

# *Energy Users Coalition of Victoria*

**Australian Energy Regulator**

**Victorian Gas Distribution Revenue Reset**

**AER Draft Decision and revised applications**

**from**

**Envestra, Multinet and SP Ausnet**

**A response**

**by**

**Energy Users Coalition of Victoria**

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The content and conclusions reached are the work of the EUCV and its consultants.

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## Executive Summary

The Energy Users Coalition of Victoria (EUCV) welcomes the opportunity to provide comments on the review of the Victorian gas distribution revenue rest. The EUCV is an affiliate of the Major Energy Users Inc, which comprises over 20 major energy using companies operating across Australia.

The EUCV notes that the AER's draft decision clearly recognises that the gas distribution businesses (DBS) have made very ambitious ambit claims in their initial applications and the proposed reductions by the AER in the rates of return and capex and opex cost claims clearly reflect the lack of justification contained in the initial applications.

However, it is noted that the revised applications by the DBs, whilst lower than the initial applications, still remain ambitious and the EUCV is unconvinced that the claims made are justifiable.

Notwithstanding the aforementioned comment, the EUCV strongly considers there is still scope for rolling back more of the DB cost claims, especially in light of the lower gas demand forecast for AA4 period.

The EUCV considers that, where the AER has the discretion, it must be exercised in accordance with the National Gas Objective. In particular, in relation to setting the rate of return, the AER is in error should it rely on its regulatory principles to take precedence over the Objective, and not set the rate of return at a level that is economically inefficient. The AER will also should be in error should it accede to Gasnet's application for higher value for the MRP and the DRP. As this submission argues:

“Just as the AER has refused to accept changes to the setting of the DRP, so must it refuse to make a change to setting the MRP until the entire approach to setting regulatory rates of return has undergone the formal processes already in train.” (EUCV submission page 36)

Notwithstanding the AER's draft decision, all the DBs are still claiming significantly higher capex requirements in their revised applications (see the following table) by between 20% and 90% above their actual AA3 capex, even though there is a forecast reduction in gas consumption for AA4 compared to AA3 and a slowing down of new connections.

\$m pa ((\$'12)	AA3 allowed	AA3 actual*	AER DD	Initial claim	Revised claim
Envestra	88.36	55.55	60.74	154.86	116.2
Multinet	53.40	46.40	35.54	77.94	60.06
SPAusnet	81.20	79.00	82.20	108.00	100.36
Envestra Albury	1.57	1.25	1.04	1.63	1.34

Note: \* Only the actual recorded opex has been used as the final year opex is only an estimate. Using an estimate which is inflated could distort comparisons.

Again, notwithstanding the AER's draft decision, the forecast and changed conditions, all the DBs are still seeking large increases in opex requirements in their revised submissions (see the following table) of between 5% and 15%, but still well in excess of the AER view as to what is efficient opex

\$m pa ((\$'12)	AA3 allowed	AA3 actual*	AER DD	Initial claim	Revised claim
Envestra	52.0	49.9	58.8	73.0	65.6
Multinet	47.0	50.5	54.0	72.6	69.2
SPAusnet	54.5	43.5	47.5	54.5	48.7
Envestra Albury	1.75	1.71	2.7^	2.5	2.2

Notes: \* Only the actual recorded opex has been used as the final year opex is only an estimate. Using an estimate which is inflated could distort comparisons

^ The EUCV notes that the AER has recognized that the actual opex included a negative charge from the EBSS and has sensibly decided that Envestra should not be "penalized twice"

The EUCV considers the AER must:

- Closely examine the justifications for mains replacement, augmentation and new connection claims, especially in terms of units costs where benchmark rates were established in AA3
- Satisfy consumers' absolute requirement that the prudence of investment claims must be rigorously attested to, particularly as none of the DBs provided any analysis of prudence of claims for augmentation and new connections, nor, for that matter, has the AER!
- Assess whether all the step changes in opex claims by the DBs are legitimate exogenous changes (this has not been fully established in the AER draft decision)
- Not accede to the DB request to raise the values of the DRP and the MRP – regulatory consistency must be maintained.
- Not accede to the requests from two of the DBs to change the approach to calculating depreciation – again regulatory consistency and the Rules support maintenance of the historic approach.

More details are provided in the body of this submission.

## **1. Introduction**

The Energy Users Coalition of Victoria (EUCV) welcomes the opportunity to provide comments on the AER's draft decision regarding its review of the revenue reset for the Victorian gas transmission business.

### **1.1 AER discretion and the Objective**

The EUCV has reviewed the AER commentary on what the requirements of the National Gas Law (NGL) and the National Gas Rules (NGR) impose on the AER as it performs its regulatory review and determination in regard to the application and revised application by GasNet for setting the allowed revenue and reference tariffs for the next 5 years. The EUCV does not disagree with the AER assessment but does highlight some issues that the AER does not address.

Both the NGL and NGR allow the AER significant discretion in the performance of its regulatory role, which is in stark contrast to the limited discretion afforded the AER under Chapter 6A of the National Electricity Rules.

As a matter of principle, the AER must, where it has the discretion, exercise this in relation to the National Gas Objective (NGO) so that the AER is undertaking this review in the "long term interests of consumers". This means that even if the AER has established principles that it uses for its regulatory processes, if these principles do not result in an outcome which is in the "long term interests of consumers" then the principles are inappropriate and must be amended accordingly – there is no scope for the AER to place regulatory principles above the NGO.

However, in relation to the NGR, the AER must assume that the Rules have been developed to be in accord with the Objective, even if it considers that this is not the case<sup>1</sup>. Equally, the specific requirements in the NGL addressing network regulation (the six revenue and pricing principles in section 23) must be assumed by the AER to be consistent with the Objective.

Accordingly, the EUCV sees the ranking of the various elements of the NGL, NGR, AER discretion and AER pricing principles would be as follows:

1. NGO and NGL revenue and pricing principles
2. Specific requirements of the NGR
3. AER discretion
4. AER pricing principles

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<sup>1</sup> The EUCV expects that if the AER considers the NGR not to comply with the Objective, then it would initiate a rule change to rectify this view

The importance of this ranking cannot be overstated. For example, the AER had in previous regulatory decisions accorded its regulatory principles above the NGO, and has done so again in this draft decision.

For example, the AER has the discretion to set a rate of return which is efficient recognizing that the NGR do not stipulate how the rate of return is to be developed. To achieve this, the AER has developed its own principles based on its views and to reflect the decisions of the Australian Competition Tribunal. The AER has then decided that its regulatory principles take precedence over the Objective, which requires that the rate of return be set at a level that is economically efficient<sup>2</sup>.

Where the AER exercises its discretion, it must benchmark this exercise against outcomes seen in the “real world” of competitive business to ensure that its discretion results in an outcome which meets the requirements of the Objective.

To develop an approach to arrive at the allowed rate of return, the AER has developed principles for this development, but they must be in accordance with the Objective.

## **1.2 Regulation is intended to be incentive based**

The Australian energy regulatory environment is intended to be incentive based. This means that regulated firms are rewarded for operating within a cost structure that is lower than the allowance provided by the regulator.

The corollary to providing this reward is that the benefits from the regulated firms finding lower cost ways of delivering the services, are passed on, over time, to consumers and the benefits effectively shared.

There are five basic elements of the building block approach to setting regulatory revenues for a service provider subject to price cap regulation that should be subjected to incentives, viz:

1. Deferring or minimizing capital
2. Developing more efficient opex
3. Reducing the cost of debt
4. Setting depreciation to be equitable to current and future users
5. Increasing flows to reduce the unit prices for reference tariffs

The regulatory decision should be crafted so that each of these five elements can be incentivised to provide lower overall unit costs to consumers over time.

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<sup>2</sup> The EUCV concerns in this regard are developed in more detail in a later section of this submission addressing the cost of capital

It is also important to recognise that the intent of the Objective (“long term interests of consumers”) is not to be interpreted so that the interests of existing consumers are to be excluded from assessment. As the Limited Merits Review Expert Panel comment in their stage 1 report to the Standing Committee on Energy and Resources (SCER)<sup>3</sup>:

“It is the long-term interests of consumers that are relevant. This cannot reasonably be interpreted as meaning that the interests of consumers today are irrelevant, and that the only thing that matters is the welfare of energy consumers at some distant point in time. It does, however, mean that it is not just the interests of consumers who will vote in the next election that count: there are future generations also to be taken into account. To the extent that the AER is required to engage in ‘balancing’ judgments, the chief balancing required is between the interests of consumers at different points in time<sup>4</sup>.”  
(page 37)

The import of the Expert Panel comment is that unless the interests of future consumers are impacted, then the AER must have regard for the interests of current consumers as a priority. If there is conflict between the interests of current consumers and of future consumers, then the interests of future consumers must be balanced against those of current consumers.

In addition, there is a need to recognise there is conflict between the impacts of the various incentives provided. Higher costs now might result in lower costs for future consumers but imposing higher costs now might have a negative impact on future consumers because of the changes made by current consumers to manage the higher costs

To put these observations into context for the current review, the EUCV considers that the AER is obliged to ensure that, in arriving at the efficient levels of allowed revenue, the allowed revenue must reflect the outcomes of the incentives provided in the previous regulatory decisions.

For example, GasNet is currently seeking to increase the depreciation rate for its assets and advises that this will reduce costs for future consumers. However, higher costs now could reduce gas consumption as consumers could convert to alternative fuels. Conversely, lower costs now will encourage gas usage so that costs in the future will be amortized over greater gas flows.

The power of incentives cannot be over-emphasized. Exogenous issues like the high \$A, a price on carbon, compulsory renewable electricity generation and energy efficiency programs have all had the impact of

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<sup>3</sup> Review of the Limited Merits Review Regime Stage 1 Report available at <http://www.scer.gov.au/files/2012/06/Stage-One-Report-to-SCER-29-June2.pdf>

<sup>4</sup> The Expert Panel goes on to highlight that the interests of consumers at different points of time is usually done through “some or other form of discounting”.

leading to reductions in the use of gas and electricity and these have all impacted on the expected use of gas in the next five years.

The outcome of the regulatory incentives that the AER must impose is for the allowed revenue and reference tariffs required to reflect a need for the gas delivery service to be more efficient with lower unit costs, so that future consumers can have a gas transport service that meets their needs.

### **1.3 A view of the Victorian future gas demand**

The AEMO has recently released its 2012 Gas Statement of Opportunities (GSoO). Its forecast in relation to Victorian gas consumption provides some salient points.

1. The 2011 Victorian gas consumption levels will not be exceeded until 2020
2. The 2008 Victorian gas consumption levels will not be exceeded until 2016
3. The Victorian gas mass market will remain at or below 2011 levels until 2016
4. Consumption by large Victorian gas users will not reach current levels until 2020
5. Consumption by gas fired generation will not reach 2008 levels until 2026

It is pleasing to note that the 2012 GSoO forecasts for gas consumption in Victoria closely correlate with the AER draft decision for gas consumption.

The observations drawn from the AEMO forecasts are critical to the current AER review, because the access arrangement was established on expectations and usage seen in 2007/2008. Bearing in mind that the current period (AA3) investment allowance provided considerable capex to address an expected growth in consumption that has proven to be optimistic, at the most basic level, over the next five year regulatory period, there will be:

- No need for any investment for augmentation as there are forecast reductions in gas consumption compared to actual consumption in AA3 and consumption is again at the levels seen during AA2
- A reduction in opex for any replacement investment made
- No need for any reliability investment as reliability is already at an acceptable level

### **1.4 An overview of the draft decision**

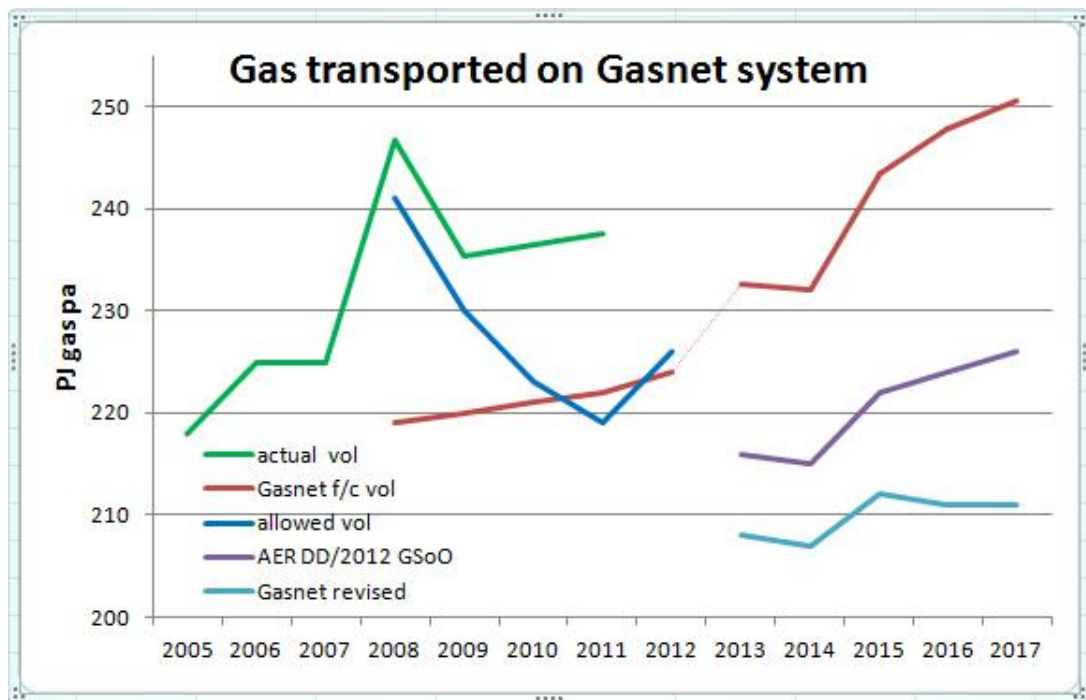
It is quite clear from the draft decision that the AER has identified a number of significant unnecessary costs that had been claimed by Gasnet. The AER has also identified that Gasnet has considerably overstated the expected volumes of gas to be transported over the Gasnet system. The EUCV had



provided a view Gasnet had overstated its forecast volumes and suggested that the AEMO 2011 GSoO should be used as the basis for forecast transport volumes. The AER considered that the 2011 GSoO overstated the expected gas volumes for gas powered generation and commissioned ACIL Tasman to provide a better estimate of gas volumes. Concurrently, AEMO carried out its 2012 GSoO and the forecasts closely correlate with the AER draft decision on expected gas volumes to be transported.

