Major Energy Users Inc.

Australian Energy Regulator

Better Regulation Program

MEU Response to

Shared asset guidelines for electricity distribution and transmission

Submission by

The Major Energy Users Inc

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1. Introduction

The Major Energy Users Inc (MEU) welcomes the opportunity to provide comments on the AER Issues Paper on shared asset guidelines for electricity distribution and transmission. The guidelines are being established under the recently approved revised Rules, whereby customers who funded shared assets through their electricity bills are able to share the benefits of unregulated revenues derived from unregulated activities. The guidelines are part of an overall work program to improve energy regulation, focussed on consumers' long term interests.

The preparation for the guidelines is particularly welcomed by the MEU. Against the background of stable to declining energy consumption, and of rapid changes in the development of industries, such as clean energy and digital communications, there is every expectation that network service providers (NSPs) will be seeking to escalate their participation (and responding to new demands) in non-regulated activities, in order to raise revenues. In doing so, and against the background that low marginal costs will obtain (much assets used would have been already paid for by energy customers), the margins that could be obtain would be highly profitable there will be every incentive and expectation that NSPs would be growing this part of their business. This is to be encouraged, provided the core business of providing electricity remains and that electricity customers – who pay or have already paid for the assets used by the NSPs to benefit from unregulated activities – are able to appropriate a good share of the benefits arising from such expanding activities.

1.1 Some realities

Consumers pay for all regulated assets that are used to provide the services provided to consumers connected to the networks. The implication of this is that consumers should be entitled to any benefit whether this benefit is in financial form or via the service the assets provide. To allow consumers any less than this is to provide a free benefit to the NSP.

NSPs already are rewarded by consumers through a return on the assets, return of the capital used to provide the assets and payment for the costs in ensuring the assets are maintained to provide the service expected for the payments made. NSPs faced little or no risks.

On the basis that consumers are already paying full value for the use of the assets, any additional revenue that the assets can provide should substantially revert to consumers to offset their costs for using the assets.

An analogy to this is where a user hires some assets from the owner. The terms of the hire are based on the premise that the user has rights to

whatever revenue it can generate from using the asset. The hirer is entitled to the cost of providing the asset (in terms of capital and operating costs) and a profit for providing the asset for hire. In the case of networks, the NSP is the hirer which gets paid for providing the asset and keeping it in operating condition (receiving a profit for doing this) and the electricity consumer is the user entitled to the benefit that hiring the asset provides.

Based on this analogy, any revenue that accrues from the use of the NSP's asset while the consumer is paying an appropriate tariff which recovers all of the costs incurred should go to the consumer.

Currently, NSPs are allowed to permit third parties to use the assets paid for by consumers and for the NSP to retain any payment that the third party provides for using the assets. Because the NSP incurs little or no cost (ie the marginal cost only) for allowing the third party to use the assets, then the cash benefit goes to the bottom line and increases the NSP profit. In concept, this is both iniquitous and inequitable.

At its most basic, the NSP should only recover the costs it incurs in providing the service to the third party, perhaps with a small profit margin (and no more) on its actual costs.

The argument has been posited that unless the NSP is incentivised to seek out opportunities for third parties to use (and pay for the use) of assets paid for by consumers, then the NSP will not seek these opportunities to gain additional revenue. Further, so the argument goes, the NSP needs to be incentivised to maximise the additional revenue – if the NSP did not benefit from the revenue from the third party, it would offer the access to the assets at merely the cost the NSP incurs in providing the access.

The MEU can see little validity in these arguments but does point out that use of such assets is more likely to be triggered by potential users than by the NSPs themselves. Therefore, the costs incurred by the NSP in selling access to the assets will be marginal but that to maximise the revenue from the third party does need the NSP to be able to share in the revenue that the third party provides.

