Australian Energy Markets Commission

Economic Regulation of Network Service Providers –

AER Proposed Rule Change

Comments on the Consultation Paper

Submission by

The Major Energy Users Inc

December 2011

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

This project was part funded by the Consumer Advocacy Panel (www.advocacypanel.com.au) as part of its grants process for consumer advocacy and research projects for the benefit of consumers of electricity and natural gas.

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, Inc (MEU) strongly supports the AER rule change package but with some minor changes. These are provided in the text of this submission and by the addition of some related rule changes submitted separately.

The AER package addresses the discredited network regulation rules implemented in 2006 and in subsequent years that have demonstrably failed to reflect a balance between rewards, risks and regulatory scrutiny. The outcomes from the Chapter 6 and 6A rule changes, and those of the NGR, have meant there has been an over-incentivisation of network investments and operational expenditure claims. Some elements- such as automatic rolling-in of actual capex into the RAB without ex post review and optimisation – are an open-door invitation to excessive and inefficient capex claims and implementation.

MEU member companies have experienced rapidly escalating and unsustainable network charges as a result of the new rules. The magnitude of resultant network charge increases have been so large that downstream business operations have been adversely affected. Given the size of the increases in network charges – which have been impossible to budget for – labour shedding has been a major consequence. The price signals have major long term implications with respect to potential investment by downstream industry.

The outcomes from the about to be completed current regulatory round have been particularly astonishing with regard to government-owned network businesses, with the very large increases in capex and revenues raising many questions in independent reviews, such as Garnaut, NSW government, NSW's regulator IPART and from MEU member companies.

In section 2, this submission tabulates the major AER rule changes grouped under five categories – rate of return, process issues, capex and opex, miscellaneous and transitional.

Other sections address specific concerns that arise as a result of the AER package. Section 8 responds to questions posed by the AEMC in the Consultation Paper.

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.

In the MEU's considered view, the outcomes of the Chapter 6A review by the AEMC were unbalanced whereby the AEMC proposals meant that the risks faced by the networks were reduced by:

- The approach to automatically roll into the RAB capex actually incurred without any ex-post assessment that the amount is demonstrably prudent and efficient.
- The decision not to carry out assessments from ex-post optimisations of the networks.
- The reduction of the powers of the AER to assess on a holistic basis the entire revenue and performance package proposed by the TNSPs.
- They could include "contingent projects" in the capex forecast and be permitted to vary the expenditure in the future, both with regard to timing and value.
- The propose/respond model of regulation combined with easier access to merits reviews, required the AER to accept proposals that were within the credible range of possible outcomes, so that the TNSPs were able to consistently set their allowances at the high end of the credible range.

At the same time as the risks were reduced, the TNSPs were provided with increased rewards as:

- The return on funds was increased by reducing the debt credit rating to that actually achievable by the lowest rated and highest geared TNSP, even though the actual gearing was well in excess of that used for the notional TNSP.
- The return on funds was increased by applying an equity beta of 1.0, even though most state regulators had reduced the equity beta on electricity distribution businesses (which have higher risks).
- The TNSPs were provided with greater freedoms and incentives, such as setting their own depreciation schedules
- The TNSPs were provided with greater freedoms and incentives, so that under-runs in capex and opex automatically resulted in a bonus to the TNSPs, without any assessment as to whether these and other incentives included in the AEMC rules package would provide a driver for TNSPs to actively game the rules by either front-loading or back-loading allowed expenditures.

In the MEU's views, the Chapter 6A rules were the most blatantly biased and unbalanced rules determined in the regulated energy sector since the advent of energy reforms in the early 1990s. These rules were implemented despite very strong opposition from consumer groups, and from the AER, who were concerned that the floodgates had been opened by the AEMC.

The MCE, in their revisions of the electricity distribution revenue rules (chapter 6) and of the gas network access rules, used the Chapter 6A as a template for the new rules, and most of the features of the Chapter 6A rules were integrated into the other network revenue rules. In this process, those states that owned network assets also participated in the decision-making process, and the strong opposition by consumer groups was simply over-ridden in a largely opaque decision making process.

The results from the last AER regulatory round were as predicted by the MEU at the time of the Chapter 6A rules being developed. Every MEU member (and all other consumers) has been hit with dramatically increased energy network prices. These substantial increases are not sustainable and are becoming increasingly difficult for all consumers to pay whether they are industrial users or residential users. The higher network prices have already resulted in a significant contraction of the manufacturing sector and further job losses and investment deterrence will result unless a balanced set of network rules is instituted, and the regulator is not proscribed from exercising independent regulatory judgment in accordance with the NEL and NGL Objectives.

