UE & Multinet Pty Ltd
ABN 31 093 273 851

UNITED ENERGY Multinet GAS

20 January 2012

United Energy and Multinet Gas
43-45 Centreway
Mt Waverley VIC 3149
PO Box 449
Mt Waverley VIC 3149
T 03 8846 9900
F 03 8846 9999
www.ue.com.au
www.multinetgas.com.au

Our Reference: REG.08.05.07

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

Dear Mr Pierce,

Major Energy Users' rule change proposal - Optimisation of regulatory asset base and replacement of fully depreciated assets

United Energy (UE) and Multinet Gas welcome the opportunity to lodge this joint submission in relation to the rule change proposal from the Major Energy Users (MEU). The MEU's rule change proposal would require the AER to:

- Optimise the regulatory asset base at each regulatory review to reflect the AER's asset valuation. The AER's valuation would be based on the its assessment of the assets required to provide the service; and
- Protect customers from the unnecessary replacement of fully depreciated assets that continue to provide regulated services, and therefore do not need to be replaced.

The Commission's consultation paper[1] notes that the MEU's rule change proposal must be assessed against the national objectives[2] defined by the relevant legislation. These objectives focus on efficiency, as set out below:

> "The objective of this Law is to promote efficient investment and efficient operation and use of [network] services for the long term interests of consumers with respect to price, quality, safety, reliability and security of supply."

1 Australian Energy Market Commission, MEU rule change proposal, Consultation Paper, 1 December 2011.

2 This submission uses the shorthand "national objectives" to refer to the National Electricity Objective and National Gas Objective in sections 7 and 23 of the National Electricity Law and the National Gas Law, respectively.

UE and Multinet agree with the Commissions' suggestion that the following matters are relevant in assessing whether MEU's rule change proposal promotes the national objectives:

- recovery of efficient costs – whether the proposed rule would allow businesses to be able to fully recover an efficient level of costs to deliver secure and reliable supplies to customers;
- efficient utilisation – whether the proposed rule would provide the appropriate signals for efficient utilisation;
- investment incentives – whether the proposed rule would have an impact on incentives to invest in services that would benefit customers; and
- regulatory process - whether the proposed rule would create complexity or uncertainty in the regulatory process.

As explained in further detail in this submission, the proper application of these concepts to MEU's rule change proposal demonstrates that the proposed changes would be detrimental to the achievement of the national objectives.

The remainder of this submission is structured as follows:

- Section 2 describes and comments MEU's rule change proposal; and
- Section 3 provides concluding comments.
- An attachment addresses the questions raised by the Commission in its consultation paper.

1. MEU's rule change proposal

UE and Multinet note that MEU has expressed extreme views regarding the existing rules and the regulatory process that produced them. For example[3]:

> "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."

In addition to the unsubstantiated claims of bias, MEU's rule change proposal contains a number of factual errors, including the following comment in relation to investment incentives[4]:

> "If the actual cost of an investment exceeds the allowance used to demonstrate efficiency of the investment, the regulated business incurs no penalty because the actual cost is rolled into the asset base. This means there is an incentive for the regulated business to underestimate the cost of its preferred solution, knowing the actual cost will be used for future revenue and therefore there is no penalty. Consumers pay the costs resulting from the in-built inefficiency."

3 Major Energy Users, Submission to AEMC, Economic Regulation of Network Service Providers – AER Proposed Rule Change Comments on the Consultation Paper, December 2011, page 5.

4 Ibid, pages 8 and 9.

Contrary to MEU's views, a key feature of incentive regulation is to reward network service providers for achieving capital and operating expenditure efficiencies. As discussed in further detail below, MEU's rule change proposal is predicated on an erroneous assumption that regulation rewards increases in expenditure.

In reality, UE and Multinet commit significant engineering resources and skills to develop condition-based expenditure plans that optimise costs and service performance. As a result, since privatisation customers have enjoyed significant benefits through the efficient deferral of capital expenditure; increased asset utilisation; retention of assets well-beyond their expected lives; and improved focus on service performance and risk management. A cursory review of submissions from regulated companies will reveal similar approaches to asset management that are also focused on minimising total life cycle costs.

In light of the above discussion, MEU's claims that the rules provide incentives to over-invest are unfounded. In today's financial climate, in which companies such as UE and Multinet face significant capital constraints, concerns regarding over-investment are at odds with commercial reality. Although MEU's rule change proposal is based on a false premise, in the following two sections we examine MEU's proposed clauses in turn.