Another reality that must be considered is what exactly do consumers pay for? This issue is important because the new rule seems to imply that if the unregulated revenue exceeds the return on the assets involved used to generate the unregulated revenue, the amount to be shared is limited to the return on the assets involved. The outturn of this is whether the value of the unregulated revenue stream should be related to specific assets (eg to each pole used for providing the unregulated service), to a group of assets (eg a line of poles) or to all assets in a network.

As discussed below in 1.4, the purpose of the materiality is to limit transaction costs. The amount of the transaction costs incurred by the NSP would increase dramatically with the degree of specificity of definition of the assets

involved and the regulated revenue the specifically identified assets would produce.

When looked at this way, if the unregulated revenue is taken by the NSP without sharing, the NSP takes all of the benefit and incurs little cost. Applying the rules as might be interpreted by an NSP looking to limit its sharing with consumers, the transaction costs could be made very large and therefore imply a high trigger.

In this regard, it must be recognised that consumers do not pay for the use of a single asset (eg a pole or group of poles); what they pay for is a network that delivers power to the point of usage. To limit the value of the amount of the unregulated revenue to purely to the return of depreciated value of individual assets does not recognise the totality that the entire network is required to provide the service.

This means that it is both inappropriate to assess limit the value of the amount to be shared to a very few individual assets and unnecessary cost allocation intensive to calculate the depreciated value of just the assets involved.

This then raises another issue. If individual assets are to be assessed for value, is the depreciation of the asset related to the specific asset or is the depreciation applied on the average of all assets? The complexities implied by the assumption that just the value of the specific assets used drives the entire matter into the realms of absurdity.

1.2 The trigger: relate to revenue?

The AER posits in its Issues Paper, that the NSP should be ale to retain all of the benefit of unregulated revenue from using the shared assets up to a trigger point, and relates this trigger point to a proportion of the total revenue the NSP receives from consumers.

The MEU considers that using a proportion of allowed revenue as a trigger makes little sense. For example[1]:

- Assume the value of the assets provided for network services is $1,000m[2]
- Allowing for all of the costs associated, the allowed revenue would be some $150m pa or 15% of the asset value
- Included in this cost is a post tax nominal return on equity (the profit share that asset owner gets) of some 8.2% or $82m pa

As there are few costs incurred in allowing a third party to use the assets, the bulk of the unregulated revenue would accrue to the profit of the NSP. So

[1] This example is based on the relative costs included in the recent draft decision by the AER for ElectraNet
[2] Most electricity NSPs have an asset value well in excess of this value

relating the value of the unregulated payment to revenue to create a trigger has about half the benefit that really accrues to the NSP

The argument for setting a trigger for sharing the unregulated revenue is that the transaction costs involved in passing the benefit to consumers would be too great a proportion of the unregulated revenue. The MEU accepts this argument in principle, but then asks the question – what would the transaction costs be for passing this benefit to consumers?

The MEU can see that the initial set up of the arrangement with the third party might include some significant costs (although we remain to be convinced), but once established the ongoing costs are very small. A third party is unlikely to want to expend considerable cost in setting up an arrangement that required significant ongoing costs, so whilst the initial cost might be significant, over the long term the set up costs will be amortised considerably.

The MEU can see that the costs an NSP is likely to incur, to establish an arrangement to allow a third party to use regulated assets might be measured in some $100,000s, but the ongoing costs incurred by the NSP would be considerably less than this in subsequent years.

To use an annualised revenue stream as the basis for setting a trigger is therefore likely to overstate what the real costs are associated with establishing this unregulated arrangement.

An alternative approach is clearly needed to be equitable for consumers.

1.3 What is material?

The purpose for identifying a value as a trigger for implementing a sharing scheme is to ensure that the transaction costs for the implementation are commensurate with the revenue that is earned. The Issues Paper implies that a materiality threshold of the proposed annual unregulated revenue would be 1% of the allowed revenue stream.

