establishes a Statement of the Cost of Capital (SOCC) setting out the parameters or methodologies to be adopted in subsequent reviews unless there is persuasive evidence to adopt a different value or methodology. It is important that the SOCC is subject to merits review, given that it establishes the default parameter values for the cost of capital. In these circumstances, UE and MG do not consider that it would be necessary for the AER to produce periodic guidelines on its proposed methodology for particular WACC parameters. This latter approach is unlikely to have the rigour of a periodic SOCC process, especially if it is subject to merits review.

Q22.	Given the uncertainty in estimating certain parameters, should the AER be required to produce the best possible values for all parameters or adopt a range from which it can choose a preferred estimate? Which WACC parameters are inter-related and should the rules recognise the inter-relationships of these WACC parameters?

UE and MG do not support a formulaic approach to addressing the question of uncertainty in estimating the WACC. The primary objective is to establish an estimate of the costs of equity and debt that properly reflect the requirements of investors in the context of competitive capital markets. UE and MG believe that businesses should have discretion to present WACC parameter estimates as a range in circumstances where required, for instance when presenting results from alternative asset models. However the presentation of numbers in a range should not be prescribed.

The building block methodology necessitates the use of a WACC point estimate. In selecting a point estimate for the WACC, careful consideration must be given to the asymmetric risks and consequences of setting the WACC too low. These considerations suggest that there is a need to examine the uncertainty in relation to each parameter value as well as the uncertainty in relation to the overall WACC.

However, it is important that discussion and analysis of WACC parameter ranges does not distract from the overarching objective, which is to estimate a WACC that properly reflects investors' requirements. There may be high social costs if the WACC is set too low. In these circumstances, application of a formulaic approach to determine how ranges should be converted into an overall WACC estimate is unlikely to be helpful.

Q23.	How do the outcomes with the persuasive evidence test applying at the time of the regulatory determinations in Chapter 6 of the NER differ from the NGR rate of return framework? Does the persuasive evidence test make it less likely that values of WACC parameters will be updated as quickly as under the NGR framework, or vice versa?

The AEMC will be aware that the SOCC applies to electricity, but not to gas networks. The persuasive evidence test applies to WACC parameters established during each electricity distribution review and in each periodic review of the SOCC. There is every reason to suppose that the same framework would be equally appropriate for all energy networks, including gas.

UE and MG note that the efficacy of the WACC arrangements does not depend on the frequency with which changes to the parameter values can be made. Instead, it is essential that the WACC regime provides investors with the confidence that they require to invest in long-lived assets. Therefore, the WACC regime should recognise the need for certainty, whilst also providing the flexibility needed to respond to changing market conditions. The WACC regime embodied in the electricity distribution Rules provides a reasonable foundation for the development of a regime that could apply to all regulated energy networks. However, the establishment of the WACC parameter values in the SOCC must be subject to merits review. However, UE and MG recognise that merits review is not an issue that can be addressed in this Rule change process.

Q24.	How has the rate of return framework under the NGR worked alongside the NER frameworks?

To a large extent, the AER has applied a similar philosophy and approach to estimating the WACC when making decisions under the NGR and NER. UE and MG consider that this has been a sensible and pragmatic response to Rules provisions that are significantly different across the regimes. It is timely, however, to consider the application of a more consistent approach across the NGR and NER frameworks.

Q25.	Are there any concerns about the lack of guidance in the NGR on how the AER and ERA will approach the rate of return decision? To what extent is the rate of return framework under the NGR influenced by the WACC approach adopted for the electricity sector by these regulators?

As noted in response to question 24, the AER has adopted a sensible and pragmatic approach in managing the differences between the NGR and the NER provisions. In practice, the AER has tended to apply the rate of return provisions of the NGR in a manner which is consistent with its decisions under the NER. UE and MG support this pragmatic approach, although there are benefits in bringing the regimes into alignment.

Q26.	Are there any reasons to adopt a WACC definition other than the vanilla post tax nominal definition that is used under the NER? Alternative proposals should explain why that alternative is likely to result in a better WACC estimate.

No. UE and MG are not aware of any compelling reasons to depart from the current practice of applying the vanilla post tax nominal WACC definition.

Q27.	Should the AER/ERA be given discretion to consider models other than the CAPM when estimating the required return on equity under the NGR? What prescription or principles could the rules contain to guide the way in which information from other models might be used to produce a better WACC estimate?