The assessment of forecast transportation volumes is critical on two bases – as an indicator of the need for augmentation capex and as the basis for developing reference tariffs; estimates of gas volumes that are too high support claims for increased capex but lead to lower notional tariffs, whereas, low forecast volumes indicate a need for less augmentation capex but result in higher tariffs. A gas network is incentivised to overstate volumes because this supports a high capex program and implies tariffs will be lower than they will be ultimately.

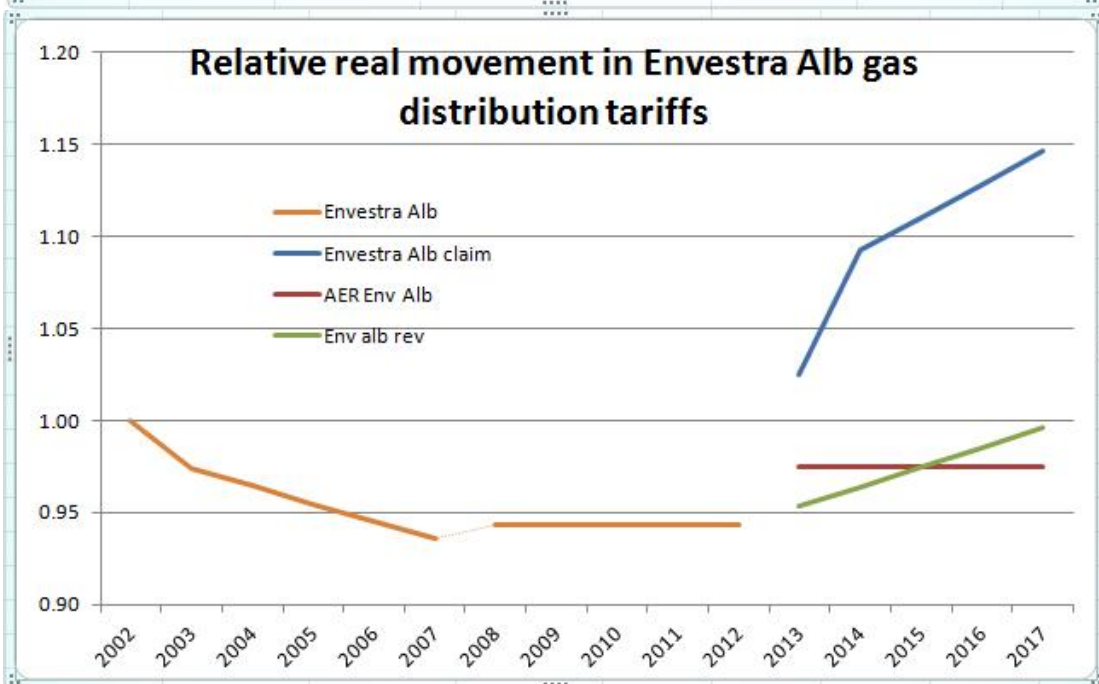
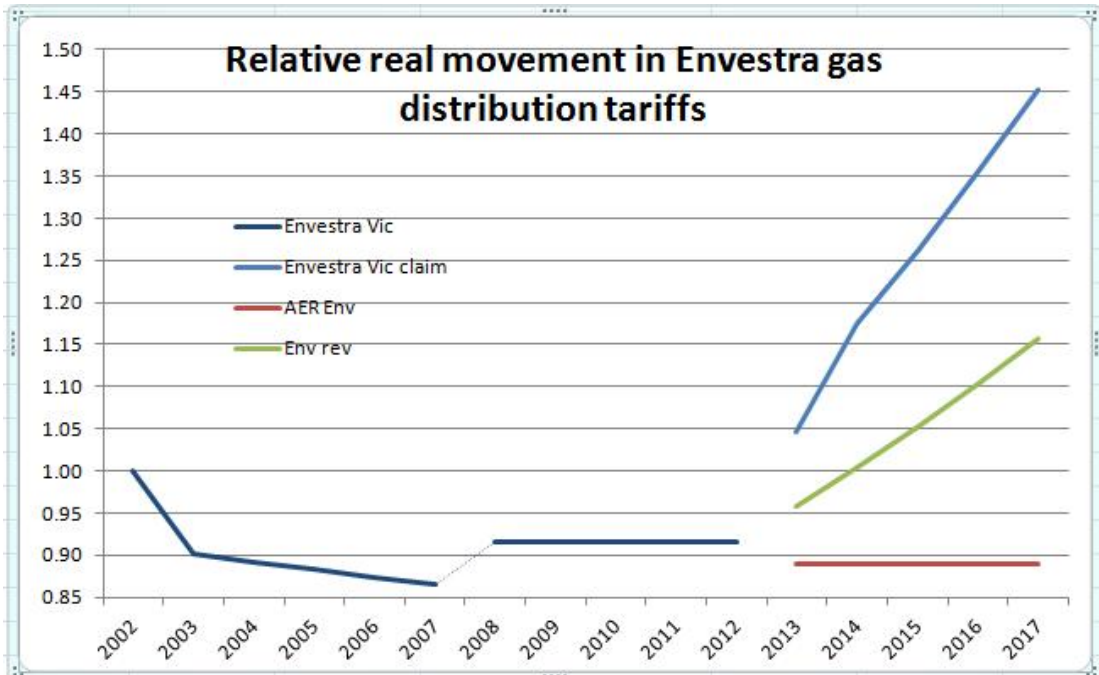
The following chart shows the historic actual and allowed gas volumes and the forecasts by Gasnet and the AER/AEMO.

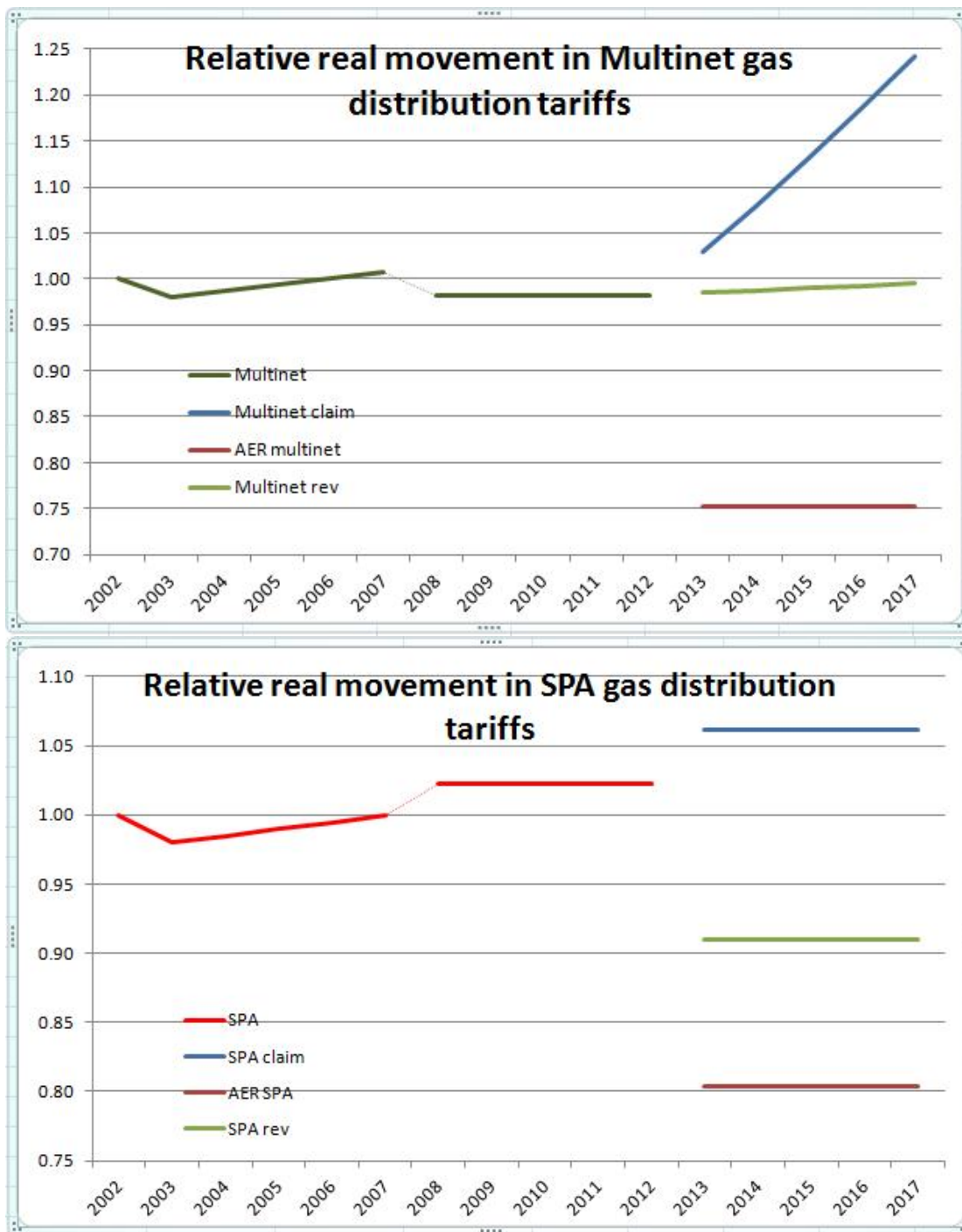


Source: Gasnet applications, ACCC FDs, AER DD, AEMO GSoO2012

The risk to consumers of the low forecast of gas usage over the next five years will be similar to that in the current (AA3) period where gas volume forecasts have been low compared to actual volumes, and Gasnet acquired considerably more revenue than was expected to occur. That Gasnet achieved a considerably higher revenue than was forecast was a direct result of setting the forecast volumes too low.

The issue of differing expectations of gas consumption, the expected movements in tariffs (based on the X-factor adjustments proposed) delivers varying tariffs depending on the volume assumptions made for each. The following four charts summarize the tariff movements based on the X-factor adjustments provided in each document (ESCV final decisions, DB applications and revised applications and the AER draft decision. Even with this qualification, the charts reveal some interesting outcomes.





The charts show that:

- In the initial applications, all proposed tariffs show a significant increase
- The AER draft decision either maintain the current tariffs (Envestra and Albury) or reduce tariffs (Multinet and SPA) compared to current levels

- The revised applications show the new tariffs are all less than the initial applications and they would be much the same as current, or lower, except in the case of Envestra which still seeks an increase although much lower than was the case in the initial application

Bearing in mind that there are important differences in the forecasts of gas consumption, the EUCV recommends that the AER uses the AEMO forecasts for expected gas usage to ensure there is consistency in the development of the gas tariffs.

As the AER has used a significantly lower WACC for AA4 compared to that used by ESCV for AA3, there would be an expectation that tariffs would fall considerably. This is seen in the case of the Multinet and SPAusnet tariffs but it is concerning that a similar fall is not noted in the case of the Envestra networks. The EUCV considers the AER should investigate the reasons for this disparity.

### **1.5 The EUCV'S General View of the Draft Decision**

The EUCV notes that many of the concerns it raised in its initial response to the DB applications have been addressed in the AER draft decision. Despite the commentary provided by DBs in their revised applications, the EUCV does not consider that there is a need for the AER to change many of the elements of its draft decision as the changes sought in the revised applications from the DBs have little or no merit.

The main exception to the above comment concerning the AER draft decision is the continuing EUCV concern about the debt risk premium to be included in the WACC. This aspect is discussed in more detail in the following section on WACC.

The EUCV also notes that much of the reduction in the average tariff is an outworking of the fall in the yield for 10 year CGSs. The AER needs to be cognizant that the reduction is therefore short lived as, in time, the "risk free rate" will inevitably return to its long term level or even exceed this. It is therefore imperative that the AER ensure that the approach to determining other allowances is not relaxed and that all elements must be fully justified

### **1.6 An overview of the DBs revised applications**

All the DBs have reduced their expected revenues following the release of the AER draft decision. Whilst reducing their expectations and accepting some of the points made in the AER draft decision, they have not accepted all of the views of the AER, and as a result their revised claims are still higher than the AER considered appropriate in its draft decision.

It is clear that the DBs are still seeking to utilize the benefits of the Gas Rules to force the AER to accept conclusions about issues that are at the

very high end of the acceptable range for inputs. The AER must ensure that, in its final decision, it allows only costs which are demonstrably efficient and is not swayed by arguments based on “bottom up” assessments. The EUCV members have all commented that they fully understand that “bottom up” assessments need to be constrained by the realities of “top down” controls. This is commercial reality and no exception should be contemplated in the treatment of monopoly infrastructure network businesses. The fact that the historic cost performance of the DBs all show that the initial applications and the revised applications all seek higher input costs than were sufficient in a market where gas consumption was higher than is forecast for AA4, provides a clear indication that the “bottom up” based claims are excessive.

### **1.7 Outsourcing of activities**

In its response to the initial applications, the EUCV highlighted a concern that the use of outsourcing of some activities to related parties has the potential to embed additional and unnecessary costs, especially in the allowance for opex and overhead recovery.

The use of the benchmark year of 2011 as the basis for setting future opex incentivises the DBs to maximise expenditure in this year and to embed related party profits into the basic building block. In this way, related party profits are then locked into the supposedly “efficient” opex without further investigation.