As well as ensuring the transaction costs are not absorbed in allowing the benefit to be passed to consumers, it is important to assess what these transaction costs might be (see 1.2 above) and what is seen as material in regard to setting the allowed revenue for an NSP.

A review of a revenue resets made by the AER indicates that values of less than $1m are often debated in the analysis. For example, in the recent ElectraNet review by the AER, detailed analysis is devoted to annual costs of less than $1m pa[3].

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[3] Such as $0.2m for equity raising; self insurance and debt raising costs just above $1m pa (AER draft decision on ElectraNet)

This indicates that NSPs see costs and allowances they and the AER consider to be material are being measured in terms of $100,000s rather than in $m.

The analysis in the Issues Paper does little to substantiate the proposed trigger of 1% of revenue is material, and there is no analysis as to whether this is a reasonable trigger, bearing in mind that any unregulated revenues less than this would be retained by the NSP.

1.4 When to start sharing?

The Issues paper proposes that a trigger for the commencement of sharing unregulated revenues with consumers would be 1% of the allowed revenue. As noted above, the MEU considers that there is no justification of such a high trigger point.

What also needs to be addressed are:

- Is the trigger applied for each unregulated revenue stream or for all in total?
- If there is a trigger, there is an incentive on the NSP to ensure the unregulated revenue remains marginally below the trigger

The MEU is of the view that all unregulated revenue should be totalled and used against the trigger and a mechanism implemented to ensure that the NSP is not incentivised to negotiate an unregulated revenue stream so that the revenue does not trigger the sharing scheme.

1.5 Structure of this submission

This rest of this submission follows the structure of the AER Issues Paper.

2. Expansion of unregulated activities

The MEU agrees with the Issues Paper that:

> "unregulated revenues may grow with (the) roll-out of fibre optic cable, energy network digitalisation and increasing network easement values" (Page 11).

This is notwithstanding that:

> "Available information suggests they are less than 1 per cent of regulated revenues". (Page 11)

The MEU notes, in particular, that the roll-out of electric car charging stations and of fibre optic cable (by NBCo) will gather pace over the next 5 years. Furthermore, continuing increases in easement values, particularly significant

in urban area where fibre optic cable roll-out is occurring by use of NSPs easements, will be expected to enhance revenues in non-regulated revenues.

A number of key issues arise in designing the mechanisms for cost reductions arising from the use of shared assets:

- the need to ensure fair and equitable benefits to both consumers and NSPs
- the need to ensure robust and transparent information on unregulated activities
- the interaction between the shared assets guidelines with the confidentiality guidelines.

As can be seen from the observations made in section 1 above, the MEU recognises that the task set regarding this issue is not straight forward and may require some lateral thinking to develop the optimum approach.

3. The Rules' shared asset mechanism

3.1 What are shared assets?

The MEU agrees with the AER Issues Paper's definition of shared assets, and the range of services provided by these assets. (Page 13 and 14)

It is essential though that the guidelines ensure that there is no opportunity for costs shifting – i.e. shifting of unregulated costs to regulated costs. In this regard, attention should not only be directed at physical assets such a power poles and easements, but also extended to corporate overhead costs (e.g. building, marketing and account costs) and other opex costs.

3.2 Shared asset cost reductions

The MEU agrees with the AER's explanation of shared asset cost reduction and the examples provided.

There is the issue of cost increases and the allocation of these costs to electricity customers that needs clarification. Clearly, any new costs incurred to provide unregulated activities should be allocated to those activities. However, if there is a cost incurred to provide an unregulated service, such as strengthening of poles to carry the increased load, how is this to be measured and the cost allocated?

There is also the question of the treatment for the use of easements for unregulated activities. Costs of easements are not based on land values but more on surveys and once off payments. These are treated in regulatory accounts as opex costs which are then capitalised.

As these opex costs are capitalised (and never depreciated but escalated with land values) the model for asset sharing needs to address how this feature of the asset roll forward can be accommodated.