1.1 RAB optimisation proposal

MEU propose the following clause to allow the AER to optimise the RAB:

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

The effect of the proposed clause is to require the AER to determine an optimised value for the RAB. If the AER's assessment leads to a lower valuation than the 'roll forward method', the AER's valuation is adopted. However, if the AER's valuation leads to an increased valuation – for example because the company has achieved savings in unit capital costs – the lower valuation would again be adopted. MEU's proposal is therefore asymmetric because it can only lead to rates of return below the cost of capital, contrary to the competitive market paradigm advanced by MEU in its proposal.

MEU's proposal creates serious practical implementation problems and also damages investment incentives. The Commission has previously examined these issues in developing the Chapter 6A rules for electricity transmission networks. In that review, MEU also proposed that RAB optimisation should be adopted by the Commission.

It is helpful to revisit the Commission's analysis[5] of the issues at that time, which reflected on the practical problems and negative incentive properties associated with optimisation exercises.

> "As noted in the Proposed Rule report, the Commission intends to adopt a lock-in and roll forward approach to the determination of the RAB. The ACCC's initial approach to the RAB in its 1999 Draft Statement of Regulatory Principles provided for periodic optimisation of TNSPs' assets. The rationale for periodic optimisation is that it can provide incentives for TNSPs to utilise their information advantage over the regulator to only invest in those assets that are likely to remain 'used and useful' in the longer term. However, the strength of incentives for efficient investment depend on the extent of clarity around when and if assets will be optimised.
>
> The Commission has taken the view that providing clear and consistent signals surrounding the likelihood of optimisation is unlikely to be feasible and hence that a roll forward approach to the RAB is preferable. The periodic optimisation approach is very information intensive and likely to remain highly subjective. It confers a great deal of discretion on the regulator and thereby creates a high degree of uncertainty for TNSPs considering investment. Such uncertainty is ultimately paid for by transmission customers through higher prices than would otherwise be the case. The roll forward approach avoids these problems by placing the emphasis of regulatory attention on ensuring transparent decision making processes for future investments, supported by prescribed requirements for public consultation.
>
> The Commission has also decided against requiring ex post reviews of the costs of capital projects before including them into the RAB (see section 6.4.1 of this Draft Determination). This requirement was aimed at balancing the relief of investment risk provided by the Commission with a mechanism to ensure TNSPs managed their capital expenditure projects efficiently.
>
> In general the criticism of the proposed ex post prudency review was that it undermined the incentives of the ex ante cap and contributed to the investment uncertainty the remainder of the package sought to overcome. Submissions also raised the legitimate concern that ex post prudency reviews are, by their very nature, an intrusive form of regulation. An ex post review effectively requires the regulator to put itself in the position of a TNSP at the time that they were undertaking a particular project to determine if the project was undertaken efficiently. Previously, this process has been the subject of controversy when it has been applied to network businesses.
>
> For these reasons, the Commission is sympathetic to submissions for the elimination of ex post reviews and has instead focused more on improving ex ante incentives. For example, to the extent overspending occurs, this can be taken into account in the setting of the capital expenditure allowance for the following regulatory period. The Commission considers that the inclusion of depreciation into the capital expenditure incentive mechanism will partly offset the loss of regulatory discipline inherent in the removal of ex post reviews."

The above quotation is from the Commission's Draft Determination, and the approach was subsequently adopted in the Final Determination. The AER had earlier made the following submission in relation to the Commission's earlier suggestion (in its initial Rule proposal) that an ex post prudency reviews should be re-introduced[6]:

---

5 AEMC, Draft Rule Determination, Economic Regulation of Transmission Services, 26 July 2006, pages 75 and 76.

6 AER submission to the AEMC's Rule Proposal, March 2006, page 8.

"The second change to the SRP's [Statement of Regulatory Principles] incentive scheme is the re-introduction of ex-post prudency assessments. By requiring an assessment of the efficiency of investment decisions after they have been made, an ex-post regime creates the risk of investment write downs. This gives rise to significant investment uncertainty and has the potential to deter efficient investment. So while the package outlined in the draft Rules may increase returns to TNSPs, at the same time it unnecessarily creates risks to TNSPs due to the ex-post revaluations. An ex-post approach is also highly intrusive and, by its nature, creates an adversarial relationship between the regulator and service provider. These concerns led the AER to move away from an ex post approach in the SRP. The AER considers that efficient investment outcomes can be achieved through a well designed incentive regime and that ex-post prudency assessments are dysfunctional and not necessary."

UE and Multinet note that MEU regards the Commission's earlier assessment of these issues as "blatantly biased and unbalanced". Nonetheless, the fact remains that the AER recognised the practical difficulties and poor incentive properties of an ex post prudency review. It is unusual for the AER to use such strident language, describing ex post prudency assessments as "dysfunctional and not necessary".