The MEU, however, draws particular attention to the privileged position of government-owned network businesses and their ability to sustain claims that are far from commercial reality. The experience of network regulation in NSW is salutary: network price increases of 30% to 50% in just one year (2010) were experienced by MEU members and similar large increases in subsequent years have been forecast by the networks. Some MEU members in NSW have experienced network costs increases of the order of 71% and 59% over the three years ending 2011/12 – all this occurring despite relatively flat consumption of electricity.

The price shocks experienced by MEU members have now also been assessed and reinforced by three respectable and independent reports – the Garnaut Update #8, the Parry/Duffy Report to the previous NSW Government, and the IPART regulated retail report. Together, these assessments are clear about one major conclusion – the current regulatory regime is not credible, it is not sustainable and there must be substantial change to the rules – it has failed to measure up to the NEL and NGR Objectives of having investments that are "...in the long term interests of consumers."

The AEMC inspired rules have failed to provide balance between risk, rewards and regulatory scrutiny and, by doing so, worked against the interests of consumers – it was a process that produced outcomes that were blatantly against the public interest.

2. The AER Rule Change Package

The following shows in tabulated form the major AER rule change package grouped under 5 categories (rate of return, process issues, capex & opex, miscellaneous and transitional) together with the MEU's views. The MEU strongly considers that the AER rule change package addresses most of the key aspects where independent scrutiny has been compromise, thereby over-incentivising "gaming" and excessive network investment and operational expenditure claims. The AER package provides a sensible, balanced and fair (to both networks and consumers) set of rule changes. More importantly, it offers the potential to drive far more efficient outcomes and help raise the productivity growth in network businesses and downstream industries.

Subsequent sections will discuss and elaborate the MEU's views on the main elements of the AER rule change proposal.

In addition, the MEU has provided a table listing 6 issues that the MEU is concerned with that the AER has not adequately addressed within its rule change proposal.

	Issue	MEU view of the AER proposal	MEU preferred approach
Rate of return			
1	WACC approach	Set for all networks every five years, not just electricity transmission. AER can initiate earlier than 5 years. NGR to mirror NER with respect to nominal post tax WACC and use of CAPM	Agree in principle but sees some difficulties with implementation (see section 6.1
2		WACC parameters to apply to TNSP, DNSP and Gas decisions	Agree
3		Parameters are fixed until next review	Agree
4		Risk free rate and DRP are not defined in the rules but in AER procedures	Agree
5	Debt risk premium	AER allowed to set DRP dependent on actual debt financing approaches and the current cost of borrowings for comparable debt. Actual DRP set at the WACC review	Agree in general, but need to reflect that if debt is secured (eg from T-Corps or definable borrowing rate) then this rate should apply ie use the lower of the AER determined rate and the actual. See section 6.2 below
6		Requirement for "persuasive evidence" needed to make change is removed.	Agree in principle, but needs further consideration
Process issues			
7	Propose Respond model	AER proposes Receive Determine model which is what used to apply	Agree
8	Confidential information	AER allowed to determine the "weight" of confidential information from networks on the same basis as other stakeholders	Agree
9	Procedural processes	Remove need for consultation on application of processes to be used	Agree
10	Material errors	Free up AER ability to accept, modify or reject	Agree
11	Time frames	Allow AER to extend timeframes on certain activities other than	Agree

		revenue determinations	
12	Scope of determination	AER will now determine all aspects whereas under the current rules it has to approve some elements proposed by the applicant which led to the MAR	Agree
13	Provision of information	Networks precluded from providing additional information after applications made	Strongly agree. See section 7
Capex & Opex			
14	Investment in excess of approved capex	Allow only approved capex plus 60% of excess investment into RAB	The MEU supports the principle behind this concept but disagrees with the proposed solution. The MEU considers this aspect needs more consideration and will provide its detailed input and preferred approach during the detailed examination of each proposal provided by the AER.
15	Assessment	Include as part of assessment a top down analysis (including benchmarking) of capex and opex	Strongly agree
16	Opex and capex allowances	Added requirement that allowed opex and capex reflects outcomes of incentive schemes	Agree
17	Ex post prudency of capex	Deliberately excluded. Point 14 limits the need, as does the decision not to allow depreciation calculations	The MEU disagrees with the AER proposal not to carry out an ex post review. The MEU will provide its detailed input and preferred approach during the detailed examination of each proposal provided by the AER.
18		Suggests RIT-T and RIT-D assumptions be verified in ex post assessment – to be reviewed as part of TFR?	The MEU agrees with the concept, but it should be part of the rules not left to TFR. The will provide its detailed input and preferred approach during the

