

31/01/2018

AER Board
Mr Adam Petersen, Co-ord Director – Murraylink
Australian Energy Regulator
By email: adam.petersen@er.gov.au Cc: ccp@er.gov.au

Dear Paula,

Re: Draft Decision and Revised Proposal – Murraylink transmission 2018-23

Please find attached our submission in relation to the above network determination.

Kind Regards,

Eric Groom

Submission to the Australian Energy Regulator (AER)

Consumer Challenge Panel Sub-Panel 9

Response to Draft Decision and Revised Proposal for Revenue Reset for Murraylink for 2018-2023

Sub-Panel 9

Eric Groom

Bev Hughson

Andrew Nance

29/01/2018

1. Executive Summary

CCP9 has considered the AER's Draft Decision of September 2017 and the revised proposal of Murraylink (the Network Service Provider or NSP) of December 2017 in light of the objective of the CCP which is to:

- advise the AER on whether the network businesses' proposals are in the long term interests of consumers; and,
- advise the AER on the effectiveness of network businesses' engagement activities with their customers and how this is reflected in the development of their proposals.

As was the case with the original proposal, CCP9 considers the consumer engagement by Murraylink to be profoundly disappointing.

Further, there are a number of areas where CCP9 is concerned that the proposal from Murraylink may not be in the long-term interests of consumers.

In this section of our advice to the AER we summarise the issues of interest to CCP9 and our recommendation as follows:

A. CONSUMER ENGAGEMENT

CCP9 has found Murraylink's approach to Consumer Engagement (CE) to be profoundly disappointing. Despite the requirements under the NER and the AER's Guideline, Murraylink has made no effort to engage stakeholders other than its business-as-usual process contacts.

Recommendations:

- a. ML's continued failure to demonstrate that it has developed and implemented a broader consumer engagement program should be a factor that is considered by the AER when it makes its Final Decision on ML's request for a 30% increase in total revenue
- b. The AER should not accept ML's proposal for additional capital expenditure to cover its forecast costs for regulatory proposal and customer engagement
- c. ML should be encouraged to learn from its peers in establishing an effective program in the future, particularly if it anticipates conducting a RIT-T process consistent with the requirements in the rules

B. LONG TERM INTEREST OF CONSUMERS

Our approach to considering the long term interests of consumers is based in the National Electricity Objective (NEO). The NEO is an economic efficiency objective that is often described in terms of three dimensions: productive, allocative and dynamic efficiency. There are a number of issues in the Murraylink proposal which show, or raise the prospect, that the proposal is not in the long term interest of consumers.

Capital Expenditure and RAB

The focus of this submission in relation to capital expenditure has been on the proposed control system replacement. The application of a cost-plus 10% to the project is not accepted as being in the consumer interest

Recommendations:

- d. Maintain the capital expenditure allowance for the control system replacement from the Draft Decision and not accept the revised proposal
- e. Reiterate in the Final Determination that efficient costs should not be tied to ownership arrangements.

Operating Expenditure

CCP9 supports most aspects of the AER's draft determination on the forecast opex for Murraylink electricity transmission and acknowledges the fact that Murraylink has decided to accept the AER's opex forecast notwithstanding its stated reservations about the components of the forecast. CCP9 also strongly supports the AER's approach to assessing, and rejecting, Murraylink's proposed step change.

Recommendations:

- f. The AER undertake further investigation of the efficiency of the base year 2015-16 and, preferably, update the assessment using audited data for 2016-17.
- g. The AER review its decision on its forecast of the rate of price growth. In particular, the AER reconsider its forecast of labour cost growth given the views of Business SA and The Central Irrigation Trust (CIT) who are familiar with SA labour market conditions and regional cost structures.

Rate of Return, Inflation and Tax

The AER's Draft Decision rejected Murraylink's proposed WACC of 6.54% and proposed a WACC of 5.7% (nominal vanilla), consistent with the AER's Rate of Return Guideline. The difference primarily reflects differences in the proposed return on equity, where the AER maintained its use of a Market Risk Premium (MRP) of 6.5% and beta of 0.7. The AER's estimate for inflation expectations was 2.5%, compared to Murraylink's proposal of 2.0%. and it used a gamma (value of imputation credits) of 0.4 in estimating the allowance for tax expense, compared to Murraylink's proposed gamma of 0.25.

In its Revised Proposal Murraylink accepted the change in AER's estimate of inflation expectations and value for gamma but did not accept AER's estimates of beta and MRP, using 0.8 and 7.7% respectively. As a consequence, Murraylink used a WACC of 6.4% in its revised proposal.

CCP9 supports the application of the AER's application of the Rate of Return Guideline and the proposed WACC of 5.7%. In doing so, it notes that:

- It considers that AER's current approach and values for key parameters have resulted in WACCs that have systematically erred on the high side, but that this is best considered through the current review of the Rate of Return Guideline
- It supports the CCP submission to the Rate of Return guideline.

CCP9 does not support Murraylink's approach to applying the Sharpe-Lintner model which is contrary to common practice and can result in unstable and counter-intuitive outcomes. This is illustrated by the increase in the MRP and the ROE between its original proposal and its revised proposal at a time when other indicators suggest that the expectations for the MRP and ROE have been falling.

Recommendations:

- h. CCP9 accepts the Draft Decision WACC of 5.7% (nominal, vanilla) and recommends that in its final decision the AER updates the proposed WACC only for changes in interest rates.

Incentive Schemes

The AER has three standard incentive mechanisms: the Efficiency Benefit Sharing Scheme (EBSS), the Capital Expenditure Sharing Scheme (CESS) and the Service Target Performance Incentive Scheme (STPIS). In principle these incentives are in the long-term interest of consumers and their application is also supported by ML. The only issue where there may be a difference of view is whether debt raising costs should be included. While ML has stated it agrees to the exclusion of debt raising costs the estimates in its Revised Proposal appear to include debt raisings costs in the opex for the EBSS. CCP9 supports the AER in excluding debt raising costs as these costs are not reset using the revealed cost approach.

Recommendations:

- i. CCP9 supports the application of the EBSS, CESS, and STPIS as proposed by the AER (including the exclusion of debt raising costs from forecast opex for the EBSS)

More detailed consideration of these issues is set out in CCP9 advice below.

2. Background

- This advice was prepared in accordance with the Schedule of Work agreed upon between sub-panel CCP9 working on the Murraylink, TransGrid and ElectraNet resets and Adam Petersen and Andrew Ley, Co-ordination Directors for the resets.
- The NSPs commenced the process of preparation of their access arrangement proposal and the related consumer engagement early in 2016. During 2016 the NSPs undertook a range of consumer engagement activities and processes.
- CCP9 was established in September 2016.
- CCP9 held regular meetings with the Co-ordination Directors since October 2016.
- Introductory contact was made with Murraylink (via APA) on 30 November 2016.
- A briefing was provided by APA to the AER and CCP9 on 25 January 2017.
- On 10 April 2017 CCP9 participated in the public forum convened by the AER in Adelaide and Sydney via videolink. Beyond AER staff, CCP members and APA representatives the only attendees were representatives from ElectraNet and the South Australian Government.
- CCP9 made a submission on the Proposal on 12 May 2017
- The AER released its draft decision on 28 September 2017

- CCP9 presented at the pre-determination forum on 11 October 2017
- Murraylink submitted its revised proposal on 1 December 2017

3. Consumer Engagement

The effectiveness of network businesses' engagement activities with their customers and how this is reflected in the development of the network business' revised proposals

Stakeholder Feedback on Murraylink's initial proposal

In CCP9's response to Murraylink's (ML's) original proposal, CCP9 acknowledged the challenges facing a relatively small transmission network in establishing and maintaining an effective customer engagement program. Nevertheless, CP9 highlighted that:¹

- CCP9 found ML's approach to consumer engagement to be profoundly disappointing
- ML provided no evidence of any attempt to engage stakeholders other than its 'business-as-usual' (BAU) contacts
- ML has shown no evidence of any attempt to measure the quality of even these BAU relationships
- ML has ready access to a variety of sources that can provide information and guidance on developing an effective consumer engagement program, including the AER's 2013 Consumer Engagement Guideline² and Energy Networks Australia's Customer Engagement Handbook and related material³.
- Under the NER, consumer engagement is a factor the AER must consider when deciding on ML's expenditure proposals.

CCP9 further highlighted that ML has sought a significant increase in its overall revenue and that fact alone should point to the importance of ML engaging with consumers as part of their revenue proposal.⁴ It is consumers, not AEMO or other transmission companies that ultimately fund ML's expenditure program.

Based on this assessment, CCP9 recommended that:⁵

A significant factor in the AER's evaluation of Murraylink's proposal should be their lack of interest in engaging energy consumers

Other stakeholders also raised concerns about the quantity and quality of ML's consumer engagement in submissions, perhaps best summarised in the submission by the SA Department of Premier and Cabinet. This submission highlighted that, in its experience, ML had not conducted an effective consumer engagement program and that ML has an obligation to engage with not only their direct customers, but also consumer representatives.⁶

¹ See, *Consumer Challenge Panel subpanel 9 – Response to proposals from Murraylink*, 12 May 2017 updated, p 6.

² www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/consumer-engagement-guideline-for-network-service-providers

³ <http://www.energynetworks.com.au/customer-engagement-handbook>

⁴ NER cl.6A.6.6(e)(5A) for opex and 6A.6.7(e)(5A) for capex.

⁵ *Consumer Challenge Panel subpanel 9 – Response to proposals from Murraylink*, 12 May 2017 updated, p 6.

⁶ Government of South Australia Department of Premier and Cabinet, *Submission on the Murraylink electricity transmission revenue proposal for 1 July 2018-30 June 2023*, 17 May 2017, p 2.

The AER's Draft Decision

In its Draft Decision, the AER agreed with the observations of CCP9 and the SA Government. The AER noted ML's "*lack of commitment to ongoing and genuine consumer engagement on issues relevant to consumers*"⁷ and considered ML "*must do more consumer engagement consistent with our consumer engagement guideline and not simply leave this to the regulatory determination process*".⁸

The AER also noted it has seen a similar lack of commitment to consumer engagement by the APA Group, which has equity in and manages Murraylink, in its determinations for the Roma to Brisbane Gas Pipeline (RBP) and Victorian gas Transmission System (VTS). The AER concludes that:⁹

Our own consultation on Murraylink's proposal has shown that there is stakeholder interest in the proposal. These submissions have highlighted areas of our Murraylink's proposal that we have subsequently rejected such as Murraylink's proposed capital expenditure and WACC. We consider that Murraylink's revenue proposal would have benefited from stakeholder engagement on these matters at an early stage.

The revised revenue proposal provided an opportunity for ML to respond to this wide spread criticism of ML's approach to consumer engagement. It was an opportunity for ML to demonstrate that it recognises and respects the importance of its regulated infrastructure to the security of supply to consumers in South Australia and Victoria and the value of working with consumers and their representatives to address the critical supply security issues and ML's own requirements for new investment capital.