3.3 Shared asset principles

The MEU agrees with the shared asset principles established by the November 2012 Rule change, albeit with the following comments:

With regard to the principle, viz:-

> "'Unregulated services' use of assets must be material, or significant, for share asset cost reductions to apply" (page 15)

The MEU considers that the materiality threshold needs to address the comments made in section 1 above. As there is no definition of materiality (or what is significant) the MEU considers that for this process, the costs the NSPs consider need specific attention in a regulatory review provides a guide as to what they consider is significant.

In addition, the AER should consider:-

- the treatment of lump sum payments and the benefit of cashflow
- the use of a trigger followed by a sharing mechanism creates a disincentive when the benefit approaches the trigger point[4]
- that consumers have not only funded the assets, but also paid for the risks of redundancy, failure, or maintenance.

3.4 Regulatory asset values cap potential benefit sharing

The MEU notes that the threshold for unregulated revenues being subject to benefit sharing should be on an aggregated asset value basis over the 5 year regulatory period.

This threshold principle should apply irrespective of whether, for discussion purposes, an NSP were to earn say, $20 a year by renting space on a pole when the cost of the pole is $10 a year.

3.5 Depreciation of regulatory asset values

The MEU considers that where the NSP is no longer charging electricity customers for the asset (which has been depreciated, even to zero), as long as unregulated revenues are being earned by the asset, electricity consumers should continue to share in the benefits accruing from unregulated activities.

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[4] For example. if the trigger point is $1m pa after which the shares are 70% consumers to 30% NSP, then a revenue increase from $999k to $1m would cause the NSP benefit to drop from $999k pa to $300k pa. This incentivises the NSP not to seek the maximum benefit from the unregulated use of the assets.

3.6 Cost allocation and share assets

There will be many circumstances where a shared asset will arise subsequent to its initial cost allocation. Changes will also occur even after the initial cost allocation of a shared asset. In these circumstances, it is important that the AER is able to obtain robust information from the NSP on a continuing basis, whenever non-regulatory activities contracts are arranged. Adjustments to the regulatory asset base (and to other costs) should be made on an annual basis within the now regulatory period. This is to avoid any attempt at gaming the regulator by the timing of non-regulatory contracts.

4. The AER's shared asset approach

Question 1

Should shared asset guidelines incorporate a materiality threshold of 1 per cent of the annual revenue requirement? Please provide your reasons. Alternatively, what approach to materiality?

As discussed in section 1, there is no basis for the NSP to acquire any unregulated revenue from assets that are being fully paid for by consumers. On this basis alone, there should be no trigger.

However, at a pragmatic level, it is recognised that there are transaction costs that will occur, so the logic of a trigger has some merit as long at the unregulated revenue is below the costs incurred in the transaction. This means that the trigger point needs to be set at a very low level and 1% of allowed revenue is relatively a very high trigger point (see comments in section 1).

The level of materiality is addressed in section 1, but the fact that NSPs have considered as material amounts as low as $200k pa when developing their revenues at resets, provides guidance as to what is material. See also comments in section 1.

Question 2

We propose to forecast share asset cost reductions and not require any adjustment once actual outcomes are known. Do you agree with this approach? Please provide your reasons.

No, we disagree with the AER. Unless adjustments are undertaken during a regulatory period, all NSPs will be incentivised to time their non-regulatory activity contracts post the start of the AER review. Consumers stand to lose substantial benefits in the event NSPs 'game' the process, which they will

have every incentive to do so. Should the AER choose to not make adjustments during the regulatory period, there should be a 'catch-up' adjustment factor (to reflect the opportunity cost of non-adjustment) applied at the start of the next regulatory review, so that consumers can have the benefits consistent with the Rules objective of being "....in the long term interests of consumers".

Question 3

We propose that when shared assets produce revenues exceeding 0.5 per cent of the annual revenue requirement that more detailed reporting of these revenue sources would be required on an annual basis. Do you agree? Please provide your reasons.