At the conclusion of its extensive consultation process, the Commission correctly concluded that it is better to focus on strengthening incentives to deliver efficiency gains through ex ante incentives, rather than attempting to scrutinise the efficiency of investment decisions after the event[7]. The MEU's rule change proposal has not provided any new evidence or analysis that would support a return to a discredited regulatory approach.

It is worth noting that the National Gas Rules presently provide scope for a mechanism to be included in an access arrangement to remove assets from the RAB that cease to contribute in any way to the delivery of pipeline services. While such a mechanism could be developed, compensation[8] would need to be provided to the network service provider in terms of an increased rate of return and shortened expected asset lives, both of which would lead to increased prices to customers. Without these countervailing adjustments, the access arrangement would not comply with the revenue and pricing principles in the National Gas Law. In practice, the regulation of gas networks does not provide for the removal of assets from the RAB.

1.2 Protecting customers from unnecessary replacement of assets

MEU proposes the following clause to protect customers from the early replacement of assets that continue to provide regulated services:

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

It is noted that the drafting of this clause is confusing because it requires that <u>proposed</u> capital expenditure should not be added to the regulatory asset base. It should be understood, however, that <u>proposed</u> expenditure is currently subject to review by the AER prior to the AER establishing a

7 For completeness, it should be noted that Transmission Network Service Providers (TNSPs) are exposed to stranded asset risk in the limited circumstances where a TNSP has failed to establish contracts or price in a manner to reduce the risk of stranding.

8 As explained in the attached response to the Commission's question 4, the form of compensation was stated explicitly in the National Gas Code and is now reflected in the National Gas Law's revenue and pricing principles.

benchmark capital expenditure allowance. The AER would not accept proposed capital expenditure that included the uneconomic replacement of assets. As drafted, the MEU's clause is therefore unnecessary because the rules already provide for scrutiny of proposed capital expenditure.

An alternative interpretation of MEU's proposed clause is that it is intended to refer to actual capital expenditure, not proposed. Under this interpretation, MEU's concerns would be addressed by its first proposed clause which provides for RAB optimisation. In optimising the RAB, the AER would necessarily examine all capital expenditure (including replacement capital expenditure) to assess whether it should be removed from the RAB on the grounds that it is not necessary. MEU's second proposed clause is therefore a specific example of the ex post review discussed earlier.

As already explained, contrary to MEU's views, the existing rules provide network companies with an incentive to minimise expenditure, and extend asset lives wherever possible. While the MEU is correct that fully depreciated assets will not generate a return on those particular assets, it does not follow that the network company has an incentive to replace those assets.

The incentive mechanisms reward capital expenditure efficiencies relative to the allowance set by the AER. There is no incentive to increase capital expenditure unnecessarily, even if the resulting expenditure is rolled into the RAB. To illustrate this point, UE's most recent regulatory proposal identified that it has a number of fully depreciated assets with lives in excess of 80 years[9].

As noted earlier, the best approach to regulation is to provide financial incentives to deliver services efficiently. The MEU has not provided any specific examples of inefficient behaviour. However, even if such examples did exist, the response should be to strengthen the incentives to deliver efficiency improvements. Instead, the MEU is proposing an administrative solution that would require the AER to judge whether investment decisions have been efficient. As the AER itself has explained, the MEU's suggested approach is not workable or desirable. It is disappointing that MEU is continuing to propose this type of regulation, despite the overwhelming evidence that it will not promote the achievement of the national objectives.

2. Concluding comments

MEU's rule change proposals would reintroduce a form of regulation that was found to be unworkable, intrusive and damaging to investment incentives by creating unnecessary uncertainty regarding cost recovery. The proposed rule changes would not promote the national objectives.

UE and MG agree that a regulatory model should seek to simulate the key characteristics of a competitive market. However there are a number of important features of a competitive market are currently missing from the regulated market that would require consideration as part of this consultation. For example rates of return are higher, depreciation rates of assets (noting that current rates are approximately 50 years) are shorter which are built into higher short-term prices, and firms will continue to charge market prices for the use of assets if possible.

A better approach to regulation is one that provides incentives on the network companies to act commercially to improve outcomes for customers. Ultimately, the investment and commitment that is

9 United Energy, Regulatory Proposal for Distribution Prices and Services, January 2011 – December 2015, 30 November 2009, page XXII.

required to deliver improved services and cost efficiencies will only be forthcoming if regulatory risk and uncertainty is minimised. A proposal that has risk and uncertainty as its core tools is bound to work against the objectives that have been established for the regulatory regime.