Murraylink's Revised Proposal

ML again emphasises that it has ongoing engagement with its 'customers' and that feedback from these customers forms part of the process of ML operating its business. ML states that: "Engagement with AEMO, ElectraNet and TransGrid in particular was pivotal to Murraylink's consideration of the requirements of the network".¹⁰ In CCP9's view this is simply BAU activity and again, ML has shown no evidence of any independent assessment of the quality of this BAU engagement.

With respect to the concerns by the CCP9 and the AER regarding the need for ML to broaden its consultation beyond its direct customers¹¹, ML states that:¹²

[Murraylink] has commenced discussions with ElectraNet and other parties on ways to participate in their broader consumer consultation processes. This will focus on

⁷ AER, *Draft decision Murraylink Transmission determination 2018-23*, Overview, 23 September 2017, p 39.

⁸ Ibid.

⁹ Ibid.

¹⁰ Murraylink, *Revised Revenue Proposal*, 1 December 2017, p 43.

¹¹ Note, the SA Department of Premier and Cabinet also made the same point and other submissions noted their concerns. ML does not refer to these important stakeholders.

¹² Murraylink, *Revised Revenue Proposal*, 1 December 2017, p 43.

ways that could provide Murraylink with meaningful avenues to communicate with relevant representative groups identified by the AER.

ML then proceeds to discuss the costs that should be recovered in the 2018-23 revenue determination, stating as follows:¹³

As part of the revenue determination process Murraylink has combined it with the forecast capital expenditure associated with the revenue determination costs. The stakeholder engagement cost represents part payment of shared costs with the body organising the stakeholder engagement.

....

Table 6.4 sets out the expected consumer engagement and revenue determination costs by year. The consumer engagement costs represent the contribution that Murraylink is anticipating to making to the costs of consumer engagement by ElectraNet, AusNet Services and AEMO. The revenue determination costs are based on those costs incurred in the current period.

	2018/19	2019/20	2020/21	2021/22	2022/23	Total
Revenue Determination and consumer engagement	10	36	61	82	56	245

CCP9's Assessment of Consumer Engagement – Revised Proposal

In its revised proposal, ML has clearly missed the opportunity to effectively respond to the concerns raised by consumer and government stakeholders (above) and to develop a broadly based customer engagement program and illustrate how this engagement has informed its revised proposal, including the proposed contingent project.

In the first instance, ML cites its engagement with AEMO, ElectraNet and TransGrid but also notes this is part of 'operating its business'. CCP9 agrees. This is simply BAU activity. Moreover, ML has shown no evidence of any independent assessment of the quality of this BAU engagement or how this has informed its proposal.

Second, it is not up to the AER or other bodies to identify the broader field of stakeholders that are relevant to an effective consumer engagement program or to the structure of the program itself. As CCP9 has noted, there is considerable material available for Murraylink to draw on and to tailor to its specific requirements.

Third, other than a general statement that it is talking to ElectraNet and other parties, ML provides no detail on the nature of these discussions and what concrete steps it has taken over what period (other than it is sharing costs). For example, ML has given presentations to an AEMO consumer groups in the past and has indicated it regards this as adequate

¹³ Ibid.

consumer engagement. Does it plan to do the same with ElectraNet. CCP9's view was that these presentations with AEMO were very high level and did not invite active discussion, but were more in the nature of 'call me if you have questions'. That is not effective consumer engagement.

On the other hand, if ML is talking to ElectraNet to learn how to further develop its program then this may be useful as ElectraNet has much to offer having one of the most well developed, and ongoing consumer engagement program of all the networks. ElectraNet's consumer engagement program has, for instance, enabled ElectraNet to respond to consumer concerns and to be a very effective participant in the development of a wider response to the electricity supply issues facing South East Australia.

The difficulty is that, based on ML's one page on its consumer engagement development, CCP9 has no indication of the type of process that ML has in mind.

Although CCP9 recognises that ML is a relatively small network business, the parent companies have interests in a range of regulated assets in Australia and receive the benefit of reliable cash flows for their investors as a result – in particular, protection from demand changes is a major benefit for all these customers. As the AER has noted in its Draft Determination, the approach taken by APA (and presumably its other investors) towards consumer engagement is very poor relative to their peers. However, APA has a clear opportunity to develop a business wide approach (that can be tailored to individual networks) that will reduce overall costs of complying with its consumer engagement obligations.

As a final note on the assessment of ML's revised proposal, CCP9 recommends that the AER reject the proposed capital expenditure allowance. The table provides no clarity on the breakdown between the regulatory determination costs and the customer engagement costs. Moreover, there is no explanation as to why these costs – which are usually part of operating costs – should be included as capital costs. Furthermore, given the past behaviour by ML and APA where past criticisms of the lack of customer engagement have gone unheeded, CCP9 has no confidence that the allowed revenue would translate into effective customer engagement. It would be concerning if ML saw this as an opportunity to obtain a return on investment from expenditures that once allowed may not be spent.

Concluding comments on Customer Engagement

Based on its capital expenditure proposal and its contingent capital expenditure project, ML appears to indicate that it is interested in long-term involvement and investment in the developing electricity market and associated transmission network developments. However, its attitude and approach to consumer engagement does not augur well for its ability to be a significant, effective and consumer oriented contributor to addressing the important challenges ahead.

For example, in terms of the proposed contingent project, a condition of approval of such a project is the successful completion of a RIT-T. The successful completion of a RIT-T requires a demonstrated program of stakeholder engagement throughout the process to complement the economic benefit tests. To date, ML has not demonstrated either interest in or capability of developing such a program.

Moreover, if ML’s contingent project(s) were to be seriously considered, it would become part of ML’s regulated assets. Consumers’ views of ML’s efforts to date may raise concerns in their minds about the wisdom of expanding ML’s capex program and subsequent expanded regulated asset base.

Since CCP9’s response to the initial proposal CCP9 has become aware of the developments in the Victorian Essential Services Commissions approach to assessing effective customer engagement and rewarding or not Victorian water utilities (large and small) on this basis. Of particular interest are the processes of self assessment and parallel independent assessment and the separate process of linking the allowed return on equity to the assessment of the quality of the engagement (along set criteria) and also the degree of alignment of the self assessment and independent assessment outcomes. Such an approach may provide the motivation for undertaking customer engagement in line with the standards now expected in the rules and across the industry, as illustrated by the work being undertaken by the ENA in conjunction with the AER and Energy Consumers Australia (ECA).

CCP9 would welcome further discussion of this approach with the AER.

Recommendations:

1. ML’s continued failure to demonstrate that it has developed and implemented a broader consumer engagement program should be a factor that is considered by the AER when it makes its Final Decision on ML’s request for a 30% increase in total revenue
2. The AER should not accept ML’s proposal for additional capital expenditure to cover its claimed costs for regulatory proposal and customer engagement
3. ML should be encouraged to learn from its peers in establishing an effective program in the future, particularly if it anticipates conducting a RIT-T process consistent with the requirements in the rules

4. Capital Expenditure and RAB

The AER’s Draft Decision

AER’s Draft Decision was to not accept Murraylink’s proposed total forecast capex of \$33.8 million (\$2017-18) for the 2018-23 regulatory control period and to replace this with a forecast capex of \$26.6m (\$2017-18), a reduction of 21.3% as shown in AER Table 6.1:

Table 6.1 AER draft decision on Murraylink’s total capex (\$2017-18, million)

	2018–19	2019–20	2020–21	2021–22	2022–2023	Total
Murraylink’s proposal	5.8	13.9	10.8	2.4	1.0	33.8
AER draft decision	4.0	11.1	8.8	2.0	0.7	26.6
Difference (\$million)	-1.8	-2.8	-2.1	-0.4	-0.2	-7.2
Difference (per cent)	-30.3	-19.9	-19.0	-18.0	-21.3	-21.3

Source: Murraylink, Attachment 4.1 - Murraylink - Capex Model, 31 January 2017; AER analysis.

Note: Numbers may not add to total due to rounding.

The reductions included approx. \$2.1m for projects insufficiently supported by a business case and \$4.5m in relation to the Control System Upgrade project.

The Control System Upgrade project represented \$27.2m out of the original \$33.8m total capex (80%) and is the focus of this submission. In response to information requests from the AER, Murraylink revised down the proposed capex by \$2.27m (AER page 6-20). The AER then further reduced allowances for management costs to arrive at the final figure.

The Control System Upgrade, as replacement expenditure, will also be subjected to a Regulatory Investment Test (RIT-T) following a change to the NER in 2017¹⁴.

Revised Proposal

Murraylink's revised capex proposal is included in Chapter 6 of the Revised revenue proposal. Murraylink has rejected the AER's draft determination with respect to the control and protection system replacement (page 35).

The revised proposal emphasises the differences between Murraylink and Directlink and rejects the AER's use of the equivalent DirectLink project as a 'relevant comparator'. The AER had acknowledged differences between the two but sought to include some economies of scale in the alternate capex estimate. Murraylink have asserted that "While there may be some scale efficiencies to be identified in the hardware these will be more than offset by the additional complexity (and cost) for the software." (page 36)

The revised proposal also rejected the AER's reduction of APA's management costs. APA provides asset management, operating, maintenance, capital and commercial services to the Murraylink assets under the Management, Operations and Maintenance and Commercial Services Agreement (MOMCSA). Murraylink then state:

To summarise the contract Murraylink is required to pay APA all the costs and expenses incurred by APA in providing the services under the contract plus 10 percent. The 10 percent margin on the contract gets Murraylink access to economies of scale, scope and other efficiencies, along with asset management and corporate services expertise that Murraylink would not otherwise be able to access. (page 36)

In the Draft Decision, the AER has removed an allowance for the 10% margin from the \$2.3m for *Owner's Engineer* costs (AER p 6-22) and suggested that applying the margin to the projects capital costs was 'double dipping' since there was also an allowance claimed in the Operating Expenditure category for "... the provision of asset management, operating, maintenance and *capital services*".

Murraylink has emphasised that the MOMCSA with APA is for a 10% margin on **all** costs incurred and that if Murraylink is unable to recover the 10% margin charged by APA then the National Electricity Objective will be violated (page 38):

This means that Murraylink will incur the full prudent and efficient cost of replacing the control and protection system but will have revenue set in such a way that they will recover less than the full value of the capital expenditure.

This directly contradicts rule 6A.6.7 and the National Electricity Objective by not allowing Murraylink the efficient and prudent amounts necessary to meet the requirements of the forecast capital expenditure objectives and the AER is

¹⁴ Replacement expenditure planning arrangements Rule Change 18 July 2017, www.aemc.gov.au/Rule-Changes/Replacement-Expenditure-Planning-Arrangements

undermining investment in the network resulting in long term outcomes inconsistent with the National Electricity Objective.

Consequently, Murraylink’s revised capital expenditure for the control and protection system replacement is \$25.2m (2018). This compares to the original proposal’s \$27.2m and the reduction of \$2.27m that the AER reports was advised by Murraylink that would total \$25m. We have assumed that the minor discrepancy relates to aspects of project timing.

Murraylink’s revised proposal also included an updated attachment (labelled Attachment 8.2 and 8.1 on the cover page but referred to in the revised proposal as Attachment 6.2) titled “Outsourcing arrangements and margins July 2017 to June 2022” dated November 2017.