The EUCV considers the AER must dig deeper into the actual base year costs to ensure there are no embedded related party profits.

### **1.7 Summary**

There is little doubt that the DBs have sought to maximise their revenues in their initial applications and their revised applications. The AER draft decision imposes some sensible controls on the massive increases in opex and capex claims. But more should be done.

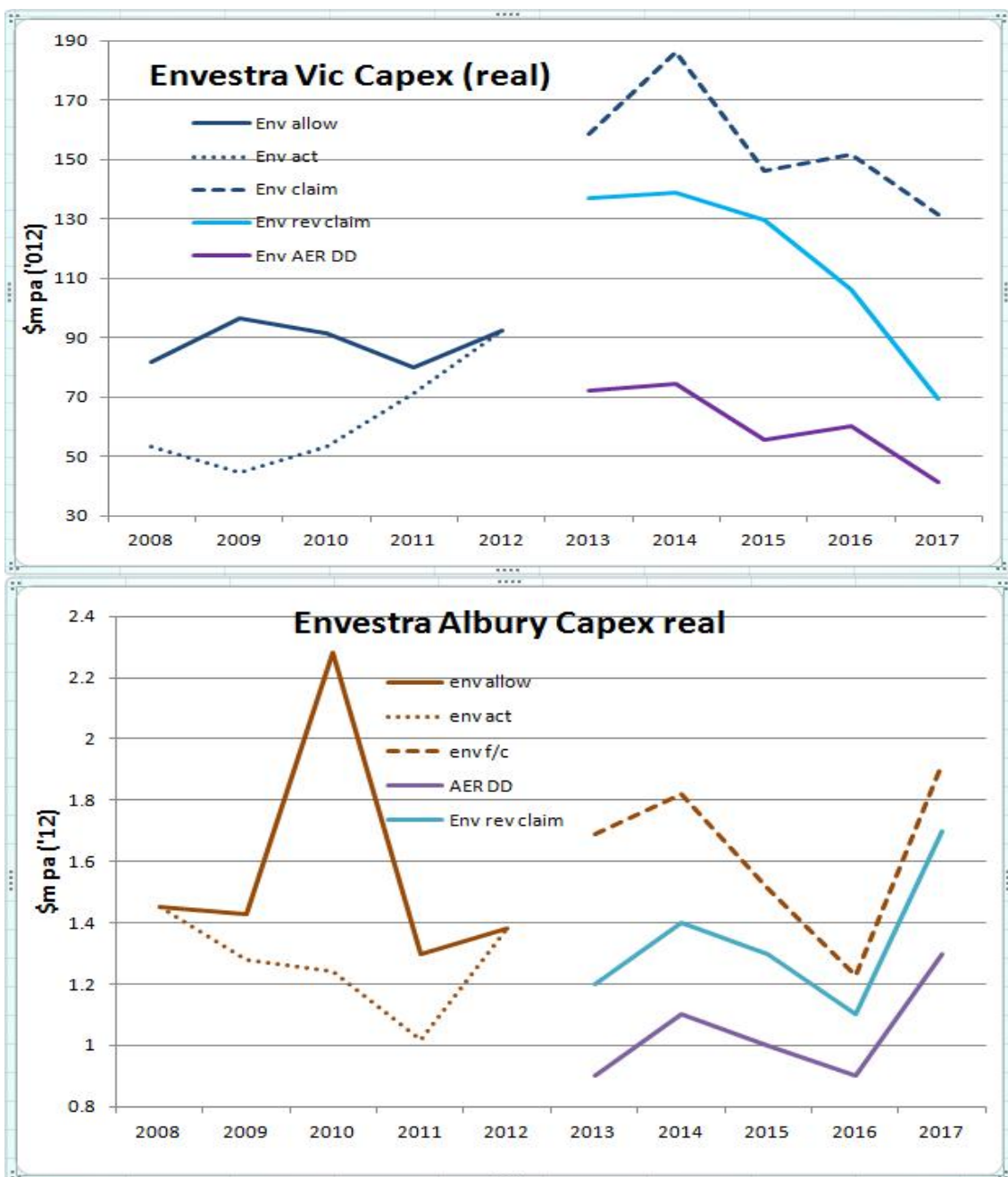
At its most basic, the EUCV expected that, with the reduction in the WACC calculated in the draft decision compared to that used by the ESCV for AA3, there would be a significant reduction in tariffs. That is, in all cases but SPAusnet, revised tariffs show an increase from current levels indicates that the DBs continue to believe they are entitled to increases.

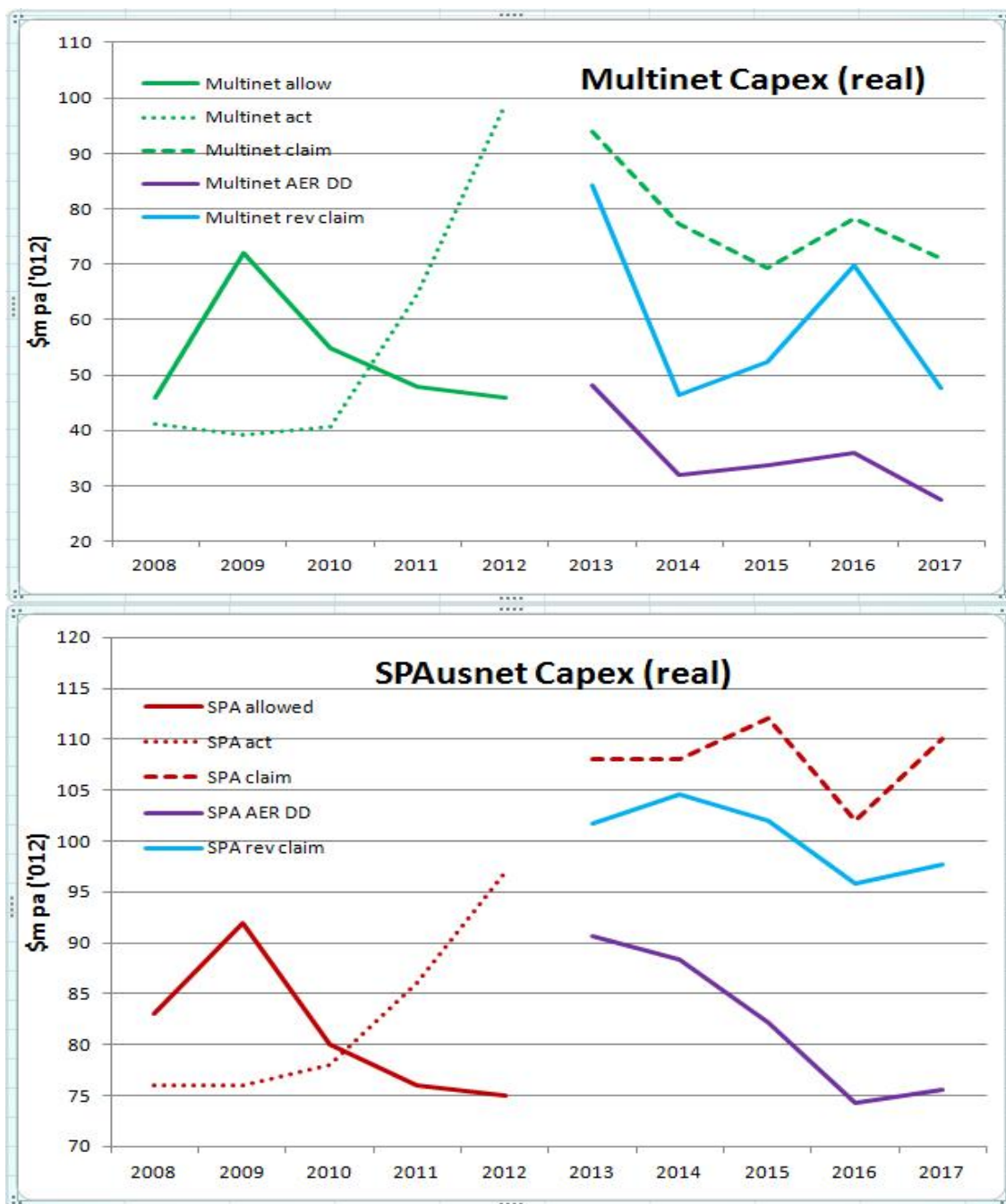
The AER has the task to ensure that the final tariffs are developed and are reflective of efficient costs.

## 2. Total Ex-Ante Capital Allowance

### 2.1 An overview of the DB capex claims

The forecast total capex for AA4 can be seen in comparison to the much lower actual capex for AA3 in the following charts. The charts also include the revised capex claims and the capex allowed in the AER draft decision. The source of the information in these charts is from the ESCV 2006 Final Decision, the initial and revised applications for the DBs and the AER draft decisions.





In addition to the charts, the following table showing average annual capex adds a further dimension to the transparently excessive claims for AA4 capex by the DBs with Envestra, in particular, proposing to double its capex from the AA3 period in its revised application.

\$m pa ((\$'12)	AA3 allowed	AA3 actual*	AER DD	Initial claim	Revised claim
Envestra	88.36	55.55	60.74	154.86	116.2
Multinet	53.40	46.40	35.54	77.94	60.06
SPAusnet	81.20	79.00	82.20	108.00	100.36
Envestra Albury	1.57	1.25	1.04	1.63	1.34

Note: \* Only the actual recorded opex has been used as the final year opex is only an estimate. Using an estimate which is inflated could distort comparisons

From the above charts and table a number of salient issues can be identified:

- All DBs did not use all the capex that was included in the AA3 allowances by the ESCV in 2006. This provided all DBs with additional revenue for which consumers receive no benefit.
- All DBs underspent their capex allowances in the first three years of AA3 and then significantly increased expenditure in year 4 and forecast even greater expenditure for year 5. This deferral of capex allowed all DBs to significantly increase their revenue for which consumers received no benefit. The spikes in the 4<sup>th</sup> and 5<sup>th</sup> years of AA3 are clearly evidence of regulatory gaming.
- All DBs forecast a significant increase in capex for AA4 despite not using the capex allowed for AA3
- All DBs significantly reduced their capex claims in their revisions by between 10% and 30%, implying the initial claims were grossly overstated and so it would be expected that the revised claims remain excessive.
- All DBs sought an increase in capex above the AER draft decision in their revised submissions by between 20% and 90%

The AER draft decision capex allowances generally reflect the capex that all DBs incurred in the first four years of AA3. This approach is consistent with self benchmarking. As there is a forecast reduction in gas consumption compared to consumption during AA3, and the rate of new connections has slowed, it would be expected that capex needs of AA4 would at the most optimistic be similar (or even lower) than in AA3.

The Gas Rules require that capex must be prudent and efficient. The EUCV finds it amazing that, in an environment of falling gas consumption and a slowing of the need for new connections, the DBs consider that they require more capex in AA4 compared to that actually used in AA3. This does not make business sense and is illogical.

On a comparative “top down” analysis, the EUCV considers that the approach used by the AER in the development of the capex needs for AA4



provides a sensible and consistent approach to setting capex allowances for AA4.

## **2.2 Specific areas of concern**

### **2.2.1 Mains replacement**

Analysis of the actual areas of difference between the AER views of the appropriate capex for AA4 and the claims by the DBs for AA4 capex, shows that a consistent difference of approach lies with the assessment of mains replacement. Here the DBs have all sought considerable capex to replace gas mains.

It is the leakage of gas from distribution gas mains that is considered to be the main driver of gas main replacement. It is intriguing that all DBs had proposed significant mains replacement programs for AA3 yet the main cause of the capex underspends in AA3 was that mains replacement did not occur as proposed when AA3 capex allowances were set.

In assessing the prudence for mains replacement, the AER (as do the DBs) needs to assess two aspects – firstly does the cost of the gas escaping from the mains warrant the amount of investment required to prevent it, and secondly does the amount of gas escaping pose a safety risk.

Addressing the second point first, the EUCV notes that the DBs did not use the amount of capex allocated for mains replacement in AA3. This implies that the issue of safety is not a concern.

With regard to the amount of gas escaping, the EUCV notes that the cost for unaccounted for gas (UAFG) is a risk primarily borne by consumers under the current arrangements – either through paying more for UAFG than actually occurs and for the cost of providing capex to reduce the amount of UAFG. The EUCV notes that the DBs have recently had the new benchmarks for UAFG in AA4 set by the ESCV (and promulgated by the Victorian government). These benchmarks have been set independently of the cost of achieving these benchmarks as the cost for AA4 is currently under review by the AER. The EUCV considers this is inappropriate.

Under the current arrangements, the DBs are incentivised to seek more capex to reduce the amount of UAFG. They then have the ability to trade off the benefits of not spending the capital against the cost of any over-run of UAFG that might occur. It would appear that this occurred in AA3 where as long as they spent sufficient to keep UAFG under the benchmark, they had no need to use the available capex allowances for mains replacement.

In its draft decision the AER used the historic actual expenditure pattern for mains replacement as the basis for setting mains replacement in AA4. The EUCV considers that this is a very sensible approach and fully supports this.