			detailed examination of each proposal provided by the AER.
19	Contingent projects	Use process for distribution as well, and allow re-openers and change materiality to 1% - same as TNSPs	The MEU considers this needs more consideration. The MEU does not agree with the concept of adding contingent projects at a later stage. It considers that such projects should be added at the expense of existing projects as occurs in the competitive sector. The MEU will provide its detailed input and preferred approach during the detailed examination of each proposal provided by the AER.
20	Capex efficiency program	Can be developed under the new approach	Agree. The MEU considers the absence of a capex incentive program is a failure by the AER
21	Incentive schemes	Proposes being added at AER discretion subject to over-riding goals	Agree
22	Capitalising related party costs	Proposes being at AER discretion	Agree
23	Non-network solutions	Require tighter requirements	Agree, but the MEU considers that if a non network solution is implemented, there should be a compensating reduction capex if a non-network solution is added to opex
Miscellaneous			
24	Reliability standards c/f capex and opex	No change, but note the AEMC is to review distribution reliability standards set by jurisdictions	Agree in principle, but the MEU considers there is a need to more strongly link reliability standards and capex

25	Use of shared assets	AER has discretion to adjust revenue to reflect use of assets used for regulated and non-regulated services	Agree
Transitional			
26	Transitional	Only part of the proposed changes are to apply to NSW reviews	The MEU does not agree with this as it considers all of the changes need to be reflected in the NSW revenue rest review. It must be realised that NSW networks have been excessively rewarded under the current pricing round and there is over-whelming evidence of “gaming”, “cost padding” and “ambit claims”. MEU members cannot be viable should NSW network businesses be again rewarded with price increases of the magnitude seen in the just completed regulatory round. It is preferable that the changes to the rules be applied
		RAB roll forward at next review should accept the current decision process	Probably agree

In addition to these issues that are included in the AER proposal, the MEU considers that certain other elements should have been addressed by the AER as they also contribute to the current biased network regulation.

<table>
<tr><th></th><th>Issue</th><th colspan="2">MEU Comment</th><th>Added rule change needed?</th></tr>
<tr><td></td><td></td><td colspan="2"></td><td></td></tr>
<tr><td>1</td><td>Optimisation</td><td colspan="2">The AER has not addressed that utilisation of assets is to be maximised and consumers should not pay for assets not used</td><td>Yes, see MEU rule change proposal</td></tr>
<tr><td>2</td><td>Setting ex ante capex</td><td colspan="2">The AER has not addressed to there is too much flexibility for NSP to use capex for other purposes than those for which the capex was developed and decisions made about</td><td>No. The MEU concerns can be addressed within the AEMC process for the AER proposal</td></tr>
<tr><td>3</td><td>Inefficient investment</td><td colspan="2">The AER has not addressed the issue of inefficient investment or that there are no penalties applying to inefficient investment</td><td>No. The MEU concerns can be addressed within the AEMC process for the AER proposal</td></tr>
<tr><td>4</td><td>Replacement of assets</td><td colspan="2">The AER has not addressed the fact that fully depreciated assets can be replaced even if they are still used and useful</td><td>Yes, see MEU rule change proposal</td></tr>
<tr><td>5</td><td>Pricing</td><td colspan="2">The AER has not addressed the issue of pricing at all, especially the concept that pricing should reflect a need to allocate costs based on times of peak usage</td><td>Yes. The MEU will address this at a later stage</td></tr>
<tr><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>6</td><td>Merits review</td><td>AER view</td><td>MEU view</td><td></td></tr>
<tr><td></td><td>Appeals to ACT</td><td>AER has previously stated that this is part of the NEL and NGL and not a rule, so they cannot propose this as a rule change</td><td>Cherry picking of parts of AER decision not liked still permitted, but discretion allowed AER would limit this</td><td>Need to get NEL and NGL changed so no new rule change needed</td></tr>
</table>

To address the shortcomings, the MEU Has introduced rule changes to address items 1 (optimisation) and 4 (replacement of assets) to complement the AER rule change proposal. The aspects of pricing and merits review are outside the current scope.

3. The Principles of Network Regulation

The National Electricity and Gas Laws highlight six principles for the regulation of monopoly networks. The MEU is very concerned that the rules developed, apparently to reflect these principles, have failed to replicate the combination of these with the Objectives provided in each Law.

