Major Energy Users Inc.

Australian Energy Markets Commission

Economic Regulation of Network Service Providers

AER Proposed Rule Change

Comments on the Directions Paper

Submission by

The Major Energy Users Inc

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The views expressed in this document do not necessarily reflect the views of the Consumer Advocacy Panel or the Australian Energy Market Commission. The content and conclusions reached in this submission are entirely the work of the MEU and its consultants.

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Executive Summary

The Major Energy Users (MEU) welcomes the opportunity to provide its views to the AEMC Directions Paper addressing the AER proposed rule changes to network regulation. The MEU notes that this rule change proposal was initiated following widespread concern about the sharp escalation in the rising costs of energy to consumers, especially the element of network costs. The MEU participated actively in the last round of network pricing reviews and has first hand experience with the unbalanced network revenue Rules that had heavily constrained the AER from performing its regulatory role.

As a general comment, the MEU supports the AER proposed changes although the MEU has concerns about some aspects. The MEU has noted that there is considerable doubt raised by some that the AER has not used its available powers to the extent possible, thereby implying there is no need to make change. The MEU considers that if there is no doubt that the AER should have the necessary powers, then this should be made clear in the rules to avoid any doubt.

The MEU has a concern that the AEMC review process is being used by NSPs and some others to imply that the AER is biased against NSPs and/or that the AER has not correctly interpreted its powers under the Rules. The MEU considers that the AER (as the independent regulator) has a responsibility to seek to correctly interpret and apply the rules in terms of the NEO. What the AER has identified. is that key aspects of the rules are hampering it in its responsibilities to ensure there are efficient outcomes, thereby discharging its obligations under the NEO. The sharp rise in network charges, relative to historical trends, is prima facie evidence that this has been the case. This implies that rather than assuming the rule changes proposed by the AER are not appropriate, the AEMC should be examining why the AER proposals should not be implemented. That is, the onus is solely being placed on the AER to prove why the rule changes are needed, to the exclusion of the onus being placed on stakeholders as to why the rule changes should not be implemented. This is very disconcerting to large energy consumers, who have borne the brunt of sharply escalating network prices over the past five years and face the prospect of more of the same in the event NSPs succeed in over turning the AER package of reforms.

The MEU has provided answers to the specific questions raised by the AEMC, both posed at the forum and in the Directions Paper. Throughout the MEU‘s response, we take the view that regulation is a second best option to competition and is applied to natural monopolies, such as the energy networks notwithstanding the limitations inherent in regulation, such as the problems of information asymmetry.

Regarding the specific issues summarised by the AEMC under the four main headings (opex and capex allowances, capex incentives, rate of return and regulatory processes) the MEU provides the following comments:

- The AER concerns are shared by the MEU (as an active participants in the previous pricing round and as major consumers that bore the brunt of the regulatory determinations) regarding the AER's ability under the existing Rules to set efficient levels of opex and capex.

- Whilst the MEU agrees with the AEMC that more investigation might assist in identifying the drivers for network increases, there is already evidence provided by NSW IPART, Garnaut (Update 8) and the NSW Government report (Parry/Duffy) that the existing Rules have over-incentivised network investments and contributed to sharply escalating network prices (especially when compared with historical trends)

- The MEU concurs with the AEMC that regulatory practices used elsewhere (including benchmarking) should be examined in order to provide the AER with a wider range of analytical tools and improve the effectiveness of regulation, in order to ensure that regulated allowances are efficient

- The MEU concurs with the AER that there is an incentive to overspend on capex allowances and that the AEMC is wrong in its preliminary conclusion that this is not the case.

- The MEU agrees that because there is no ex post scrutiny of the use of capex there is a very substantial incentive for profit maximising monopolies to over spend approved allowances and is therefore a major failing of the existing Rules.

- Whilst the MEU considers that the AER's 60% proposal could introduce unintended outcomes, it is important that a variant of this or some other better option for limiting overspending must be introduced.

- The MEU agrees with the AER and AEMC that the current regulatory framework in setting the WACC for electricity and gas pipelines are not satisfactory and the MEU agrees with the AER that a single framework is preferable to multiple frameworks.

- The MEU agrees with the AEMC that the framework should be based on estimating the WACC for an efficient firm but that this benchmark must be tested in the wider market, including account taken of the special position of government owned networks which are able to access debt at considerably lower levels than their private sector counterparts, and the significant differences in their corporate governance arrangements..

- The MEU agrees with the AER and the AEMC that there needs to be less prescription in the setting of the WACC but, as noted above, the outcome needs to be tested against a much wider range of actual WACCs seen in the competitive market place (including overseas capital markets) to ensure that the outcome is efficient.

- The MEU does not agree that the use of a range of parameter inputs will improve the process and that it has the potential to lead to more disputes and appeals to the ACT, and to drive outcomes towards the high end of the range.

- The MEU shares with the AER, the AEMC and the EURCC a view that the current approach to the cost of debt delivers outcomes that do not reflect the cost of debt incurred by the NSPs and that change is necessary to ensure that the allowance for the cost of debt is efficient.

- The MEU agrees with the AER and the AEMC that assessing the cost of debt should not be hardwired into the rules and that the AER should have discretion as to what allowance should be used.

- The MEU notes that the cost of debt actually incurred by government owned NSPs is considerably lower than the cost of debt incurred by privately owned NSPs and a common approach to both would provide government owned NSPs a source of additional profit and a cost imposition on consumers that is not efficient. To overcome this anomaly the MEU considers that the Rules should provide guidance to the AER that the allowance for the cost of debt should be efficient and should reflect the likely costs the entity will encounter in sourcing its debt.

- Increasing the averaging (trailing) period does not appear to provide a disincentive to using a longer period and perhaps provides a more consistent outcome.

- The MEU notes that the AER has raised the concerns that stakeholders have regarding the processes, other than that of stakeholders being specifically involved in the two forums currently required under the rules. Generally, stakeholders are considered to be an adjunct to the processes rather than an integral part. The AER proposals would increase the opportunity for greater stakeholder involvement. The AER also has to significantly improve its own processes in interacting with non NSP stakeholders.

- The MEU agrees with the AEMC that the entire regulatory process needs to be addressed to maximise stakeholder involvement and to provide adequate time to make proper decisions

1. Introduction

The Major Energy Users Inc (MEU) welcomes the opportunity to provide its views on the AER's rule change in relation to the economic regulation of network service providers.

The MEU comprises over 20 large energy using companies across the NEM and in WA and the NT. Industries represented cover the following:

- Iron and steel
- Cement
- Paper, pulp and cardboard
- Aluminium
- Mining and mining explosives
- Tourism and accommodation
- Infrastructure services

MEU members have major activities in regional centres throughout Australia, e.g. Newcastle, Gladstone, Port Kembla, Mount Gambier, Westernport, Western Sydney, Geelong, Launceston, Port Pirie, Kwinana and Darwin.

The MEU participated in all the major electricity and gas pipelines reviews conducted by the AER in the last regulatory round. The MEU also actively participated in the 2005/06 AEMC Chapter 6A review as well as the MCE 2007 and 2008 reviews into electricity network regulation and gas network regulation.

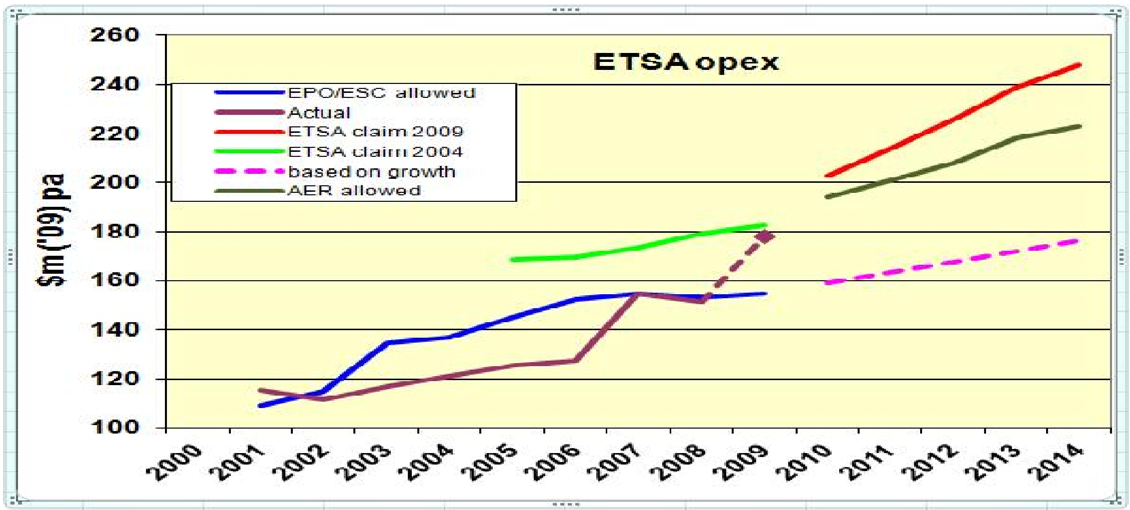
With this background combined with the experiences of being active consumer advocates for most of the regulatory reviews carried out under the Gas and Electricity Codes since 1996, the MEU is also well placed to be able to compare the processes and outcomes of regulatory reviews on a "before and after" basis.

1.1 The "prove it" hypothesis

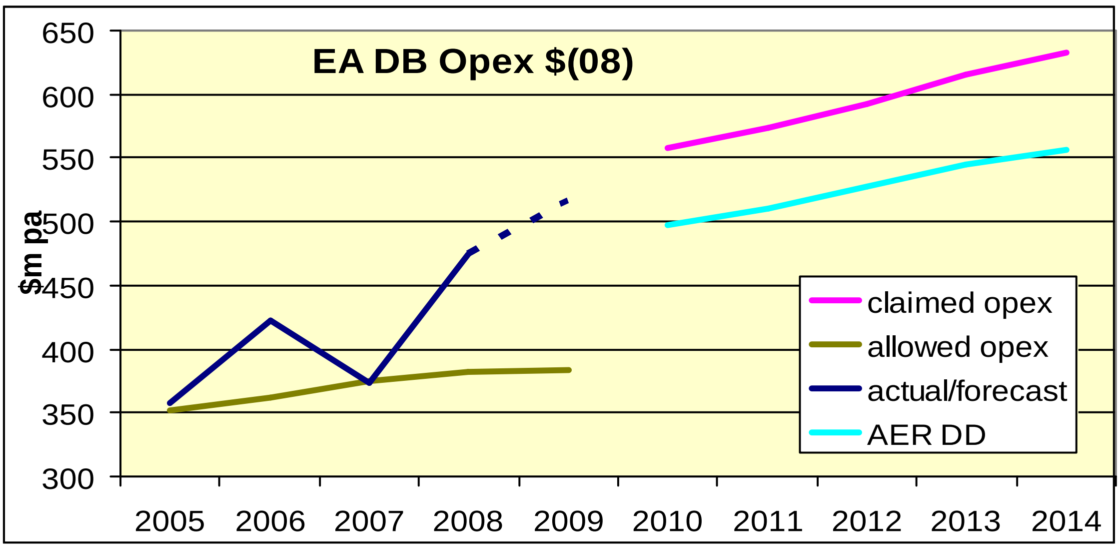
Since the release of the AER network regulation rule change proposal, there has been a consistent view put by the regulated firms, that the AER view (and that of Garnaut and others) on the drivers of the sharply rising network prices was not proven, and that the proponents should prove that the current rules are unbalanced. This is an unreasonable claim as there was no similar demand on the AEMC that proof be provided, when the rules were changed in 2006 and 2007 to provide greater incentives, and that the Codes used for a decade were insufficient. The MEU was heavily involved in the processes to develop the new chapter 6A and chapter 6 changes and when it called for evidence that changes were needed, the current claimants for proof stated that proof was not needed.

As stated above, the MEU and its affiliates have been involved with nearly every regulatory review since 1996 and one aspect that they have used when acting as a consumer advocate in these reviews is to track the historical movements of opex and capex levels in terms of the claims by applicants, the actual performance and the regulatory draft decisions. This historical data is an important element as to assessing what a reasonable future allowance should be for opex and capex.

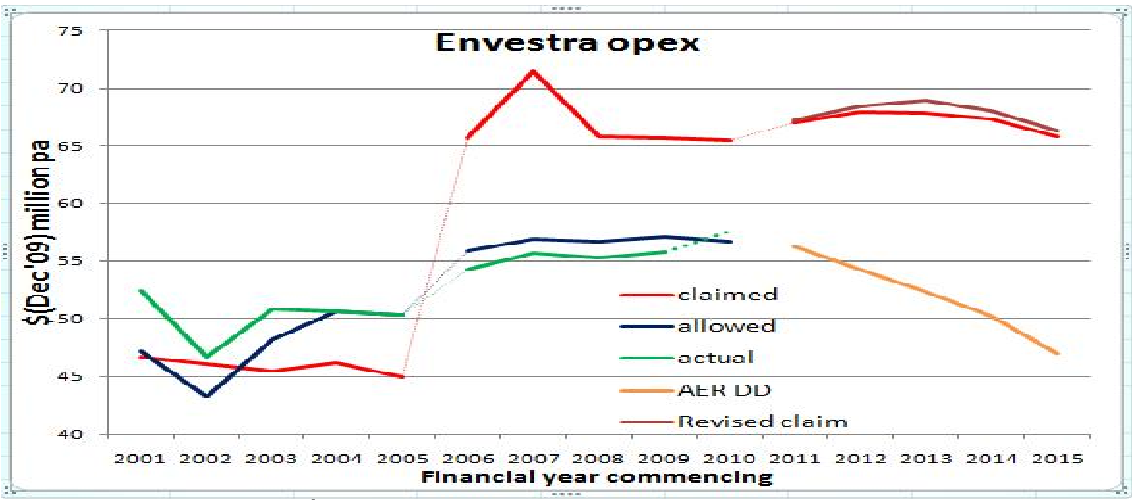
The following charts provide a typical cross section of gas and electricity reviews for distribution and transmission under the application of the Codes and most recently under the new Rules. It is a relatively straightforward exercise for the AEMC (with the assistance of the AER) to carryout its own assessment of the historical trends to replicate the MEU affiliates' historical analysis.