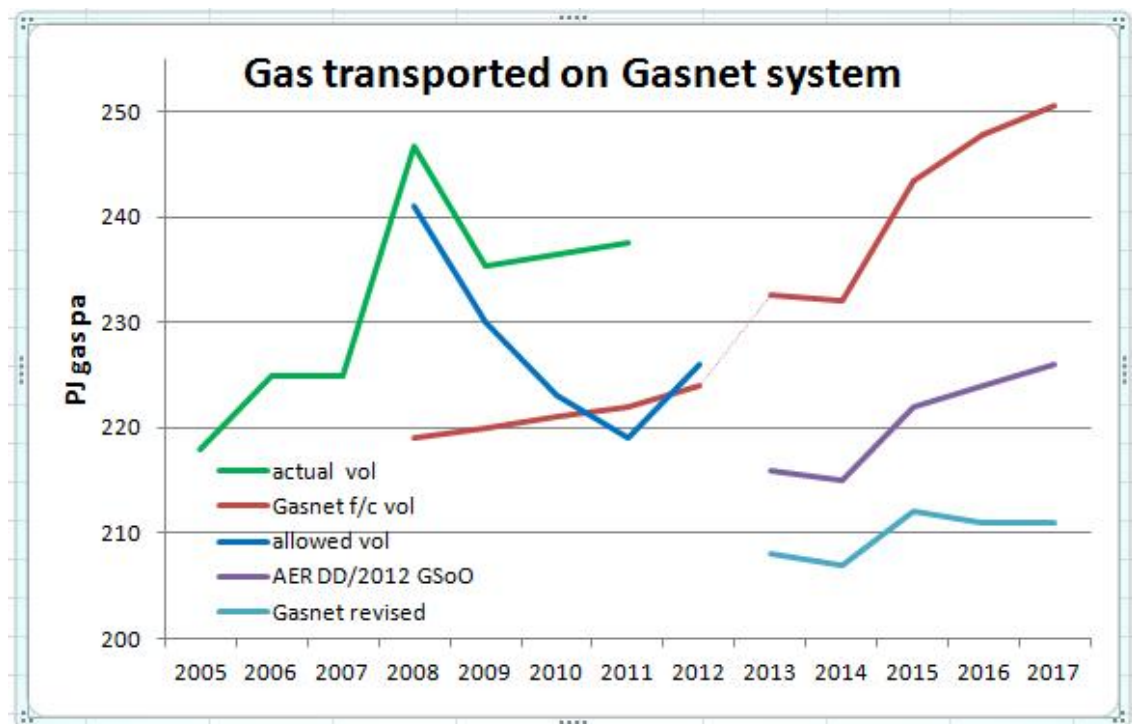
Such an approach provides a sound balance between the cost of replacement gas and the cost of mains replacement.

Further, it will also result in the DBs being driven to the most efficient outcome between the cost of replacing gas lost through leakage and the cost of mains replacement. At the end of AA4, the AER will be in a much better position to identify the most efficient approach to setting the balance between the two competing elements of cost for consumers.

### 2.2.2 Augmentation and new connections

Another area of disagreement between the AER draft decision and the revised applications is the extent of capex needed for augmentations and new connections.

The 2012 GSoO issued by AEMO indicates that the amount of gas likely to be used in AA4 is considerably less than was used in AA3 and is unlikely to reach AA3 levels at any time in AA4. This assessment reflects the independent analysis undertaken by ACIL Tasman for the AER as part of the review of the Gasnet price review. The following chart shows this in global terms for Victorian gas usage.



Source: ACCC FD, AER DD, Gasnet applics and revised applics, AEMO 2012 GSoO

The clear implication of this analysis is that there is no need to augment the distribution networks to accommodate gas usage growth as was seen during AA3. In fact, the forecasts imply that there will be considerable underutilized capacity in the distribution networks for the entire AA4 period. Whilst this is a simplistic and “top down” assessment, the import is that augmentation

needs will at best be quite modest and only be needed in areas of expansion of the distribution networks to accommodate new gas users.

There is also a clear separation of views between the DBs and the AER regarding new connections with regard to the cost of each new connection and the expected numbers of these. The AER has again used costs based on the costs incurred in AA3 as the basis for its allowance and its independent forecasts of customer increases. The EUCV sees this as an appropriate method to develop these costs.

The EUCV notes there is a suggestion that if the AER does not agree with the DB forecasts, then there should be an adjustment methodology which removes the risk from the DB of an AER error. The EUCV considers this quite understandable for the DB viewpoint (why accept a risk if it can be laid off to consumers?) but this completely obviates the purpose of incentive regulation.

Incentive regulation is all about providing incentives for regulated firms to drive towards the most efficient outcome as this will be in the long term interests of consumers (and new network businesses). It is not about providing benefits without some risk. The EUCV considers that the historic costs (adjusted for changed circumstances) provide the best basis for what costs are most likely to be in the future. Not to use this as the basis for setting the costs in AA4 would be remiss of the AER and cause consumers not to benefit from the incentives that have been provided to achieve this very outcome.

Forecasts of new connections need to be made independently of the business that is incentivised to maximise these numbers, and the EUCV considers that both ACIL Tasman (for the AER) and AEMO are both competent and sufficiently independent to provide an unbiased assessment of future needs of the DBs.

Overall, the EUCV still considers that the benefit of the increased gas consumption resulting from new customers being connected needs to be balanced against the cost to existing customers of the increased capital required to add the new customers. This basic analysis demonstrates the prudence of investment. None of the DBs provided such analysis proving the prudence of the augmentations and new connections and neither has the AER. This is a considerable failing of the analysis of the capex required for this element of the capex program. Without this level of transparency (which is expected under best regulatory practice in all effective regulatory regimes), there is NO evidence that the capex requirements are in the interests of consumers and, therefore, will be inconsistent with the NGO.

### 2.2.3 Step increases

Generally the EUCV considers the AER has addressed the step increases claimed by the DBs in relation to capex.

The one area of concern is the continued need for capex to upgrade, replace and/or augment the IT and SCADA systems. The AER has allowed over \$100m between the three main DBs to provide capex for IT and SCADA. This is more than 10% of the total capex budget allowed by the AER and appears to be excessive. The AER is urged to reassess this issue again.

### **2.3 Summary of EUCV views on capex**

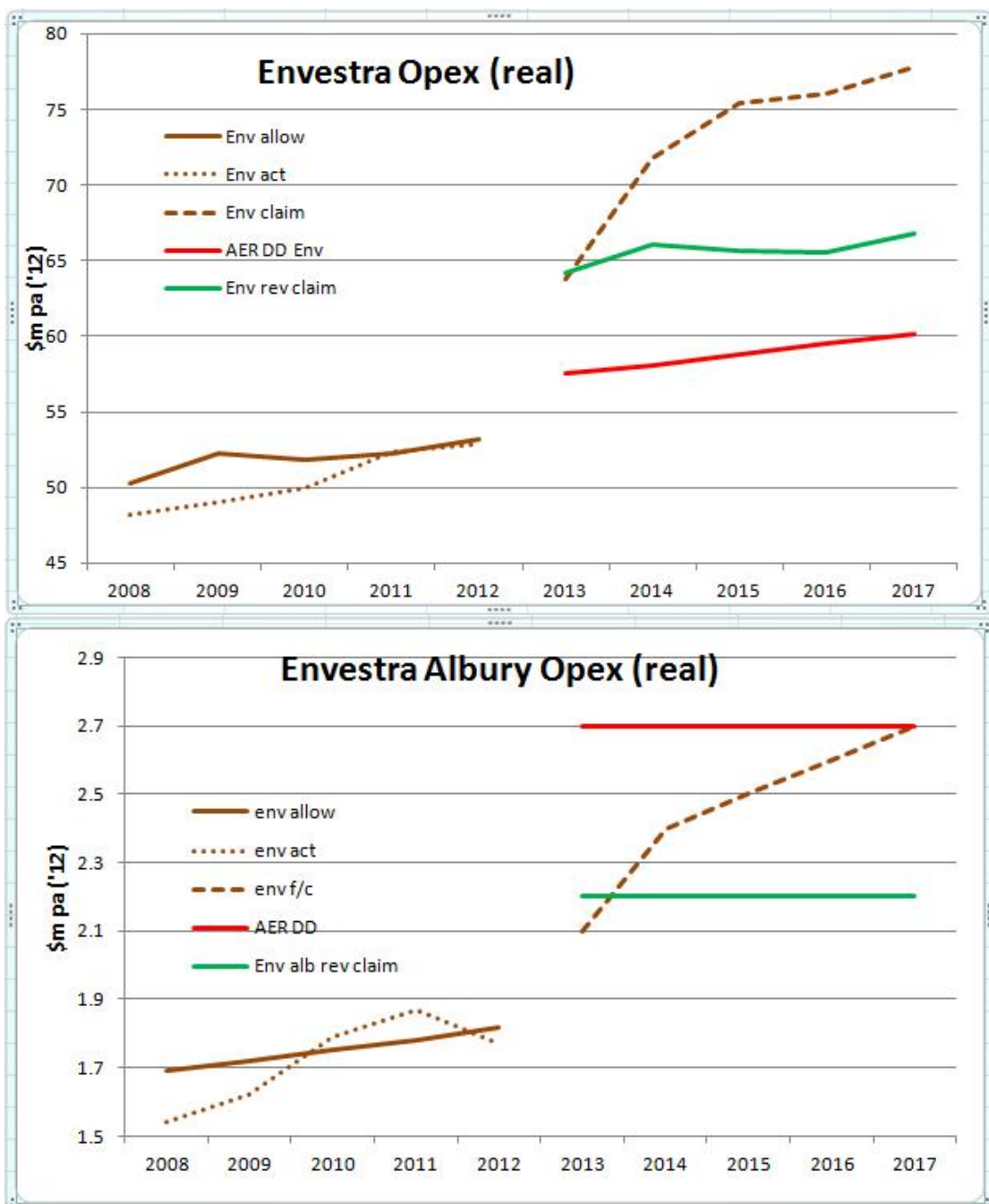
The approaches to setting capex allowances used by the DBs all result in significant amounts of ambit claims, even after they are toned down in the revised applications. On a top down assessment, the capex claims all provide for more capex than were used in AA3, despite the forecasts for gas consumption all showing considerable reductions. This does not make business sense.

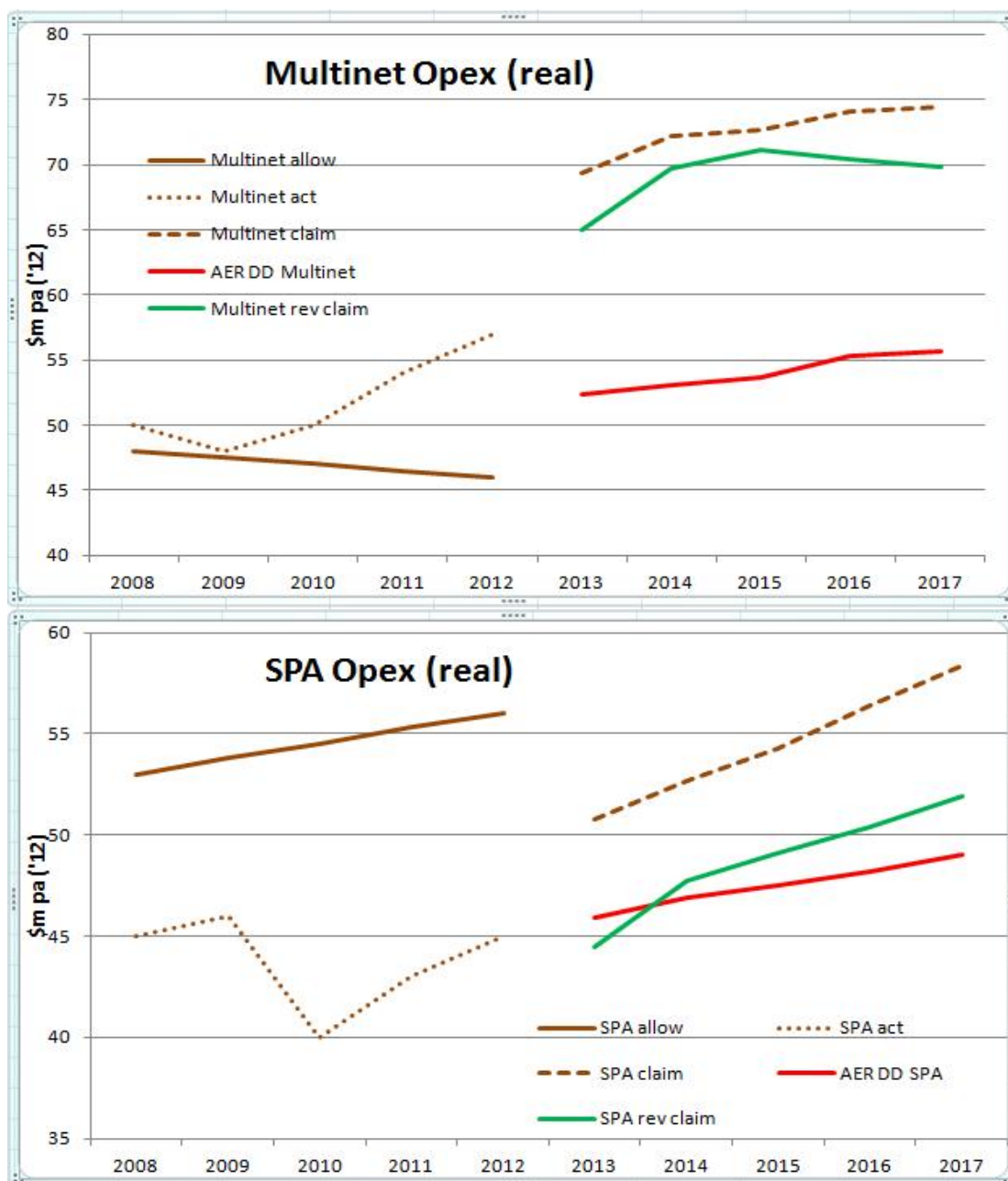
That this is occurring imposes a responsibility on the DBs and the AER to demonstrate that the capex programs that are allowed for will be demonstrably prudent as is required by the Gas Rules. In the absence of such analysis, the EUCV has concerns that the capex allowances are indeed prudent. The AER must insist on the transparency of the necessary information from the DBs and undertake an analysis to satisfy consumers that the capex allowances are prudent and are therefore consistent with the NGO.

### 3. Forecast Operating Expenditure

#### 3.1 An overview of the DB opex claims

The forecast total opex for AA4 can be seen in comparison to the much lower actual opex for AA3 in the following charts. The charts also include the revised opex claims and the opex allowed in the AER draft decision. The source of the information in these charts is from the ESCV 2006 Final Decision, the initial and revised applications for the DBs and the AER draft decisions.