In the Second Reading Speech in 2007 (for electricity) and 2008 (for gas) the Minister expanded on each of these principles. From this, the following deductions can be made about each of the principles:

1. A regulated entity must be able to recover at least the efficient costs – i.e. not its actual costs – but costs that are efficient to deliver the service.
2. There are to be incentives to promote economic efficiency and efficient investment, including efficient provision of services and use of systems.
3. There is to be regard for previous regulatory settings of the RAB – not necessarily thoughtlessly accepted, but regard must be given.
4. Return on investment should be commensurate with the risk (commercial and regulatory) faced for each service – not that there be a single rate of return applying to every service provided or asset used.
5. The regulator has to assess the benefit/detriment of over/under investment – to ensure consumers receive the level of service expected at the right price.
6. Utilisation of the assets is an indicator of efficiency – decision makers must assess the efficiency of utilisation of assets as over or under utilisation can have adverse consequences for consumers.

In assessing the proposed changes from the AER in relation to network regulation, the MEU considers that the AEMC must review the current rules and the AER proposals to identify whether (or not) the current rules actually provide for the outcome intended by the Objective and these six principles.

The MEU considers that to address the principles in isolation of the Objectives will result in different outcomes than if the principle are assessed holistically.

3.1 NEL Principles 2 and 4

In relation to the issue of incentives for investment, the MEU considers that the principles have not been properly reflected in the current set of rules.

Principle 2:

The first part of Principle 2 concerns an Incentive for capex to ensure that capex is efficient. However, whilst there is a reward to be paid for being efficient, there is no penalty for inefficient capex. Thus, any reward from the incentive for efficient investment needs to be greater than the reward from inefficient investment, otherwise over-investment occurs.

Equally, a penalty is needed to ensure there is no inefficient investment and this penalty needs to be greater than the rewards that might be derived from inefficient capex (i.e. over-runs on capex and/or under-utilisation of capex).

In any case, most regulatory decisions do not contain a capex incentive, and this principle has been ignored. Specifically, the AER regulatory approach does not include any incentive program for ensuring there is only efficient capex. In contrast, the AER has implemented an incentive scheme (EBSS) for driving a network towards efficient opex.

Principle 4

Principle 4 concerns the rate of return which needs to reflect the risk for each service provided. A TNSP provides a number of services, but there is only one rate of return applied, regardless of the different risks with each service. Principle 4 implies that different rates of return could be applied to different services with different risks.

3.2 Rate of return (principles 1 and 4)

The principles in relation to rate of return are quite clear.

Principle 1

Principle 1 requires the rate of return not to be less than that needed to provide for an efficient service. This principle, when seen in isolation, allows an unlimited upside to the rate of return – it must not be less than.

However, when combined with the Objective, the price for the service must be in the long term interests of consumers. The implication of the Objective is that the rate of return must be no more than that needed to provide an efficient service.

Taken together, the rate of return must be set an efficient level. It is not conceived by the Law that the rules can provide for a rate of return that is above the efficient level. But this is what has occurred under the current rules.

What the current rules do is to enshrine process over outcome. For example, the process for setting the debt risk premium is considered to be more important than ensuring the debt risk premium reflects the actual costs of providing debt. The provision of debt is a cost like other costs, and under the building block approach should not include any element of profit[1].

Principle 2 coupled with the Objective effectively limits the debt risk premium to the cost the regulated firm will incur it]f it is efficient. The rules should not provide for an allowance which clearly provides reimbursement well in excess of the actual costs involved.

Principle 4

As noted in 3.1, the principle implies that more than one rate of return is permissible so as to reflect varying risks faced by a regulated firm. In this regard, the MEU considers that where a regulated firm has a higher risk (eg when it provides for assets that might not be required for the full life of the asset, then there is an argument that the firm should be provided with some ability to mitigate that risk, such as through a higher rate of return or accelerated depreciation.

Such flexibility should be provided to the regulator to best provide a balance between the party paying the cost and the interests of the regulated firm.

3.3 Incentives

Principle 2 makes reference to the need for incentive programs in order to drive the most efficient outcome. This is appropriate for an incentive regulation regime that underpins the NEM.

It does also imply that the outcomes of such incentive programs must have more weight than other forms of forecasting elements of revenue elements in a revenue reset review. Currently the rules imply that the setting of allowances should reflect a number of parameters or a process embedded in the rules.

The MEU is of the view that capex, opex and provision of debt should all be subject to an incentive regime. The outcomes of this incentive regime should be the basis for setting the next period allowances, with the incentive program providing some longer term benefit than just the benefits accrued in the regulatory period in which the benefit was generated.