UE and MG would be pleased to respond to any queries the Commission may have in relation to this submission. Please contact me on 03 8846 9860.

Yours Sincerely,

Andrew Schille

General Manager Regulation

UE and Multinet's responses to the Commission's questions

Q1 What would the impact on investment be with the rule change requests? Would this have a positive or negative impact?

As explained in the above submission, the proposed rule change would have a negative impact on investment because it would create significant uncertainty and regulatory risk regarding cost recovery.

Q2 Is it appropriate for the AER to determine and assess the age and condition of a regulated network business's asset?

No. Regulation should provide financial incentives on the network companies to make soundly based decisions regarding investment and maintenance. It is not appropriate for the AER to second-guess a network company's investment decisions. The AER is not equipped to make such assessments, and previous AER submissions and analysis have firmly concluded that asset revaluations are undesirable.

Q3. Does the increase in administrative burden outweigh the benefits of the proposed rule?

Yes. As explained in the above submission, the AER has previously recognised that ex post prudency reviews are dysfunctional and unnecessary. We agree with this assessment.

Q4. Does rule 85(1) of the NGR (capital redundancy) adequately address the proposed rule's objective to remove under-utilised assets from the RAB? Should rule 85(1) of the NGR be duplicated in the NER?

No. In relation to the first question, it is important to note that rule 85(1) does not mandate the removal of under-utilised assets from the RAB. The rule states that:

> "A full access arrangement may include (and the AER may require it to include) a mechanism to ensure that assets that cease to contribute in any way to the delivery of pipeline services (redundant assets) are removed from the capital base."

Rule 85(1) provides that a mechanism <u>may</u> be included in an access arrangement for the removal of assets that cease to contribute in any way to the delivery of pipeline services. This contrasts with MEU's rule change which would effectively mandate the removal of under-utilised assets. To understand the significant difference between these propositions, it is helpful to recap on the origins and intended purpose of rule 85(1).

In developing the National Gas Rules, the Ministerial Council on Energy's Standing Committee of Officials explained the rule 85 in the following terms (please note the numbering of the relevant provisions changed through the consultation process)[10]:

[10] Standing Committee of Officials, 2006 Legislative Package: Initial National Gas Rules, November 2006, page 12.

"Rules 33 [subsequently rule 85] and 34 [86] replace ss 8.27 and 8.28 of the Gas Code respectively, which relate to capital redundancy. The policy contained in these rules is essentially unchanged from that in the Gas Code. Under the NGR:

- service providers may include in an access arrangement a mechanism to ensure that assets that cease to contribute to the delivery of services are not reflected in the service provider's capital base;
- the AER may require a service provider to include a capital redundancy mechanism in an access arrangement;
- the AER must consider the uncertainty that requiring or approving such a mechanism would cause for users, prospective users and the service provider; and
- assets that have been classified as redundant and removed from the service provider's capital base may, in future, be rolled into the capital base as new capital investment if they begin to contribute to the delivery of services."

The intention, therefore, in drafting the National Gas Rules was to preserve the National Gas Code provisions. Section 8.27 of the National Gas Code articulates the matters that would need to be considered in deciding whether to apply a mechanism to remove redundant assets.

"Before approving a Reference Tariff which includes such a mechanism, the Relevant Regulator must take into account the uncertainty such a mechanism would cause and the effect that uncertainty would have on the Service Provider, Users and Prospective Users. If a Reference Tariff does include such a mechanism, the determination of the Rate of Return (under sections 8.30 and 8.31) and the economic life of the assets (under section 8.33) should take account of the resulting risk (and cost) to the Service Provider of a fall in the revenue received from sales of Services provided by means of the Covered Pipeline or part of the Covered Pipeline."

The above provision therefore makes the following points clear:

- such a mechanism may not be desirable because of the uncertainty that it creates;
- if such a mechanism is adopted, a compensating adjustment must be made to the return on and rate of capital (by adjusting the economic life of the assets).

In accordance with the intention of the architects of the National Gas Rules, rule 85 together with the revenue and pricing principles in the National Gas Law effectively preserve these requirements on the AER. In particular:

- 24(2) requires that a service provider should be provided with a reasonable opportunity to recover at least the efficient costs the service provider incurs in providing reference services;
- 24(5) states that a reference tariff should allow for a return commensurate with the regulatory and commercial risks involved in providing the reference service to which that tariff relates;

- 24(6) requires the AER to have regard to the economic costs and risks of the potential for under and over investment by a service provider in a pipeline with which the service provider provides pipeline services.