Adjustments have also been made to other component replacement activities to result in a final forecast capex outlined in Murraylink Table 6.6 (page 45):

Table 6.6 – Forecast capital expenditure 2018-23 by asset driver (\$'000 real 2018)

	2018/1 9	2019/2 0	2020/2 1	2021/2 2	2022/2 3	Total
Augmentation/Expansion	-	-	-	-	-	-
Replacement/Refurbishment	4,340	11,953	9,605	2,071	746	28,715
Non-network	10	36	61	82	56	245
Total	4,350	11,988	9,666	2,153	802	28,960

The total of \$28.96m compares to Murraylink's original proposed total forecast capex of \$33.8 million (\$2017-18) and the Draft Decision’s forecast capex of \$26.6m (\$2017-18)

Assessment

Control system replacement

CCP9 is of the view that a blanket 10% margin on all expenditures – particularly when this margin is paid to a part-owner of the asset - is an arrangement that most consumers would likely question.

The ‘Owner’s Engineer’ cost of \$2.3m has been accepted by the AER but, in our view, this seems excessive. A Senior Consulting Engineer is likely to charge out at \$300-\$400 per hour. \$2.3m at \$400 per hour therefore represents 3 years full time of such expertise (or three Engineers full time for one year). To then expect consumers to fund a 10% management fee on top of this appears unreasonable, especially as a capital expenditure item that grows the Regulatory Asset Base and receives the regulated rate of return.

Attachment 6.2 quotes the findings of the Australian Competition Tribunal’s (Tribunal) findings in *Application by Envestra Limited (No. 2)* [2012] ACompT 3 as the precedent for the current arrangements. CCP9 is not convinced that the ‘efficiency’ argument of that decision in relation to gas networks is readily transferable to the situation of rather specialised HVDC electricity interconnectors such as Murraylink. The sole-source arrangement with ABB as technology provider and proprietary support provider already challenges the notion of efficient costs. Section 2.5.1 of the attachment provides a comparison of costs that would be incurred if APA still had 100% ownership of the asset (as opposed to its current 19.9%). Section 2.5.2 of the attachment provides a comparison of costs that Murraylink would incur were it to provide the services in-house. CCP9 is of the view that these are not appropriate

benchmarks. A more appropriate comparison would be one where the services were provided by a specialist TNSP (such as, for example, ElectraNet or AusNet Services) and therefore able to access economies of scale more directly related to the assets in question.

CCP9 is concerned that consumers may be exposed to costs above efficient levels as a result of the ownership and management arrangements of this asset.

Overall, the lack of interest in engaging with consumers and the absence of any information that explains to consumers the value the asset provides makes it difficult for consumers to accept. In relation to the control system upgrade it is sincerely hoped that through the RIT-T process Murraylink will demonstrate the prudence of the investment and the value that this asset provides to consumers.

Recommendation(s):

1. Maintain the capital expenditure allowance for the control system replacement and not accept the revised proposal
2. Reiterate in the Final Determination that efficient costs should not be tied to ownership arrangements.

5. Operating Expenditure

The AER concluded that Murraylink's (ML) opex proposal of \$22.1m (\$2017-18) 'reasonably meets' the opex criteria in the NER. The AER has, therefore, accepted ML's opex proposal for 2018-23 subject to updating a number of parameters. ML has accepted the AER's updated draft decision. However, the AER and ML disagree on a number of the component elements even though they are in agreement with the total forecast opex, particularly the interpretation of 'step-changes'.

CCP9 largely supports the AER's decision and, in particular, the AER's rejection of the step change proposal. However, CCP9 remains concerned with a number of aspects including the assessment of the efficiency of the base year opex (2015-16) and the assumptions on labour costs growth and the ratio of labour to non-labour in what is basically an automated remotely managed transmission link. CCP9's concerns were raised in its response to ML's initial proposal and have also been raised by other consumer representatives and the SA Government. In the absence of benchmarking, the AER should be more open to the views of representatives close to conditions in South Australia.

CCP9 therefore recommends that:

1. The AER undertake further investigation of the efficiency of the base year 2015-16 and, preferably, update the assessment using audited data for 2016-17.
2. The AER review its decision on its forecast of the rate of price growth. In particular, the AER reconsider its forecast of labour cost growth given the views of SA Business and CIT who are familiar with SA labour market conditions and regional cost structures.

AER's Draft Decision on Murraylink's opex proposal

The AER accepted ML's opex forecast of \$22.1m (\$2017-18) for the 2018-23 regulatory period 2018-23. This forecast represents a 5% real increase in to ML's actual/estimated opex for the 2013-18 regulatory period. In accepting this revised proposal, the AER states that the

proposal 'reasonably meets' the opex criteria. Figure 1 below illustrates the actual, estimated and forecast opex.

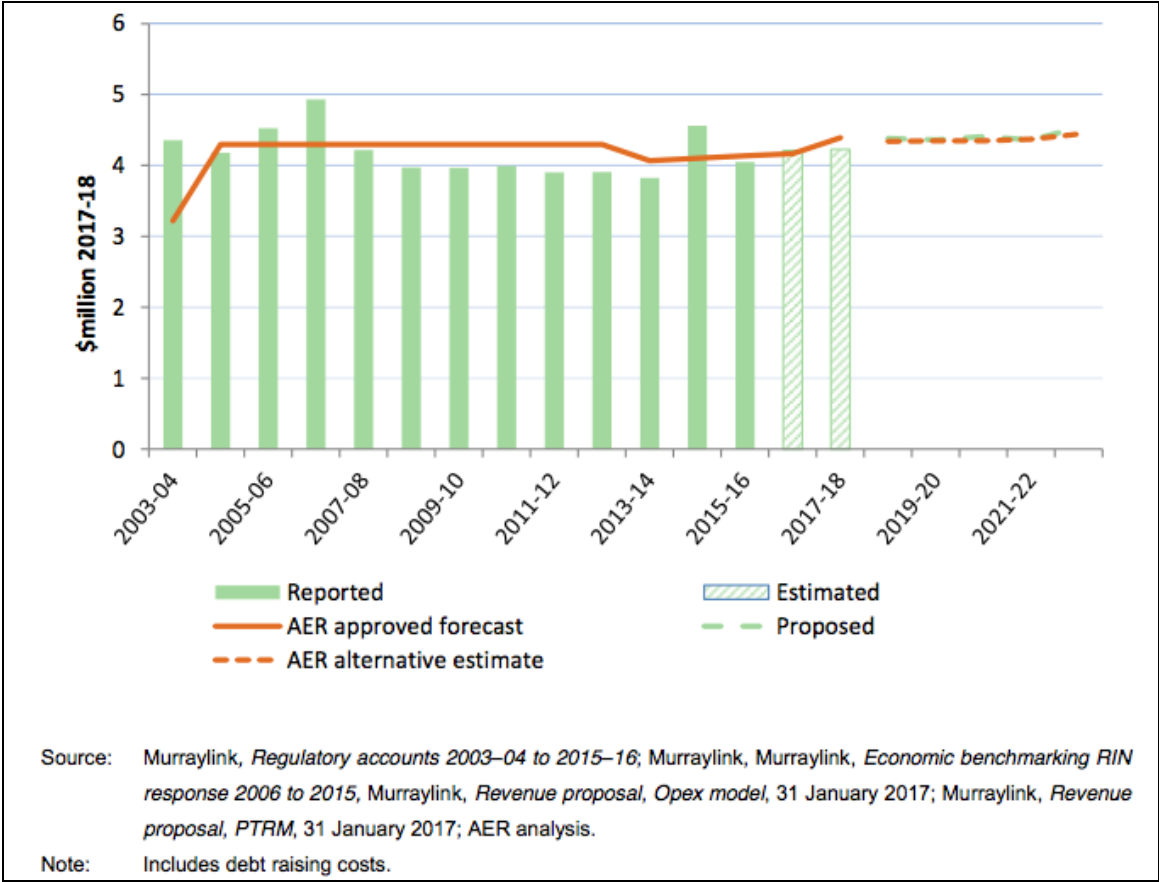


Figure 1: Historical and forecast opex (\$m, 2017-18)

Source: AER, Draft Decision Murraylink transmission determination, Attachment 7, 28 September 2017, Figure 7.2, p 7-6.

ML’s initial proposal combined the ‘base-step-trend’ and bottom-up approaches. The key elements, that were reviewed by the AER included a base year of 2015-16 actual opex that, when extended to 2018-23, would result in a total opex of \$20.9m (\$2018-18). In terms of the rate of change components, ML did not propose any changes in real prices and proposed zero productivity growth over the 2018-23 period. ML forecast also included a step change and two category specific costs, resulting in the total forecast opex over 2018-23 of \$22.1m (\$2017-18).

After considering all these elements, the AER’s alternative estimate of total opex was \$21.8m. The AER considers this is not materially different from the forecast provided by ML in its initial proposal. However, the AER’s component forecasts did differ from ML’s opex proposal and these differences raise a number of important points of regulatory principle. AER’s Table 7-2 (reproduced below) summarises the differences in the components between ML’s proposal and the AER’s alternative estimate.

	Murraylink	Our alternative estimate	Difference
Base opex	20.9	20.3	-0.7
Opex change 2015-16 to 2017-18	-	1.2	1.2
Price growth	-	0.3	0.3
Step changes	0.9	-	-0.9
Category specific forecasts	0.2	-0.0	-0.3
Debt raising costs	0.0	0.0	-
Total opex	22.1	21.8	-0.3
Source: Murraylink, <i>Revenue proposal, Opex model</i> , 31 January 2017; AER analysis.			
Note: Numbers may not add up to total due to rounding.			

Source: AER, *Draft Decision Murraylink transmission determination*, Attachment 7, 28 September 2017, Table 7.2, p 11.

Base Year Opex

The AER stated that ML's opex was subject to the incentives of an ex ante regulatory framework including the application of an efficiency sharing scheme (EBSS) in the 2013-17 period. Further, the AER has no evidence that ML's 2015-16 opex was materially inefficient. Therefore, the only difference between ML and AER's Draft Determination was that the AER moved connection costs from the base opex and forecast these costs as category specific costs.

Opex change 2015-16 to 2017-18

The largest opex item above the trend from the base year is the opex change over the two years from 2015-16 to 2017-18. As indicated in AER's Table 7-2 above, this amounts to \$1.2m over the two years. The basis for this increase is not made clear in the AER's draft decision documents, but a review of the AER's opex model spreadsheet suggests that this increase amounts to around \$0.25m per annum from the base year¹⁵.

Rate of change

Forecast price growth

The AER forecast a real annual price growth of 0.55% real per annum (cumulative 2.8% real), compared to ML's 0%. The AER has applied its standard methodology to calculate changes in labour costs using the SA utilities industry forecast by Deloitte Access Economics (DAE) and 0% change in real non-labour prices. Labour costs increases range from 0.73% (real) in 2018-19 to 0.98% real by 2022-23 with an average increase of around 0.9% per annum. The AER also applied its 'benchmark' weighting of labour and non-labour costs of 62% to 38%.

Forecast output growth

¹⁵ See AER spreadsheet: "Opex model/ calc/Opex forecast", 29 September 2017.