[1] Under the building block approach, all profit is intended to be recovered through the market risk premium

4. Assessing Inefficient Investment

In the MEU's view, the current rules do not provide any ability on the part of the regulator to assess if there has been inefficient investment as:

- The ex-ante approach to capex allows the TNSP to use the capex for any purpose and not just the purposes used to establish the level of approved capex
- Actual capex incurred must be automatically rolled-into the RAB.
- There is no ex-post assessment of past capex to assess its efficiency or even its appropriateness with electricity networks although the Gas Rules do impose a prudency test. Despite the Gas Rules requiring such a test, the regulator has not been rigorous in assessing, ex post, the prudency of past gas capex.
- There is no action by the regulator assessing utilisation, as there is no optimisation.
- To encourage better utilisation of assets, the rules allow a TNSP to set its prices based on peak utilisation of the assets, but the regulator allows TNSPs the right to either use demand based on the 10 peak system days or to average demand over a year at the election of the TNSP.
- Assets are retired when they are fully depreciated – even if they are still used and useful – and replaced with new assets; this is inefficient investment. This incentive is driven by the use of the building block approach, where the regulated profit for the firm is embedded in the WACC, incentivising the increase in the RAB regardless of efficiency.
- The rewards for over-investment are greater than the reward from the incentives to invest efficiently and there is little penalty on over-investment.
- There is little or no penalty for inefficient investment, but there are rewards.

Box1 (below) shows in tabular form the MEU's concerns with the existing rules that have over-incentivised investments, but are contrary to the network regulation principles contained in the NEL

Box1 – Inefficient investment

Issue	Contrary to principle
The ex ante approach to capex allows the TNSP to use the capex for any purpose and not just the purposes used to set the capex	2,5,6
Actual capex must be rolled into the RAB	1,2
There is no ex post assessment of past capex to assess its efficiency	1,2,5,6
There is no action by the regulator assessing utilisation as there is no optimisation allowed	2,5,6
To encourage better utilisation of assets, the rules allow a TNSP to set its prices based on peak utilisation of the assets, but the regulator allows TNSP's to average demand over a year at the election of the TNSP.	5,6
Assets get retired when they are fully depreciated even if they are still used and useful	1,2
TNSP better able to manage risk (i.e. SENE) but require a reward for doing so	4
The rewards for over investment are greater than the reward from the incentive to invest efficiently	1,2,5
There is no penalty for inefficient investment	1,2
TNSP's can game the propose/respond model (i.e. capex with revised application after DD is higher than initial application)	5

5. Capex and Opex Framework

6.1 Forecasting required expenditure

The MEU notes that the AER's proposal with respect to the current framework for setting forecasts of capex and opex is not promoting efficient outcomes and it has delivered inflated forecasts of capex and opex. The MEU is also of that view.

Together with the automatic roll-in of capex into the RAB under the existing rule, the above framework clearly incentivises the network businesses to set inflated forecasts, with the clear knowledge that they will automatically roll-into the RAB. This takes away the efficiency driver in capex implementation, especially by government-owned network businesses which tend to display a cost-plus approach.

The AER is also heavily proscribed under the rules to exercise regulatory judgment and substitute lower forecasts

A 'bottom up' approach which the AER has to undertake, limits the AER in undertaking a 'top down' holistic approach (applying benchmarking, sampling and historical comparison techniques). Stakeholders are also precluded from involvement in the assessments as they are resource intensive and involve complex engineering detail.

Whilst NSPs have noted that the framework is working well and the AER have substituted forecasts, the MEU would observe that:

- o The AER has had to undertake the tasks under strict proscription in the rules
- o The AER has, therefore, had very close regard to the easy ability to 'cherry pick' issues and access the Tribunal
- o The AER revised forecasts have still left very significant increases allowed for NSPs.

5.2 Efficiency Incentives

The automatic rolling in of all actual capex incurred within a regulatory period into the start of the next regulatory period is not efficient and/or prudent. This has meant little discipline in:

- o Seeking future capex allowances
- o Efficient project management
- o Appropriate governance to ensure capex allowed is spent correctly

The MEU considers that where an efficiency incentive scheme (such as the Efficiency Benefit Sharing Scheme (EBSS) used for opex savings) is implemented, then the impact of such a scheme must be given primacy in the setting of future allowances for the next access arrangement period.

Currently the impacts of the incentive schemes are provided equal standing with other approaches to setting future allowances. This does not deliver the full benefit to consumers of the efficiency gains made by NSPs, despite the NSP being rewarded for under-running on the allowance provided.