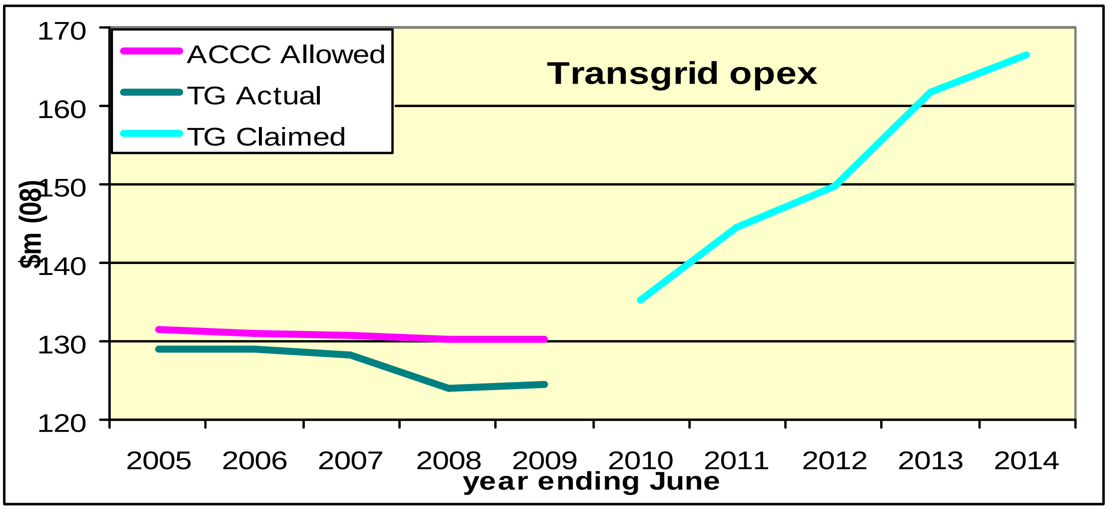
Source: MEU affiliate ECCSA response to AER draft Decision on ETSA utilities



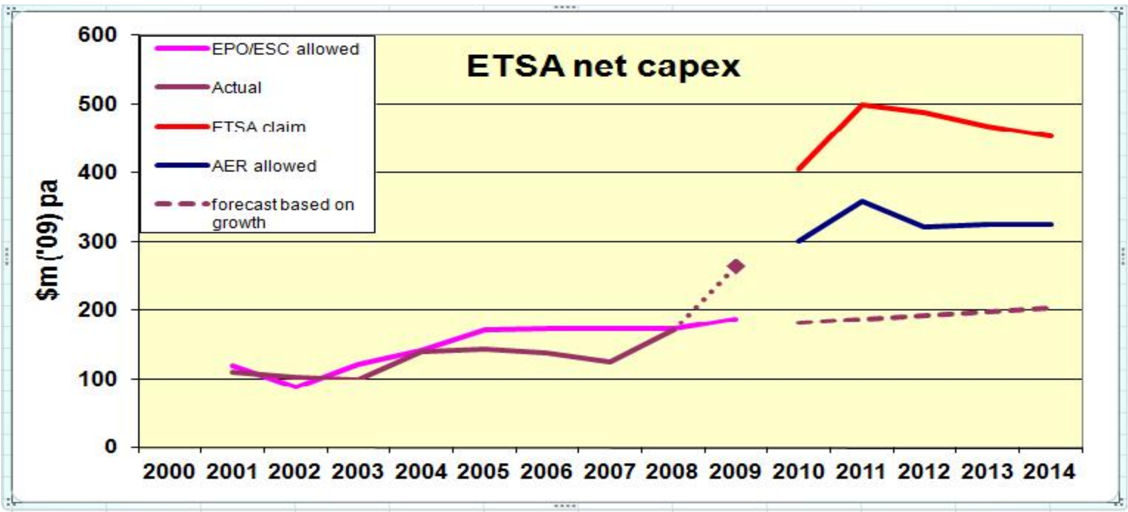
Sources: ACCC and IPART decisions 2004, EA application, AER DD



Source: Envestra applications[1], AER, SAIPAR and ESCoSA decisions

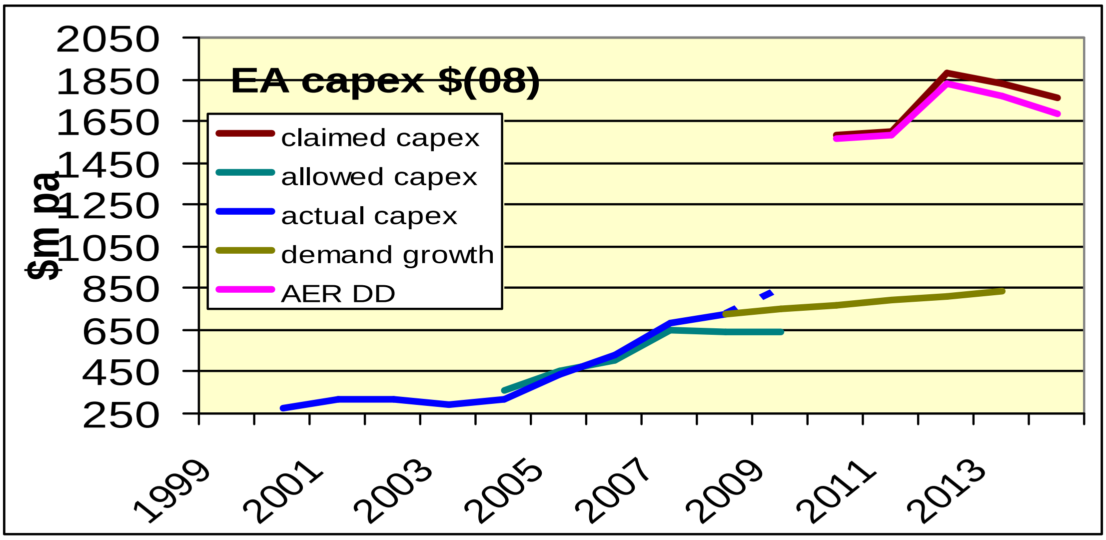


Sources: ACCC decision 2004, TransGrid application

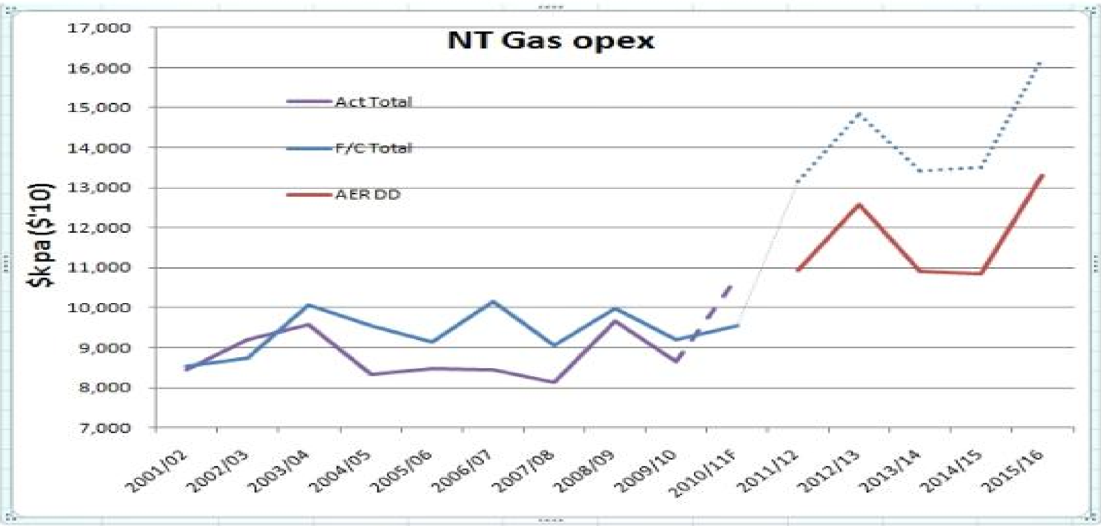


Source: MEU affiliate ECCSA response to AER draft Decision on ETSA utilities

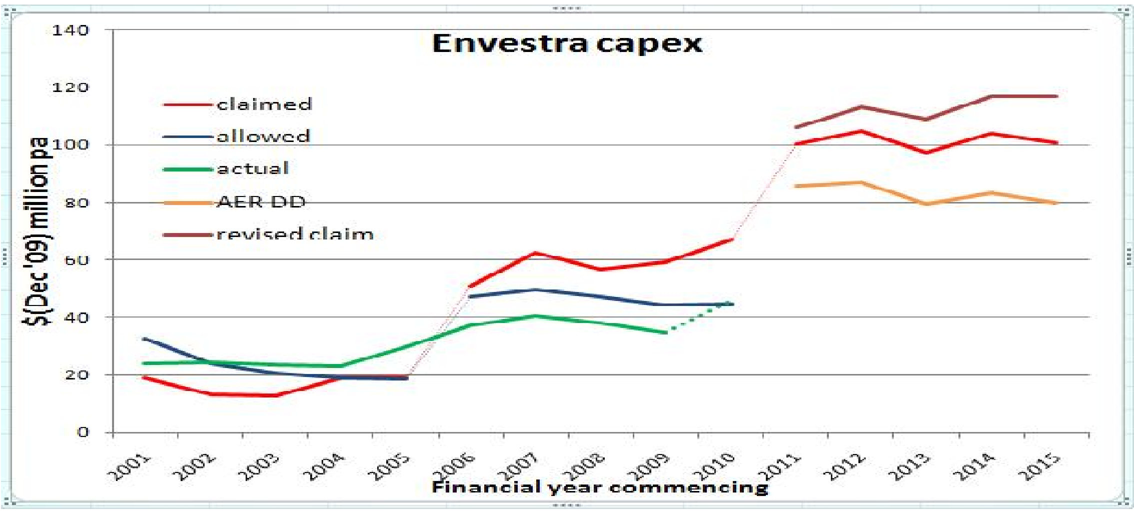
[1] The 2006-2010 Envestra application excluded UAFG. For comparison purposes the Envestra application for opex includes the amounts for UAFG allowed by ESCoSA



Sources: ACCC and IPART decisions 2004, EA application, AER DD



Source: NT Gas applic, ACCC FD, AER DD



Source: AER, ESCoSA and SAIPAR decisions, Envestra applications

It is important to note that during the periods before the last review, if the allowances were insufficient for the needs of the businesses, there would have been a clear deterioration in service standards. In fact, service standards under the historic allowances were maintained and in many cases, they actually improved, implying that the historic allowances and actual expenditures were adequate.

There is a recognised relationship between capex and increase in demand (especially in electricity networks). A review of network capex shows that generally the amount of capex used for growth is consistently 50-70% of the total capex, reinforcing this correlation between capex and demand. Opex is related primarily to the expansion of the network, again reinforcing this correlation between expenditure and demand. Demand growth is regularly in the range of 2-5% annually and this would imply that capex and opex growth would be in the same range.

Under the reviews undertaken prior to the last (AER) review this growth trend seems to be reflected in the opex and capex outcomes, yet with the last review under the new rules, there is a clear discontinuity in applying this basic trend.

There are a number of observations that can be drawn from the above charts:

- Generally, the growth in opex and capex under the Codes tended to track the growth in demand, but with the most recent reviews under the new Rules, there was a significant step increase in opex and capex levels, well above increases in demand
- Generally, the allowances in the second period (ie the one before the most recent reviews) were greater than the actual expenditure
- Generally, where the actual expenditure was more than the allowance, the amounts claimed by the firm also were less than the actual expenditure
- Historic increases in opex and capex levels tended to match the growth in demand, yet this does not apply with reviews under the new Rules.

Overall, there is sufficient comparative data to clearly show that with the change in the Rules, there is a clear disconnect between what were appropriate allowances to provide the services prior to the new Rules and what occurs under the new Rules.

1.2 The AER response to the disconnect anomaly

The AER has recognised that the causes of the disconnect relate to the changes in the Rules made in the 2006-2008 period and, as is appropriate for an independent regulator, has proposed Rule changes to address this. Garnaut, the NSW government review (Parry Duffy) and IPART all identified that the new Rules were the drivers of this disconnect and the AER review would have reinforced that, thereby causing the AER to propose its Rule changes.

It is worth noting that, prior to all of these reviews, the MEU (and other consumer representatives) had also noted the bias in the new Rules and had flagged rule change proposals. For instance, the Pulp and Paper Industry Strategy Group (comprising industry, unions and government) in its report[2] to government made a recommendation (17b)

> "Noting the significant increase in network transmission and distribution costs, the Strategy Group recommends that the Ministerial Council on Energy consider rules and policies to ensure that network investment is prudent, necessary and tightly controlled and that the costs of the investments are transparent, justified and affordable."

That the AER decided to propose a rule change to address the challenges they faced with every regulatory reset review under the new Rules is much to its credit and reflects an appropriate response of an independent regulator to what it sees was bias in the rules that was resulting in inappropriate outcomes for consumers when measured against the intent of the regulatory regime.

The response by the regulated firms to assert that there is no evidence of bias detracts from the essential fact that the "independent umpire" has observed first hand that the rules it is required to use, does not provide an outcome that is in the "long term interests of consumers".

In its Directions Paper (and in the reports of Professors Yarrow and Littlechild) there is embedded a view that the AER has not proven its case that change is necessary. The MEU is concerned that there is not an acceptance that the views of the AER (the independent entity with the most experience of the regulatory review processes) should be taken as prima facie evidence that there is a problem that requires to be fixed.

There is overwhelming evidence from a variety of sources (independent agencies, such as AER, IPART and Garnaut, the network asset owning NSW government, and consumers such as the MEU and PPISG), all being of the view that there is a problem. The AEMC must take cognisance of this and not be swayed by the partisan assertions of the regulated firms that there is no evidence that there is a problem. The MEU would be very concerned should the views of the abovementioned entities were to be dismissed by the AEMC and its consultants.

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[2] Available at http://www.innovation.gov.au/Industry/PulpandPaper/PPIIC/Pages/PulpandPaperIndustryStrategyGroupFinalReport.aspx

2. The AEMC Approach to the Rule Change Proposal

The Commission's broad assessment approach is appropriate. There are, however, a number of important factors that should be taken into account in assessing the rule change requests:

- The Commission is correct in describing electricity and gas networks as natural monopolies. However, it falls short at describing the behaviour of natural monopolies. Such behavioural conduct has been extensively documented in the economic literature since Adam Smith wrote "The Wealth of Nations": that such monopolies are profit maximising firms that do not face the forces of competition to drive them to the efficient frontier. It is in their DNA to increase their regulatory revenue allowance by raising each and every key variable in the regulatory building block equation, viz. ((RAB + Capex– Depreciation) X ROR + Opex).

  Because under the existing regulatory regime, networks are assessed using either the revenue cap or price cap forms of regulation, incentives to increase regulatory allowances are different. Thus, under the revenue cap form of regulation, NSPs have the incentive to overstate demand and consumption, whilst under the price cap form of regulation, NSPs would tend to overstate demand (to increase allowances for capex) and understate consumption (to increase tariffs) – all acting under the profit maximising motive.

- Because economic regulation is a second-best alternative to competition, it can only ever hope to be "approximate". There is a massive asymmetry problem faced by regulators (and stakeholders). Regulatory rules can only seek to very broadly replicate competitive forces. Prescription in the regulatory rules more likely than not, restrains the regulator, as can the precision (or lack of precision) in the language of the rules. Regulatory judgement, whereby the regulator takes a holistic view of the NSP's application, is likely to be preferred, than a form of regulation whereby the regulator is constrained from acting flexibility (especially if prescription is not to the liking of the NSP) because a regulator is unlikely to starve the NSP of revenues because of the risk asymmetry between outcomes from over and under allowances. With greater flexibility, an impossible task is eased by the regulator being able to more readily to balance competing elements and to reach a balanced final answer, even where there may be some lack of precision in a single element.

- Reflecting the above considerations, the regulatory process is unlikely to be a level playing field, and it is clear from the AER rule change package, that more balance is required to the rules to enable the regulator to perform its functions to meet the energy Law Objective. But given the asymmetric nature of the regulatory process, availability of more powerful incentives to improve NSP performance is more likely to deliver better (more efficient) outcomes for consumers than more stringent rules, notwithstanding the strong support for the AER rule change package to redress the current imbalances in the rules.

- There can be no doubt that the regulated firms use every opportunity to maximise the regulatory allowances provided. The fact that there has been an amazing increase in appeals against the AER decisions under the new rules implies one of two reasons. Either the AER is less competent than the ACCC and state regulators that provided regulation under the energy Codes, or the new rules are so poorly crafted that the AER has difficulty in arriving at a balanced outcome which is capable of not being appealed.

  The MEU is of the view that the new rules are written in such a way that the lack of flexibility provided, permits the easy ability to identify aspects where there is doubt and so underpin an appeal. This ready ability to find the basis for an appeal has to be addressed.

Overall, the MEU considers that increased flexibility will lead to a number of more preferable and balanced outcomes, and which will result in a lesser ability of the regulated firm to use the other elements of the Laws (eg the limited merits review process) to over-ride the regulatory decision what can only be described as an outcome which reflects a balance between the needs of the regulated firms and the ability of consumers to pay an equitable amount for the service provided.