In its Draft decision, the AER accepted ML's forecast of 0% growth in output. ML also stated that it did not include any expansion capital in its 2018-23 regulatory period and the forecast capex expenditure in its proposal was directed at maintaining the existing capability and reliability of the link while meeting its legal and regulatory obligations. The AER accepted that overall this was consistent with a forecast output growth of 0%.

Productivity growth

AER accepted ML's proposal for a 0% productivity factor. While the AER had used +0.2%pa for the transmission companies, the AER accepted that it has not developed an opex productivity trend for interconnectors.

Step changes

In response to the AER's Issues Paper, Energy Infrastructure Investment (EII) disputed the AER's approach to assessing step changes. EII's argument is that the AER's test for a step change is narrower than the rules and restricts step changes to events that are not specifically cited in the rules.¹⁶ ML claimed that the test for inclusion of expenditure for a step change should not be restricted in the way that the AER is alleged to do. Rather, the step change should include any 'new' opex that is required in order to satisfy the rules and, in particular to:¹⁷

- Maintain the quality reliability and security of supply of prescribed transmission services;
- Maintain the reliability and security of the transmission system through the supply of prescribed transmission services.

ML then argues that under its current contract with its engineering service provider (ABB), ABB has an effective monopoly on the provision of key engineering services. As a result, ML claims that it has no surety that ABB will deliver the relevant quality and timeliness of the engineering services particularly as the ABB's systems age. ML is therefore seeking to establish a new service agreement between EII and ABB with terms and penalties that address the timing and quality of the services provided by ABB. ML concludes:

Murraylink's proposal is that the service level of agreement is necessary in order to maintain the reliability of the Murraylink transmission line. As the operating expenditure seeks to maintain the reliability of the ML transmission line it is consistent with 6A.6.6(a)(3)(iii) and (iv).

The AER considers that ML has 'mischaracterised' the AER's assessment approach.¹⁸ The AER therefore rejected ML's proposed step changes totalling \$0.9m (\$2017-18). The AER assessed the proposal against the criteria set out in the AER's Expenditure Assessment Guideline, which have been further developed in subsequent decisions by the AER. The AER highlighted that its focus is on assessing the overall opex rather than individual

¹⁶ Energy Infrastructure Investments, Murraylink Transmission Company Pty Ltd, *Response to AER issues paper (public)*, May 2017, pp 8-10.

¹⁷ See NER, cl 6A.6.6.

¹⁸ *Draft Decision Murraylink transmission determination, Attachment 7, 28 September 2017, p 7-13.*

components and it does not determine which activities a network business should undertake and how it should allocate priorities and expenditure. As the AER states:¹⁹

An opex project that satisfies one or all of the opex criteria does not necessarily require an increase in our total opex forecast under the base-step-trend approach. This is because we recognise that network businesses have an incentive to identify cost increases but not cost decreases. Yet, numerous countervailing factors impact a business' opex requirements such that its revealed aggregated opex remains relatively stable.

....

We consider that our alternative total opex forecast reasonably reflects the opex criteria. Murraylink ought to be able to manage this opex, including of the kind and magnitude contemplated by the proposed step change, within that overall forecast.

Category specific forecasts

ML proposed two category specific forecasts, namely a forecast of \$0.2m (\$2017-18) for non-recurrent maintenance costs and \$0.04m (\$2017-18) for debt raising costs.

The AER's DD accepted ML's debt raising costs and the forecast connection costs that the AER had removed from the base year. The connection costs amounted to a total of \$5.1m (\$2017-18).²⁰ On the other hand, the AER rejected non-recurrent maintenance costs. The AER states that:²¹

*We do not consider a category specific forecast is required for specific activities simply because a business did not undertake those same projects in the base year. The business will have undertaken other different projects in the base year that it will not undertake in every year going forward. The important consideration is whether **total** opex is recurrent.*

CCP9 agrees with the AER's approach to both step changes and category specific costs. CCP9 has observed a tendency for networks to seek compensation for new costs without a corresponding and systematic consideration of other costs that may no longer apply or whether the costs are driven by new regulatory requirements or by expenditure required for ongoing compliance with existing regulatory requirements. In most instances, the latter category of 'new costs' should not be considered as either a step change or a category specific cost.

Murraylink revised opex proposal

ML has accepted the AER's overall allowance subject to adjusting for consistency with the AER's historic and forecast inflation, noting that given the similarity in outcomes, it would not reject the AER's decision.

¹⁹ Ibid, p 7-14.

²⁰ Ibid, p 7-15. The AER has also accepted ML's proposed cost pass through event for the difference between forecast and incurred connection costs.

²¹ Ibid, p 15.

However, ML also states that it still has “significant concerns” with the AER’s approach to assessing the forecast opex. ML claims that:²²

[the AER’s approach] is not particularly fit for the purpose of assessing operating expenditure for a small transmission line like Murraylink.

However, as the results of the AER’s assessment has, coincidentally, produced a result similar to Murraylink’s assessment under the National Electricity Rules it would be obtuse for Murraylink to reject the outcome based on the weaknesses in the AER’s methodology.

The alleged “weaknesses” in the AER’s methodology refers back to ML’s original revenue proposal and response to the AER’s issue paper discussed above.

Has the AER’s Draft Determination addressed the issues raised by the CCP9 and other stakeholders?

CCP9’s response to ML’s proposal

In response to ML’s initial proposal, CCP9 raised questions regarding the efficiency of the proposed step charges and the need for ML to market test the Operating Agreement with related party part-owner, the APA Group.²³

CCP9 considers that the AER has appropriately addressed ML’s claim for a step change (the AER has rejected this claim as noted above). However, CCP9 would have preferred to see some additional assessment of the efficiency of the related party Operating Agreement through, for instance, market testing.

The AER does not appear to address this issue at all. Rather, the AER has claimed that, in the absence of information on ‘efficient performance’ of a transmission link service, it accepts that ML’s expenditure on the related party proposal is “not materially inefficient”.

However, the AER also states in its review of ML’s proposed capex for 2018-23, that the \$1.9m claimed by ML for 2018-23 under the Management, Operations and Maintenance and Commercial Services Agreement (MOMSCA) is recovered in ML’s proposed opex (which the AER has accepted in total).²⁴ The AER therefore concludes that the ML should not apply a margin to the control system capex costs, as the margin paid for capital services is likely to be recovered through the opex proposal.²⁵

CCP9 agrees with this observation and notes that the AER has also set out a number of important principles in relation to the recovery of related party margin charges associated with capex and opex expenditure. However, it is not clear if the AER has specifically addressed CCP9’s concerns about whether the opex margin on the APA Operating Agreement is efficient. This issue is also raised in a number of the other submissions to the AER as discussed below.

²² Energy Infrastructure Investments, *Murraylink revised revenue proposal 2018-23*, 1 December 2017, p 32.

²³ Consumer Challenge Panel subpanel 9, *Response to proposals from Murraylink*, 12 May 2017 (updated), pp 11-12.

²⁴ See, AER, Draft Decision, Murraylink transmission determination, Attachment 6, 28 September, pp 6-22 to 6-23.

²⁵ Ibid, p 6-23.

Government of South Australia SA²⁶

The SA Government's primary concern is that the ML revenue proposal does not clearly demonstrate how it will provide value to consumers given the 30% increase in the maximum allowable revenue. In particular, the SA Government highlights that:

- Murraylink put a very different cost of \$843,700 for control system end of life replacement project forward in their last revenue proposal (for 2013-18). The SA Government notes that: "it is not entirely clear from the information provided how the current proposal differs from this previously proposed project".²⁷
- Murraylink has redacted a substantial amount of relevant information including the identification and discussion of alternate options. The Government's submission states that: "there is insufficient information provided to allow stakeholders to assess this proposal [for replacement expenditures]".²⁸

As discussed in relation to Capital Expenditure in this submission, the AER considers the requirement for, and efficiency of the control system capex may be addressed as part of a RIT-T now required for significant replacement capex.

Business SA:

Business SA has generally accepted ML's opex proposal as reasonable and notes that: "generally Murraylink's historical revenue recoveries from consumers have grown at relatively acceptable rates". Business SA also recognises ML's efforts to keep opex real price growth at 0% including labour costs given the conditions facing the SA economy. However, Business SA also notes that ML's proposal represents an increase of 30% in allowable revenue (including opex) that this represents a significant "step change" in contrast to the relatively stable revenue recovery profile of ML over the past decade.²⁹

In general, the AER's Draft decision has addressed many of the issues driving the overall revenue level. However, with specific reference to opex, Business SA has highlighted that in making its decision on SA Water's revenue, ESCOSA has determined that for SA, labour costs should be capped at the rate of change in the Australia-wide CPI.³⁰ This is in contrast to the AER's allowance of labour cost increases above CPI. The AER has not adequately addressed Business SA's comments on this issue, but instead, has relied on its standard approach to labour cost forecasting.

Central Irrigation Trust (CIT):

The CIT expressed strong reservations about the extent of the overall revenue increases including ML's claim about the costs of the replacement control system and ML's claim that it has higher costs than other businesses as it operates in a rural area.³¹

²⁶ Government of South Australia, "Letter to the AER re Murraylink transmission revenue proposal for 1 July 2018 - 30 June 2023", 17 May 2017.

²⁷ Ibid, p 1. The current proposal includes \$27.2m capex out of a total of \$33.8m capex for this replacement expenditure.

²⁸ Ibid.

²⁹ Business SA, "Response to Murraylink's Revenue Proposal for the regulatory period 2018-23", 12 May 2017, p 2.

³⁰ Ibid, p 3. Business SA quotes from ESCOSA's determination for SA Water for the regulatory period 2016-20.

³¹ Central Irrigation Trust, "CIT Submission to Murraylink Revenue Proposal 2018-23", 23 March 2017, p 2. Murraylink had stated in its initial proposal that the remote rural setting and environment of the link imposes logistic issues and costs for

Of particular relevance to the opex forecast is the CIT's observation that while some costs may be higher, there are many benefits and cost reductions of operating in rural areas. The CIT operates in a similar area of SA and states that: "We find little trouble in attracting employees, be they professional or otherwise".³² Further, the CIT states that accommodation and facilities costs are considerably cheaper in regional areas and since the downturn in the mining industries there are many firms willing to tender for works in these regions creating greater competition and lower prices. In CIT's view, these lower costs should be reflected in the service agreement that ML has with their operator and query how the contract is being assessed as to its competitiveness.

CCP9 considers that again, the AER has not fully addressed the issues of operating costs raised in the submissions by CCP9, Business SA and CIT. Rather, the AER has stated that it has no evidence to demonstrate that the base year opex was "materially inefficient". These submissions are all relevant to the AER's assessment of the efficiency of the base year opex and the price growth component of the forecast opex. It would, therefore have been valuable for the AER to more carefully consider these consumer concerns in its DD, particularly given the AER's lack of benchmarking data and the fact that Business SA and CIT are familiar with the economic conditions and local issues in South Australia thus providing a relevant perspective for the AER to consider.