6. Process for determining the capital cost parameters

The MEU notes that the AER proposal posits that there should be a WACC review at least every 5 years (and perhaps more frequently, at which time the AER would determine the WACC parameters for the next five year period. This review would set the WACC parameters for all electricity transmission and distribution networks and for gas pipeline and gas distribution networks

The MEU agrees, in principle, with the AER proposal but has three major caveats. These relate to the impact on review late in the five year cycle, the debt risk premium and the risk free rate.

6.1 The impact on the cycle

The first and only WACC parameter review was carried out during 2008 and early 2009. The AER WACC decision was not early enough to have the parameters applied to the NSW electricity and transmission revenue reset reviews.

The cycle of reviews means that under a five year cycle for this arrangement, the next decision of the 2008/09 WACC parameter reviews would apply for the 201NSW distribution and transmission revenue reset for NSW applying from 2014/15 to 2019/20. Effectively this means that the AER WACC parameter decision would have validity in NSW for a 10 year period.

The MEU has considerable concern that the approach to setting WACC parameters this far ahead, can introduce considerable risks

For example, the MEU notes that the AER WACC parameter decision in 2009 allowed for a market risk premium of 650 bp to be applied; this was an increase from the long term average for the market risk premium of 600 bp. The reason for the increase was that the impact of the global financial crisis of 2007/2009 was still very evident when the WACC parameters were set. By late 2010, the AER had decided (quite rightly) that the effects of the crisis had abated and recommenced setting the market risk premium to the long term average of 600 bp.

The application of the WACC parameters set in 2009 would still be used for the NSW electricity networks revenue reset carried out in 2014 and would apply until 2019/20 year. This means that the MRP set in the WACC decision of 2009 would still have currency into 2020. If such variation in what is considered to be a quite stable average value can occur in a period of less than 3 years, then to assume that such a setting could be valid for a decade has been demonstrated as an incorrect assumption.

The MEU supports the concept of addressing all of the WACC parameters at one time in an in-depth review, but sees that fixing the parameters so that they apply for a five year period and could be used in a decision that is made near the end of that 5 year period and then be applied for the 5 year regulatory period thereafter, raises some considerable concern and greater risks for all.

6.2 Debt risk premium

It has been identified that most network providers incur a cost for debt that is significantly less than the allowances provided by the AER in the regulatory reset reviews.

In particular, government owned networks secure their debt from government treasury corporations which secure debt from the market under the high credit rating the governments have, usually AAA.

The treasury corporations are required to apply, in accordance with the Competition Principles Agreement, a notional charge (a Competitive Neutrality Fee or CNF) to the cost of debt provided to all government owned corporations (GOCs) which are provided with funds from the State's treasury corporation. This CNF is apparently individually determined for each GOC in accordance with its stand alone credit rating and the market cost of debt, to ensure that the cost of funds paid by a GOC is equivalent to a similarly rated private sector entity. Further, the treasury corporations advise the related government owned networks what the amount of future debt provision will be by them and at what rate to debt will be provided in the future.

However, what has been observed is that debt provided to government owned networks is similar to the risk free rate that is used as the basis for the development of the weighted cost of capital. So effectively, government owned networks are incurring a debt risk premium of zero, whereas privately owned networks are paying a debt risk premium somewhat higher.

The sourcing of debt by an entity and the payments that it must make for the supply of that debt, is a cost to the entity. That this is the case can be readily demonstrated by the way the Taxation Office treats the provision of debt where tax is not payable on interest paid for debt. The MEU considers that debt should be assessed like any other cost in the regulatory setting of revenue – that debt is a cost that needs to be set at the efficient level.

At its most fundamental level, the most efficient cost for the provision of debt is the lowest cost that can be achieved. If debt is provided by a state treasury corporation at near the risk free rate (as occurs with government owned networks), and this is the lowest cost possible, then this is the most efficient source of debt and this is the cost that the regulator should allow.

In the case of privately owned networks, the most efficient source of debt will be provided on a portfolio basis of debt source[2] with varying durations. It is not efficient to assume that all debt has the same rate, duration or source as is the current practice. The private networks should be incentivised to reduce the costs of its borrowings by application of an incentive scheme, just as they are for minimising other costs.

With this in mind, the MEU considers that there is a need to have a two part debt provision arrangement. For government owned networks, the cost of the debt should be the cost the network actually pays. In the case of privately owned networks the cost of debt should be capped at a rate based on the efficient level which reflects the reality of debt provision with relation to a portfolio of sources and typical durations.

6.3 Risk free rate

In the early period of regulation the ACCC used a five year CGS as this replicated regulatory period under review, although jurisdictional regulators used the 10 year nominal Commonwealth bonds (CGSs). As the calculation of the market risk premium was based on 10 year CGSs the ACCC changed its approach so there was consistency in setting the risk free rate with other parameters.