- 24(7) requires the AER to have regard to the economic costs and risks of the potential for under and over utilisation of a pipeline with which a service provider provides pipeline services.

In addition, rule 85(4) requires:

> "Before requiring or approving a mechanism under this rule, the AER must take into account the uncertainty such a mechanism would cause and the effect the uncertainty would have on the service provider, users and prospective users."

To date, Multinet's access arrangements have not included any mechanism to remove assets from the RAB in accordance with rule 85(1). This reflects a conscious decision by Multinet and the Essential Services Commission (which was responsible for approving Multinet's current and previous access arrangements) that exposing network service providers to stranded asset risk would not provide long term benefits to customers. In particular, network service providers would need compensation for the stranded asset risk that would lead to higher prices to customers without delivering any discernable benefit.

In light of current regulatory practice and the inherent difficulties in exposing network service providers to stranded asset risk, UE and Multinet would not support the duplication of rule 85 in the National Electricity Rules. A case could be established for removing rule 85(1) from the National Gas Rules on the grounds that a mechanism could not be established that:

- would be consistent with promoting the national objectives;

- would be consistent with the revenue and pricing principles; and

- would appropriately consider the impact of the resulting uncertainty, as required by rule 85(4).

While UE and Multinet would support the removal of rule 85(1), we regard the existing provision as redundant in practical terms for the reasons set out above.

Q5. The proposed rule requires the amount (to be determined by the AER) to reflect the difference between the actual depreciated value of assets provided and the depreciated replacement value of assets (to be deemed by the AER) required for provision of services. Does this provide the appropriate signals for efficient utilisation of assets? If not, is there a better alternative approach?

The national objectives appropriately focus on efficiency, which has three components:

- allocative efficiency,

- productive efficiency; and

- dynamic efficiency.

Allocative efficiency is achieved by ensuring that network pricing accurately reflects the fixed and variable costs of network usage. Where assets are under-utilised, it may be appropriate to set lower network usage charges for those particular assets to provide appropriate signals to current and prospective network users. Network pricing is therefore the means by which allocative efficiency is achieved.

However, it does not follow that allocative efficiency should be achieved at the expense of total cost recovery, as proposed by MEU. A reduction in total network revenue as a result of the under-utilisation of a particular network asset will adversely affect the achievement of productive and dynamic efficiency. In particular:

- failure to achieve cost recovery will mean that future investments are sized to ensure that under-utilisation does not occur. As a result, the average costs of providing network services will increase, resulting in a loss of productive efficiency.

- the expected return on investment will be reduced, weakening the incentives to invest and adversely affecting dynamic efficiency.

It follows from the above discussion that questions of asset utilisation are best addressed through network pricing considerations, without compromising the objective of cost recovery. It is important to recall that the revenue and pricing principles in the law mandate that network service providers are provided with a reasonable opportunity to at least recover their efficient costs. MEU's proposal focuses on one aspect of efficiency (allocative efficiency) to the exclusion of the other two components (productive and dynamic efficiency). For these reasons, MEU's proposal is inconsistent with the law.

Q6. The proposed rule places a requirement that would disincentivise expenditure for replacement of a fully or partially depreciated asset from being included in the RAB. Does this ensure that fully or partially depreciated assets that are still in use and useful are not replaced? If not, is there a better alternative?

As explained in the above submission, the proposed rule exposes network service providers to ex post prudency reviews even though the AER has explained that such reviews are highly problematic. The better approach to regulation is to rely on the incentive properties of the regime to deliver the efficient outcomes. Contrary to the claims made by MEU, the current regime does not provide any incentive to replace assets unnecessarily. The incentives provided by the regime are to minimise expenditure, subject to satisfying the regulatory and statutory obligations and maintaining service performance. It is better to adjust the incentive mechanisms if necessary, rather than change the form of regulation to a more intrusive and costly examination of each company's investment decisions.

Q7. Should optimisation of the RAB be considered as an alternative to the "40/60 sharing factor" approach when the AEMC is considering the best capex incentive mechanism in response to the AER's rule change request?

UE and Multinet have separately commented on the AER's rule change proposal in relation to the 40/60 sharing. UE and Multinet agree with the Commission's decision to keep the rule change proposals separate, rather than join the consultation exercises. It is worth noting, however, that the AER's 40/60 proposal is not consistent with the national objectives because it would strongly discourage network service providers from exceeding the AER's capital expenditure allowance, even if the additional capital expenditure were efficient. The MEU's proposal is different because it applies to all network assets, and is not limited to new capital additions.

Q8. When should any proposed rule commence?

For the reasons outlined in this submission, the proposed rule should not be approved by the AEMC.