With respect to labour costs and the AER's weighting of labour and non-labour costs using its standard benchmark weightings, CCP9 also highlights to the AER that ML's operations are remotely controlled and that the DC cables are underground which should reduce cable maintenance requirements.³³

CCP9 Assessment of the AER's Draft Decision and Murraylink's revised proposal Overview

CCP9 notes that, while the AER has accepted the overall opex proposal by ML for 2018-23 regulatory period, it has done so on the basis that the AER:

- does not have evidence that the proposed base year costs are materially inefficient
- does not accept the step change proposal or the category specific costs
- this is offset by the AER applying a higher price growth rate of increase than proposed by ML, due to the AER's approach to forecasting labour costs.

CCP9 agrees with much of the AER's reasoning with respect to step change and category specific changes to ML's initial proposal. Moreover we appreciate that ML has accepted the AER's overall opex in its revised revenue proposal even though it continues to disagree with the AER's interpretation of the criteria for step changes.

Murraylink's maintenance operations including obtaining skilled staff, accommodation and storage for equipment. Murraylink also stated that these cost elements are factored into the contract costs as well as the costs incurred directly by Murraylink. (see Murraylink 2018-23 revenue proposal, p 14).

³² Ibid.

³³ See for instance, APT Management Services statement on the acquisition of Murraylink transmission company in March 2006. <https://www.apa.com.au/globalassets/documents/presentations/2006-03-30-acquisition-of-murraylink-transmission-company.pdf>

Further discussion of a number of specific issues follows.

Step changes

CCP9 strongly supports the AER's view on step changes. CCP9 agrees with the AER that it is not the AER's role to endorse particular opex projects; rather the AER's role is to consider whether the overall expenditure is reasonable and satisfies the opex criteria in the rules.

CCP9 agrees with the AER's further comment that while some opex may go up, other opex costs may decline. This is why the AER, quite correctly, has strong requirements before it accepts a step change. Simply because a new expenditure is required by the business to maintain the integrity of the system does not automatically justify a corresponding increase in opex in the absence of a change in regulatory requirements. The case for a step change must be clearly and unambiguously made, and in this instance, ML's case is based on some theoretical possibility of increasing requirements that will not be adequately met by APA under the current contract, a supposition that has not been adequately supported by any convincing evidence from ML.

In addition, CCP9 does not accept the proposition that consumers should fund revisions to a service contract under the circumstances set out by ML in their proposal (see above). As a counterparty to the service agreement, ML should have undertaken due diligence at the start of the contract to ensure the terms and conditions of the contract will meet its ongoing requirements for quality and timeliness of the provision of maintenance and other services to the level required by the rules.

This argument applies whether ML/EII were the first parties to the contract, or they purchased the business, and the contracts, from another party. For instance, if ML/EII were purchasing the business with the APA maintenance contract in place, they had a duty to ensure that the contract would be implemented in a manner that satisfies all regulatory requirements over the remaining course of the contractual period and/or to reduce the price paid for that business in accordance with the added risk.

Either way, for consumers to be now asked to pay for contract changes that do not relate to a regulatory change, but do relate to a contractual flaw, is inappropriate. Even a regulated business must accept the risks arising from its own past or present decisions in these types of matters. Consumers must not become the implicit guarantor for management's poor contracting or purchase decisions. Otherwise, there is little incentive for the network to negotiate an efficient commercial agreement with its counterparty (whether a related party or not) if it believes the contract will sit outside the purview of the regulator and any inefficient costs can simply pass this cost directly on to consumers.

Moreover, ML has provided no evidence that ABB's performance is declining in the ways suggested that would make future ABB response to the alleged increase in operational faults increasingly problematic. This is a theoretical risk and is provided without any supporting trend analysis.

Areas of ongoing concern with the AER's Draft Decision

CCP9 remains concerned with a number of other aspects of the AER's decision and ML's revised proposal, including:

- The AER's view that there is no evidence that the base year is materially inefficient therefore the AER should accept this proposal. The core issue here is whether the operating contract (including margin) with a related party is efficient and represents best practice and this has not been adequately tested by the AER.
- The views of CIT based on relevant experience that overall, operating costs in the rural areas should be lower than businesses located in the cities or surrounding regions.
- The adoption of a labour cost increase averaging around 0.9% (\$real) per annum for the five regulatory years, given the claim by ML of an average 0% increase per year, and the views of SA Business and CIT regarding wage growth rates and the ready availability of skilled labour in SA.
- The concerns raised by the SA Government regarding the amount of redacted material, gaps in the supporting evidence and the lack of consumer engagement.

Finally, CCP9 is concerned that the 2015-16 remains the base year for the purposes of the Final Decision. There does not appear to be any reason why 2016-17 audited accounts should not be available to the AER before the AER makes its Final Determination. Using the 2016-17 year would mean that the AER does not have to estimate two years of expenditure for the current regulatory period; an outcome that would provide some reassurance to consumers that there is a firmer foundation for the forecast of efficient expenditure for 2018-23. For example, APA (who has a 19.9% interest in the ML project) published its audited annual report for 2016-17 to shareholders on 23 August 2017, along with its final distribution to security holders.

Recommendation(s):

CCP9 supports most aspects of the AER's draft determination on the forecast opex for Murraylink electricity transmission and appreciates the fact that Murraylink has decided to accept the AER's opex forecast notwithstanding its stated reservations about the components of the forecast. CCP9 also strongly supports the AER's approach to assessing, and rejecting, Murraylink's proposed step change.

CCP9 makes the following recommendations to the AER for its consideration in the Final Determination of the efficient operating costs for Murraylink transmission for the regulatory period 2018-23.

1. The AER undertake further investigation of the efficiency of the base year 2015-16 and, preferably, update the assessment using audited data for 2016-17.
2. The AER review its decision on its forecast of the rate of price growth. In particular, the AER reconsider its forecast of labour cost growth given the views of SA Business and CIT who are familiar with SA labour market conditions and regional cost structures.

6. Rate of Return, Inflation and Tax

The AER's Draft Decision

The AER rejected Murraylink's proposed WACC of 6.54% and proposed a WACC of 5.7% (nominal vanilla), consistent with the AER's Rate of Return Guideline. The difference primarily reflects differences in the proposed return on equity, where the AER rejected

Murraylink's proposed change in the approach to estimation of the return on equity and market risk premium. The AER maintained a Market Risk Premium (MRP) of 6.5% and beta of 0.7. When combined with the current yields on 10-year government bonds, this resulted in a nominal return on equity (ROE) of 7.2%, compared to Murraylink's proposed ROE of 8.6%.

Consistent with its Rate of Return Guideline, the AER adopted the transition to the trailing average in estimating the return on debt at 4.78%. This is lower than Murraylink's proposed return on debt of 5.16% due to the incorporation of more recent interest rate data. The cost of debt is based on a benchmark credit rating of BBB+ and term of 10 years.

The estimate for inflation expectations is 2.5%, compared to Murraylink's proposal of 2.0%. While the WACC is set in nominal terms, the net effect of the AER's Post-Tax Revenue Model and Asset Roll-Forward Model is to incorporate the real WACC in the revenue build-up. A lower rate of inflation would result in a larger real WACC and real revenues for a given nominal WACC.

Finally, the AER used a gamma (value of imputation credits) of 0.4 in estimating the allowance for tax expense, compared to Murraylink's proposed gamma of 0.25.

Revised Proposal

In preparing its Revised Proposal Murraylink accepted:

- The use of current yields on government bonds for the estimation of the risk-free rate (RFR) and estimated the value using data to 31 October at 2.78%
- The approach to the cost of debt (which was consistent with Murraylink's original proposal) and estimated the value using data to 31 October at 4.70%
- The estimate for inflation expectations of 2.5%
- The value for gamma of 0.4

Murraylink did not accept:

- The beta of 0.7 and used a beta of 0.8
- The AER's method of application of the Sharpe-Lintner CAPM or the MRP of 6.5% and used an MRP of 7.7%

As a consequence, Murraylink used a WACC of 6.4% in its revised proposal rather than 5.7% due to its decision not to accept the approach to the estimation of the ROE set out in the Rate of Return Guideline and applied by the AER.

Assessment

CCP 9 supports the application of the AER's application of the Rate of Return Guideline and, as a consequence of this, the proposed WACC of 5.7%. In doing so, it notes that:

- It considers that AER's current approach and values for key parameters have resulted in WACCs that have systematically erred on the high side, but that this is best considered through the current review of the Rate of Return Guideline
- It supports the CCP submission to the Rate of Return guideline.

CCP 9 does not support Murraylink's approach to applying the Sharpe-Lintner model which is contrary to common practice and can result in unstable and counter-intuitive outcomes. This is illustrated by the increase in the MRP and the ROE between its original proposal and

its revised proposal at a time when other indicators suggest that the expectations for the MRP and ROE have been falling.

Why we have accepted the AER's proposed WACC of 5.7%

While we consider that AER's approach has resulted in WACC's that have erred on the high side, we support the application of the Rate of Return Guideline as AER has done in the draft determination. The AER developed the Rate of Return Guideline through a process of extensive consultation and research. While the Guideline is non-binding, it created a reasonable expectation that the AER would apply the Guideline unless there was strong persuasive new evidence or a substantial change in circumstances such that a change in approach and parameters was necessary to achieve the ARORO and NEO. That is, in layman's terms, there is a high burden of proof on those requesting a variation in approach or parameters from those in the Rate of Return Guideline

We find it disappointing that some NSPs, such as Murraylink, have been selective in their approach and not respected the role of the Rate of Return Guideline in promoting certainty and consistency of regulation, consistent with best practice principles of regulation and NSPs past requests for greater certainty. The extent to which the Rate of Return Guideline has been selectively relitigated through the proposals submitted at revenue resets and subsequent appeals was a factor in the Government's decision to support the move to a binding Rate of Return Guideline.

As discussed below, Murraylink's proposed approach to implementing the Sharpe-Lintner model has not identified significant new research or raised new substantive issues not considered in the development of the Rate of Return Guideline. The proposed increase in beta has been based on scanty evidence and a reliance on short term estimates that is inconsistent with common practice and not supported by experts in the field. Clearly, the proposed changes do not meet the burden of proof required to justify a change in approach under the Rate or Return Guideline.

In our submissions to the AER on the TNSPs proposals, we argued that:

1. Market evidence, such as market value to RAB ratios, suggests that the allowed rates of return have exceeded the expected rates of return required by investors
2. Indicators of investment climate and uncertainty/risk do not support an increase in the MRP, which is the risk premium for investing in equities compared to risk-free investments.

Since we made that submission there has been further evidence – the Market to RAB ratio for the Endeavour Energy transaction – suggesting the return allowed exceeds expectations of the required return and further improvement in the indicators of investment climate. This has been documented in the CCP submission on the review of the Rate of Return Guideline. CCP 9 considers that the evidence supporting a reduction in the MRP is substantially stronger than the evidence for an increase in the MRP. Furthermore, it is consistent with a return to long term averages for the MRP with the passage of time from the GFC.

The CCP submissions on profitability measures and review of the Rate of Return Guideline have both made the case for the AER giving some weight to profitability measures in assessing the ROE WACC. The CCP submission to the rate of return also proposed that the

AER collect further information to test whether the actual costs of debt for regulated utilities, such as the TNSPs, is systematically lower than the benchmark chosen.