UE and MG consider that the cost of equity and debt should be estimated using well accepted financial models. The CAPM is a well-accepted model for estimating the cost of equity, but it must be employed intelligently in order to derive a cost of equity estimate that is consistent with the regulator's task. Using other methods to estimate the cost of equity, or employing different formulations of the CAPM may assist in providing assurance that the estimated cost of equity is appropriate given the prevailing market conditions. UE and MG therefore support the use of other models. However, it would be erroneous to suppose that any particular model should always be regarded as providing the 'best' estimate of the WACC.

UE and MG have observed the decisions that the AER has made under the NGR, where alternative asset pricing models can be applied. We note that the AER does not have a fair and reasonable framework for assessing and comparing different asset pricing models. Alternative asset models should not be subject to more exacting tests than those to which the standard Sharpe-Lintner CAPM is itself exposed.

Q28.	Are there any reasons why an appropriate WACC estimate cannot be provided to NSPs and gas service providers from a common WACC framework, without necessarily requiring the same parameter values to be adopted across the electricity transmission, electricity distribution and gas sectors?

No. This is a reasonable expectation.

Q29.	Which rate of return framework would best meet the key attributes identified? Are there any other attributes that should be considered?

UE and MG consider that the WACC framework that applies to electricity distributors provides an appropriate foundation for the other energy networks. It is essential, however, that the SOCC is subject to merits review. Without this modification, the default WACC parameter values could reflect regulatory errors that cannot be challenged and corrected.

Q30.	Is the benchmark DRP approach likely to overstate the prevailing cost of debt, having regard to the suggestion that the overstatement may be a reflection of shorter maturity debt leading to a higher refinancing risk for NSPs? What weight should be placed on the views of market analysts on the ability of stock market listed NSPs to out-perform their cost of debt allowances?

UE and MG note that there has been considerable debate regarding the appropriate benchmark cost of debt. The matter has been subject to several appeals to the Australian Competition Tribunal, which has consistently concluded that the AER has erred in various approaches that produced an artificially depressed cost of debt benchmark. These debates have not been focused on the appropriate term to maturity, but rather the construction of an appropriate market measure.

UE and MG concur with the AEMC's reasoning that it is not possible to conclude that NSPs are currently being over-compensated by the cost of debt allowances. As SFG advises, the fact that debt was historically sourced at a lower cost is independent of any investment decisions that would be made by the NSPs today.

UE and MG does not consider that analysts' assessments of differences between embedded and benchmark costs of debt should play a role in setting the benchmark cost of debt allowance. The AER should make its own assessment of the benchmark debt cost allowance in accordance with the Rules, which in this case require the use of current market data.

Q31.	What are the pros and cons of the recent approaches taken by IPART and the ERA in estimating the DRP?

UE and MG note that there is considerable complexity involved in developing an appropriate benchmark cost of debt, which can lead to error. UE and MG refer the AEMC to the submission made by the ENA on this issue. It should be noted, however, that regulators should be cautious in developing their own benchmarks in preference to those of Bloomberg that have credibility and widespread use in financial markets.

Q32.	What evidence is there that the DRP benchmark in the NER may have changed? Would it be appropriate for the regulator to specify the DRP benchmark in any periodic reviews or would it be more appropriate to specify it at the time of the determinations?

UE and MG note that the benchmark DRP allowance will change over time in response to changes in market conditions. The task in designing the regulatory framework is to ensure that it is effective in all market conditions, not just those that prevail today. UE and MG favour an approach to all WACC parameters that provides both certainty to investors and the flexibility to respond to current market conditions. While the existing arrangements have been heavily criticised by some stakeholders, it is doubtful whether the concerns reveal material problems with the regulatory framework. In fact, the outcomes from the regulatory framework simply reflect unprecedented market conditions in which debt premiums have increased significantly.

Q33.	Is the EURCC's proposal of establishing the cost of debt using historical trailing average compatible with the overall framework for estimating a forward-looking rate of return? What are the potential benefits of using a trailing average and do they outweigh the potential costs if the estimate is less reflective of the prevailing cost of debt for NSPs?

UE and MG has previously expressed guarded support for the EURCC approach. As explained in the ENA submission, the challenge will be to develop a workable approach that does not introduce excessive complexity. It is unclear at this stage whether a workable proposal can be developed in the timeframes envisaged by the AEMC's rule change process.

Q34.	What possible changes would be required in the NER to implement the EURCC's trailing average approach?

As noted in response to question 33, the EURCC's averaging approach may involve significant complexity in its application. UE and MG support the ENA's view that these issues may be better addressed through a separate process.

Q35 - 46.	Regulaotry Framework

UE and MG rely on the ENA submission.