3. Capex and opex allowances

The setting of opex and capex allowances is one of the main tasks of the regulator. In an incentive regulatory regime, it is essential that the outcome for opex and capex allowances finally reach the efficient boundary. The only way that the efficient boundary will be reached is by external comparison with similar enterprises. In a competitive environment, the competitors of the firm's product force the firm to reach and operate at the efficient boundary (or go out of business). In a monopoly setting, the regulator has this role. This means that the regulator has to review all elements comprising the allowed revenue to assess that each is operating at the efficient boundary.

It is important to note that it is the not the allowance for each line of an application or even each sub element that drives a firm to the efficient level, but the final price and quality of the product that causes this. As regulation is a surrogate for competition, the regulator essentially has to look at the final price and quality of the product to assess if the firm is operating at the efficient boundary. External benchmarking achieves this rather than an assessment on a line by line approach, although the line by line approach is likely to highlight specific areas where the firm is not at the efficient boundary.

Based on this general concept, the MEU comments on certain aspects of the AEMC's assessment:

- On the basis of this review, the AER's reasons in its determinations of NSP capex and opex allowances do not appear to demonstrate convincingly that it has been constrained by the NER in the way that it claims in its rule change request. While there may be a problem, the AER's regulatory determinations do not indicate what that problem is, or that it would have done anything differently under the rules it has proposed. While the Commission accepts that the AER would not have undertaken additional analysis beyond that which the AER considered necessary to meet the NER, it might have been expected that the determinations (or some other work undertaken internally by the AER) would have given some indication of how the AER's concerns about its powers under the NER had constrained the analysis it could undertake. (Page 22)

The MEU considers that it would be totally improper for the AER to provide a commentary on the Rules in its pricing determinations, as suggested by the AEMC, nor is a determination the right forum to express its concerns about its powers. The correct approach would be for the AER to review the rules (after a period of testing them) and then propose changes it considers necessary.

In its proposal the AER has offered an opinion that it does not consider it has the necessary powers to produce an equitable regulatory decision. In this regard there has been no argument raised that the AER should not have these powers. Therefore, the issue is quite readily resolved by it being made clear in the Rules that the AER does have these powers.

The MEU points out that the record of the AER in merits appeals is such that it indicates that there is indeed a soundly based concern about the extent of its powers, and the AEMC should recognise this.

- In AER regulatory determinations, there is almost no reference to the AER starting its assessment of a capex or opex forecast by considering what a reasonable range might be for the capex or opex. This might be suggested by the "reasonably reflects" concept and the requirement that a substitute be amended from the regulatory proposal only to the extent necessary to be approved. References can be found in AER regulatory determinations to changes being made only to the extent necessary to meet the NER, but it is unclear what the effect of this is in the absence of other references to a range. Indeed, the AER itself notes that it generally does not approach assessment of a capex or opex forecast by adopting a maximum possible number and a minimum possible number. The Energy Networks Association (ENA) also notes this point. Conversely, there is evidence of the AER having used a mid-point between its consultant's analysis and the relevant estimate provided by DNSPs (Page22)

It is not clear what value is achieved by the AER stating, in a pricing determination, a ‘reasonable range’ for capex and opex when it already considers that it is constrained by the Rules from doing just that. What purpose would it serve?

Further, the AER has observed that the use of a “reasonable range” would tend to drive the allowances to the high end of the “reasonable range” with the result that the allowance would never reach the efficient frontier, and would always be in excess of the needs of the business.

There must be a final allowance so the use of a reasonable range does little to assist the setting of a single point allowance. The use of a range of outcomes for a series of assessments for each elements and sub element makes it more difficult to provide a single point allowance and opens up the ability of the regulated firm to challenge individual sub element assessments. Therefore, the concept of ensuring the final outcome is balanced and represents a holistic assessment of the revenue required by the firm, becomes clouded and more exposed to appeals.

- In respect of DNSPs, the AER claims that the requirement that a substitute forecast is based on the regulatory proposal locks it into a line-by-line approach to assessing forecasts. In fact, it is possible to find evidence of the AER applying its own analytical techniques to capex and opex proposals. A good example of this is the "repex" model that has been applied by the AER recently to determine replacement capex. This uses age as a proxy for the range of factors that are drivers for individual asset replacements. It also reflects historical levels and costs.(Page 22)

A line by line assessment is essentially a "bottom up" assessment. This approach assesses the relative accuracy of the estimates for each sub element of work. It is not feasible (and effectively impossible) for the AER to assess every single cost element on this basis and the purpose of sampling is to assess the degree of accuracy inherent in the development of the estimates by the firm.

Already, the AER has attempted to use the sampling technique and then to use the outcome of the sampling to apply across all estimates. This sampling and broad brush application of the outcome has been challenged by regulated firms and raised in appeals. Similarly, regulated forms have rejected the "repex" methodology as being an accurate assessment of need.

What is needed is a tool which can assess the claims on a top down approach which is the technique used by senior management in firms subject to competition. The limited use of the outcomes of the EBSS has been used by the AER to drive opex to the efficient boundary, but the exclusions from the EBSS tend to limit its effect. Widespread benchmarking, based on data from a large number of firms carrying out similar tasks provides "competition by comparison" which is a surrogate for real competition. Benchmarking has the ability to drive the regulated firm to the efficient boundary.

Self benchmarking (ie assessing past performance as the starting point for future estimates) assists in establishing a driver towards the efficient boundary, this assumes that the current performance is near efficient. In fact this may well not be the case as the firm itself might not realise that it is not operating efficiently. Benchmarking using external performance measures is the only way (short of actual competition) of getting a monopoly to operate at the efficient boundary.

- The AER has stated that it is inevitable that a portion of costs escape regulatory scrutiny. In practice the AER has from time to time used a sampling approach, where it reviews a portion of projects proposed by the NSP and then, based on a reduction for that sample of projects,

> makes a proportionate reduction to projects it has not reviewed in detail. For example, in the regulatory determination for ETSA Utilities, the following comment was made:
>
>> "The AER considers that given the level of adjustment required to the categories subject to the detailed review, a general adjustment to the remaining replacement capex is, under the circumstances, justified."
>
> This suggests the AER has found ways of applying specific analysis more broadly to cover all costs. (Page 23)

As noted above, whilst the AER has attempted to use sampling approaches and then use the results across the entire spectrum, this practice has been roundly criticised by the regulated firms and could expose the AER to an appeal on the basis that it is drawing on the particular to develop a general rule. Prima facie, where the pressure is on the AER to prove that its assessment is correct rather than on the regulated firm, this provides an avenue for an appeal to the ACT.

The MEU approached its members (which all operate in a competitive environment) and they advise that senior management makes an assessment of the ability of buyers to pay for the firm's products (a powerful form of benchmarking) to assess what allowances for opex and capex are permissible. It is the responsibility of junior management to prove that what they want in terms of opex and capex is essential. The MEU considers that this approach needs to be replicated in the interaction between the AER and the regulated firm.

- **Tribunal comments**

  The Australian Competition Tribunal (Tribunal) has had a number of opportunities to consider the provisions in the NER relating to capex and opex forecasts. A review of the Tribunal's decisions in respect of electricity matters since 2008 reveals several things.

  First, the Tribunal takes a relatively expansive view of clause 6.12.3. In the matter of Application by EnergyAustralia and Others it states the following:

  > "The primary discretion given to the AER by cl 6.12.3(a) is to refuse to accept or approve any element of a regulatory proposal. The AER's power to substitute an amount or value or methodology exists so that it may properly perform its obligation under cl 6.12.1(4)(ii) to set an estimate of the total

> opex that the AER is satisfied reasonably reflects the opex criteria."

> This suggests that the Tribunal's view is that NER clause 6.12.3 is a clarification of, rather than a limitation on, the requirement that it estimate the required opex or capex by reference to what is required to reasonably reflect the opex or capex criteria.
>
> Secondly, the Tribunal has on a number of occasions taken a different view to the AER and varied an AER decision. There is no indication, however, that the Tribunal has ever formed a view that the AER has exceeded or come close to exceeding the limits of the discretion it has in respect of capex and opex allowances.(Page 24)

It is clear from comments from NSPs that they do not consider the AER contention that it is constrained, is correct. The AEMC assessment of the Tribunal's comments would seem to support this contention. This implies that there is no doubt that the AER has the necessary powers and that it should use them. If the AER is unclear about its discretion on forming views on opex and capex, then the Rules should provide the necessary clarity and detail to confirm that the AER has the powers it seeks in its rule change package.

- More useful is a comparison of the average reductions by the AER under the present framework compared to those under the previous regulatory framework, as presented by Grid Australia, the ENA and the Financial Investor Group. It is difficult to compare the figures produced (for example the Financial Investor Group suggest jurisdictional regulators reduced capex forecasts by 10 per cent and the AER by 11 per cent, whereas the ENA suggests the median reduction by jurisdictional regulators for capex forecasts is 15.6 per cent and by the AER is 10.3 per cent). Based on what has been provided to the AEMC thus far, however, the results suggest that the AER has the power to reduce expenditure forecasts by at least an equivalent level as the jurisdictional regulators, where it determines to exercise its discretion to do so.(Page 26)

This observation is based on an unsound premise. The fact that the AER has reduced opex and capex claims from applicants is essentially immaterial. The issue that the AER contends is that it feels constrained from driving the allowances to the efficient boundary. This is the core issue! Merely the fact that the AER has reduced opex and capex claims does not provide evidence that the AER might have, with sufficient powers, reduced the claims by even greater amounts because the efficient boundary was not reached.

Again, the MEU suggests that the AER rule change package should provide the necessary clarity and detail on the AER's power to reduce expenditure forecasts.

- Professor Yarrow concurs with the view that the AER has not provided enough evidence of the problem in this area that it has raised.

The implication of this comment is that the AER is expected to prove that it would have provided different outcomes if it considered it had the necessary powers that the consultant considers is embedded in the Rules.

There is no view that the powers should not be available to the AER. Therefore the argument is not that the powers should not be available (which should require evidence) but more as to whether there is clarity as to whether the powers are already there. It seems totally appropriate that this issue could be resolved by making it clear that the powers are available.

- Finally, both Professors Yarrow and Littlechild see benefits in outcomes that are arrived at by a process of agreement between the relevant parties, rather than having to be mandated (such as by a regulator). (Page 27)

The MEU provides strong support for more innovative approaches. Certainly, the reference to agreement between relevant parties offers an improvement to the current regime and the regulatory process in practice, if such would permit greater interaction between the AER and stakeholders other than the NSP involved. Under the current arrangements large users are not significantly engaged with NSPs when the latter are forming forecasts or demand. However, there is concern if the suggestion relates to the regulator and the NSP reaching "agreements" which are not transparent and reflect "side deals"

Professor Stephen Littlechild would seem to refer to the UK experiments.

- While the AER proposes no changes to the capex or opex objectives, it identifies a perceived problem regarding these objectives. In particular, it notes that the objectives refer to expenditure required to "maintain" quality, reliability and security of supply. It observes that this may mean capex allowances could not decrease in the event jurisdictional standards were lowered since enough capex must be allowed to permit levels of reliability to be kept at existing levels. The Commission considers that a valid concern has been raised by the AER and that there is merit in exploring this issue further, particularly given

> the Review of Distribution Reliability Outcomes and Standards that the Commission is undertaking.
>
> The solution may be simple, such as an amendment to the objectives to clarify that the level of capex described by the objectives should only be enough for the relevant jurisdictional reliability standard, and any other statutory standards covered by the objectives, to be met and not exceeded. The Commission invites submissions on this issue. (Page 30)

The MEU notes that the solution may be simple, but when jurisdictional reliability standards and other statutory standards covered by the objectives are not necessarily set on a cost-benefit basis, then network costs could escalate.

The MEU notes the responses from the regulated firms to the earlier consultation paper.

> "…most NSPs argue that the current regulatory framework is effective and a fundamental change is unnecessary…
>
> NSPs suggest there are other reasons for rising network prices. For example, one submission provides that the changes in price are a reflection of the poor regulatory decisions in the past which produced artificially low prices compared to costs. NSPs also submit that it is the investment required to meet the need for replacement of ageing assets, spatial peak demand and higher reliability standards that has resulted in higher network charges.
> NSPs also argue that higher network costs are not any proof of failure of the regulatory regime or the regulatory bodies which currently apply them." (Page 18)

Such responses are to be expected as the NSPs strive to protect their current ability to maximise opex and capex allowances. What comments such as these do not reflect is that it is the AER (the "independent umpire") that has raised these concerns, along with IPART (another independent umpire, Garnaut (who gains no benefit from the change) and the NSW government which owns significant network assets and would therefore have an interest in supporting the current regime. When concerns such as these are raised by those who are clearly disinterested, it clearly implies that the current mechanism "is broke" and should be fixed.

The responses also indicate a lack of true examination of the facts. If the previous regulatory decisions had resulted in artificially low allowances compared to costs then the outcomes would have been significant overspend of the allowances and/or a reduction in service standards. Whilst there has been some overspend in some regions, service standards did not fall, effectively demonstrating that the assertions have little basis. Equally, if the previous allowances had caused an underinvestment in replacement of ageing assets, there would be two direct outcomes – firstly the service standards would have fallen (which they have not) and the bulk of the capex in the last round of regulatory decisions would have been heavily biased to asset replacement, yet a review of the claims does not support that this is the case, with asset replacement rates remaining relatively constant.

As noted in section 1 above, it is clear that there is wide concern about the levels of opex and capex that are being awarded by the AER in its regulatory decisions. This concern is both about the large amounts being awarded for both opex and capex and about the increasing inability of consumers to pay for the amounts included.

The debate has now centred on whether the AER has the necessary powers to ensure that only efficient allowances are included in the allowed revenue. The MEU is of the view that there appears to be no doubt that the AER should only include efficient allowances. To this end, the AER has advised it considers that it does not have sufficient powers to enforce that only efficient allowances should be included.

The sensible solution to the debate therefore revolves around ensuring the AER does exercise its powers to the extent that the efficient boundary is reached and this could be readily achieved by ensuring the rules make this clear.

There is reference in the Directions Paper to benchmarking of opex and capex. Benchmarking is all about applying the effects of competition to a monopoly by comparing its performance to the most efficient monopoly service provider in the same industry.

To reach the efficient frontier, competition in the wider market provides the driver to provide the most efficient service to consumers. Where there is no competition an alternative tool is required to drive improvements in efficiency – “competition by comparison” is one such tool and for this benchmarking is the only tool available for imposing this.

There has been some benchmarking of opex over the years, but this has reduced dramatically in recent years and this has been essentially assessed in terms of self benchmarking through the use of the Efficiency benefit Sharing Scheme (EBSS) introduced by the AER . There has been no benchmarking of capex (or indeed of the WACC) yet benchmarking of these can be carried out effectively.

Not to impose benchmarking on all facets of the building block approach to setting the regulated revenue allowance, results in a less efficient outcome.

The MEU notes that currently the Productivity Commission is undertaking a review of the use of benchmarking for electricity networks and the MEU considers the AEMC needs to address this issue as well in the context of the Commission's review..

Summary

The AEMC observes:

- "Under the NER, the AER has responsibility for approving NSPs' forecasts of capex and opex. The NER include detailed provisions about how the AER is to approve such forecasts.
- The AER is concerned the NER overly restricts its ability to interrogate and amend these forecasts, and that this means network costs are higher than efficient.
- The Commission seeks more evidence to understand the drivers for increases in network costs, and the extent to which the NER approach to capex and opex forecasts is contributing to this.
- The Commission will also confirm whether the policy settings for capex and opex allowances are consistent with the practices of other regulators in Australia and overseas."