In addition to the above charts, the following table showing average annual opex adds a further dimension to the excessive claims for AA4 opex by the DBs

\$m pa ((\$'12)	AA3 allowed	AA3 actual*	AER DD	Initial claim	Revised claim
Envestra	52.0	49.9	58.8	73.0	65.6
Multinet	47.0	50.5	54.0	72.6	69.2
SPAusnet	54.5	43.5	47.5	54.5	48.7
Envestra Albury	1.75	1.71	2.7^	2.5	2.2

- Notes: \*
- Only the actual recorded opex has been used as the final year opex is only an estimate. Using an estimate which is inflated could distort comparisons
- ^
- The EUCV notes that the AER has recognized that the actual opex included a negative charge from the EBSS and has sensibly decided that Envestra should not be “penalized twice”

From the above charts and table a number of salient issues can be identified:

- All DBs (other than Multinet) did not use all the opex that was included in the AA3 allowances by the ESCV in 2006. This provided three DBs with additional revenue for which consumers receive no benefit other than that which might arise through the EBSS.
- All DBs (other than Multinet) underspent their opex allowances in the first three years of AA3 but all significantly increased expenditure in year 4 (the benchmark year) and tended to forecast even greater expenditure for year 5. This deferral of opex allowed all DBs to significantly prepare the case for an increase their opex in AA4 for which consumers will received no benefit. This is a common aspect of regulatory gaming.
- All DBs forecast a significant increase in opex for AA4 despite most not using the opex allowed for AA3. Multinet which had overspent the allowed opex in AA3, sought the largest step increase in opex from that used in the “benchmark year”.
- The AER draft decision basically reflects the base year opex adjusted for accepted changes. The AER draft decision opex allowances follow the general trend in actual cost growth seen over the long term
- All DBs significantly reduced their opex claims in their revised applications by between 5% and 15%, implying the initial claims were grossly overstated
- All DBs sought an increase in opex above the AER draft decision in their revised submissions by between 5% and 30%

The AER draft decision opex allowances generally reflect the opex that all DBs incurred in the first four years of AA3 and tend to follow the long term growth in costs. This approach is consistent with self benchmarking. As there is a forecast reduction in gas consumption compared to consumption during AA3, and the rate of new connections has slowed, it would be expected that opex needs of AA4 would be similar to that needed in AA3, but with perhaps, at best, a small increase.

The Gas Rules require that opex must be efficient. The EUCV finds it amazing that despite an economy which is exhibiting very modest growth and a slowing in gas demand, all the DBs consider that they require more considerably more opex in AA4 than they actually used in AA3.

On a comparative “top down” analysis, the EUCV considers that the approach used by the AER in the development of the opex needs for AA4 provides a sensible and consistent approach to setting opex allowances for AA4.

### 3.2 Setting the base opex

As noted in section 1.2, incentive regulation is to drive costs to the efficient boundary. In the case of opex this is achieved by using the Efficiency Benefit Sharing Scheme (EBSS).

The EBSS is a tool for rewarding a regulated firm for implementing efficient practices and so driving its unit costs lower in real terms. A regulated firm is rewarded for reducing its costs (in this case opex) by allowing the firm to retain the initial benefits of the lower opex (ie any under-run is retained by the firm) and then adding to the following regulated period a reward for under-running the opex in the previous regulatory period.

Using this approach the regulator can use the actual opex incurred in a regulatory year as the basis for the following regulatory period allowances. To achieve this, there is recognition of the increased scope of works, increased costs and any changes from the basis of the costs actually incurred. This approach is effectively intended to provide “self benchmarking” of performance.

In addition to self benchmarking the regulator should also carry out external benchmarking to ensure that the self benchmarking approach is providing a trend towards the efficient boundary. The regulator then uses these tools to arrive at an allowance that is demonstrably efficient as the National Gas Objective. The Gas Law and the Gas Rules all require the regulated firm to receive the efficient cost for providing the service and no more.

As has been highlighted by the EUCV and its affiliates consistently, the regulator has to assess the reasonableness of an opex claim on a “top down” basis as it has neither the technical knowledge nor the information to adequately debate with a service provider the intricacies of each specific aspect of the many elements that comprise the final opex allowance.

To put this into context, when a firm operating in a competitive business carries out its budgeting functions, senior management is presented with a “wish list” (the claim) from each operation for its opex needs. Senior management then has to examine this claim in terms of what the market for the product can stand in terms of cost increases<sup>5</sup>. This senior management

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<sup>5</sup> Frequently senior management also impose a productivity improvement on their operations as this reflects a market need to continually improve operations in order to retain market share. The AER does not impose such productivity requirements, although jurisdictional regulators did so in previous decisions. The EUCV considers that, in order to reflect market pressures, the AER should impose such a cost.



role is effectively undertaken by the regulator, so that the allowances recognise the impact on selling prices.

The EUCV is pleased that the AER has tended to use this approach in assessing allowable opex costs. In particular, the EUCV notes the rigour used by the AER in assessing the Multinet opex. The EUCV recognises the effort the AER has taken in this regard and supports the approach and conclusions reached. This is normal commercial practice and monopoly infrastructure network businesses should not be treated differently.

### **3.3 Step changes**

The EUCV notes that the AER has taken a sensible approach to the inclusion or otherwise of step changes claimed by the DBs. What appears to be lacking is an assessment as to whether some of the step changes that have been accepted are legitimate – that the step change is an exogenous change not initiated by the DB. The EUCV considers that unless an exogenous change has occurred, then it cannot be classed as a step change.

The EUCV notes that the AER has not allowed some step changes that were initiated internally by the DB (ie endogenous). One such project was proposed by SP Ausnet to carry out pipeline mapping via magnetic tomography which SP Ausnet has stated in its revised application must be retained.

The EUCV considers that there is probably a valid reason for a DB initiating an endogenous step change, such as resulting from improved technical advancements. Equally, in the absence of these advancements, it must be recognized the networks have been managed safely and efficiently. The EUCV sees that the introduction of improved technology should equally result in overall lower costs to consumers – if they don't then the change would be inefficient. The EUCV would expect that such improvements would be implemented by the DB as a matter of course and that they would retain the benefit under the EBSS incentive.

### **3.6 Summary of EUCV views of the AER draft decision on opex**

In its response to the DB applications, the EUCV was critical of the presentation of information by some of the DBs as the presentation provided made it almost impossible for a stakeholder to make the best constructive comments. The AER has sought extensive additional information from the DBs as part of its process in developing the draft decision, and some of this is provided in the AER documents.

It is concerning that the extent of information made available to stakeholders is so limited and the AER should impose on the DBs a requirement for better information provision in the future.

Overall, the EUCV considers that the AER has been rigorous in its approach to setting the opex allowances, and that the approach used reflects the incentive nature of the regulatory model used. That the outcome of the AER analysis basically is consistent with the long term growth in opex costs supports the view that the AER approach has resulted in an appropriate outcome

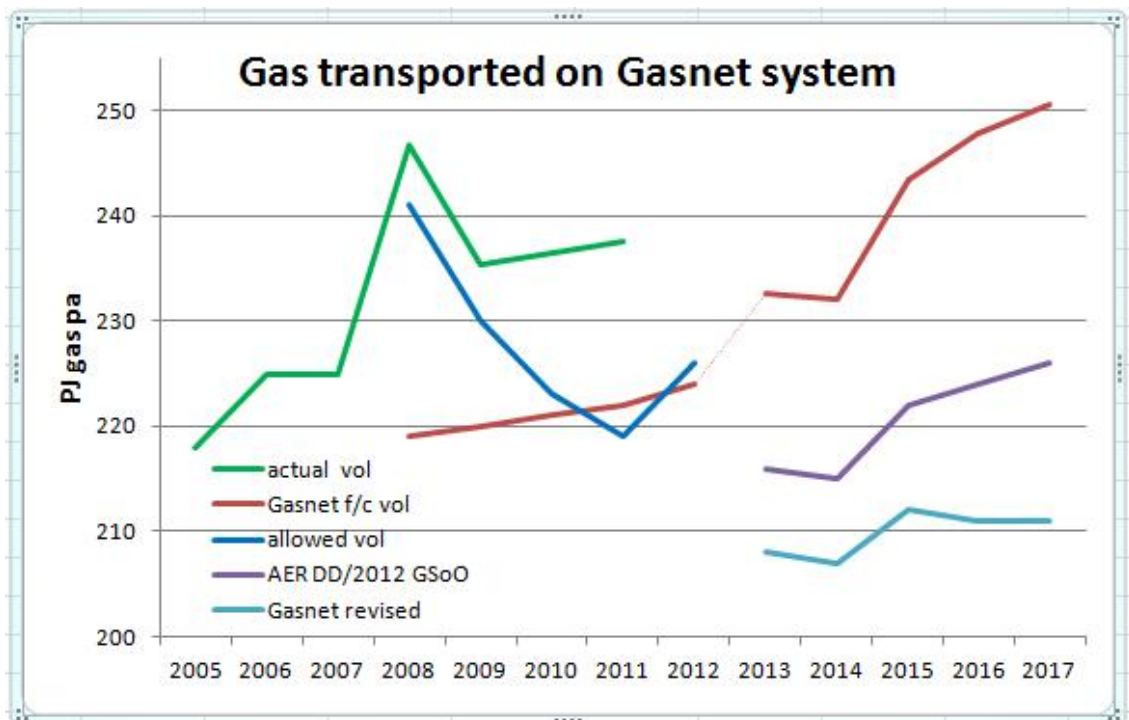
The EUCV notes that the revised applications from the DBs all result in a lowering of their forecast opex, with Multinet providing the least reduction. The EUCV is of the view that the rigour used by the AER in its draft decision provides a much better assessment of the likely actual needs of the DBs and that the revised applications predominantly constitute an attempt at rationalizing the ambit claims made initially. Nevertheless, these revised claims remain excessive too and are not justifiable.

## 4. Forecasts gas demand and consumption and escalation

### 4.1 Gas demand and consumption forecasts

The EUCV notes that the AER considered in its Gasnet draft decision that the forecasts of overall demand and consumption of gas in Victoria were too high and the AEMO 2011 forecasts might also be too high. As a result, the AER commissioned ACIL Tasman to prepare a forecast to be used as the basis of the AER draft decision.

Since then AEMO has released its 2012 Gas Statement of Opportunities (GSoO). The latest AEMO forecast exhibits close correlation with the ACIL Tasman forecasts. The EUCV considers that the AER should use the latest forecasts and notes that in its revised application Gasnet appears to consider that less gas will be transported than is forecast by ACIL Tasman and the AEMO 2012 Gas SoO. This is shown in the following chart.



Source: ACCC FD, AER DD, Gasnet applics and revised applics, AEMO 2012 GSoO

The EUCV sees that Gasnet has revised downwards its forecast volumes of gas to be transported in AA4 by reducing them by 10% or so. As the Gasnet forecast also includes a higher expectation of gas to be transported on the Culcairn interconnect, this implies that Gasnet sees that gas transported on the Victorian DB networks and used for power generation will be even lower than the amount Gasnet forecasts.

The EUCV has no better information on which the AER might assess the amounts of gas to be transported on the DB networks other than to provide

a view that it will probably be lower than that that occurred in AA3, even after allowing for the additional connections that each DB has forecast will be added to their networks.

The calculation of the actual consumption of gas is critical to the setting of the new tariffs and the X-factor adjustments that will constitute the basis for all consumer transport costs.

Generally, the AER has accepted the forecasts of gas demand and consumption provided by the DBs although it does require some “fine tuning” of the application of the methodologies used by SP Ausnet and Envestra. The AER relied on ACIL Tasman assessments of the DB applications but this work mainly addressed customer numbers and was less involved in the actual expected gas consumption for each sector of the markets.

In its reports, ACIL Tasman makes some observations regarding the certainty of the unit consumption data used raising concerns that there may be some uncertainty about the actual consumption forecasts. For example, in its report on the Envestra application, ACIL Tasman commented (pages 53 and 54):

“Notwithstanding the methodological issues identified, we have concluded that a more rigorous approach would not necessarily produce a more reliable forecast. This is because of the limitations of available data and the difficulties involved in reliably estimating the coefficients associated with each of the variables in a fully specified demand function.”

Trend charts included in the ACIL Tasman reports indicate that the forecasts of gas consumption for some sectors might understate longer term trends. If this is the case, and the DBs are underestimating gas consumption, this would provide an upward bias on tariffs and if ACIL Tasman is correct, the DBs would derive an unearned benefit.

However, because the AEMO 2012 GSoO forecasts considerably lower gas consumption in Victoria for AA4, and the DB forecasts were made before the issue of this important forecast of gas usage, the EUCV considers that there is a need to carry out a reconciliation of all the separate forecasts to ensure there is consistency between all of them and, that in aggregate, there is consistency between the separate forecasts and the AEMO Victoria wide forecast.

The EUCV considers that the AER has been remiss in not reconciling the separate DB forecasts with the overall ACIL Tasman forecast carried out for Gasnet. Now that the AEMO 2012 GSoO is available, the AER should reconcile the DB forecasts with this document as well.

If there is inconsistency between the aggregate of the DB forecasts and the AEMO and ACIL Tasman Victoria wide forecasts (adjusted for exports and gas powered generation) then the AER needs to adjust the individual forecasts to reflect the expected state wide forecasts. This is an important step that the AER must take to satisfy consumers that the allowances and tariffs that they have to pay are fair, reasonable and efficient, and that the AER review outcomes are consistent with the NGO.

## **4.2 Escalation forecasts**

The DBs have provided a view that their forecasts for capex and opex are based on costs applying at 2011 and that adjustments are required to reflect actual costs in the future as the costs are expected to exceed CPI which is included in the basis for future tariffs. The AER has concurred with this view and has provided its views on expected cost changes to be included in the forecast costs.