We accept that these issues are best considered in the review of the Rate of Return Guideline. While there is evidence that could support a lower WACC it does not meet the burden of proof required to support a change in approach at a revenue reset covered by the current guideline. However, this evidence contradicts the arguments put by Murraylink for a change in MRP and beta, and should be considered by the AER in its evaluation in its final decision of Murraylink's revised proposal.

Why we consider that the proposed WACC errs on the high-side

As the CCP submission to the Review of the Rate of Return Guideline argues:

Market evidence on the attractiveness of the sector for investors suggests that the current approach, as implemented by the AER has more than met the requirements under the NEO and ARORO to provide the utility with the opportunity to earn a fair return. In particular:

- *Acquisition values do not support the view that the allowed ROR is less than fair for investors – indeed they are more likely to be consistent with the allowed return exceeding investor expectations;*
- *Commentaries from brokers and rating agencies provide a positive assessment of the regulatory regime for investment; and*
- *Existing investors do not appear to be seeking, on balance, to reduce their exposure to the sector³⁴.*

The winning bidders in the most recent electricity network transactions, the long-term leases of the TransGrid network (2015), the Ausgrid network (2016) and the Endeavour network (2017), paid 1.6, 1.4 and 1.58, respectively, times the RAB. These multiples are significantly above the RAB multiples commonly seen internationally.

Acquisition or market values need to be treated with caution. A premium is not proof of an overly generous regulatory regime, but it provides some information on the relativity of allowed returns and investor expectations. A very conservative interpretation of the RAB multiples in the acquisitions of TransGrid, Ausgrid and Endeavour is that they provide strong evidence that the combined allowances for the cost of capital and tax under the AER's current framework are not too low and probably exceed investors' expectations for the required return on investment. This is discussed further in various CCP submissions.³⁵

Brokers and rating agencies appear to regard the regulatory regime and the rates of return offered as positive features of the investment environment.

³⁴ CCP Submission, Review of the Rate of Return Guideline, p18

³⁵ See CCP submissions on Profitability Measures, the Review of the Rate of Return Guideline, and the TransGrid and Murraylink Revenue Proposals for 2018-19 to 2022-23.

For example, in its report on Hastings Infrastructure Fund after the purchase of TransGrid, Credit Suisse commented that TransGrid was “governed by a generous regulatory regime which still by design errs on the side of over-incentivising.”³⁶

In its presentation for investors Jemena noted that both Moody’s and Standard and Poor’s referenced the maturity and strength of the regulatory regimes in providing the underpinning for the regulated businesses cash flows.

If the ROR offered were less than fair one would expect to see investors seeking to reduce their exposure to the sector. This could occur though an increase in gearing as the investor converts equity into debt or a reluctance to invest. In regard to gearing, the Frontier Economics study on beta did not suggest any significant change in gearing was occurring:

*“We note that the average leverage is reduced by the inclusion of AGL and Alinta – both of which had maintained low leverage in order to preserve borrowing capacity to enable them to acquire assets during a time of industry consolidation. But for these two firms, the mean leverage is again very close to the 60% gearing assumption adopted by the AER.”*³⁷

This apparent stability in gearing is occurring at a time when the RABs continue to increase – see for example the proposed 17% increase in TransGrid’s RAB in the TransGrid proposal. The generally moderate levels of debt of the regulated utilities and sound credit ratings do not suggest that this increase in equity exposure to the sector is due to a lack of capacity to borrow more. For example, SGSPAA has a rating of Moody’s: A3 (Stable) / Standard & Poor’s: BBB+ (Stable), has maintained a stable gearing of around 50%, which is below the metric for maintaining investment grade debt of 65%, while its RAB is increasing (for example, SGSPAA projected increases in the RAB for its Electricity and Gas networks in Victoria of 6.6% p.a. and 3.7% p.a., respectively, over 2015-2020).³⁸

Overall the evidence suggests the regulatory regime errs on the side of generosity for the NSPs rather than parsimony.

Why we reject Murraylink’s proposed approach to the ROE

Under the CAPM the expected market-wide return on equity is the sum of the risk-free rate of return (RFR) and the expected Market Risk Premium (MRP). In the Sharpe-Lintner version the interest rate on AAA-government debt is used as the proxy for risk-free rate of return. However, expectations for the Rate on Equity (ROE) and the MRP cannot be observed directly. Three broad approaches have been used to attempt to estimate the market risk premium and the expected return on equity for the regulated businesses.

1. Assume long term expectations for the MRP are anchored to the long-term average realised MRP. This is the Foundation-model version of the S-L CAPM used by the AER. The ROE is the sum of the variable RFR and a fixed MRP

³⁶ Credit Suisse, *Spark Infrastructure Group, Equity Research*, 25 November 2015 at p1

³⁷ Jemena Electricity Networks (Vic) Ltd 2016-20 Electricity Distribution Price Review Regulatory Proposal Revocation and substitution submission, Attachment 6-6 Frontier Economics - Estimating the equity beta for the benchmark efficient entity at p10

³⁸ Jemena, *Investor Update*, June 2016, downloaded from: www.jemena.com.au/getattachment/About/investors/investor-information/SGSPAA-Investor-Presentation-June-16-Roadshow.pdf

2. Assume the long-term expectations for the ROE are stable over time and based on the long-term average realised real ROE. This is the “Wright model” under which the MRP is the difference between the stable real ROE and the variable RFR.
3. Assume a long-term dividend growth rate (and shorter-term dividend) forecasts and rational well-informed investors to estimate the expected long term ROE at a point in time as a function of current share prices and assumed dividends. This is the Dividend Growth Model (DGM) – also known as the Dividend Discount Model.

All three models must make assumptions on parameters that cannot be directly observed in order to estimate the ROE and/or MRP. The AER’s foundation model is based on a model of the formation of investor expectations that is consistent with observed behaviour. For example, investment advisors and broker reports widely use this approach in estimating the ROE. The AER’s guideline provides a structured approach to considering all three models and the information – or intuitions – that they provide, alongside other relevant market information. This is consistent with the intention of the 2012 rule change.

In contrast, it appears that Murraylink wishes to reduce the range of information considered. In the original revenue proposal Murraylink used DGM estimates of the implied return on equity and estimated the MRP by deducting the current RFR from the estimated market-implied return on equity. It considered both current estimates of the ROE and averages for the ROE for previous periods using DGM models. However, in the revised proposal it narrowed the range of information further, using only recent estimates by Frontier Economics of the market ROE using the AER DGMs.

Murraylink has estimated the market risk premium as the difference between a current estimate of the expected return on the market and the current estimate of the risk free rate of return...

Murraylink has used a dividend growth model estimate of the expected return on the market. As Murraylink noted in its January 2017 revenue proposal, the dividend growth model is the only model, among those considered for regulatory rate of return determination, which can provide a forward-looking estimate of the expected return on the market. Murraylink’s estimate of that expected return, 10.48 per cent, was calculated from an estimate made by Frontier Economics, but using versions of the AER’s dividend growth models.³⁹

This narrowing of the information used to just the latest estimates of the return on equity from a single set of models weakens, rather than strengthens, Murraylink’s case. It is inconsistent with the widely acknowledged limitations of the DGM estimates and practice of considering a broad range of estimates and models and changes in levels that are sustained over a longer period.

The role and use of DGM estimates of the ROE and MRP is discussed at length in the CCP submission to the Rate of Return Guideline Review.⁴⁰ In summary the CCP concluded that DGM has some currency as a means of estimating the current expectations for the ROE over the medium to long-term. Despite this, problems with the DGM limit the weight that can be placed on it and how it can be used. In particular, DGM estimates:

³⁹ Murraylink. Revised Proposal, pp26-27

⁴⁰ CCP Submission to the AER on its Rate of Return Guideline Issues Paper, December 2017, pp98-108

1. rely on a strong assumption of efficient financial markets that is not supported empirically, especially over the short to medium term;
2. may be systematically biased upwards due to bias in analysts' dividend forecasts and the risk aversion of investors;
3. are highly sensitive to the assumptions and may be biased if there has been a significant change in the long-term growth prospects for the economy; and
4. can be highly volatile in the short-term due to the short-term volatility in equities markets."⁴¹

The Bank of England uses DGM [DDM] to analyse trends in stock prices and has had a strong research program developing and analysing DGM. But they stress the need for caution in their use

*As the ERP cannot be observed, any estimate of it is necessarily subject to uncertainty. Part of the uncertainty associated with model-based estimates of the ERP reflects uncertainty about the measurement of the model's inputs. For example, investors' true dividend expectations cannot be observed, so any proxy for these used in a DDM, whether derived from analyst surveys or GDP forecasts, is necessarily only an approximation. The inherent uncertainty about the true value of the ERP is reflected in the wide dispersion of ERP estimates in the literature. Given the uncertainty associated with measuring the ERP, the Bank's analysis tends to focus less on the precise level of the ERP and more on changes in the ERP over time or on the level of the ERP relative to historic averages.*⁴²

Partington and Satchell reach similar conclusions:

DGM-based estimates of the MRP in a 10 year horizon context, are probably better down-weighted than given more weight. We are not completely dismissive of the DGM approach, but it is more useful as a conceptual tool than a forecasting model.

*... We also reiterate our past advice that year by year estimates from the DGM are likely to be unreliable.*⁴³

CCP submission to the Rate of Return Guideline Review analysed various DGM estimates of the ROE and MRP in Australia and overseas that highlighted:

1. the range and volatility in the estimates of returns for various countries across different models with different assumptions and over time.
2. the range and volatility in the estimates of returns in Australia across different models with different assumptions and over time. Some estimates, such as the Fenebris and SFG Market Indicator DGM models have suggested flat or declining MRPs since 2013, consistent with international trends, while other estimates, such as the Frontier estimates have suggested an increase.

⁴¹ CCP Submission to the AER on its Rate of Return Guideline Issues Paper, December 2017, p98

⁴² Will Dison and Alex Rattan, *An improved model for understanding equity prices*, Bank of England Quarterly Bulletin 2017 Q2, pp92-93

⁴³ Partington and Satchell (2017) at p26

There are a number of potential biases that need to be considered in interpreting and using DGM estimates.⁴⁴ This includes systematic upward biases such as:

1. upward biases in analysts' forecasts to forecast earnings in the short to medium term;
2. growing importance of non-dividend forms of cash flows between companies and shareholders
3. use of the GDP growth rate as a proxy for the expected long run growth rate for dividends.
4. simplistic assumption of investor's perceptions of risk.⁴⁵

There are also other biases that may be more reflective of current circumstances. Norges Investment Bank has argued that recent strong cash flows and the very low interest rate environment may create an upward bias in the estimates of returns from DGM.⁴⁶ Long-term expectations for economic growth may be affected by periods of economic optimism or pessimism. For example, following the GFC investors may have had lower expectations for long-term growth, resulting in an upward bias in DGM estimates using constant long-term growth assumption.

Given these factors, the AER should be very cautious in adjusting the MRP in response to short to medium term variations in the forward-looking estimates of the MRP derived from the DGM. It is important that any change in the assumed MRP can be shown to be consistent with investment fundamentals and the impacts of market conditions on the relative risks and demand for different asset classes.