The AER concerns are shared by the MEU regarding the AER ability to set efficient levels of opex and capex.

Whilst the MEU agrees with the AEMC that more investigation might assist in identifying the drivers for network increases, there is already evidence that the new rules have caused this

The MEU concurs with the AEMC that regulatory practices used elsewhere (including benchmarking) should be examined in order to improve the quality of regulation to ensure allowances are efficient

4. Capex incentives (and related issues)

The issue of capex incentives is a vexed one. The NEL and the NGL both require that there be an incentive to:

> "…promote economic efficiency ... The economic efficiency that should be promoted includes … efficient investment in a distribution system or transmission system with which the operator provides [the] services…"

It is true to a point that, as the AEMC puts it:

> "..... the current mechanism provides that a NSP will have to bear the costs of any overspend during a regulatory control period until the start of the regulatory control period. This is demonstrated in Figure 4.1 and Figure 4.2. There appears to be no other incentive in the NER on a NSP to overspend. The Commission is of the view that the capex incentives in the NER do not create an incentive for a NSP to spend more than its allowance in its regulatory determination" (AEMC, Directions Paper, page 40).

The AEMC conclusion is based on rather shallow analysis and does not delve deep enough into the financial incentives that are available to NSPs nor to the time value of money.

A review of the capex use patterns of NSPs indicates that not infrequently, there is a small under run in capex in the early years of a regulatory period combined with a large over run in the latter years with a resulting overspend for the whole period. In this regard, the small under spends in the early years can provide recompense for overspends in the latter years when the value of the underspend is calculated over time. The overspend in the final year hardly impacts the financial position of the firm as the overspend is immediately rolled into the RAB and receives a return in the first year of the new period. This assessment of the time value of under and over spends tends to eliminate the assertion of the AEMC (based on its simplistic analysis) that there is no incentive to over run on capex.

The MEU points out that overspent amounts that are automatically rolled into the RAB at the next regulatory reset earns a regulated rate of return over its regulatory life. In addition, if its cost of debt is about 6% and the regulated rate of return determined is pushed up to about 9% (as in NSW in 2009 in the post GFC period), there is a very powerful financial incentive for a NSP to spend more. Moreover, as it is widely known that the normal AER practice is to look to the fourth year opex and capex levels in the previous regulatory control period to estimate the base levels for the next regulatory control period, there is every incentive to inflate opex and capex levels in the latter years in the preceding regulatory period. This is a significant point missed by the AEMC.

The AEMC assertion also overlooks the very basic element of the building block arrangement. The development of the weighted average cost of capital (WACC) comprises two elements – a return on equity and a return on debt. As noted above, if the cost to the firm for its debt is lower than the allowance for debt, the only way to garner more profit is by increasing the RAB by more capex.

The other embedded incentive to overspend capital is also embedded in the WACC. The cost of equity comprises a premium (the market risk premium – MRP) above the risk free rate. The MRP is intended to return to the asset owner both the dividend and the growth in asset value as the MRP is the long term average of stock market premium above the risk free rate as measured by the accumulation index which sums the benefits of stock value growth with dividends. Thus embedded in the WACC is the profit to the firm. As with the debt premium, the only way to realise an increase in profit is by increasing the RAB.

It is worthwhile looking at the recent regulatory reset for Western Power Corporation (WPC) in WA. In WPC's application, it explained it's significant under spending in regulated capex and opex in the previous regulatory period was as a result of Treasury cut-backs in funding provision. In contrast, there does not appear to have been any funding restraint on NSW, Queensland or Tasmanian NSPs in the previous regulatory controlled period to overspend regulated allowances. In fact, at the AEMC workshop, one NSP participant pointed to "good reasons" for NSPs to overspend allowances:

- forecasts turned out to wrong
- exogenous events, e.g. the GFC
- security and reliability requirements

In other words, NSPs have so much flexibility to overspend and that the only control mechanism is the availability of capital. And especially in the case of NSPs with weak governance/financial control arrangements, there is really no control mechanism over over-spending. In the absence of any ex-post prudency or efficiency review over capex allowances and over-spending, the incentives are very powerful to exceed capex allowances. Worse, the lack of any supervision, relaxes any discipline for efficient capital and project implementation and management – after all, any exceedence of costs is not penalised but actually rewarded by the financial incentives to overspend.

The lack of any supervision of the capex spend (combined with its automatic rolling in into the RAB) is also a powerful incentive to overspend. In this regard, the AEMC is correct in referring to the MEU's rule change proposal for the optimisation of the RAB as this also deals with the 'supervision gap' referred to by the AEMC's consultant, Professor George Yarrow.

At the moment, there is no assurance that capex spent (the allowance plus overspending) is efficient or even prudent as, although the AER does investigate the arguments demonstrating the efficiency of the proposed capex when developing the ex ante allowance, there is no subsequent power that AER has in assessing whether past capex was actually spent on the projects used to demonstrate the efficiency of the capex proposal. In fact, the ex ante allowance can be spent on any asset .

The MEU understands that the WA regulator and IPART support the use of an ex-post review mechanism and would urge further discussions with these regulatory practitioners.

What is lacking from the Directions Paper is any discussion on how to provide the incentive regime on capex that is required by the energy Laws (see the first paragraph of this section). The AER has proposed that there be a "hard wired" limitation on the capex over run combined with an ability to vary the approach to depreciation (forecast vs actual). Whilst the AER proposals might not be the most appropriate method of applying this incentive to ensure capex is efficient, the entire discussion in the Directions Paper revolves around these two options. The AEMC has the power to identify "better rules" than those proposed but seems not to delve into the issue at all. The MEU considers that the AEMC has the responsibility to examine a "better rule" or, at the very least, canvass a range of options or set down a set of principles for setting capex incentive schemes.

In this regard, the MEU points to the practice used by firms in a competitive environment where the availability of capital is limited, in the absence of issuing more shares, to the use of retained earnings and accessing additional debt. Such constraints provide two very important imperatives – the limitation of capex (and thereby maximising its efficient use) and the need to devote that capex to those aspects which will provide the best return to the firm.

It is recognised that privately owned NSPs do experience some of the pressures of accessing capital experienced in the competitive environment but as noted above, government owned NSPs do not experience this to anywhere near the necessary extent. Considering that over 80% of the electricity network assets in the NEM are government owned, this issue is one that must be addressed.

Summary

The AEMC observes

- At present, once the AER sets a capex allowance, NSPs are not prevented from undertaking capex beyond the allowance. After a period of time any such "overspend" is included in the NSP's asset base which is used to determine overall revenues and prices for the NSP.

- The AER believes that this creates incentives for NSPs to incur more than efficient levels of capex.
- The AER has proposed a mechanism by which only 60 per cent of such overspend would be included in the asset base.
- The Commission takes the view that the NER do not provide NSPs with an incentive to spend more than the capex allowance, though there may be incentives on NSPs to defer capex, in an inefficient way.
- In addition, capex above the allowance is not subject to regulatory scrutiny at all, which also creates a risk that it may be inefficient.
- The Commission shares concerns raised by stakeholders regarding the EAR's 60 per cent proposal, and will consider a range of other options for dealing with the problems identified

The MEU concurs with the AER that there is an incentive to overspend capex and that the AEMC is wrong in its conclusion.

The MEU agrees that there is no ex post scrutiny and is of the view that this is a failing of the rules.

Whilst the MEU considers that the AER's 60% proposal could introduce unintended outcomes, it is important that this, or some other better option for limiting overspending, is established.

5. Rate of return frameworks and cost of debt

The MEU notes that the AEMC is being advised on the rate of return issues raised in this rule change proposal by SFG. Bearing in mind that SFG had previously and recently acted as consultants on rate of return issues to Western Power Corporation, Powerlink, Envestra and others in relation to regulatory reviews undertaken by the WA regulator and the AER, the MEU considers it appropriate that the AEMC also obtains advice from another set of consultants on this issue that have provided services to the AER and/or other regulators.

Such an approach would be essential in ensuring that the AEMC and stakeholders receive a balanced range of views on the issue of rate of return, considering that the effect of the rate of return has impacts more than 50-70% of each NSP's annual revenue requirements. A range of independent views also provides confidence and credibility to any final conclusion.

In appendix 1 the MEU outlines the paradoxes that are inherent in the current WACC development and its application to the overall process of setting an efficient regulatory allowance for an NSP.

5.1 The implications of the WACC development

The revenue and pricing principles in the energy Laws require that the regulated firm should:

> "… be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs …
>
> … be provided with effective incentives in order to promote economic efficiency …
>
> …[receive a] price or charge for the provision of [the] service should allow for a return commensurate with the regulatory and commercial risks involved …"

In the second dreading speech the Minister made it clear that the intent of the Laws and the associated rules is that consumers should only pay for the efficient costs associated with the provision of the service.

The clear import of these requirements is that the regulatory regime should result in the NSP receiving only the efficient costs for providing the service commensurate with the risks involved.

In the development of the WACC these requirements can be summarised into a number of conclusions

- The amount of debt allowed should reflect the actual costs of the acquisition of the debt ie the acquisition of debt should not be a source of additional profit to the firm

- The cost of equity should be the element where the firm receives its profit from the investment it makes in providing the services.

- The equity beta adjusts the return on equity to reflect the risks associated with the provision of the services.

Because of this, the Rules imply that all of the profit is embedded in the MRP and that acquisition of debt is intended to be a cost recovery element, with the NSP being driven to access its debt efficiently. However, a review of the annual reports of NSPs shows that NSPs (especially government owned NSPs) access debt at considerably lower rates than is allowed by the regulator in its decisions. To provide an allowance for the cost of debt that exceeds the actual costs of debt is not efficient as it provides incentives to invest inefficiently and increase prices unnecessarily. For example, since the 2009 decision by the AER for EnergyAustralia, EA paid for its debt at ~6% yet the AER decision provided for debt at a cost of nearly 9%. This provided EA a massive incentive to invest and also cause a massive increase in the cost of the services, well above the efficient cost.

It is also important to note that the NSPs (including the government owned NSPs) have seen that the rules can be interpreted to require the AER to allow even higher allowances for debt. As a result they have appealed the AER decision to the ACT to further increase the debt rates (which it did) highlighting that the NSPs are seeking to profit through the current approach to debt.

The debate about setting the WACC have all centred on assessing the various elements used to develop the WACC with little or no assessment as to what is the WACC that exists in a competitive environment. This is important as regulation is to impose competitive pressures by comparison.

MEU members have all advised that even they operate in a competitive environment their weighted costs of capital are the same (and in some cases lower) than the WACC developed for regulated firms. This external benchmarking of the WACC is readily available and provides strong supporting evidence as to the efficiency of the outcome.

5.2 Timing

The AER proposal suggests that there be a single WACC review every five years and the WACC parameters developed at that review be used unchanged for every regulatory decision until the next WACC review.

The first reservation the MEU has regarding this approach is that this approach when combined with the normal regulatory period, means that some parameters would be fixed for up to nine years, the five year period after the last WACC review to which would be added the five year regulatory period that would apply to the review of the regulated firm occurring in the fourth year after the WACC review. There is no doubt that the market parameters could well change more rapidly than this.

For example in April 2009 the AER determined that due to the Global Financial Crisis, the MRP should be set at 6.5% yet by the end of 2010 (only some 20 months later, the AER had reverted (backed by sound reasons) to the more traditional level of 6.0%. In its reviews of ElectraNet and SP Ausnet in 2012 and 2013, (three years after the AER had reverted to MRP of 6.0) the result of the WACC review in 2009 will still provide ElectraNet and SP Ausnet with an overstated MRP of 6.5 which will continue until 2018. This is not efficient.

This real example highlights the inappropriateness of the AER proposal.

5.3 Using a range for inputs

The Directions Paper posits a preference for using a range of values for inputs into the WACC development. Combined with this is a recommendation from the AEMC consultant that all parameters be subject to a merits review.

As has been seen for the ACT reviews of the gamma inputs, the ACT reviews of this element have resulted in an outcome that is at the far end of the reasonable range and some have commented that the current value for gamma determined by the ACT implies that the entire concept of dividend imputation really has little benefit.

The aspect of using the “reasonable range” for an input has resulted in the AER noting a drift in opex and capex values to the high end of the range rather than to the efficient frontier.

The AER has to determine a single point value for the revenue allowance so the use of a range merely adds complexity, a drift towards using the high end values and the ability of an AER decision to be appealed. It is recognised that many parameters in the WACC decision vary over time(in some cases over very short time periods) but it is important to note that the AER decision applies for a five year regulatory period so that it is important that some discretion must be allowed without the risk of having that discretion being subjected to an appeal.

The AEMC makes reference to the approach by IPART to using a range of inputs and from these identifying a specific value for the WACC. Whilst the IPART does this, it is the only Australian regulator that does this, with all the others (both now and in the past) assessing he reasonable range for reach input and then settling on a preferred value for each parameter. That the IPART approach has not been taken up by other regulators implies that the weight of regulatory practice is against this concept.

5.4 Use of different approaches

There is little doubt that the inflexible approach under Chapter 6A has created certainty but also it has created anomalies[3] - the value of MRP being one.

Equally, the gas rules provide significant flexibility which should have resulted in the AER recognising the approach it uses for setting debt risk premium was flawed and should be changed. To date, even though the gas rules permit the AER to use a different approach to setting the debt risk premium, it persisted in using the flawed approach because of regulatory precedent.

Under the gas rules, NSPs have sought to change the setting of equity beta by using a multi-part approach similar to partial factor productivities. The reason for this approach is not so much to achieve an efficient outcome but to gain an improved outcome above the basic approach in the statement of regulatory principles (SRP) used by the AER.

The concern that the MEU has regarding allowing a flexible and different framework, is that the approach described in the SRP will be used as the default position with alternatives only sought for an improved outcome. Such flexibility will be always in one way – that to increase the regulatory allowance rather than to approach the efficient boundary.

If external benchmarking of WACC (and the various indicators that results from the WACC calculation) is applied then there may be merit in assessing different approaches with the goal of developing a WACC which is demonstrably efficient. But to permit flexibility without any external benchmarking to show that the outcome is efficient is to open the entire WACC assessment to increased debate.

The AEMC discusses the use of “persuasive evidence” to vary WACC parameter inputs. The issue of “persuasive evidence” has resulted in considerable debate as to what this means. The NSP concern that its removal will prevent access to appeal is concerning to consumers, as it implies that they have a view the regulator will not be impartial. The entire process of regulation is premised on this view of impartiality. The MEU is of the view that the NSPs see that having the ability to have a “second bite” at every issue they see works against them should not be an aspect that is embedded in the rules.

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[3] For example there is a rule change proposal to vary the value of gamma used for TNSPs as a result of the ACT decisions.

5.5 A common rate of return

The AEMC addresses the need for a common rate of return approach.

It is concerning that there appears to be a view that there should be different approaches for the different energies. This is surprising as all the elements of the WACC (risk free rate, market risk premium, cost of debt, etc) are independent of the sort of energy used. The only element that might be different is the risk profile and equity beta is used to reflect the risk profile.

It is concerning that there is a view that the risk profile might be different as the development for the equity beta used for electricity networks is basically derived from the performance of gas transport businesses because this is the only data that is readily available for firms providing monopoly energy transport services. As the transport of gas is, if anything, more risky than transport of electricity due to the greater ability to substitute other sources of energy for gas, then this implies that the equity beta used for electricity transport should be a lower value than for gas, yet it is based on information from gas transport businesses.

For the NSPs to imply that there should be a different framework for gas and electricity totally ignores the facts of where the differences are and from where the values are derived.