The current practice for setting the risk free rate is to use the current value of 10 year CGS just prior to the issue of the regulator's final decision. There is some flexibility as to the length of time prior to the issue of the final decision as to the period over which the value shall be averaged. The argument in favour of using a relatively short averaging period is that this provides the most current forward looking value for the risk free rate to be used for the next five year period.

A review of this practice shows that there is considerable variation between the spot value of CGS used to set the WACC for the following 5 year period and the actual values for the 10 year CGS over the five year period.

This raises the question as to whether the methodology for developing the risk free rate should be reassessed with the view to setting the risk free rate at a value more representative. One approach might be to increase the averaging period used to establish the risk free rate used in setting the regulatory WACC calculation.

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[2] This will include a mix of bank debt, local and overseas corporate bonds, internal borrowings (such as the non-cash cost accounts for depreciation and staff provisions), mezzanine debt and other sources,

7. Regulatory Processes

The MEU agrees with the AER proposal on regulatory process. The MEU notes that the frequent and extensive use of "confidential" informationwhich has prevented the MEU (and other stakeholders) from better involvement in the review process and in scrutinising the relevant issues. In particular, information involving related party transactions should be exposed for public scrutiny. This is especially important given the increasing trend in the extent of these transactions as typified by the recent Victorian electricity distribution review.

The MEU is also very concerned with the increasing trend of NSPs lodging significantly increased claims (coupled with extensive documentation) in revised applications and in responses to the AER draft decisions. The MEU is aware that in some cases revised (increased) claims have been submitted subsequent to the closing times of stakeholder submissions.

This practice places undue pressure on the AER to greatly reduced timeframes and denies stakeholders the ability to scrutinise these claims and to provide any input to assist the AER in its assessments.

That this occurs implies one of two conclusions:

1. The NSP is using this practice as a form of regulatory gaming, or
2. The NSP has not devoted sufficient resources to preparing its application and/or the NSP is unable to properly identify its future costs in its initial application (thereby signifying that much of the data in the applications might be incorrect).

8. Response to AEMC questions

Although posed as specific questions the AEMC posits four basic questions on page 5 of the consultation paper..

> **"The problem** - Do you agree with the extent of the problems with the framework for economic regulation of electricity and gas networks as characterised by the AER?
>
> **Prescription and discretion** - Have the proposed Rules achieved the right balance between prescription and discretion?
>
> **AER's use of its discretion** - Could the AER instead achieve the same outcomes through greater use of the discretions it currently has in regard to opex and capex, avoiding the need for expanding these discretions?
>
> **The solution** - On the basis of the problems raised by the AER, are there any more preferable solutions to those problems?"

9.1 The problem

The MEU considers there is a major problem with the current rules and this has been typified by the very large increases in revenue allowances the AER has had to grant the regulated businesses in the last round (ie since 2006) of regulatory decisions.

In its responses to the AER regarding applications made by the regulated businesses and the draft decisions made by the AER, the MEU has been quite concerned that issues that it has raised have not been acted upon by the AER because the AER has advised that it is not able to address the concerns raised as they are not readily addressed under the rules.

A classic (but not only) example is the issue of debt risk premium. The AER has been aware that the firms are all able to acquire debt at considerably less cost than the cost derived from the formula the AER is required to follow. The AER has accepted that it has permitted the regulated firms a considerable increase in revenue as a result of this process, and that they have been unable to address this very real concern.

The AER has commented in their decisions that they are required to accept a proposal from a regulated firm that is within the range of credible. Although when a value is queried by stakeholders, the AER has had to accept a value claimed by a regulated firm that is at the very extreme high end of the credible range. This has meant that although a regulatory decision is intended to reflect a balance of competing elements, the outcome has been consistently in favour of the regulated firm.

The MEU, along with other credible commentators such as Garnaut, Parry/Duffy and IPART, considers that there is a considerable problem that the AER has identified and seeks to redress by having a more balanced approach to setting regulatory revenue allowances.

9.2 Prescription and discretion

The MEU notes that the AER proposals provide for much greater discretion than the current rules which tend to be more prescriptive, especially after issues have been referred to the Competition Tribunal.

A regulatory decision is intended to be a balance between competing elements, and the Objectives of the Laws highlight this[3]. The AER has attempted to provide a balanced outcome, yet the regulated firms have been able to seek redress from the Competition Tribunal on specific issues where the prescription within the Rules enables such appeals to be made. At the same time, the balancing aspects of the AER decisions are not addressed and rebalanced.

The fact is that prescription is used by the regulated firms to increase their revenues.