### **4.2.1 Movement in the price of materials**

In the draft decision on the DBs, the AER has provided considerable evidence that movements the CPI will adequately address potential movements in input material prices. Whilst the EUCV has consistently made the point that CPI movements should be adequate to address the movements in materials, the AER has at times allowed networks to increase their capex forecasts on the basis that materials prices will be higher than CPI.

The EUCV is of the view that with the very high \$A the movement in the cost of material from the benchmark year of 2011 will reflect the higher buying price the \$A has for imported materials such as polythene pipe (which uses oil as its base input material).

The EUCV is concerned that the AER has imposed a biased approach to escalation of materials used by networks. When the \$A is low and imported materials cost more than movements in the CPI addresses, the AER allows the increased cost of materials to be added to the regulated revenue. However, as now when the movement in the cost of materials is likely to be lower than CPI, the AER does not impose a corrective adjustment.

Such an approach is like “heads the network wins and tails the consumer loses”. The AER (with the EUCV support) considers that regulatory consistency is an essential part of incentive regulation, yet when consumers might gain from applying regulatory consistency, the AER appears to allow the benefit not to flow to the consumer.

On balance, the EUCV reluctantly supports the AER draft decision that the movement in materials prices will be compensated by the inclusion of the CPI adjustment that all DBs will get as part of the AER draft decision.

## 4.2.2 Movement in the cost of labour

The DBs have advised that their labour costs are related to EGW for direct labour and construction labour for large elements of the capital works and incorporated adjustments for future productivity increases.

### 4.2.2.1 Productivity adjustments

The DBs have commented that, although they did not consider that the forecasts of labour cost movements should be productivity adjusted because this is not consistent with the principle of incentive regulation (which they observe allows the regulated firm to hold productivity improvements until the next reset) they accept that the forecasts of labour movements could be productivity adjusted. The EUCV disagreed with their reasoning on this issue but agreed that labour costs should be adjusted for productivity.

The AER has disagreed with the DBs with regard to the use of labour price movements (the AER sees that labour price indices – LPI – are more reflective of future labour costs than the AWOTE preferred by the DBs) and has decided to change its practice used in previous regulatory decisions and decided not to adjust indices for future productivity.

The EUCV sees that the AER decision to continue the use of LPI is consistent with its reasoning used for many years for quite valid reasons and that it has consistently supported through well developed arguments.

What bemuses the EUCV is the change to excluding productivity adjustments for this decision – especially for the reasons given; that the development of productivity adjustments is difficult even though the AER openly comments:

“The AER considers that in theory productivity adjustments should be applied to real cost escalations if productivity adjustments are not undertaken elsewhere in opex and capex forecasts.

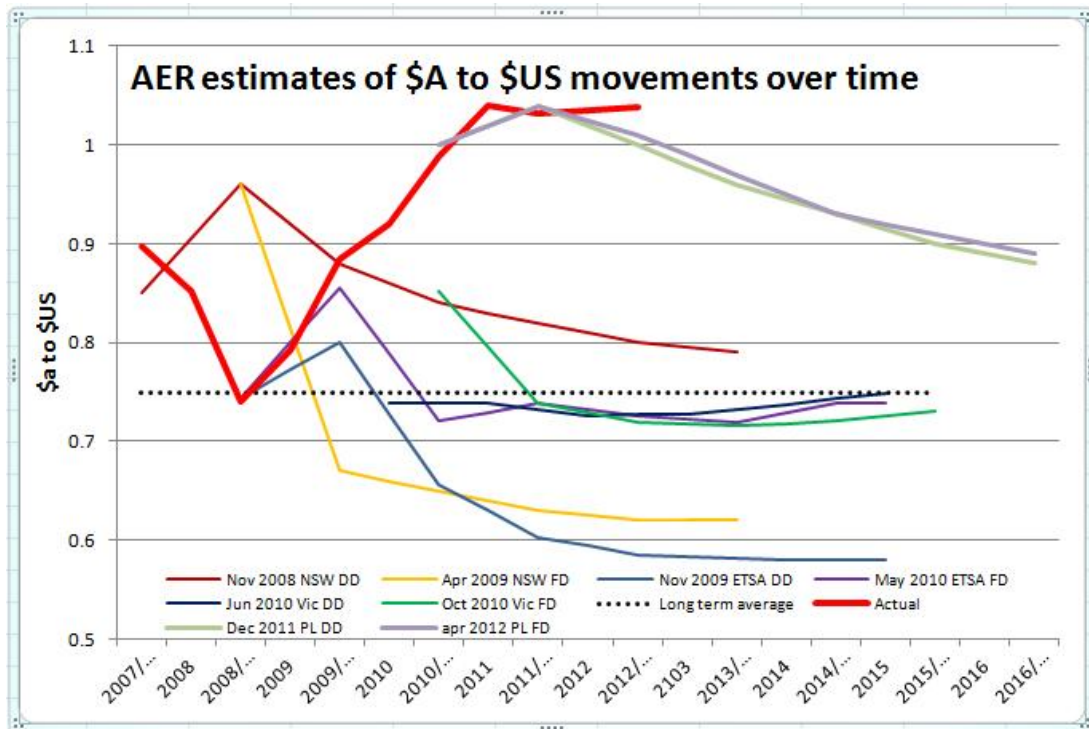
However, the AER notes the high degree of difficulty in estimating both quality adjusted labour productivity and conventional labour productivity as evidenced by the conflicting productivity estimates from BIS Shrapnel and DAE and the analysis conducted by the PC.

Thus, while the AER expects worker productivity to improve over the long run, due to estimation difficulties, it has not sought to address this effect, at this stage, in APA Gasnet’s forecasts of labour costs.” (Gasnet DD pages 73 and 74)

The AER has made similar comments in the draft decisions for the four DBs as well.

That the AER is prepared to allow the DBs increased costs above the efficient level due to difficulties in estimation is beyond belief, especially as the AER has previously allowed other increases in costs when estimation has been “difficult” (such as changes in the exchange rate, which are even more difficult to forecast!).

Thus, the AER has consistently allowed increases in future costs of imported materials used by regulated service providers based on low estimates of the \$A. The past performance of the AER in assessing exchange rates has been quite poor (almost entirely in favour of the regulated firms) as the following chart shows.



Source: RBA, AER decisions

The AER admits that it should apply productivity adjusted labour cost movements but declines to adjust for productivity because of the “estimation difficulty” while it willingly expresses its competence to adjust for exchange rates – albeit with extremely poor results (and not without severe warning and criticisms from EUCV and other consumer groups)..

To forecast a productivity adjusted future real labour cost requires the forecaster to estimate future labour costs, future inflation and future productivity. Excluding one element of an adjustment because of difficulties in estimation implies that forecasting future labour costs and future inflation

are more accurate than future productivity. Such a view smacks of hubris, especially when compared to other forecasts the AER has made in recent years.

The AER is required to provide regulatory certainty in its role. By changing its approach just for Gasnet and the other Victorian gas transport firms yet applying it to others introduces regulatory inconsistency. When such an inconsistency is purely based on a recently discovered “difficulty” with estimation provides no reasonable or rational basis for changing regulatory practice.

#### 4.2.2.2 Accuracy of labour forecasts

As part of the analysis for the decision to use LPI in lieu of AWOTE, the AER provided a table of the past performance of Access Economics (DAE) and BIS Shrapnel (BIS) in forecasting actual labour movements (see for example table C2 in section 3 of the draft decision on Multinet).

This data is quite fascinating and from it the AER concludes that the LPI forecasting by DAE is more stable and exhibits less volatility than does BIS forecasting and so the AER considers the DAE forecasting is preferred.

What the AER does not do is to assess the actual accuracy of the forecasts over time. For example, the DAE forecast for EGW made in 2007 for year 2010/11 shows a small under-run compared to the actual LPI. Yet these forecasts are compounded – the forecast for 2010/11 is the compounded increase of all the previous years of data. When compounding is implemented, the actual increase in LPI for 2010/11 based on movements from 2007 implies labour costs in 2010/11 were 24% higher than in 2007. The DAE forecast for the same period shows an increase of 26% (the BIS increase is nearly 29%).

Further, the errors between the actual values and the forecasts show a consistent overestimation of future LPI values. The number of times the forecasters underestimated the actual LPI is 25% whereas the overestimates comprise 60% of the forecasts – the balancing 15% is where the forecasts were accurate. On this basis the forecasters are likely to overestimate the LPI 4 times more than they get it right and underestimate it 2 times more than they get it right.

These actual calculations and comparisons show that the forecasts are biased towards overestimation and so impose increased and unnecessary costs on consumers.

#### 4.2.2.3 Summary

While the EUCV agrees with the AER that it is more appropriate to use the less volatile LPI forecaster, it does not agree that including the productivity adjustment should be excluded on the basis that there is inherent inaccuracy.



As there is an inherent bias of overestimation of future LPI estimates, including the productivity adjustment will tend to reduce the overt bias that the actual LPI forecasts already include.

#### **4.3 A better way of managing materials and labour price movements**

In its response to the applications from the DBs, the EUCV proposed a different approach to making adjustments for movements in the prices of labour and materials – one which would remove the bias that is inherent in the AER approach to adjustments for these input costs.

The EUCV is disappointed that the AER has not addressed this option in its draft decision. The EUCV does hope that the AER will consider this as it develops its guidelines for network regulation that are required with the recent changes of the Rules.

## 5. Cost of capital and allowed revenue

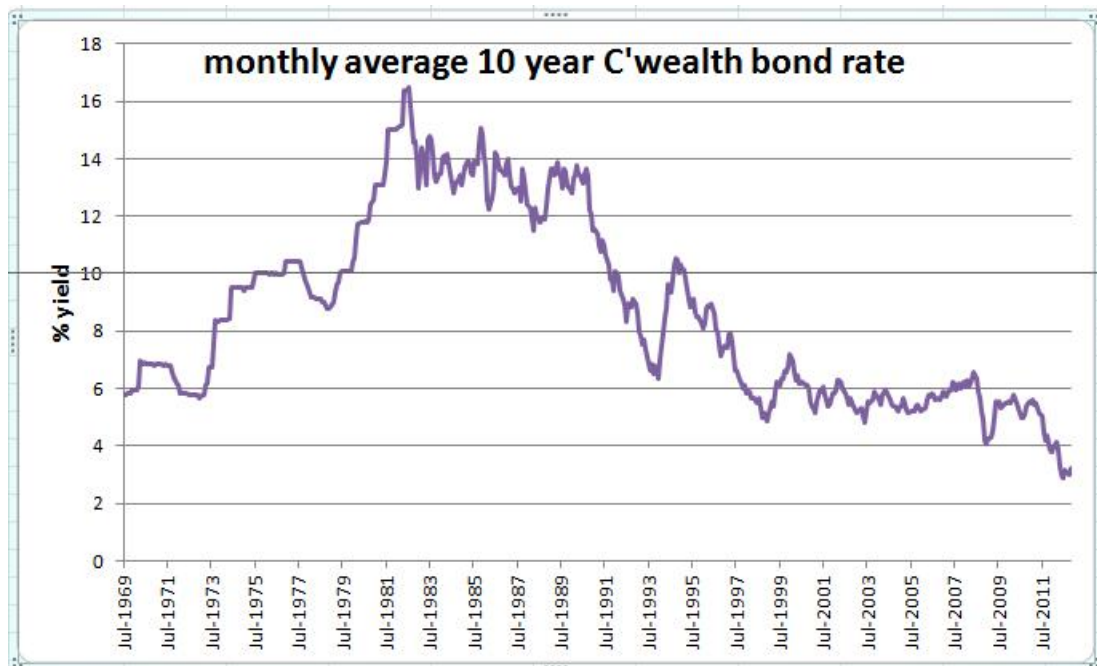
### 5.1 Weighted average cost of capital (WACC)

In its draft decision, the AER used the same approach to setting the allowed WACC as has been consistently used by Australian regulators for the past 15 years. The various WACC parameters used by the AER are essentially the same as used in previous gas pipeline decisions, but with minor changes.

Despite this, the DBs have highlighted in their revised applications that the process used is no longer valid. To back up its case, the DBs have provided a number of views from learned economists that the basic approach used by the AER is now demonstrably flawed. The entire argument posited by these experts is that using the 10 year Commonwealth bond rate as the risk free rate and adding to it the long term market risk premium (MRP) and the assessed debt risk premium (DRP), is no longer valid. They posit that with a low risk free rate, higher values of MRP and DRP are needed. The cause of this change is that the 10 year bond rate is now at the lowest value recorded in the past 40 years. The long term average of the 10 year bond rate is 8.7% and the average of the past 12 years is about 5.4%.

It must also be noted that the bond rate has reached a monthly average low of 2.89% and the monthly average for December 2012 it is 3.22%.