5.6 Cost of debt

The MEU considers that the way the WACC is developed should not provide an unearned benefit from the way the cost of debt is calculated, because the most efficient outcome for consumers is where the allowance for the provision of debt should reflect as closely as is feasible, the actual costs for the provision of debt.

One of the concerns that surrounds the development of the cost of debt is that the assessment is circular in that the calculation of the debt is based on actual values. A debt risk premium is then calculated by educting the value of the risk free rate. The WACC uses the risk freee rate plus the debt risk premium to provide a cost of debt. It would be much more efficient and transparent to eliminate the development of a debt risk premium and use market values for the cost of debt.

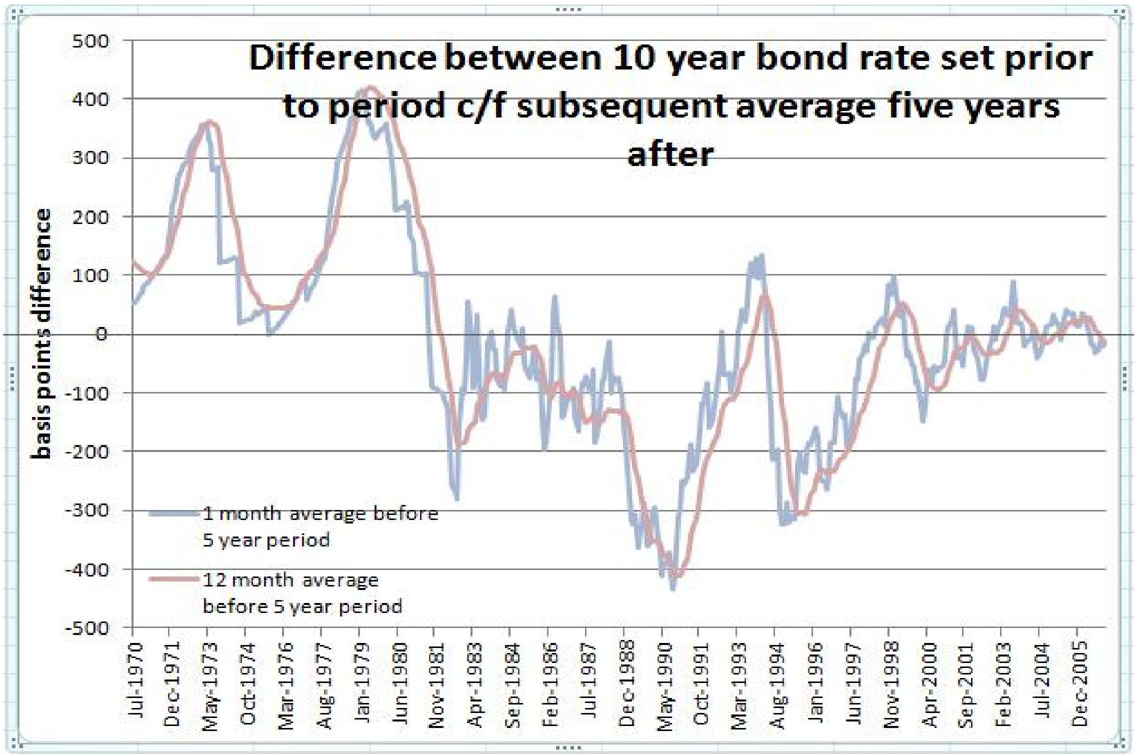
As the import of the Laws is that the cost of debt should be recovered (ie that the allowance for the cost of debt should reflect the likely actual costs that will be incurred) and not be a source of additional reward, then the focus should be on what constitutes the acquisition of debt which is efficient. As has been discussed extensively, debt is seldom acquired purely at a single point in time or from a single type of lender – efficiently sourced debt is acquired on a portfolio basis bfrom a variety of lenders over a variety of debt tenors.

If a firm can acquire debt more efficiently than a benchmark approach, then this sets a new efficient boundary which the firm should be encouraged to reach. For a regulator to knowingly grant a firm an allowance for debt in excess of the likely costs the firm will encounter (as is the case at present), this is not efficient and imposes on consumers costs that are unnecessary.

There are differences in the cost of debt for the different NSPs over time and between different ownership, with government owned NSPs being able to access debt more cheaply than private firms can. This means that the AER must have the flexibility to vary allowances for the cost of debt depending on ownership and to relfect changes that occur over time but with the constraint imposed that its allowances should not overtly include an unnecessary premium.

The MEU is intrigued by the aspect of the period over which trailing assessments are made. This applies in the case of the EURCC proposal (where the cost of debt is averaged over a period before the actual determination is made) and in the setting of the period over which the risk free rate is calculated. So far, no one seems to have assessed whether the length of the averaging period has a significanmt impact.

To this end, the MEU has looked at the risk free rate (10 year CGS) and assessed the degree of variance the averaging period causes. The following chart looks at the difference between the risk free rate averaged over a five year average (the regulatory period) compared to the risk free rate averaged over 1 month before the regulatory decision and also against an averaging period of 12 months before the determination.



Source: RBA data, MEU calculation

What the chart shows is that there is little difference between averaging over 1 month and 12 months prior to the start of the regulatory period and if anything the 12 month averaging eliminates many of the irregularities that are observed using the 1 month averaging period.

The outcome of this assessment is that the impact of a longer averaging (trailing) period probably provides a better outcome overall due to the smoothing effect – there would appear to be little downside from extending the averaging period.

The MEU is greatly concerned with the advice of the AEMC consultant (SFG) that

> "…the AER and EURCC have not presented substantive evidence that the cost of debt component in the rate of returns for NSPs and gas service providers are overstated" (Page 103)

This advice reinforces the view that the AEMC erred in seeking advice from a consultant that has an established record of providing input in relation to WACC on behalf of NSPs into regulatory reviews conducted by the AER. There is no doubt that, particularly in the case of government owned NSPs, the allowance provided for the cost of debt by the AER significantly exceeded the cost of debt the NSPs incurred. The MEU affiliates have all provided this information which is readily available from the annual reports of the NSPs[4]. Even the NSPs recognise that the cost of debt allowed by the AER exceeds their actual costs[5]. The SFG observation is disingenuous to say the least.

SFG also opines that the use of lower DRPs for government owned firms would lead to market distortion and permanent government ownership as it presupposes some future outcomes that may never occur. Again this is disingenuous and obviates the requirement that the services be provided at an efficient price which certainly does not embed a premium in the event thaqt something might occur at sometime in the future.

The AEMC makes reference to the need to ensure competitive neutrality in relation to the cost of debt and makes reference to the Competition Policy Agreement.

The MEU has advice from the Queensland Treasury Corporation that it has to implement the CPA and it provides debt to the Queensland government owned NSPs at debt rates that reflect their underlying stand alone credit rating. This means that the requirements of the CPA are not an issue for the AER or the energy Rules as the CPA requirements are implemented prior to the NSPs receiving the debt. It is therefore incorrect of the AEMC to imply that the cost of debt for NSPs has to be the same for every regulated firm as each has its own underlying credit rating that sets the cost of its debt.

It is not the role of the energy Rules to impose the requirements of the CPA – it is the role of the government lenders to do this.

5.7 Summary

The AEMC observes

- The NER and NGR allow for NSPs and gas service providers to earn a return on their investments. There is a different framework for determining the rate of return in electricity transmission, electricity distribution and gas.
- The AER proposes that these three sectors move to a single framework which most closely aligns to electricity transmission. Under this framework, there would be periodic reviews of the rate of return parameters, which are then fixed and apply to revenue/pricing

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[4] For example, in the decision on the NSW NSPs in 2009, the AER allowed for the cost of debt at nearly 9% whereas the annual reports of the NSPs all show the actual cost of debt was about 6%. This same outcome has applied to many other decisions. In the decision on NT Gas, the AER allowed for the cost of debt at some 150-200 bp above the cost of debt that NT Gas parent (APA) was securing on the open market

[5] Presentation at the AEMC forum in Queensland

determinations for NSPs under the NER and access arrangement decisions for gas service providers under the NGR.

- The Commission's view is that the current rules in this area are not satisfactory. In particular, the framework to estimate the rate of return for electricity transmission businesses does not provide sufficient flexibility to adapt to changing circumstances. The frameworks for gas and electricity distribution are preferable.
- The Commission's initial preference is for a single framework to be used across all three sectors (not necessarily the same parameter values), but will consider different frameworks for electricity and gas service providers.
- The framework(s) will continue to be based on estimating the WACC for a benchmark efficient firm. A benchmark efficient firm could be different for different electricity transmission, distribution and gas service providers
- The Commission's preliminary view is that the rate of return framework should not prescribe the methodology or values for parameters, but rather provide guiding principles.
- The Commission's view is that the rules should require the regulator to consider using ranges for certain parameter values and linkages between different WACC parameters when it applies them.

The MEU agrees with the AER and AEMC that the current framework is not satisfactory and the MEU agrees with the AER that a single framework is preferable to multiple frameworks.

The MEU agrees with the AEMC that the framework should be based on estimating the WACC for an efficient firm but that this benchmark must be tested in the wider market.

The MEU agrees with the AER and the AEMC that there needs to be less prescription in the setting of the WACC but, as noted above, the outcome needs to be tested against a much wider range of actual WACCs seen in the competitive market place to ensure that the outcome is efficient.

The MEU does not agree that the use of a range of parameter inputs will improve the process and that it has the potential to lead to more appeals to the ACT and to drive outcomes to the high end of the range.

The AEMC observes:

- An important component of rate of return decisions is the cost of debt allowance.
- The AER and the EURCC consider that the current approach to the cost of debt in the NER is not optimal.

- The AER proposes that the cost of debt methodology should be left to its discretion in the periodic review of rate of return parameters.
- The EURCC proposes a new benchmark cost of debt for privately-owned NSPs, and that the actual cost of debt should be used for government-owned NSPs.
- The Commission shares the view that the current approach to the cost of debt in the NER is problematic, though it does not agree there should be a different approach depending on whether a NSP is government-owned or privately-owned.
- The Commission's initial view is that the cost of debt methodology should not be detailed in the rules, but should be determined by the regulator.
- The Commission is seeking further comments and analysis on whether the EURCC's proposal to use the trailing average approach to estimate the cost of debt should be an option available to the regulator under the rules.

The MEU shares with the AER, the AEMC and the EURCC a view that the current approach to the cost of debt delivers outcomes that do not reflect the cost of debt incurred by the NSPs and that change is necessary to ensure that the allowance for the cost of debt is efficient.

The MEU agrees with the AER and the AEMC that assessing the cost of debt should not be hardwired into the rules and that the AER should have discretion as to what allowance should be used.

The MEU notes that the cost of debt actually incurred by government owned NSPs is considerably lower than the cost of debt incurred by privately owned NSPs and a common approach to both would provide government owned NSPs a source of additional profit and a cost imposition on consumers that is not efficient. To overcome this anomaly the MEU considers that the Rules should provide guidance to the AER that the allowance for the cost of debt should be efficient and should reflect the likely costs the entity will encounter in sourcing its debt.

Increasing the averaging (trailing) period does not appear to provide a disincentive to using a longer period and perhaps provides a more consistent outcome.

The MEU reiterates its recommendation that the AEMC seeks wider advice on the WACC issues.

6. Regulatory determination process

The MEU makes it quite clear that it supports all of the AER rule change proposals except where it specifically disagrees. The MEU's experience over 15 years of energy regulatory reviews supports the AER contentions that the current rules unnecessarily constrain good regulatory practice and restrain the ability of stakeholders to provide the maximum of useful input to the regulatory processes.

The processes require the AER to hold two public forums but these have degenerated into an opportunity for the NSP to present its application and than at the second, for the AER to present its draft decision. Whilst there has been some instances where consumers have presented their views at these forums, this has been at the instigation of the stakeholder which has very limited time to review and provide competent comment of the application or the draft decision. These forums seldom provide the opportunity for significant debate on critical aspects. The AER has much work to do to improve the existing processes.

The MEU has participated in nearly all major regulatory pricing reviews under both the previous codes and the current NER/NGR and based on that experience considers that:

- The AER and stakeholders should have enough time to scrutinise material provided by a NSP in its initial and revised regulatory proposals, as well as for stakeholders, enough time to scrutinise the AER's consultants' reports which currently are only made available at draft decision time, thereby placing enormous pressure on stakeholders' capacity to properly scrutinise both the consultants' reports and the AER draft decisions.

- To this process is added the need to scrutinise the revised NSP application which should not contain significant material from initial applications or the AER's draft decisions. What has been seen is that the revised application process has resulted in new information being provided which has limited time to assess and where stakeholders cannot see the AER response to the added information. Under the NGR, the use of the revised application has allowed circumventing of detailed stakeholder input to the revised information.

- The MEU agrees with option 1 (creating a new consultation step in the regulatory determination process) supplemented by a mandatory regulatory Issues Paper at the time of the initial application

- The MEU agrees with option 2 (extending the period for NSPs to submit revised regulatory proposal) but allowing additional time for stakeholders to consider the AER position on the revised information(this implies that there be an additional step where the AER publishes its views on the revised application and additional information

- The MEU agrees with option 3 (commencing the regulatory determination process earlier) provided stakeholders are brought into the process at an earlier stage; hitherto the process has been on a bilateral basis between AER and NSPs – it would be useful for NSPs to relate with consumers, especially in areas such as demand and consumption forecasts and capex proposals. This is an approach used successfully by state based w=energy regulators where aspects of specific concern were addressed well ahead of the applications and where other stakeholders were involved in the process.

- The MEU does not see where option 4 adds value to the process. Merely delaying the determination for a set period after the receipt of the last piece of information does not provide other stakeholders with the option of addressing their concerns or seeing the AER reaction to the latest information. What option 4 does is to provide pressure on the NSP to be diligent in providing its information but only if the start of the new regime is deferred until this period of time is over.

- The MEU agrees with option 5 (restricting the scope of NSP submissions) as currently stakeholders have little opportunity to scrutinise NSPs voluminous submissions, especially those where the revised applications contain extensive additional information and changes and where stakeholders have not seen the AER views on the revisions and added information..

Claims of confidentiality

The MEU supports the AER proposals with respect to confidentiality claims. One related issue is the increasing use of related party transactions by some NSPs so that a trend has emerged whereby they represent a rising proportion of total opex and embed cost premiums in capex claims. Where these related party transactions are also claimed to be "confidential", stakeholders are unable to scrutinise the opex and capex claims in their entirety. The AER's proposals reflect stakeholder concerns.

Summary

The AEMC observes

- "The NER set out, with some prescription, a process by which the AER is to determine revenues (and in some cases, prices) of NSPs.

- The AER has raised a number of issues that relate to the ability of stakeholders to engage effectively in the regulatory determination process. Related to this is whether the AER can adequately consider all material submitted as part of its process.
- The Commission shares some of the AER's concerns but considers that as well as specific amendments to the process it is necessary to consider the process as a whole to ensure stakeholders have sufficient opportunity to provide input and the AER has sufficient time for its decisions.
- Process issues must be considered alongside the other issues raised."

The MEU notes that the AER has raised the concerns that stakeholders have regarding the processes, other than that of stakeholders being specifically involved in the two forums currently required under the rules. Generally stakeholders are considered to be an adjunct to the processes rather than an integral part. The AER proposals would increase the opportunity for greater stakeholder involvement.

The MEU agrees with the AEMC that the entire regulatory process needs to be addressed to maximise stakeholder involvement and adequate time to make proper decisions

7. Response to specific AEMC questions raised for the Forum

In the tables below the MEU provides responses to the specific questions raised by the AEMC for discussion at the forum on this rule change proposal. These responses were prepared by the MEU in preparation for the Forum and provide a useful expansion of the views of the MEU.