Why we reject the proposed increase in the MRP

While noting the expectations for the MRP may vary from time to time, we support the AER's presumption that these expectations are anchored⁴⁷ to the long-term average excess return. This implies that variations from the long-term average are likely to be muted, except in extreme circumstances, and not persistent. As noted above changes in the MRP cannot be done mechanically but require the careful exercise in judgement having regard to the investment climate.

Professor Damodaran similarly adopts a fundamentals approach when examining the market risk premium and the latest evidence from the DGM models and other information.⁴⁸ The MRP is the additional return for holding an asset with the average market risk rather than a MRP and should reflect a level of market uncertainty and risks. Damodaran lists the following factors that should determine the market risk premium:

⁴⁴ See CCP Submission to the AER on its Rate of Return Guideline Issues Paper, December 2017 pp98-108 for further discussion and references.

⁴⁵ Behavioural economics suggests investors' approach to risk may not match the common assumptions of neo-classical economics. Investors may be risk averse, with losses and gains measured against a reference point – or expectation – rather than absolute terms. This may be factored into decision-making through conservative assumptions on future income streams. That is the investors may sensibly discount analysts' forecasts and future growth rates. DGM estimates that do not reflect this will result in estimates of the required ROE that are biased upwards

⁴⁶ Norges Bank, *The Equity Risk Premium Discussion Note*, 2016 at p3.

⁴⁷ The analogy is a boat at anchor – it does not stay in a fixed position but the extent to which its position changes with currents and tides is limited and non-linearly proportionate to the strength of the current or wind.

⁴⁸ A Damodaran, *Equity Risk Premiums (ERP): Determinants, Estimation and Implications – The 2016 Edition Updated: March 2016* at pp10-21

1. risk aversion and consumption preferences
2. economic risk
3. information and volatility of returns
4. liquidity and funds management
5. catastrophic factors
6. government policy changes
7. monetary policy
8. the behavioural/irrational component

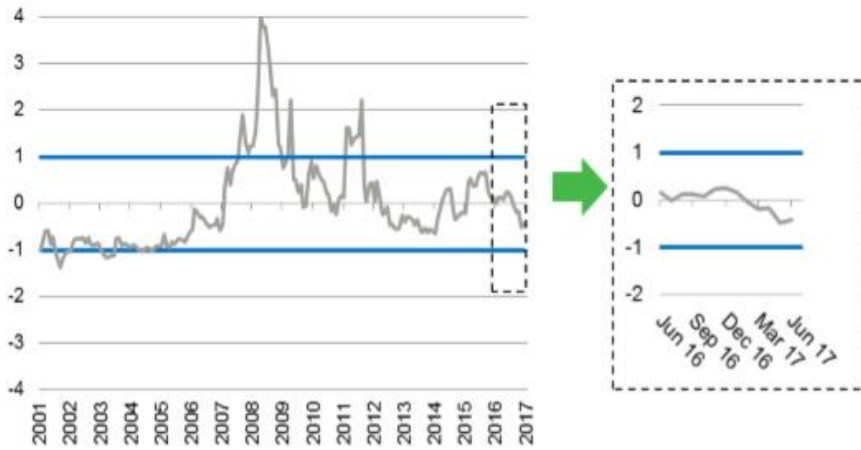
The most relevant factors in the period since 2013 are 2, 3, and 4 – the broadly defined economic conditions. Except for the last factor, the others have been broadly stable. The last – the behavioural/irrational component – is important as it acts as a caution against putting too much weight on short-term movements.

When it adopted a MRP of 6.5% in applying the approach to setting the ROE in the 2013 rate of Return Guideline, the AER did so in the context of the aftermath of the GFC; a period where various indicators, including the DGM estimates, indicated elevated expectations for the MRP. Murraylink needs to show not just that the current DGM estimates from one set of models are higher but that:

1. The estimates have been persistently and significantly higher over time and across alternative models than in 2013; and
2. Changes in the investment climate support a presumption of an increase in relative risk for investments in equities.

As noted above, Murraylink have not demonstrated a persistent increase in the estimates of ROE and MRP. Below we argue that changes in indicators of the investment climate do not support and increase in the MRP.

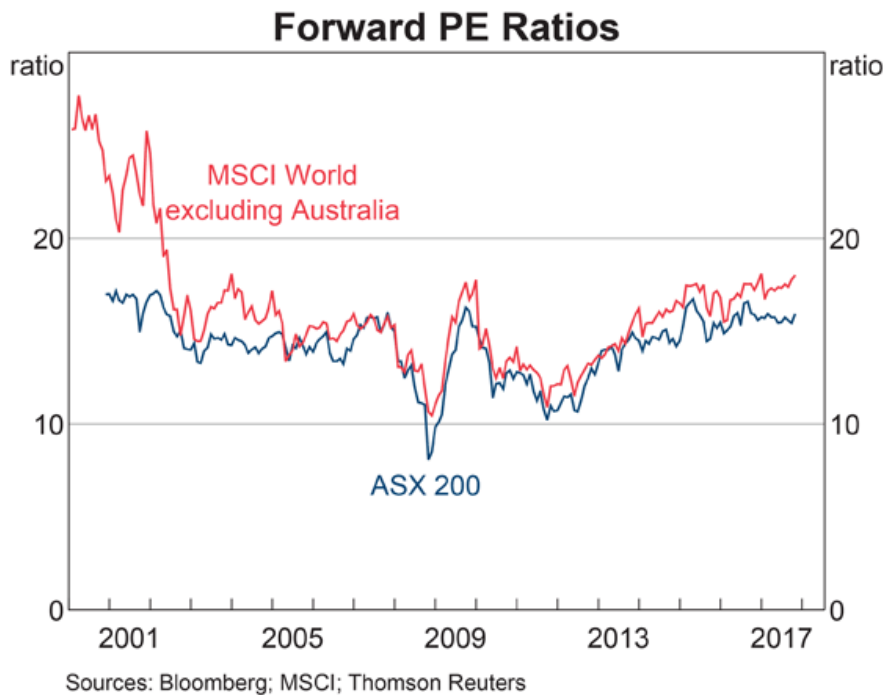
A key factor in the investment climate is the level of economic uncertainty. IPART's Uncertainty Index, which draws upon comparable international indices and the literature on conditioning variables show that while there was an increase in the level of uncertainty in 2015 it did not reach the heightened levels of the GFC or 2011. Through 2017 the uncertainty index has been comparable to the levels of 2013 and below the average levels of uncertainty since 2000.



Source: IPART analysis.

Figure 2: *IPART Uncertainty Index*

There are additional indicators of investment climate that can put the trends in the allowed ROR and assumptions on individual parameters in context. One indicator is the forward price/earnings ratio for Australian stocks since 2000.⁴⁹ As expected, it fell substantially during the GFC, and then went through a period of instability. However, since 2012 the forward price earnings ratio has returned to previous levels and recently been relatively stable.



Sources: Bloomberg; MSCI; Thomson Reuters

Figure 3: *Forward price/earnings ratio for Australian stocks since 2000*

Source: RBA Chartpack

⁴⁹ Reserve Bank of Australia, *Chart Pack*, December 2017 accessed at www.rba.gov.au

Like the DGM, the forward P/E ratio is a measure of the relationship of the asset's price and the expected earnings⁵⁰. In principle, the P/E ratio would rise (other things being equal) with a fall in the required return on equity, which is the sum of the RFR and the MRP. However, it is important to examine the fundamental drivers of risk and return in considering the evidence put forward of a higher MRP.

In its advice to TransGrid for the Power Sydney's Future RIT-T, Houston Kemp commented:

*“TransGrid Australia’s RIT-T Handbook (July 2011) recommends that a commercial discount rate of 10 per cent (real pre-tax) be adopted in any RIT-T assessment unless there is compelling evidence to adopt a different rate. In this section, we identify that financial conditions have changed since Grid Australia recommended a 10 per cent commercial discount rate, with rates on both risk free and risky assets falling since July 2011.”*⁵¹

Overall market conditions do not appear similar to, or better than, conditions in 2013. For example:

- Variability in dividend yields in the period since 2012-13 has been comparable to the periods prior to the GFC, nor are the recent yields substantially higher than in 2012-13.
- While there have been some periods of increased volatility in stock options in the period since 2012, these have been limited and the overall picture shown by the VIX index is one of lower volatility over the period. In the last year the VIX index published by Standard and Poor's shows further reductions in volatility to levels at or near 10-year lows.
- Bond spreads spiked in 2016, but more recent data shows a return to levels comparable to, or below, 2012-13, a point that again highlights the risk of placing too much weight on short term movements in data.

Overall indicators of investment climate since 2012-13 have shown a continuation of more normal conditions. As the length of normal conditions increases and GFC recedes into the past for investors, the argument to return the MRP to average historical levels strengthens.

Why we reject Murraylink's proposed increase in the beta

In their original revenue proposal Murraylink proposed an increase in the estimate of beta from 0.7 to 0.8. In this proposal it discussed at length estimates of beta from more recent studies where if a shorter estimation period were chosen there appeared to be higher estimates of beta.⁵² In putting the case for a beta of 0.8 Murraylink argued that:

More recent analyses, by the ERA, by CEG, and now by Frontier Economics, provide statistical evidence of an increase in estimates of beta since 2014.

⁵⁰ Indeed, with stable returns the DGM model can be expressed in regard to the P/E and the growth rate

⁵¹ Appendix C of TransGrid, Powering Sydney's Future, PADR, May 2017, Houston Kemp, The Commercial Discount Rate to be used in the RIT-T Test, September 2016 at p5

⁵² See Murraylink Revenue Proposal, July 2018 – June 2023, pp 36-38.

When estimates of beta are increasing, an updated estimate is essential to making an estimate of the return on equity which has been made having regard to prevailing conditions in the market for equity funds.

...

Econometric analyses by Frontier Economics show an increase in estimates of beta when estimation makes use of data for the period 2014 to 2016. Higher beta estimates for Australian energy network businesses are supported by estimates of beta which Frontier Economics has made for a set of comparable infrastructure businesses operating in the transport sector.

If empirical estimates of beta for Australian energy network businesses are now above 0.5, the additional information provided by beta estimates for overseas energy networks, and the theoretical principles underpinning the Black CAPM, indicate that a beta above 0.7 is now appropriate for estimating the return on equity of a gas pipeline service provider.

As Frontier Economics notes, using data for the most recent five years in beta estimation risks producing estimates with relatively low statistical precision. Longer data series are required to improve the precision of the resulting beta estimates.

Frontier Economics recommends using at least ten years of data for estimation. But simply taking data for the last ten years accords weight to a period of some 7 years in which betas appear to have been relatively low. This is clearly shown by the Frontier Economics estimates: using data for the most recent 10 years, the value and equally weighted portfolio estimates of beta were, respectively, 0.52 and 0.57.

Beta has risen, but the magnitude of the increase is difficult to gauge.