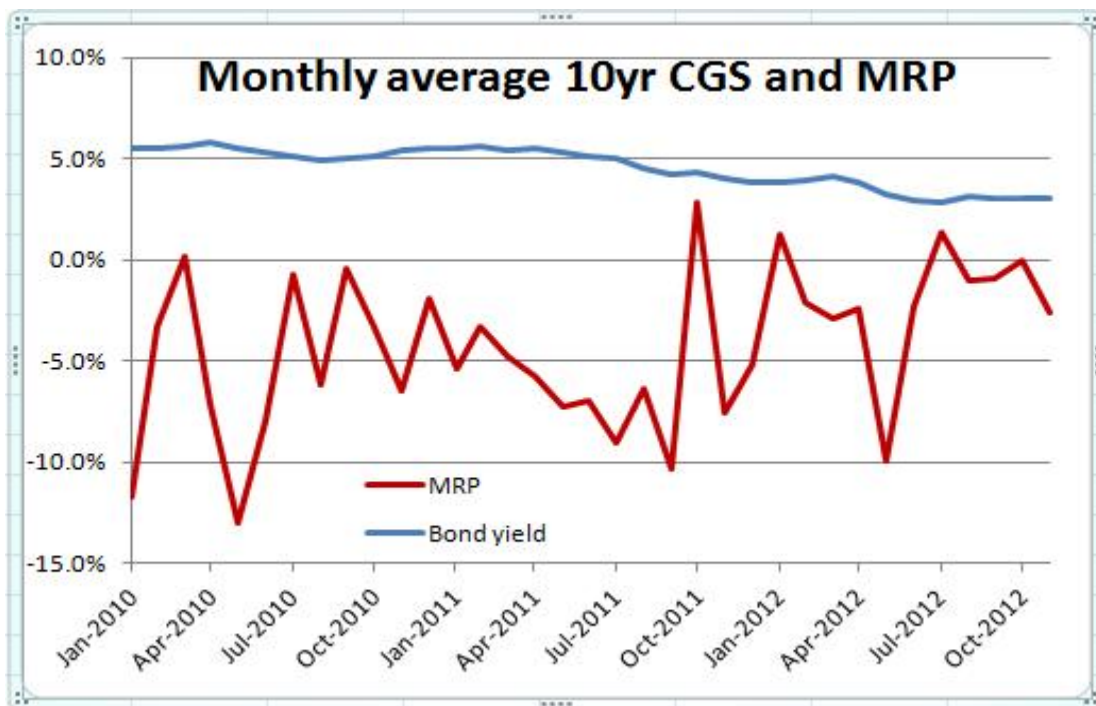
Below is the average monthly yield on 10 year Commonwealth bonds since 1969



Source: RBA

The DB's experts posit that the return on equity is a notional constant over time regardless of the movement of government bonds. They posit that applying the long term market risk premium to the government bond rate does not reflect this "truism". It is clear that since the advent of incentive regulation in the late 1990s the 10 year bond rate has averaged 5.4% and when the long term market risk premium of 6% was added to the average bond rate of 6%, the return on equity was seen to be about 11.4% based on an equity beta of 1.0. Because of this they consider the AER has to change the way it (and other Australian regulators) have consistently calculated WACC.

There is little doubt that the fundamental reason for the DBs seeking a higher MRP is because the risk free rate is currently so low. If the DBs and their experts are correct that the low risk free rate is associated with a higher MRP then this would be apparent since the low bond rate appeared in the last 12 months or so. In fact, the reverse is the case. The current lower than average bond rate has been associated with MRP values that are mainly negative and barely become positive. This is shown in the following chart.



Source: RBA data for 10 year CGS and ASX accumulation index

As can be seen, the bond rate has been at its 12 year average for over half of the last three years and this has been associated with negative MRP values even though during this time the AER granted an MRP value at the long term average of 6%. The lower bond rate seen over the last 15-18 months or so has been equally associated with an MRP of zero or for all but 3 months of the last 18. For the 4 DBs and their experts to claim that the lower bond rate needs a higher MRP than the long term average is just not supported by the facts and recent actual outcomes!

It must also be stated that for much of 2012, there has been considerable debate as to the best way to set the WACC for regulated firms (as a direct result of the AER proposed rule changes for network regulation) yet throughout the many debates and forums discussing the development of the WACC, the only two issues that arose regarding the setting of the risk free rate were:

- The averaging period of the risk free rate to set the forward looking risk free rate for the regulatory period, and
- Whether the risk free rate should be set to align with the regulatory period applying to the determination – whether the 5 year bond rate should be used for a 5 year regulatory period and a 10 year bond rate for a 10 year regulatory period

There was no discussion that using the 10 year CGS as the risk free rate was inappropriate for use in setting the WACC.

The EUCV can understand that with the current low risk free rate, this does reduce the WACC calculated for regulated firms and that they would seek to find ways of increasing this. This approach by the regulated firms that a higher MRP is warranted because the spot MRP compared to the spot risk free rate is higher than the long term MRP used by regulators is not supported by the facts.

The EUCV makes the rhetorical observation whether the massive debate as to the setting of the risk free rate would have been raised if the bond rates were at the levels seen in the 1980s, with an average value of some 13%, rather than the current value of about 3%? Would there be a debate that the return on equity has a constant value of about 12% when the AER approach would deliver a value of 19%?

This call for an increase in MRP must be seen in the context of recent (and unsuccessful calls by consumers) for a change in the way debt risk premiums are calculated.

As the bond rate has fallen in recent times (since the Global Financial Crisis) the debt risk premium as forecast by CBA Spectrum and Bloomberg has risen well above actual the cost of debt. Despite this, the regulated firms have consistently argued that the AER has to comply with the Statement of Regulatory Principles (SRP) established by the ACCC and AER must prevail – that spurious outcomes from the application of the SRP must be applied regardless of whether the outcomes deliver a patently high cost of debt. The EUCV has noted that in recent AER decisions, the cost of debt has nearly reached the cost of equity, despite the fact that the cost of debt has always been considerably lower than the cost of equity due to the much lower risk profile.

The EUCV affiliate NTMEU made the point in the AER decision on the Amadeus gas pipeline (AGP) that it was granting a debt cost allowance some 200 bp higher than the cost of debt that APA (AGP owner) had actually acquired debt for on the open market, and that the actual cost of debt to APA was even lower. The reason that APA (and the AER) gave for using this blatantly excessive debt cost allowance was that there needed to be regulatory certainty. The Australian Competition Tribunal also considered that the approach detailed in the SRP had precedence over actually observed outcomes that would have been more in the “long term interests of consumers” as required by the Objective.

Just as the EUCV affiliates identified that the SRP had imposed much higher costs on consumers than was warranted through the rigorous application of the SRP in setting the WACC when there were anomalies in calculating debt risk premiums, so too the regulated firms must accept that sometimes, the application of the SRP will be to their disadvantage. If regulatory certainty is sufficient justification for consumers to pay more than is necessary for regulated services, then so it is just as appropriate for network service providers to be granted a lower WACC than they would like.

The AER has advised that it will develop new guidelines for developing the WACC to apply to regulated energy assets and this is the time to address changes to the way the WACC is developed – not to make major changes on a case by case basis as part of a specific regulatory review.

Just as the AER has refused to accept changes to the setting of the DRP, so must it refuse to make a change to setting the MRP until the entire approach to setting regulatory rates of return has undergone the formal processes already in train.

## 5.2 Depreciation

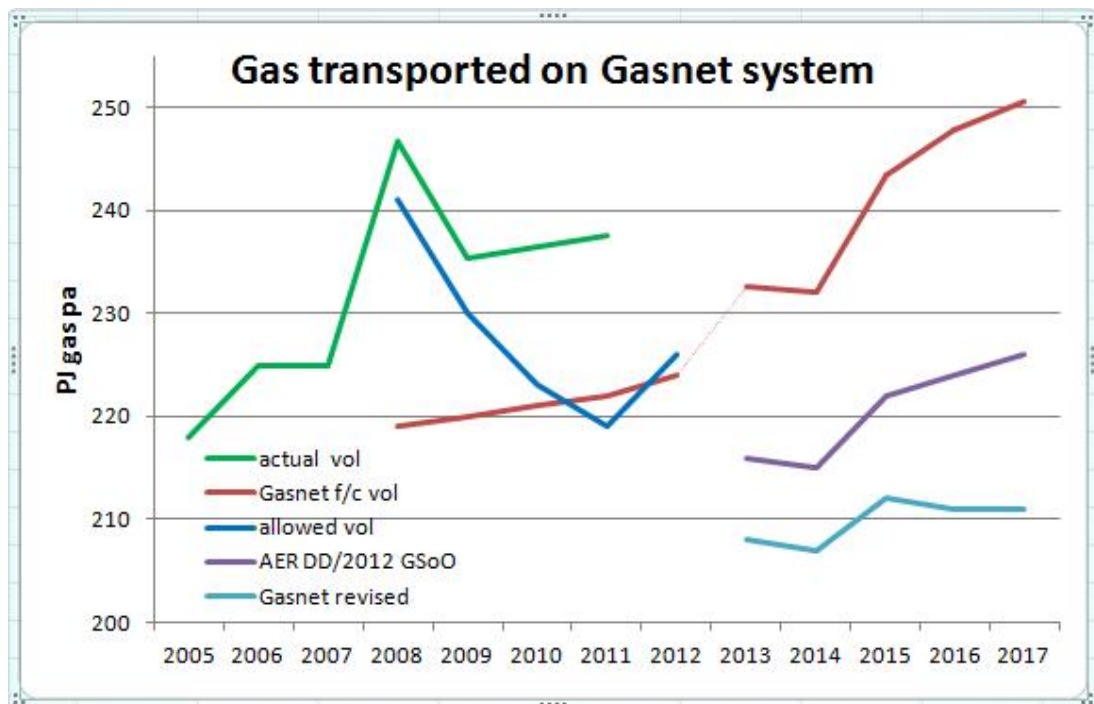
Two of the DBs have proposed a change to the way their assets are to be depreciated from the approach used for the past three regulatory periods. The EUCV sees that despite the DB’s desire to change the approach to setting allowed depreciation, the AER considers that the historic approach to depreciation should continue unchanged.

The proposal by the DBs to increase the depreciation allowance clearly has its genesis in the reduction in revenue that they see will result in the next regulatory period (AA4) due to the lower WACC that will apply due to the low risk free rate. This assessment is supported by the report to Gasnet from PwC (Mr Jeff Balchin) provided with the revised application, which points out that higher tariffs should apply when an assets is heavily used in order to incentivise change in usage patterns. PwC considers that setting higher tariffs will promote efficient growth in the market and will maintain consistency in tariffs rather than the sharp downward adjustment followed by constant prices that the AER approach would provide.

As depreciation of an asset is permitted only once, the increasing in depreciation allowance (however done) has the effect of transferring depreciation that would occur at some other time<sup>6</sup> to the present, with current consumers paying a premium for the benefit of past or future consumers.

What the DBs (and PwC) do not consider in their analyses and arguments is that the forecasts for gas consumption over AA4 are that there will be a significant reduction in AA4 compared to AA3. This reduction has been identified by ACIL Tasman for the AER and in the AEMO 2012 GSoO which both show a close correlation in forecasts<sup>7</sup>.

The actual and various forecasts of gas consumption provided are shown in the following chart.



Source: Gasnet applications, ACCC FD, AER DD, 2012 GSoO

What the chart highlights is that utilization of the Gasnet assets is likely to fall by 10-15% for AA4 compared to 2011. Therefore, the commentary that higher tariffs are justified because they reflect high utilization and a drive to better utilize assets, is not sustainable. In fact, lower tariffs are preferable in the case of falling utilization as this provides an incentive to increase usage.

<sup>6</sup> eg SP Ausnet proposed that its unrecovered depreciation from AA1, AA2 and AA3 should be recovered in its entirety over AA4 and Multinet had received accelerated depreciation in AA3 for assets that it still uses but proposed to accelerate depreciation for some assets in AA4

<sup>7</sup> Gasnet revised State wide forecasts are 5% lower than those forecast by AER/AEMO reinforcing the view that lower consumption will occur.

A reduction in demand places higher costs with consumers as the allowed revenue is recovered over a lesser amount of gas. If there is a clear fall demand, to argue that higher tariffs are required because this is more efficient becomes a spurious argument. In fact, because there is falling demand, lower tariffs are more appropriate to encourage greater use of the assets.

The EUCV notes that there are five criteria on clause 89 of the Gas Rules that apply to the depreciation allowance in the reference tariffs. These are:

The depreciation schedule should be designed:

- (a) so that reference tariffs will vary, over time, in a way that promotes efficient growth in the market for reference services; and
- (b) so that each asset or group of assets is depreciated over the economic life of that asset or group of assets; and
- (c) so as to allow, as far as reasonably practicable, for adjustment reflecting changes in the expected economic life of a particular asset, or a particular group of assets; and
- (d) so that (subject to the rules about capital redundancy), an asset is depreciated only once (ie that the amount by which the asset is depreciated over its economic life does not exceed the value of the asset at the time of its inclusion in the capital base (adjusted, if the accounting method approved by the AER permits, for inflation)); and
- (e) so as to allow for the service provider's reasonable needs for cash flow to meet financing, non-capital and other costs.

There is no disagreement between the AER and the DB's commentary regarding criteria (b), (c) and (d), and the EUCV agrees that the proposals comply with these criteria. The arguments Gasnet provide for its disagreement with the AER approach lie with criteria (a) and (e).

With regard to criterion (a) a higher tariff now (when gas demand is falling) is not efficient and will not encourage greater utilization of the assets. Gasnet provides a view that higher tariffs now with lower tariffs in the future will provide the basis for efficient utilization of the assets. As noted above, what Gasnet fails to recognise and address, is that it is forecasting a considerable reduction in gas transport.

In this regard, the EUCV notes the clause 89(2) – an argument that Gasnet used to justify higher tariffs – specifically highlights that depreciation can be deferred when setting higher tariffs (as might occur when a new pipeline commences operation) might not encourage greater utilization.

Gasnet comments that maintaining the tariffs at near current levels is more efficient than the AER approach which results in a step reduction in tariffs. What Gasnet does not take into account is the falling demand for gas transport in AA4 compared to AA3.

The EUCV is of the view that the falling demand warrants the maintenance of the historic approach used by all the DBs to providing for depreciation. A view of the current price paths of tariffs proposed by the DBs and by the AER draft decision is shown in section 1.4 above.

The charts show that falling tariffs over AA2 are associated with an increase in gas flows, but the constant tariffs in AA3 are associated with rising consumption until the final years. As consumption is falling, it would make sense that tariffs should be lower to encourage greater utilization providing a more efficient outcome overall. To increase the revenue requirements to recover more depreciation at this time, is simply not sensible or appropriate. The reality supports a view that criterion (a) is supported by the lower tariffs proposed by the AER draft decision. The EUCV considers that lower tariffs are required to address the falling consumption that is forecast.