The reasoning behind the responses is partly explained by the commentary in the preceding sections and is also derived from MEU experience in being an active advocate in almost all regulatory reviews carried out under the Electricity and Gas Codes and then under the Gas and Electricity Rules developed in the second half of the last decade.

Workshops 1+5 questions – Capital expenditure and operating expenditure allowance

1. What are the key reasons for rises in network prices? To what extent do deficiencies in the NER contribute to this?	• Overstated DRP, opex and capex claims and allowances. • Inability of AER to correct these sufficiently due to the inherent conflict between the claims and the self benchmarking, the AER having to accept a "reasonable" value and the AER having to prove its view its correct rather than the onus being on the applicant • Overstated demand leading to overstated augmentation • Profit lies in the MRP which is used on asset value • There is an implicit assumption in the rules that consumers will pay whatever is decided for each element – there is no requirement to assess ability to pay • One of the main criticisms of the AER compared to the state regulators is that the state regulators carried out considerable investigation well ahead of a reset review, examining the forecasts of demand and consumption, setting the basis for assessments of WACC, opex and capex, and then carrying out much more detailed analysis than the AER. One of the reasons for this is that the AER has less time from the rules

	• AER public forums have become presentation forums by the applicant and the AER rather than provide for debates on issues. This again relates to the way the rules are crafted
2. Has the AER been constrained in practice in assessing expenditure forecasts? What are the practical constraints experienced by the AER in assessing expenditure forecasts?	• Yes. • Onus of proof, benchmarking minimised and other assessments given equal or greater weight (eg claims by NSPs, relative prices, consistency with incentives, alternatives, substitution, etc) • In private commercial enterprise, capex has an upper bound as to what the business can afford. Opex is set by what the market will pay for the products that are sold. The AER is intended to provide a surrogate competition but cannot do this • To a degree private NSPs have a constraint on capex but not on opex. Government NSPs are generally less constrained than either private NSPs or commercial enterprises • Essentially opex is open ended for regulation but in competitive business opex is limited by competition
3. Could the wording of the NER be amended to better reflect the policy intent in respect of capex and opex allowances?	• Yes. • Capex and opex must be efficient, but the current approach allows the NSP to determine what is efficient and the AER must prove otherwise • The rules should aim to reflect what occurs in the commercial world and the constraints competition imposes (eg limiting capex by availability, limiting opex to what the market will stand) • Competition is sees as leading to the most efficient cost structures, so the wording of the rules needs to lead to this outcome
4. In the process for setting expenditure allowances, should either the AER or the NSP bear an "onus of proof"? Is there currently an onus of proof?	• NSP should be required to prove the AER allowance is too low. The NSP has much more information than the AER and therefore is more able to prove its needs • Yes AER has onus on proving allowance is overstated and AER must accept a reasonable allowance even if this is high end

5. Should the AER be required to accept forecast expenditure that is reasonable, even if it is of the view there is a better estimate of expenditure? Does this mean the AER needs to start by identifying a reasonable range?	• No. • An allowance needs to be a single amount. Having a range will lead to the upper bound becoming the allowance and this is not provide an efficient figure • A major issue is the use by NSPs of related parties. There is an assumption that using related parties is more efficient but equally there is the risk that using related parties allows the ultimate owner to inflate profits above the efficient level. Using past expenditure couples with good benchmarking sets a cost independent of related party costs.
6. Should the AER be free to use a number of different techniques to assess an expenditure forecast proposed by a NSP? What are examples of these techniques? In addition to these other techniques, should the AER be required to undertake a line by line assessment of the proposal in every case?	• The outcome required is that the costs be efficient. In practice this can only be assured if there is strong competition. • This means that the techniques used must be driven by competitive outcomes. To use techniques that are not based on competitive outcomes should be excluded • It is impracticable to carry out a line-by-line assessment as this will lead to an overstated outcome • In a competitive business, middle management develops a line-by-line allowance and senior management determines what is sustainable for the business, bearing in mind the competition. The AER must provide this senior management role and determine what the allowance must be. The NSPs then allocate the allowance how they see they can deliver the best service.
7. Are there any circumstances of a NSP which the AER should not take into account when it benchmarks against other NSPs?	• Good benchmarking must reflect a reasonable body of comparative performance. To do less leads to arguments as to why each NSP is different and how to adjust for the differences. (eg in Germany where DNSP benchmarking is used extensively there are some 200 DNSPs in an area less than half NSW). • Incentivised self benchmarking provides a good start but this must be moderated by benchmarking with similar NSPs • Attempting to adjust a benchmark allowance to reflect future trends is fraught. (eg allowances tend to be on the high side at consumers expense – see AER ability to

	forecast $A/$US)
8. Should the AER be required to have published in advance any material on which it intends to rely in a draft or final determination? Or, is it more appropriate that the material be published at the same time as the determination in which it is used?	• If the rules allowed more time to assess specific aspects (as the state regulators used to do) then the AER can provide more information on the way they intend to review a specific reset • Applicants don't have to provide back up information and argument until an application is made. Until this information is available, the AER cannot properly respond to specific aspects. • The WACC review was intended to eliminate some of the arguments but each applicant still tries to improve their position at each reset. All that happened was those NSPs that could, accepted the good bits of the WACC review and argued again against the bits they didn't like

Workshop 2+6 questions – Capital expenditure incentives (and other related issues)

Capex incentives	
1. In its directions paper the AEMC stated that the national electricity rules (NER) create an incentive for network service providers (NSP) to defer capital expenditure (capex) until the end of the regulatory control period. To what extent is this a problem and does it matter?	• The Rules already provide an incentive for NSPs to invest in assets as the profit they get is embedded in the WACC. Increasing investment increases the RAB which, when multiplied by the WACC, provides the profit generated by the NSP • This incentive is exacerbated in the case of Government owned networks where these firms access debt at a rate considerably lower than the allowances provided under the current rules. Eg since the 2009 decision on EnergyAustralia, it paid for debt at ~6% yet the AER provided for debt at a cost of nearly 9%. This provided EA a massive incentive to increase its RAB. • Yes, it is a problem. The capex program allowed by the AER is based on a number of expectations and requirements, including continuing reliability and meeting needs of customers. Deferring capex puts these at risk • The capex program allowed is intended to deliver an efficient outcome. Delaying

	the program results in the NSP gaining an unearned profit which they can retain. • Delaying the investment until the end of a regulatory period minimises their risk as the investment is immediately added to the next period RAB. • If the investment could have been delayed until the end of the period, then it is more efficient to have this built into the capex allowance in the first place. • Further, by backloading the capex, there is an impression provided that the next period capex needs to be higher when the past capex is used as a guide to setting future capex as the AER is known to use the 4th year capex and opex as the "efficient" level of future opex and capex. • We have also seen capex deferred for an entire period and then added into the next period, so that consumers pay the WACC on capex never used but paid for. This is not efficient
2. Why might a NSP spend more than its regulatory allowance for a regulatory control period, given the existence of an uncertainty regime; that some projects identified in a NSP's proposal will not need to go ahead; and that NSPs may have an ability to defer some capex?	• An NSP might need to spend more capex than it forecast for a variety of acceptable reasons. It is not the project itself that should be questioned, but the process of using capex by the firm. • What happens in a competitive environment is that the amount of capex is fixed and is limited to what the firm can afford. To seek additional capex needs quite extraordinary reasons. Therefore it is most unlikely that in a competitive business added capex will be provided and other projects will be "bumped" so that the allowed capex is not exceeded • NSPs are insulated from this if the capital is accessible as by deferring the investment to the end of the regulatory period, they know that the capex will be rolled into the RAB and a return generated. This means that less critical capex will still be made when it would be more efficient to defer the less critical capex and insert the more critical project • If there was an ex post review of the capex then the less critical project might not be accepted into the RAB. This imposes a discipline to ensure that capex is

	incurred in the most appropriate way.
3. A criticism of the AER's 60/40 proposal is that it is too prescriptive and does not allow for flexibility in application between NSPs. What factors should be taken into account in setting capex incentives for NSPs and why might capex incentives need to differ between NSPs?	• The imposition of an ex post review of all capex incurred will impose the necessary discipline to ensure capex is incurred in the most efficient way. • Capex should be limited to what has been allowed and no more (just as occurs in competitive business. This imposes the discipline to use capex on the most important areas. The contingent project process allows for the extreme situation where failure to incur capex will impact users • The AER approach will impose some discipline but might prevent essential projects from being implemented to the disadvantage of users
4. To what extent would a capex efficiency benefit sharing scheme (EBSS) deal with the issues identified? What are the advantages and disadvantages of a capex EBSS? How can any perverse incentive to defer capex from one regulatory control period to the next under an EBSS be dealt with? Should an EBSS be required to be symmetrical?	• The purpose of an EBSS is to drive the firm to minimise the expenditure and to use the reduced expenditure as the benchmark for future allowances. Capex doesn't fit easily into this mould as capex can be deferred into the next period allowing the firm to retain the return of and return on the unused capital. Capex can also be more lumpy than opex (which works well with an EBSS) so another approach is needed to drive the firm to minimise the actual spend on a project and not allow excessive capex in the first place. • Ex post reviews provide a mechanism to minimise project over-runs. • Forecast depreciation provides an incentive to minimise capex in a period, but does not prevent the transfer of the same project to the next period • Limiting capex and prioritising projects within the allowance prevents capex over-runs • Probabilistic capex setting allows considerable freedom to the NSP but acts against regulatory management of the capex allowance. Deterministic capex setting allows the regulator to allow the re-prioritising of projects within an overall capex budget and this is how competitive business works and how the NSP Board should operate. • Under a deterministic approach, the AER could allow the replacement of one

	project with a more urgent one and so overcome the problem of deferring a project to the next period. If there was no replacement project, then the deferred project would not be added to the next period capex.
5. How effective are ex-post prudency reviews for dealing with inefficient capex? What are the incentive effects of an ex-post prudency review? What are the practical implications for stakeholders of an ex-post prudency review?	• Ex post prudency needs to be enforced and rigorously applied for it to be effective. Once seen in this guise, it will become a deterrent. No regulator has yet really challenged a capex amount so the process is seen as ineffective. • In a competitive environment, capex over-runs are seriously addressed because capex is limited affecting other projects and the planned return on the capex is reduced. This doesn’t happen to NSPs • The expectations of the RIT are based on a certain capex amount. If the capex is exceeded, then the RIT might not hold up. Therefore the budget for a project must be maintained regardless and over-runs not allowed into the RAB
6. What role could consumers have in the setting of capex forecasts and assessing capex efficiency?	• The RIT is the tool to ensure the investment is efficient and sustainable. The RIT is predicated on a certain amount of capex and this should be the limit of the capex allowed for the project
Actual or forecast depreciation	
1. How does using actual or forecast depreciation to establish an NSP’s opening regulatory asset base affect an NSP’s behaviour? Could external factors affect which form of depreciation is more advantageous for a NSP?	• The issue of which is used comes back to the issue as to whether the AER wants to be punitive or not. The NSP will want to use the approach that gives the better return at the time. The AER can accept the selected approach to reward or the other which will punish • It should not be discretionary which form to use or that one be used one period and the other at the next • What the approach is intended to do is to prevent over-runs at the end of the period or prevent under-runs in a period and defer a project to the next period
2. If the AER were to have discretion to use either approach at the time of a determination should this discretion be	• See answer to Q1 above

guided, and if so, how?	
3. If a particular approach is prescribed in the NER which approach should be prescribed?	• This should be set when the preferred approach to the answers to Q4 on EBSS is determined.
4. Would stronger capex incentives in other parts of the NER impact on stakeholders' views as to whether the AER should have discretion?	• Yes, see answer to Q3 above
Uncertainty regime	
1. Why should contingent projects and capex reopener mechanisms apply to electricity distribution?	• They shouldn't. • The reason given for these to apply for TNSPs is the lumpy capex that TNSPs face and the uncertainty of when and where for generation investment • Distribution has few very large projects and most are small and therefore capex is more easily redirected to higher priority projects • Competitive business has few options in providing for the contingent projects and reopeners due to the constraints on acquiring capital and there is a sound argument that they should not be allowed for TNSPs • TNSPs should be required to set their capex on approved projects (deterministic) and then reprioritise the projects as necessary, just like competitive businesses do. If there is an overwhelming need, then they need to prove to the AER that reprioritisation can't work and that consumers will suffer if the project does not proceed in the current period.
2. How might the impact of cost pass throughs, capex reopeners and contingent projects on changes to retail prices be minimised?	• It can't easily be done and therefore should not be permitted • Projects should be reprioritised to take forward essential projects and others deferred. Projects deferred in this way can be re-entered in the next period • If there prices were to be held fixed, then the project costs could be borne by the NSP and the return on and of the capital within the period could be capitalised and the inflated capex amount introduced into the RAB for the next period. This is not

	supported as it adds an unnecessary cost to consumers. It would be better to reprioritise the project
Related party margins and capitalisation changes	
1. Comment on whether capex incentives differ between NSPs that engage related parties and those that do not?	• Yes, in that an NSP would use the best approach that returned the maximum to the overall corporate identity. This is option is not available to those NSPs without related party ties. • Neutrality requires that the same approach must be used for all.
2. If there were stronger capex incentives in general would there be a need for specific incentives to deal with related party issues? If so, why?	• Yes, because there is an incentive to overstate the capex needs behind the veil of secrecy. The AER would have to have the right to examine the books of the related party to ensure that the costs were reasonable. • It would be better if the work was openly tendered so there is no veil
Other incentive schemes	
1. Comment on whether the AER should be given the power to develop and implement pilot or test incentive schemes within a controlled environment?	• Yes • This allows the development of the most efficient outcome because implementing capex incentives is a challenging task
2. What limits should be placed on the extent of these schemes?	• This needs more work

Workshops 3 + 7 questions – Rate of return

Part A - Frameworks

Existing frameworks	
1. Comment on the AEMC's initial assessment that:	• Ch 6A is inflexible and has resulted in MRP set at the height of the GFC applying well after a lower MRP is considered appropriate. It also reflects the current low 10

• Chapter 6A framework for TNSPs is inflexible to deal with changing market circumstances. • Chapter 6 framework for DNSPs provides flexibility but does not allow the regulator/Tribunal to consider the inter-relationships of parameters where persuasive evidence is found to depart from the WACC review values. • Gas framework has many desirable qualities of flexibility, but lacks guidance leading to open-ended debates and, consequently, the rate of return framework under the NGR is influenced by the WACC approach adopted for the electricity sector.	year bond value which is probably insufficient to provide a reasonable WACC with the current parameters. There must be some method that allows changes in the market to be implemented • Ch 6 is better than 6A but there is only a review of specific parameters rather than a holistic review • NGR is too open ended and the AER SRP becomes the default approach which leads to argument • A big issue is the RFR used which varies considerably but the parameters used are relatively fixed, creating considerable volatility in the WACC calculated at each reset. Using a spot value for the RFR leads to problems (eg the current Powerlink review)
2. What are the attributes of a good rate of return framework? Which rate of return framework would best meet attributes such as: • estimating a rate of return for benchmark efficient firms; • allows methodologies for parameters to be driven by principles and reflect current best practice;	• A rate of return varies with the type of task the funds are to be used for. The more speculative the investment, the higher the return needs to be. Funds invested to stay in business will be lower than the return on discretional investments • The return on an investment recognises that accessing debt is a cost to the business. The real return on an investment is the profit a business generates. This profit is usually allocated part as a dividend paid to shareholders and the balance as retained earnings to be reinvested in the business and the amount retained for reinvestment reflects funds needed for capex. The proportions of each reflect the needs for capex in the coming period but as a rough rule of thumb the ratio is