For application of the SL CAPM in estimating the return on equity for its revenue proposal, Murraylink therefore proposes to retain the AER's 2013 estimate of 0.8.⁵³

In our submission on Murraylink's revenue proposal we reviewed the evidence cited for the increases in beta and concluded that the evidence was weak and relied heavily on the estimates for beta's over 5 years after excluding DUET (one of the four firms) because the estimates of its beta are lower and outside the range of that for the other firms. Inclusion of firms outside the regulated energy sector increases the estimated beta but it is not clear that the additional firms have comparable risks. Given the small sample size and high standard errors it was doubtful if the apparent increase was significant or the product of statistical 'noise'. Experts and practitioners are cautious in placing weight of short term movements in beta. The issue of the volatility of beta, especially when estimated over short time period and with a small set of comparators, was raised in IPART's hearings on its review. Justin De Lorenzo (Sydney Desalination Plant) and Professor Stephen Gray both cautioned against placing too much emphasis on short term volatility. Justin De Lorenzo observed that:

"Also I think in terms of any review that IPART would do from time to time on beta, looking at different comparator firms and periods of time, there needs to be a very high threshold or compelling evidence to change the beta estimate."⁵⁴

⁵³ See Murraylink Revenue Proposal, July 2018 – June 2023, pp 38-39

In its revised proposal Murraylink continues to propose a beta of 0.8 but states that it “did not claim, on the basis of those studies, that there was a material change in beta. Those studies pointed to, but did not confirm, higher statistical estimates.”⁵⁵ Murraylink’s revised proposal argues that:

1. AER used a beta of 0.8 in the previous determination for Murraylink in March 2013 when beta estimates were in the range of 0.4-0.7
2. “draft determination advances no substantial reason for a change in the relative risk of Murraylink in respect of the provision of prescribed transmission service since 2013”
3. Since the AER’s estimates of beta remain in the range of 0.5-0.7 the AER should continue to use a beta of 0.8.

This argument unwisely seeks to consign the Rate of Return Guideline to irrelevancy and poses the wrong question. The question is not whether there is evidence supporting a change in beta from the 2013 Murraylink decision, but whether there is strong new evidence that would justify a change from the 0.7 Beta proposed in the Rate of Return Guideline subsequent to that decision.

The Rate of Return Guideline was determined through an assessment of the relevant information and comprehensive review of all the components of the WACC. There was extensive consultation with stakeholders to ensure that the Rate of Return Guideline benefited from a wide range of views and critical evaluation. A new empirical study was undertaken to estimate the beta which gave the AER greater confidence in the range of 0.4-0.7 for the beta. The AER also reviewed its overall approach to the estimation of the ROE and WACC. In regard to the ROE it continued to rely primarily on the Sharpe-Lintner model but gave greater weight to other models and information sources. The AER was quite transparent that the choice of a beta at or near the top end of the range had regard to the Black CAPM and the studies that suggested the Sharpe-Lintner model may under-estimate returns for low-beta stocks.

The previous Murraylink decision pre-dated the development of the Rate of Return Guideline. Perhaps it could be argued that the decision created a reasonable expectation that future decisions would be made using a similar methodology. But this does not bind the AER or prevent the AER from changing its approach so long as it gives notice of its intentions and an opportunity for stakeholders to have their views considered. This is precisely what the review and development of the Rate of Return Guideline provided. Having set out its approach in the Guideline, that Guideline became the basis for AER’s future decisions and expectations about those decisions. Murraylink has not presented any new evidence or information that would justify a variation from the 0.7 beta proposed in the Rate of Return Guideline. Indeed it has walked away from the previous argument it put that new studies provided evidence of an increase in beta.

Recommendation:

CCP 9 accepts the Draft Decision WACC of 5.7% (nominal, vanilla) and recommends that in its final decision the AER updates the proposed WACC only for changes in interest rates.

⁵⁴ Justin De Lorenzo, Review of the IPART WACC Method, Transcript of Public Hearing, August 2017 at p18

⁵⁵ Murraylink, revised Revenue Proposal, p22.

7. Incentive Schemes

The AER's Draft Decision

The AER has three standard incentive mechanisms: the Efficiency Benefit Sharing Scheme (EBSS) and the Capital Expenditure Sharing Scheme (CESS) which are designed to provide stronger and more neutral incentives for efficiency in opex and capex; and the Service Target Performance Incentive Scheme (STPIS) that seeks to balance the TNSP's incentives to reduce costs or improve services. The AER's draft decision proposes to:

1. *Continue the application of the EBSS.* The AER has determined that the carry over from 2013-18 period will be \$0.41 million (rather than the \$0.71 million proposed by Murraylink). Connection charges are to be included in the EBSS but not debt raising costs for 2018-23
2. *Apply the CESS for the 2018-23 period.* The CESS covers all capex except priority projects approved under the STPIS.
3. *Apply the STPIS for the 2018-23 period* covering unplanned outages and market impacts.

This is consistent with AER standard approach to incentive-based regulation.

Revised Proposal

In its revised proposal Murraylink:

1. Accepted the application of the EBSS but appears to include debt raising costs of \$10,000 p.a.
2. Accepted the application of the CESS
3. Accepted the application of the STPIS with the parameters proposed in the draft decision.

Assessment

CCP 9 considers that incentives to improve efficiency is in the long-term interest of consumers as long as it is not at the expense of service quality and supports the application of the EBSS, CESS, and STPIS as proposed in the AER's draft decision.

Incentive mechanisms and the long-term interest of consumers

The set of performance incentives are in the long-term interest of consumers if they are successful in promoting larger efficiency improvements.

In the absence of the EBSS and CESS, the TNSPs' incentives to pursue efficiency improvements diminishes through the regulatory period. As a result, reductions in costs that could be achieved in the last years of a regulatory period may be foregone or deferred to the subsequent period. Under the revealed costs approach, where costs in the last year of one regulatory period form the basis for assumed costs for the first year of the next, this results in higher prices for consumers.

The EBSS and CESS:

1. Equalise the incentives to improve efficiency across each year of the regulatory period
2. Equalise the incentives to improve efficiency through reductions in opex and capex
3. Determine and equalise the fair allocation of the benefits of efficiency gains between customers and the TNSPs.

Equalising the incentives over the regulatory period provides a stronger incentive for the TNSP to reduce costs in the latter years of the regulatory period. If the TNSP responds to these incentives the costs at the end of the period will provide a base for future prices. This should provide a benefit that more than offsets the increment to prices in the next regulatory period under the EBSS or CESS to provide the incentive to the TNSP.

Equalising the incentives between Opex and Capex removes a potential distortion in the TNSP's that could lead a utility to inefficiently substitute opex for capex or vice versa. Again, this should result in lower revealed costs that provide the basis for future prices.

It is important to note the differences in incentives for costs not set using the revealed preference approach and hence the coverage of the EBSS and CESS.

One concern is that in strengthening incentives to reduce costs it also strengthens the incentives to reduce costs through reductions in service standards. The concern is that there may be cases where the increased costs (or loss of value) for consumers may exceed the reduction in costs for the TNSP. The STPIS provides a mechanism for protecting against this and is an important component of the incentive framework from eth consumers' perspective. However, it is subject to the constraints on measuring service performance and the limitations on the revenue at risk.

Under the current approach some costs – most notably debt costs and tax expense – are set using a benchmark without reference to actual costs incurred. Debt costs are based on the yield for benchmark corporate bonds. These may vary from actual costs incurred but there is no adjustment or reset at any point to actual costs incurred (in contrast to most opex and capex). Tax expense is based on an estimate of taxable income based on the allowed revenue requirement and the statutory tax rate. The forecast tax expense may vary from tax paid – indeed it appears to systematically exceed actual tax paid – but there is no adjustment or reset at any point to actual costs incurred (in contrast to most opex and capex). This means that for debt and tax costs the utility retains 100% of the benefit of any reduction in these costs and that the consumers do not benefit. This has two important implications:

1. **The incentives for the utility to minimise debt costs or tax costs are more than 3 times as strong as the incentive to achieve opex and capex efficiencies.** Unfortunately, this means that if there are limited management resources, it would be rational for the TNSP to prioritise minimising tax, to the detriment of other taxpayers and without benefit to consumers or economic benefit through more efficient resource usage.
2. **Costs which are based on benchmarks alone and do not use the revealed cost approach at the revenue reset should not be included in the EBSS or CESS.** The utility already retains 100% of any reduction in these costs. Inclusion in the EBSS would 'double count' these benefits to the detriment of consumers who would have to fund the incentive payments with no benefit through a reduction in the cost base for the determination of future prices.

Coverage of the EBSS

The AER proposed to exclude debt servicing costs and include connection costs in opex for the EBSS. However, while stating that it “accepts the AER’s draft determination with regards to the approach to calculating the Efficiency Benefit Sharing Scheme for the next regulatory control period”⁵⁶, Murraylink’s revised proposal appears to include debt servicing costs in the EBSS. The table below sets out the Opex forecasts for the EBSS in the AER’s draft decision and Murraylink’s revised proposal.

	2018-19	2019-20	2020-21	2021-22	2022-23
<i>AER Draft Decision</i>					
Opex	4.39	4.37	4.42	4.37	4.54
Debt raising costs	0.01	0.01	0.01	0.01	0.01
Opex forecast for EBSS	4.38	4.36	4.41	4.36	4.53
<i>Murraylink Revised Proposal</i>					
Opex	4.39	4.37	4.41	4.37	4.54
Debt raising costs	0.01	0.01	0.01	0.01	0.01
Opex forecast for EBSS	4.39	4.37	4.41	4.37	4.54

Table 1: Operating Expenditure Forecast for EBSS (\$M, real)

Sources: AER, *Draft Decision, Attachment 9-EBSS, p9-7*, Murraylink, *Revised Proposal, P56*

Debt raising costs for future regulatory periods are not set using the revealed costs approach (i.e on the basis of actual costs at the end of the previous period) but using a benchmark approach (like debt costs). The amounts are small but debt raising costs should be excluded from the opex costs for the EBSS. Inclusion of these costs in the EBSS would result in Murraylink benefiting twice from any reduction in debt raising costs relative to the allowed costs and would clearly not be in the long-term interest of consumers.

Recommendation(s):

CCP 9 supports the application of the EBSS, CESS, and STPIS as proposed by the AER (including the exclusion of debt raising costs from forecast opex for the EBSS)

8. Conclusion

As was the case with the original proposal, CCP 9 considers the consumer engagement by Murraylink to be profoundly disappointing.

Further, there are a number of areas where CCP 9 is concerned that the proposal from Murraylink may not be in the long-term interests of consumers.

Capital and Operating Expenditure forecasts have a common issue of a fixed margin being paid to the Operator (and part-owner) APA and a lack of competitive pressure or market testing of key contracts with APA and ABB. Further, APA has attracted similar criticism of its


⁵⁶ Murraylink, Revised Proposal, p56

Customer Engagement in relation to its regulated gas assets. Murraylink has claimed that, in relation to operating expenditure, the AER’s approach “... *is not particularly fit for the purpose of assessing operating expenditure for a small transmission line like Murraylink*” (revised proposal page 32). Our view is that pursuit of the long term interests of consumers should not be predicated on the ownership arrangements of the asset and this has triggered concern from a range of stakeholders, not just the CCP.

Murraylink’s revised proposal also includes rate of return parameters that are not consistent with the rate of return guideline and CCP9 do not believe this is in the long term interest of consumers.

CCP9 commends to the AER the issues raised in this advice and the recommendations made.


Signed



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B. Hughson

Bev Hughson



Andrew Nance