With regard to criterion (e), Gasnet provided a view (although this has not been made by the DBs) that the lower revenue from applying the same approach it has to depreciation in the past will result in it not receiving sufficient revenue to meet its reasonable needs. To support this contention, it provides a view by Australian Ratings that the revenue afforded by the AER draft decision is insufficient for it to maintain a BBB+ credit rating and would maintain (at best) a credit rating of BBB.

It is important to note that Gasnet's parent (APA Group) has a credit rating of BBB – so the AER draft decision would not impact on APA's ability to raise debt. Gasnet overcomes this inconsistency by pointing out the AER needs to ensure there is internal consistency in the draft decision by ensuring the cash flows for Gasnet equate to the benchmark service provider rated at BBB+ because the cost of debt has been included in the draft decision as if the service provider was rated at BBB+.

There is an essential inconsistency in Gasnet's argument. The assessment by Australian Ratings is that Gasnet would be rated at BBB based on the AER assessed cashflow and its costs to raise debt on the open market would exceed the benchmark cost of debt for a BBB+ rated firm used by the AER. However, the benchmark cost of debt used by the AER for the Gasnet decision is higher than the actual cost of debt incurred by Gasnet's parent APA (which is rated at BBB) when it recently raised debt from the open market. This means that either APA is actually operating at a higher credit rating than is published, or the cost of debt allowed by the AER in its draft decision is higher than cost of debt incurred by a BBB+ rated firm. Either way, there is inconsistency in the Gasnet argument.

At its most basic, the credit rating set for a firm is used to identify the risk premium a lender would impose on a borrower – the lower the credit rating the higher the cost of debt. The setting of the credit rating is secondary to the actual cost for its debt that a firm will incur. Therefore if the AER



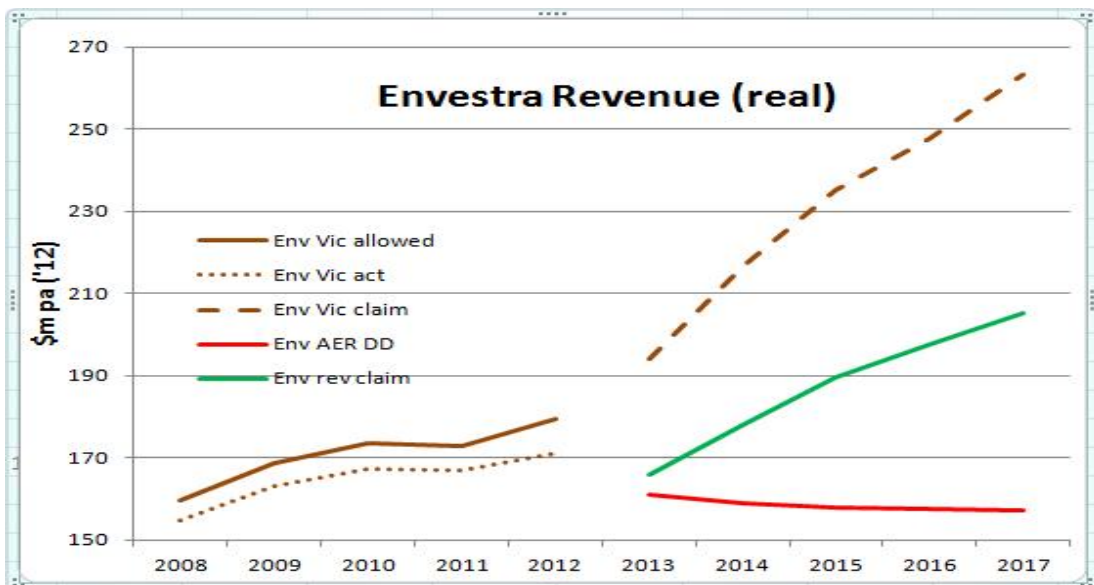
considers that the cost for debt a regulated firm will actually incur will be lower than the cost for debt it allows within the determination, then the actual credit rating a firm might have is immaterial.

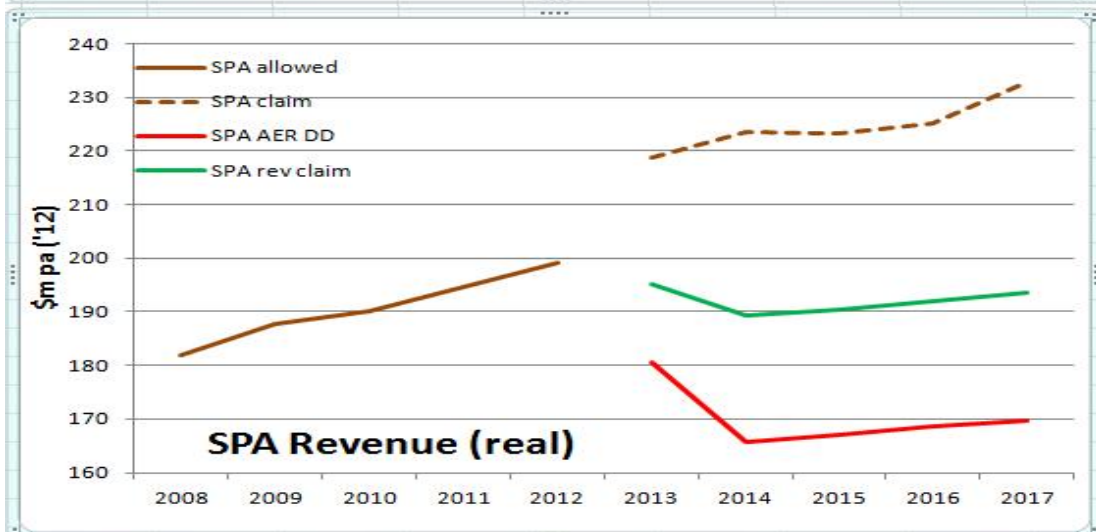
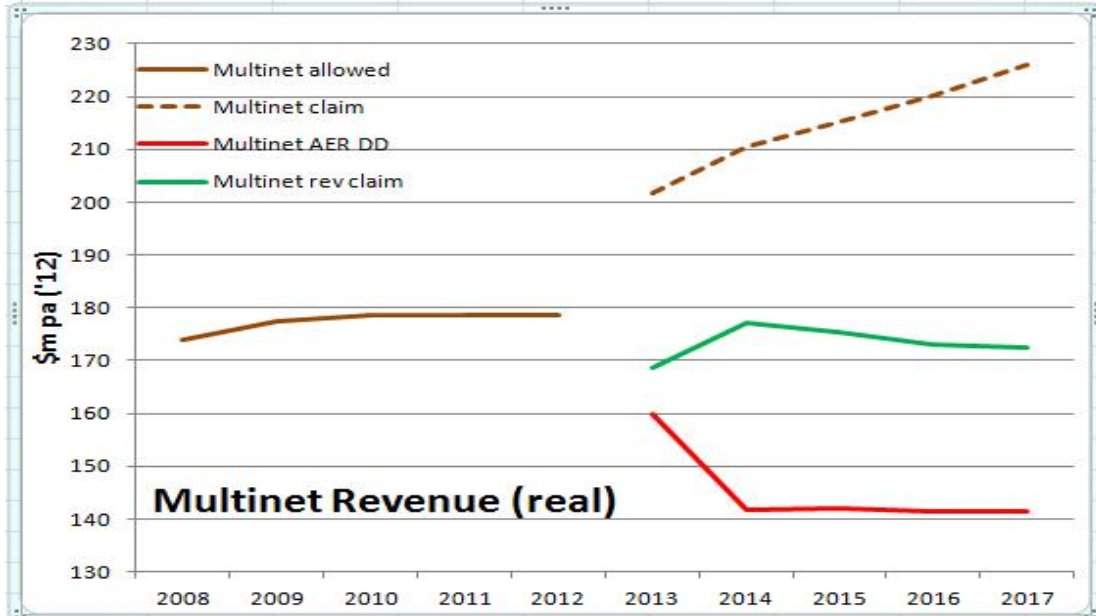
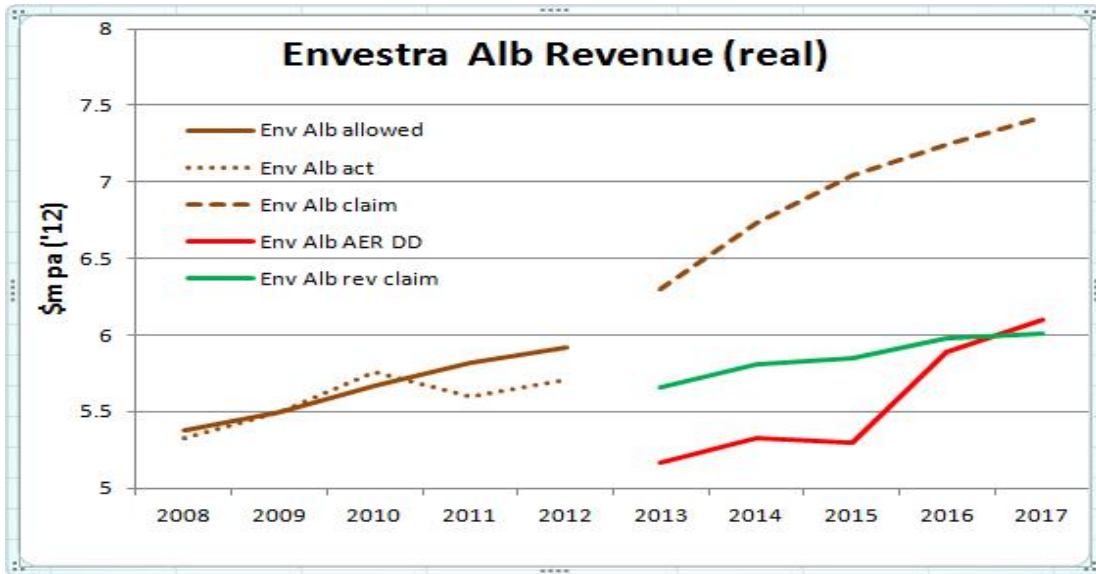
The EUCV is of the view that the AER determined cashflow will be sufficient for Gasnet to acquire its debt at a cost less than the BBB+ benchmark used by the AER in developing the WACC. Therefore, the argument that the resultant cashflow would only sustain a credit rating lower than the notional benchmark, is not the issue the AER need address, providing the cost of debt the AER allows is higher than the cost for debt Gasnet is likely to incur. As there is no doubt that the allowed cost of debt exceeds the actual cost of debt then the imputed credit rating from a reduced cashflow is not an issue.

On balance, the EUCV considers that the AER should maintain regulatory consistency and require the DBs to utilize their historic approach to depreciation.

### 5.3 Revenue allowed and the impact on consumers

All the DBs initially sought a revenue allowance that shows a marked increase from the allowances seen in the current AA3 period. The actual revenue achieved, the allowed revenue for AA3 and sought for AA4 in the DB applications and revised applications, and the revenue allowed in the AER draft decision are shown in the following charts. The source of the information in these charts is from the ESCV final decision, the DB applications and revised applications and the AER draft decision.





It is clear that the AER considers that the revenue the DBs should receive will be a considerable reduction to the revenue allowed by the ESCV in 2007. In the case of Envestra, the ESCV allowances were apparently too low but neither Multinet nor SP Ausnet provided information to assess whether their allowances were too low<sup>8</sup>. However in all cases other than Envestra, the revised applications from the DBs show that they need less revenue for AA4 than they were allowed in AA3.

Overall, the EUCV would expect that the allowed revenue for AA4 should be lower than in AA3 as there is a reducing need for investment due to the lesser amounts of gas being transported (reducing the need for capex) and a much lower WACC applying in AA4 than applied in AA3. The EUCV considers that the AER draft allowances are in keeping with the allowances that were provided in AA3, evidencing regulatory consistency.

Analysis of the tariffs (see section 1.4 above) supports this view that the revenues calculated for the AER draft decision are reasonable.

The EUCV recognises that such analysis is simplistic and does not reflect the risk faced by the DBs from gas consumption changes, but it does provide an indication that the AER draft decision tariffs are more consistent with historic levels than either of the Gasnet average tariffs derived from its application or revised application.

This supports the view that the AER draft decision allowed revenue provides a more reasonable outcome than either of the Gasnet assessments.

#### **5.4 Pass through events**

The EUCV notes the proposed arrangement for pass through events proposed by the AER but considers that the AER has been lax in allowing consumers to take these additional risks, bearing in mind that the DBs are receiving such a high equity beta compared to their actual risk profile. Its comments provided in its response to the DB applications are still applicable.

The EUCV notes the comments and changes proposed in the DB revised applications. The EUCV considers that the transfer of risk to consumers inherent in the changes is not commensurate with the rewards Gasnet seeks and risks it faces.

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<sup>8</sup> This implies that they considered the revenue they received in AA3 were adequate

## **6. Pricing Methodology**

Under a price cap regulatory approach, the network takes the risk on the amount of energy that flows in the network. If the DBs are subject to price cap regulation, this incentivizes the DBs to maximise their allowed revenue and to understate their expected gas volumes. As has been seen in AA3, there was more gas transported than was assumed in the development of the DB tariffs for AA3 and by implication there would have been more gas transported by the DBs.

Great care is needed by the AER to ensure that the tariffs it agrees to are cost reflective. If this is not done, there is potential for the DBs to significantly over-recover on their allowed revenues.

The EUCV notes that the AER has received considerably more data regarding the development of the individual tariffs and has reached its own conclusions regarding the methodology used by the DBs. The EUCV remains concerned that cost reflectivity has not been fully applied and as a result the tariffs sought by the DBs might allow them to over-recover their allowed revenue.

To address this problem, the EUCV considers that the AER should require the DBs to demonstrate that the tariffs they propose will (just) recover the allowed revenue.