- allows flexibility to deal with changing market conditions; - recognises the inter-relationships between some parameter values; and - creates a framework of accountability for both the regulator and the NSP/gas service provider in determining an appropriate rate of return.	usually 50/50. - Competitive business has a cost of capital that is the outworking of how the finances are developed. They are flexible and look to minimising the cost of money used - The problem with the development of the WACC is that it is a regulatory input whereas in business it is an output, reflecting a range of activities and mix of funding sources. - The cost of money is always changing and does not remain constant for 5 years, even allowing for changes in RFR - Benchmarking a calculated WACC against historical WACCs seen in firms with a similar risk profile would help - Instead of developing a WACC to apply to assets, it would be better to separate equity from debt. The return on debt would be the actual cost benchmarked against efficient acquisition of debt. - The cost of equity would reflect retained earnings and an efficient dividend reflecting the risk of the investment.
3. How should the rate of return framework balance the need for investment certainty and predictability against the need to have a flexible framework that can respond to changing market circumstances?	- The pre tax WACC awarded in regulatory reviews is similar to the EBIT/assets employed seen in financial reports. Regulators do not like to compare these because WACC is an economic assessment whereas EBIT is a financial one and (supposedly) subject to manipulation. However an EBIT assessed over a large number of businesses cannot be manipulated. It is the EBIT that an investor in a company looks at as a source of information (along with many other aspects). Similarly WACC is the outworkings of the outcomes of many businesses - A large part of the WACC is related to debt and the cost of debt varies continuously. Firms access their debt to reflect their needs on an annual or biennial basis and only part of the debt is exposed to renewal at any one time. - Debt is accessed from a variety of sources to provide the lowest overall cost over a

	period of time. It is not valued at a single point in time • A large proportion of the funding comes from retained earnings which can be related to the value of dividends paid
Future common framework	
4. Explain the 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?	• The dividend an investor seeks for investment of equity reflects the risk of the investment. Electricity is a very low risk investment because it cannot be replaced by another energy source – the demand for electricity might fall for a short period but its use is related to population and industry needs for motive energy • In contrast gas is mainly used for electricity or thermal needs. Therefore gas supply has some protection due to its involvement in electricity but is more susceptible to competitive pressure as there are other sources of thermal energy. Intuitively, electricity is more secure as an investment than gas and should have a lower return on equity. • Electricity transmission and distribution have similar risk profiles: transmission relies on the continuing supply locations of generation, and distribution is more susceptible to population and industry movements. On balance they probably has similar low risk profiles.
5. Would it be useful if the regulator 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?	• What parameters are subject to variability? RFR, DRP, MRP, beta, gearing, gamma • The RFR is published daily and varies considerably over time. The real issue is whether the RFR should be a spot price or calculated over a longer period to smooth out daily perturbations. • Debt should be treated as a cost like opex and an incentive regime established to drive debt to the lowest value. To prevent it rising unnecessarily, the debt allowance should be benchmarked. • MRP is where the profit for a regulated firm is provided and needs to reflect the risk of the business. Intuitively, the risk for a regulated energy transport business is

	very low (because its returns are consistent but lower over time it is frequently referred to as a defensive investment). • There are businesses (such as IBISWorld) which can provide real world outcomes, averaged to eliminate specific company bias and thereby identify real MRP and DRP values • Gearing is assumed to be 60% debt, but in most cases regulated firms have a higher debt level and still generate lower debt costs than is calculated b y the AER
6. Compared to the current approach of making a point estimate for each parameter value, what would be the advantages and disadvantages of the regulator being required initially to estimate a range for each parameter value and then choosing specific values and an overall WACC at each determination or access arrangement?	• The regulator needs to set a single figure so there is a set allowance for the future revenue. So ultimately a single point is needed. • Using a range for each parameter then can develop an outcome which has an even wider range. The regulator then has to develop a single point within the overall the wider range. This then results in less certainty for both firm and consumers as to what is the final answwer

Part B – current approach to cost of debt

1. To what extent is the current approach to cost of debt estimation in Chapter 6 and 6A problematic? Should the benchmark corporate debt rating, maturity and the risk free rate tenor be determined at periodic reviews or should it determined at the time of the determinations/access arrangements?	• The current approach is giving an inflated answer compared to the actual costs incurred, and thereby providing a higher source of profit • Interest on debt is a cost (like opex) and debt cost should reflect the actual conditions and ability of the NSP to get debt. • Debt comprises a range of sources, rates and tenor to get an overall outcome. It does not have a single source. This means that the historical cost of debt should provide a guide to the cost of debt into the future • Government owned firms get debt their debt from as single source and with a flexible tenor to reflect needs

2. Comment on whether the current benchmark DRP approach is 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?	• The current approach overstates the cost of debt. This is obvious when the actual cost of debt is measured against the outcomes of the current methodology. This used not to occur prior to the GFC so the methodology used is not consistent. • The evidence is provided by measuring the cost of debt allowed by the AER to the actual cost of debt incurred and shown in annual reports. In this regard it must be recognised that over 80% of all electricity networks are government owned • It is obviously inefficient to source all debt for the reset period as no NSP does this. Government owned NSPs get debt as they need it from their T-Corps against an pre-agreed facility and private NSPs access debt from a range of sources and a variety of tenors. • If the varying (shorter) maturities increased risk, then why do it? In fact have a variety of sources of varying tenors reduces risk. • The fact that generally firms use a range of tenors and sources indicates the fallacy of this statement • Longer term debt usually costs more because there is greater risk to the lender rather than the borrower
3. What are your views on the AEMC's initial position that differential cost of debt for government-owned and privately-owned NSPs is not appropriate?	• Debt is a cost to each NSP, not a source of increased profit. If a government owned entity can access debt more cheaply than its private competitors, then its allowance should reflect this. By having a common cost of debt merely increases the profit the owner of the government owned NSP gets and essentially becomes an indirect tax.
4. What are the pros and cons of the recent approaches taken by IPART and the ERA in estimating the DRP?	• The IPART and ERA approaches more closely reflect the reality of accessing debt by businesses. Most businesses have a portfolio of debt with differing sources, tenors and rates as this provides an overall lower risk to the businesses • This approach still does not recognise that there are different sources of debt (other than corporate bonds) or that the sourcing of debt is not intended to be a source of profit but a cost recovery exercise with downward pressure to ensure

	firms still seek the lowest overall cost of debt
5. 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?	• The EURCC approach highlights that the DRP awarded for the past 5 years is too high when compared to the actual cost of debt incurred by the regulated firms, especially government owned firms. • We have consistently used a trailing average of 100+ years for MRP as this smooths out short term fluctuations such as we are seeing now (where the growth element of the share index has been flat for a number of years • Throughout the discussion, the issue of using trailing data (and the length of the trail) is seen as an issue for setting a forward looking estimate. What is not discussed, is no one knows what the future will be (see AER estimates of $A/$US). The future estimates are all expectations, not actual. There is documented evidence that generally expectations overstate actual outcomes. Therefore to use expectations will upwardly bias WACC developments
6. 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?	• Trailing averages smooth out short term fluctuations. • Interestingly the MEU has carried out some assessment of using trailing averages of 1-2 years against the next five years looking at the RFR. Whilst there have been some anomalies in the outcome, there appears to be marginal difference overall when the trailing average is less than 1 month. It could be that a trailing 5 year average gives a better forecast for the next five years than a 1 month trailing average. This should be investigated

Workshops 4+8 questions – Regulatory process

1. What would be the effect of delaying the final regulatory determination when the AER receives a late material submission from an NSP and requires additional time to consult	• A better outcome. • However it must be realised that the NSP has the most time to develop its application and the AER has limited time for the review. There have been experiences where an NSP has massively changed its application at the revised

and assess the late submission?	application stage (NT Gas) effectively resulting in almost all of the previous assessment being made redundant. • Once an initial application has been submitted, there should be no avenue for the NSP to significantly revise its application. A revised application after the release of a DD should only permit changes to reflect the DD and not be an avenue for new or expanded claims to be made • It must be realised that an NSP will spend years in developing its initial application. To introduce new information which changes the initial application at the revised application stage should not be necessary and defeats the purpose of having a DD on the initial application
2. What would be the effect of including more consultation stages in the existing timeframe for the regulatory determination process?	• More stages are supported. The stages could address aspects that will not change over time and provide clear direction to the NSP. Once determined, there should be no changes permitted to the aspects addressed earlier • This process has been successfully used by state regulators, but more time is needed than currently allowed. • Additional stages but in the current time frame will not improve the process
3. What would be the effect of commencing the regulatory determination process earlier (say 6 months)?	• The extra time as to be used to set in stone various elements and there should not be changes permitted • Settling on certain elements will allow better utilisation of the reset process to properly investigate claims and to set efficient allowances
4. Are there any other additional steps in the process that could facilitate engagement by all stakeholders in the process?	• Yes. • Revised applications need to be limited to addressing issues where the DD differs from the initial application. The revised application should not be used to introduce new material or to increase claims. • There needs to be adequate time between the revised application and the closure of comments on the DD and revised application. • Allowing new information at the revised application stage does not allow

	stakeholders to see how the AER will react to or address the new information and the increased claim. This bypasses stakeholder review • The AER commissions consultants to review specific aspects of applications and then issues these reports with the draft decision. State regulators and the ACCC used to release these consultant reports earlier than the release of the DD so that stakeholders could review these (and make comment) prior to receiving the DD. This improved the work flow for stakeholders considerably and reduced the amount of work stakeholders had to do in the period between the release of the DD and the response to the DD
5. Are there actions that could be taken by the businesses and the AER outside of the formal process that could improve engagement of all stakeholders, in particular, consumers and their representatives?	• Yes, but only to a limited extent. • Releases by NSPs prior to an application tend to be aspirational and have insufficient information to make informed comment • NSP consultative forums tend to support the NSP claims and they can do this in isolation of knowledge of what the total cost will be to consumers • Consumer input needs to be aware of all of the elements of an application (especially the cost impacts) to give informed input • Consumer input into addressing specific elements assessed prior to an application (as the state regulators used to do) is a better forum, but the input has to be fully informed. The regulator is more likely to do this than an NSP • Release by the AER of its initial view of an application would better provide informed comment from stakeholders. The release of an issues paper by the AER on the application is seen as beneficial and has been used successfully by the ACCC and state regulators
6. If the framework and approach paper becomes an optional stage in the regulatory determination process, what is the best trigger for instigating a framework and	• This must clearly detail what is to be achieved by the earlier assessment of the aspects to be assessed and there should be no ability to reopen the aspect once it is determined • However the framework paper does not address specific issues that could be

approach paper stage?	addressed and locked down such as was done by the state regulators
7. Is the proposed “stop the clock” mechanism the best solution for addressing complex NSP applications related to cost pass throughs, contingency projects and capex reopeners?	• Yes • Time constraints work against the AER in doing its task properly. An approach such as “stop the clock” puts pressure back on the business to provide adequate supporting argument. The NSPs state that this will slow down investment so it puts pressure on the NSPs to ensure they provide all of the necessary information so the AER can make a faster decision

8. Response to specific AEMC questions in the Directions Paper

In the table below the MEU provides responses to the specific questions raised by the AEMC in its Directions Paper. The reasoning behind the responses is partly explained by the commentary in the preceding sections and is also derived from MEU experience in being an active advocate in almost all regulatory reviews carried out under the Electricity and Gas Codes and then under the Gas and Electricity Rules developed in the second half of the last decade.

	Chapter 2 Framework	
1	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 requests?	The Commission's broad assessment approach is appropriate. There are, however, a number of important factors that should be taken into account in assessing the rule change requests and these are detailed in section 2 above:
	Chapter 3 Capex and Opex	
2	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.	There is no doubt that there has been a significant increase in allowable revenue as a result of the changes in the rules. The AEMC (when developing Chapter 6A rules) stated unequivocally that the new rules were designed to increase incentives to invest. What is apparent is that this incentive has been much greater than was expected with the result that there has been greater expenditure. The AER has identified many of the reasons for this over expenditure as it has been intimately involved in the processes. To require further evidence is tantamount to stating that the AER is biased and not able to make a balanced judgement on the issues. The MEU provides evidence that shows the ambit claims and regulatory allowances provided under the latest pricing review round compared to trends from earlier reviews under the Codes..
3	Would it be appropriate for the	Yes, especially as there is no argument that the AER should have the powers that it

	wording of the NER to be clarified to better reflect the policy intent?	considers it does not have. Consumers look to the regulator to have sufficient powers to do its job. Constraining the regulator's powers is not consistent with the NEO.
4	What circumstances of the NSP should the AER be required to take into account when benchmarking?	There are a range of issues that the AER must take into account including weather, geographical and population densities. The MEU considers that the new rules should require the AER to develop a framework, based on principles guided by the AEMC, which it will use when assessing benchmarks. This process by the AER would include the outcomes of the current Productivity Commission review into energy network benchmarking
5	Would it be appropriate for the capex objectives to be clarified to better reflect jurisdictional reliability standards?	Yes, but bearing in mind that the setting of the standards should be required to recognise the cost to benefits that are an outcome of setting levels of reliability. Such standards must be at arms length from NSPs
6	What factors or 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?	There is no doubt that accessing and implementing where appropriate the experiences of other regulators will be beneficial. Provision of more powerful incentives to drive improved performance of NSPs, innovation, and negotiated agreements between NSPs and large energy consumers are some of these. What is concerning is that the current rules are so specific and constraining that the AER is not easily able to incorporate new learning from other regulators. Providing the AER with greater discretion will allow it to use this external information and approaches
	Chapter 4 Capex Incentives	
7	In what circumstances would an NSP need to spend more than its allowance under the NER?	The circumstances would include (as noted earlier): • wrong forecasts • exogenous factors • security and reliability requirements Having accepted there may be reasonable reasons for an NSP needing to increase its capex, NSPs do have enormous opportunity to spend more that its allowances under the NER. The Rules currently provide an open door flexibility to spend more AND

		without any supervision backed up by an ex post audit. What is not imposed on NSPs is that in the competitive market there is pressure to limit capex and there are constraints which the market imposes (eg access to capital). What the Rules need to reflect is this pressure to limit capex and to ensure the available capex is dedicated to the most important aspects of the NSP activities.
8	What is the best option for dealing with the capex incentive issues identified in this paper?	An ex-post review to establish efficiency and prudency of the capex spent and to include an optimisation of the RAB. Setting the WACC to reflect external benchmarks will also focus attention to the critical aspects of the NSP activity
9	How does using actual or forecast depreciation to determine the RAB affect a NSP's behaviour?	The incentives vary as to whether there is an under-run or an over-run of capex. The depreciation should be set to minimise capex over expenditure
10	The Commission notes the comments 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.	The MEU agrees with the ERAA that reopeners and contingent projects should be minimised (even excluded) as this replicates what occurs in a competitive environment. MEU members have advised that capex is limited and if there is a need for capex to address a new issue not addressed at the time, the firm will re-allocate the available capex to the new need and defer or obviate the originally identified need. There is also strong governance oversight at Board level where directors are appointed based on expectations of their ability to discharge their obligations to a professional standard The MEU considers that an urgent need for capex should be addressed within the existing capex allowance and other projects "bumped into the next regulatory period, just as is done in competitive firms
11	More extensive use of the uncertainty regime means regulatory arrangements more closely resemble commercial contracts. Is this appropriate?	The MEU disagrees with the premise behind the AEMC statement. The uncertainty is not unique to the monopoly energy transport industry and applies market wide. As capex is essentially limited, the uncertainty faced is reflected in the approach of reallocation of limited capex rather than automatically allowing increases.