The MEU considers that to ensure there is a balance between competing elements, discretion is needed to provide balance overall.

Under an incentive regulatory regime (on which the NER and NGR are supposed to operate) there is a need to utilise the outcomes of the incentives provided. Such a need presupposes that the outworkings of the regulatory process needs more (rather than less) discretion in the application of the outworkings. Imposing prescription prevents the optimum outcome occurring.

The Laws require the regulatory processes to provide an outcome which is efficient. If the Rules are prescriptive and deliver an outcome which is not efficient, there is a need to change the Rules. To prevent the need for the Rules to be changed frequently (eg every time a prescriptive element provides a less than efficient outcome), greater discretion by the independent "umpire" is a sensible approach. This is what is proposed in these AER rule changes.

9.3 Discretion on opex and capex

The current rules require the AER to assess a reasonable level of opex and capex which is within a credible range.

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[3] For example the issue of the long term interests of consumers with regard to price muct be seen to compete with the issue of the long term interests of consumers with regard to reliability.

For example in the distribution Electricity Rules the AER is required to allow a credible allowance for opex that is within the ranges determined by

"(c) The *AER* must accept the forecast of required operating expenditure of a *Distribution Network Service Provider* that is included in a *building block proposal* if the *AER* is satisfied that the total of the forecast operating expenditure for the *regulatory control period* reasonably reflects:

(1) the efficient costs of achieving the *operating expenditure objectives*; and
(2) the costs that a prudent operator in the circumstances of the relevant *Distribution Network Service Provider* would require to achieve the *operating expenditure objectives*; and
(3) a realistic expectation of the demand forecast and cost inputs required to achieve the *operating expenditure objectives*.

(e) In deciding whether or not the *AER* is satisfied as referred to in paragraph (c), the *AER* must have regard to the following (the *operating expenditure factors*):

(1) the information included in or accompanying the *building block proposal*;
(2) submissions received in the course of consulting on the *building block Proposal*;
(3) analysis undertaken by or for the *AER* and *published* before the distribution determination is made in its final form;
(4) benchmark operating expenditure that would be incurred by an efficient *Distribution Network Service Provider* over the *regulatory control period*;
(5) the actual and expected operating expenditure of the *Distribution Network Service Provider* during any preceding *regulatory control periods*;
(6) the relative prices of operating and capital inputs;
(7) the substitution possibilities between operating and capital expenditure;
(8) whether the total labour costs included in the capital and operating expenditure forecasts for the *regulatory control period* are consistent with the incentives provided by the applicable *service target performance incentive scheme* in respect of the *regulatory control period*
(9) the extent the forecast of required operating expenditure of the *Distribution Network Service Provider* is referable to arrangements with a person other than the provider that, in the opinion of the *AER*, do not reflect arm's length terms;

> (10) the extent the *Distribution Network Service Provider* has considered, and made provision for, efficient non-network alternatives”

By providing such a listing of sources of potential “credible” outcomes, the AER must allow that outcome which provides the highest credible value from all of the sources nominated. Discretion is not permitted (by dint of appeal) to exclude any one of the potential ranges implied by all of the options that AER has to consider.

The AER needs to have the discretion as how to weight the outcomes from each of the potential sources of input, and how to weight the outcomes from assessing the range of outcomes from each source.

Currently the level of prescription imposed by the wide sources of input imposes considerable pressure on the AER through the knowledge that a regulated firm can (and does) appeal the AER decisions where those decisions might not allow the maximum revenue to the firm.

The MEU has been involved with nearly every energy related regulatory revenue reset since the first one by IPART under the Gas Code. Under the original Gas and Electricity Codes the regulator (national and jurisdictional) was permitted considerable discretion. This was significantly reduced in the Chapter 6 and 6A rules and the new gas rules.

Since that time the regulatory decisions have resulted in considerable increases in allowed revenues and the numbers of appeals to the Competition Tribunal. That this has occurred after the changes in the rules is no coincidence and the MEU is firmly of the opinion it has resulted from the changes in emphasis on the requirements placed on the regulator.

9.4 The solution

The MEU supports the proposals put forward by the AER in that the AER proposes a number of changes to the electricity and gas rules which will rebalance the strong bias in favour of the regulated firms.

The MEU does consider there are perhaps more preferable solutions to the issues raised by the AER than the solutions it proposes and these are raised in the sections above (especially section 2).

The MEU also notes that there are some elements which the AER has not addressed and would therefore not be discussed within the AEMC processes. Because of this the MEU has proposed some additional rule changes which are intended to complement the AER proposal but which raise issues not addressed in the AER proposal.