12	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?	An incentive scheme is necessary. Currently the only incentive (a weak one) is that the firm retains the benefit of any capex under-run. In a competitive environment capex is limited anyway to the funds that the firm can acquire and, by competitive pressures, recognising that issuing new shares is a “last ditch” step in acquiring capital. The MEU considers that the incentive should be more akin to “capping” the capex to amounts available without new share issues.
13	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 MEU is generally concerned with the use of related party transactions that could provide incentives for raising regulated costs. The issue of related parties is that the owner of the related party has an incentive to maximise its return through the related party contract. This especially applies where the owner of the related party is only a part shareholder in the regulated entity. Through this mechanism, the related party is incentivised to maximise its return even though this might be to the detriment of the NSP shareholders. This arrangement applies, for example, in the case of Envestra where APA Group is the operator but a 30% shareholder. Similar arrangements apply to Sp[ark and SP Ausnet. Related party transactions are becoming more widespread with respect to some NSPs and represent a growing trend in total opex levels
14	To what degree would a parent company of a 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?	The MEU is generally concerned with the use of related party transactions that could provide incentives for raising regulated costs, especially in the context that the party is not a regulated entity and there are huge opportunities for costs padding. In the absence of specifics, it is impossible to answer the question other than to state that a related party wholly owned by a part owner of a regulated firm has an incentive to maximise the related party costs as this will maximise the profitability of the owner of owner of the related party

15	Should the AER be given the power to develop and implement pilot or test incentive schemes within a controlled environment?	Yes
16	What limits should be placed on the extent of these schemes?	The limits must be those that minimise the risk to consumers
17	Should the concept of compensation for consumers for use of shared assets be applied to transmission, as well as distribution?	Yes. As the assets are fully recovered by costs imposed on consumers, the revenue from other sources should be used to offset the costs that are provided by consumers in their regulated charges.
18	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?	If the assets used for alternative control purposes are fully reimbursed by the consumers of the services, then any revenue from other uses of the assets should be used to offset the costs to the users of the ACS. Where the costs of an asset are fully recovered, the NSP should not benefit from selling the use of the same assets to another party. This principle should apply across all regulated services.
19	What are the appropriate guiding principles allocating compensation arising from sharing assets between regulated and unregulated services?	See above. If the assets are fully recovered from one source then the use of the assets should not provide a source of profit to the regulated entity.
	Chapter 5: Rate of return frameworks	
20	Are some WACC parameter values more stable than others, and sufficiently stable to be fixed with a high degree of confidence for a number	No. The MEU assesses that parameters would have to be firm for a decade or more for there to be confidence in the setting of the parameter. Whilst it would appear that the market risk premium might fall into this category, the AER increased the value in early 2009 yet within 18 months had reduced it again. With this sort of experience, the MEU does not consider that any of the WACC parameters is sufficiently firm that it could be

	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 require others to be determined at the time of each regulatory determination?	assumed to be stable for a decade. As even the most stable of parameters actually being changed within a period of 10 years, it would appear that setting even the most stable parameter is not sensible, Whilst establishing a framework for setting the parameters for a long period might appear sensible, the experience with using the framework for the setting of the debt risk premium has shown that there may be a need to change a framework within a shorter period than the 9 years the framework outcome for which it would have to provide sensible solutions On this basis the MEU does not consider that the approach to setting parameters or the frameworks for their calculation should be locked into the Rules. The MEU considers that the Rules should require the AER to establish an approach which delivers WACC outcomes that reflect actual market conditions and that the outcomes of the AER working should be benchmarked against the observed competitive market WACCs, and adjusted to ensure that the regulated firms do not get WACCs higher than those achieved by firms operating in a more competitive environment
21	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?	Yes, subject to the response to question 20. The outcomes must always be checked against the competitive market and adjusted to ensure the outcomes reflect the risk profile of the regulated firms .
22	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	The MEU does not consider the development of a range of outcomes provides any assistance and it introduces the risk of increasing the scope for appeals. As the AER is required to set a single point WACC, the use of the range of parameter values merely increases complexity for no added value and increases risks of appeals.

	preferred estimate? Which WACC parameters are inter-related and should the rules recognise the inter-relationships of these WACC parameters?	
23	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?	There is value in the use of the "persuasive evidence" approach, especially when benchmarking implies the calculated WACCis wrong. In practice, the regulator uses much the same approach for gas as for electricityand this is sensible as there is little difference in the WACC outcomes between the two (other than the value of equity beta which might be lower for electricity networks due to its lower risk profile).
24	How has the rate of return framework under the NGR worked alongside the NER frameworks?	In practical terms there is little difference and nor should there be.
25	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?	The lack of guidance means that the AER and ERA use the same approach as that for electricity as this is the way the statements of regulatory practice are developed. There is a concern that the greater flexibility afforded in the NGR will lead to attempts to introduce approaches that are biased to increase the WACC and the NER approach used as the default position. This increases the work load on the AER and increases the opportunity for more appeals.

26	Are there 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
27	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?	The MEU considers that the default position should be the CAPM, but the outcomes of the CAPM should be benchmarked against actual observations from the competitive market. If this benchmarking demonstrates that the CAPM outcomes are not in keeping with the benchmarks, then alternative approaches should be examined to identify where the CAPM is failing to provide appropriate outcomes. The Rules should prescribe a requirement for benchmarking the WACC and the testing of the various indicators used in business to verify the health of the regulated firm through benchmarking these indicators.
28	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. The same framework has been used for both for some 15 years and the regulated firms have all prospered, indicating there is no need to have different approaches and the common approach is successful.
29	Which rate of return framework would	See comments above

	best meet the key attributes identified? Are there any other attributes that should be considered?	
	Chapter 6: Cost of debt	
30	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?	No. The actual reporting of NSPs (government owned and private) shows that they acquire debt at levels well below the benchmark level calculated by the AER. The assertion that the overstatement is a reflection of shorter term debt being higher due to the risks of refinancing, is not borne out by the reporting by the NSPs. In the case of government owned NSPs, they are not affected by this as they all acquire debt from their associated Treasury Corps and the issue of debt tenor is not involved. Whilst the MEU agrees with the market analysts that NSPs can reduce their debt costs by a portfolio approach (varying source and term), the MEU considers that greater note should be taken of the actual performance of the NSPs in their debt acquisition. Incentive regulation is all about using incentives to drive the regulated firm to the efficient boundary so that consumers can also benefit from this outcome. The acquisition of debt is no different to driving to the efficient boundary for opex and capex costs.
31	What are the pros and cons of the recent approaches taken by IPART and the ERA in estimating the DRP?	The use of shorter term debt costs (as by the ERA and IPART) reflects the reality of debt provision by NSPs. Assessment of the debt tenor of NSPs indicates that they have shorter term debt that the 10 year bond rate. However, this approach still leads to a debt cost which exceeds the actual costs reported by the NSPs
32	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	IT is generally accepted that the cost of debt has risen in the past 3-4 years although there are signs that this trend might be reversing. The DRP calculated for most of the past decade would be insufficient in current times so there is a prima facie case for a higher DRP. However, from observation, it would seem that the approach used before the GFC is providing unrealistically high outcomes.

	would it be more appropriate to specify it at the time of the determinations?	This indicates that the AER must be aware of the potential for change and have the ability to make change. This is why the MEU considers that benchmarking of WACC outcomes is essential so that anomalies can be addressed as they occur, whether by changing the approach or changing parameters.
33	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?	Yes, as the calculation by the MEU in section 5.6 shows. The use of a longer trailing period continues to reflect the trends that a shorter trailing period has, but eliminates much of the volatility
34	What possible changes would be required in the NER to implement the EURCC's trailing average approach?	The MEU is of the view that longer trailing periods for both debt and the risk free rate are appropriate to eliminate much of the volatility. For example, the current RFR is exceptionally low compared to historic levels and could lead to an understated WACC being granted at current times. The use of a longer trailing period will reduce the short term volatilities introduced by market aberrations. Rather than the averaging period being set as it is currently, the Rules could make it explicit that averaging periods are to be a certain period.
	Chapter 7: Regulatory determination process	
35	What factors or principles would promote an effective regulatory determination process?	The AER proposal addresses most of the MEU concerns. The MEU considers that in addition, transparent and trilateral discussions will assist, time and size limits should be placed on voluminous submissions and a requirement that revised applications must

		only be varied where the draft decision has raised an issue (eg the revised application should not comprise what is an effectively new application).
36	Which option(s) would be the best way of addressing problems with the regulatory determination process?	See comments in section 6
37	Are there any other options that could address the issue of providing adequate time for consultation and assessment during the regulatory determination process?	See comments in section 6
38	Should the AER be given more time to consider confidentiality claims in initial and revised regulatory proposals?	Yes. As noted confidentiality claims are used to prevent adequate assessment by stakeholders.
39	Should the NER be clarified to reflect the NEL and/or common law position with respect to the AER's ability to give weight to confidentiality claims in initial and revised regulatory proposals?	The NER must reflect the NEL and common law requirements but less weight must be given to aspects claimed to be confidential as there is no stakeholder scrutiny able to be provided. The risk of giving equal weight reduces the regulatory process to a negotiation between the NSP and the AER, and does not permit the AER to undertake its role as the independent umpire to the same extent as with information made publicly available.
40	Alternatively, are there any other additional ways to address confidentiality claims in initial and revised regulatory proposals that are not currently available under the NER?	The MEU is not aware of any
41	Should the framework and approach	The framework should encourage the use of tripartite discussion and allow issues to be discussed and resolved ahead of an application being submitted (eg such as previously

	paper be a discretionary stage in the distribution regulatory determination process? If so, what is the appropriate approach to triggering it? Should stakeholders other than NSPs have the ability to trigger a framework and approach paper, and in what circumstances?	used by the state regulators with great success). Whilst the process should permit this to occur, the actual issues to be addressed should be set by negotiation between the AER, the NSP and stakeholders.
42	Is it appropriate if a service classification or control mechanism can only be amended at the time of an AER final regulatory determination for circumstances that were not reasonably foreseeable at the time of the framework and approach paper?	The question raises the spectre of an NSP not knowing its business well enough to be able to manage a five year outlook. In practice, the NSP should be assumed to know its business well enough to lock in at a regulatory determination the most appropriate service classifications and control mechanisms. The fact that the NSP has the knowledge and the information available to trigger a change in these implies that the reason for the change would be to improve its financial position. If there was no improvement in the financial position, then no change would be proposed. At most, the risk to a business would be no more than a 1-2 year exposure as it would be expected to have a very strong view on these aspects for the first 3 years of the regulatory period.
43	Is there likely to be sufficient time for a NSP to accommodate an adjustment to a control mechanism in an AER draft regulatory determination?	The NSP spends many months (even years) in the preparation of its application and during this time it is expected to have assessed all of the aspects that influence its business. To assume that it would have to make a major change between the issue of a draft decision and the issue of a revised application would appear to be counter-intuitive and the risk very low. If an NSP has so little understanding of its business that this becomes an issue raises much more concern about the business than its deire to change a control mechanism
44	Should the material error list under	Yes

	Chapter 6A be amended to reflect the current prescribed list under Chapter 6 of the NER?	
45	Has the AER been constrained by the wording of Chapter 6 of the NER in its approach to revoking and substituting regulatory determinations as a result of material errors or deficiencies?	Yes. The AER has stated that this is the case.
46	What should be the approach for addressing complex cost pass through, capex reopener or contingent applications? Is the "stop the clock" mechanism appropriate for each type of application?	The MEU considers that capex should be limited and that there should be minimal opportunity to re-open the capex allowance. As stated in section 4, in a competitive business capex is constrained. If there is a critical need to change, existing and planned projects are “bumped” and the new critical project inserted into the capex program. This approach provides discipline on the NSP not to assume that it has the ability just to keep its original program and add new programs at whim. This is not how competitive market work. However the AER should have the ability in a regulatory decision to allow a specific project to be added later when costs are known. An example of this is the Victorian bushfire outcome, where the AER knew there was to be a requirement for more work as a result of the Royal Commission but the scope was not known.

APPENDIX 1

Market Risk Premium and Equity Beta

In January 2004, the Energy Consumers Coalition of SA (ECCSA) submitted a paper on the levels of market risk premium and equity beta used to develop the WACC for regulated businesses. This research paper was prepared by Headberry/Lim and uses the actual returns earned by companies, both private and public operating in Australia. This data was provided by IBISWorld.

Developing on from this work, combined with the strong criticisms of it levelled at the regulated businesses, there have been identified a number of paradoxes

Paradox 1
The CAPM determines returns (both dividends and capital) of companies listed in the ASX200 or ("all ordinaries") by use of the accumulation index. This is a reasonable assumption and is used as a performance benchmark by many funds managers.

However as the benchmark includes a limited number of companies, the acquisition of a smaller or unlisted companies can increase the value of the ASX 200 without adding to national growth. Conversely the elimination of a company from this group can have massive repercussions to the index, such as is currently resulting from the decision for News Ltd to list on the NYSE.

Paradox 2
The WACC calculated from CAPM inputs should provide a comparable return to the average of businesses operating in a competitive environment, ie the regulators should not provide favour to regulated business and should attempt to replicate the result of competitive pressures.

The ACCC in its TG and EA decisions in 2002 has calculated that the EBIT/assets resulting from their decision on WACC will provide an EBIT to assets of about 11% in year 2004/05. Because of the assumptions needed in developing this figure (that opex as granted will be entirely consumed, depreciation awarded is the same as accounting depreciation, that little of the earnings are at risk from performance measures, etc), it must be assumed that the earnings to assets are essentially driven by the WACC calculation.

What is absent from analysis of this financial indicator is any comparison to EBIT to assets of businesses operating in the competitive arena. The work by Headberry/Lim indicates that EBIT/assets for competitive enterprises has averaged between 9% and 4%, and declining over the past ten years. The weighted average of EBIT/assets of the 326 companies over the 10 year period included in the 2002 assessment showed an EBIT to assets of less than 4%.

To assume that average earnings will nearly triple between December 2002 and July 2005 raises clear doubts about the benchmark return set by the ACCC for TG and EA.

Paradox 3

The estimation of MRP uses the accumulation index as the basis of the rationale behind developing this input to the CAPM formula. However economists have stated that the use of financial data in regulatory decisions must be avoided as accounting data can be manipulated and therefore the use of actual accounting data rather than developed economic data is considered invalid.

Analysis of the accumulation index shows that its growth is predominantly driven by the share growth rather than dividend, as the dividend/share percentage has remained relatively constant over time.

Investors value an enterprise based on a multiple of its earnings. An investor may decide that there is greater potential for earnings than is being achieved currently with the existing assets, due to staffing changes, market changes, new technology, new products, etc. It is the **expectation** of the growth of future earnings using the same level of equity that drives the assessment of a share price upwards. Increasing the asset base but retaining the same gearing and rate of earnings does not axiomatically lead to an increase in the growth in the value of equity.

A regulated asset has a fixed rate of earnings allowed for the regulatory period. The increase in earnings is essentially tied to the investment of new capital approved by the regulator. Thus for the regulator to base its return on capital assuming that there is an expectation of increased earnings is patently contradictory.

Paradox 4

The WACC assumes that the regulated business has a gearing (based on interest bearing debt) of 60%. It is generally accepted that businesses in a competitive environment have a gearing of interest bearing debt lower than this (commonly between 30% and 50%). It is further accepted that debt is a lower cost source of funding than equity. That is, the lower the level of equity, the lower the average cost of capital.

Accepting that even at this higher level of interest bearing debt regulated businesses can retain the same credit rating as businesses in the competitive environment can but at lower levels of interest bearing debt, this means that the average cost of capital for a business with the higher gearing, should be less than that for a business with a lower gearing, all other variables remaining constant. In fact regulated firms tend to have a higher gearing than 60% yet still they are able to acquire debt at rates less than the AER awards based on 60% gearing.