The MEU agrees with the AER approach for detailed reporting. We consider, however, that press release material or material provided by NSPs to corporate regulators and shareholders should be automatically made available to the AER in relation to all sources of unregulated revenue generated using assets paid for by consumers.

On the completion of each regulatory period, the NSP should, as part of its revenue reset process, advise the AER of all regulated revenue it receives from using the regulated assets.

This provides a 'light-handed' approach to oversighting compliance by the NSPs.

Question 4

In light of our proposed approach to shared asset reductions, what other improvements could be made? Please provide your reasons.

As noted in section 1 above, the MEU is very concerned that the program contemplated will become very cost intensive in the development of cost allocations and assessments of unregulated revenue for an asset vs regulated revenue from the same asset. At its extreme, this transactions work could exceed the value of the unregulated revenue providing no benefit to NSP or consumer.

The MEU considers that great care is needed in setting the requirements for reporting to ensure that there is the maximum benefit available to consumers. The MEU sees that the NSP will be incentivised to argue that the reporting requirements are excessive (and they might well be!) in relation to the value of the unregulated revenue to be earned.

The MEU considers that perhaps a different approach is needed and proposes one in section 6 below that would require minimal reporting

5. The AER's shared asset method

Question 5

Should shared asset guidelines detail a method for cost adjustment?

Yes. The MEU agrees that some certainty over how the approach is to be applied is essential. This allows for the NSP reporting to be made to meet the needs of the program and for consumers to be confident they are getting the maximum benefit from the secondary use of the assets they are paying for.

Question 6

How could cost reductions best share unregulated service benefits with customers while retaining incentives for asset owners?

The MEU does not agree with the AER's view that the cost reductions be either conservative or aggressive. They should be fair and equitable to both the NSP and consumers.

The MEU accepts that the regulatory approach is based on incentives for NSPs. As noted in section 1, consumers are entitled to all of the benefit of the unregulated use of regulated assets they pay for. Equally, unless the NSP receives some incentive, there is a risk that the NSP will not enter into such arrangements or will seek to limit the benefit to remain under the trigger point[5]. This is not in the interests of consumers.

What is required is an incentive for the NSP to actively seek secondary use of the regulated assets and to maximise the revenue from the third party. This might be achieved by using a very low trigger point accompanied by a sliding scale of the share to the NSP, such that the percentage share reduces with the increase of the revenue from the third party[6]

[5] See example shown in footnote 4
[6] This is similar to the fee setting for real estate agents

> **Question 7**
>
> Should the profit from unregulated services be used to make shared asset cost adjustments?

In principle, the MEU considers that attempting to assess the profit will be intrusive and moving the regulator into areas where it should not be involved. However, the MEU also acknowledges that

- there is a need to assess the transaction costs that are incurred in obtaining the unregulated revenue.
- the NSP must offset the costs it incurs from the arrangement with the third party to demonstrate that the arrangement does provide a net benefit.
- there may be work required on the regulated assets to allow the unregulated revenue to be generated. The risk to consumers is that this would be paid for as a regulated cost but generate no benefit to consumers.

Without any intrusion, the AER will not be able to carry out its task to ensure that consumers receive fair value from the unregulated use of the regulated assets and the NSP would not be able to demonstrate the costs that it incurs in providing the benefit.

Overall, there will be required some intrusion by the regulator into the costs and benefits provided by the unregulated use of the assets. This is not unreasonable as, without consumers providing the return on the assets in the first place, they would not be available for the secondary use proposed.

> **Question 8**
>
> Is a technical/physical asset use approach to a shared asset cost reduction preferable to an approach based on proportional revenues? Please provide your reasons. What other method

The AER example highlights another of the core imponderables inherent in the approach implied by the AER.

The assets are currently fully paid for by consumers and, in principle, all revenue from secondary use should accrue to consumers (see section 1). Therefore the concept of attempting to allocate costs on individual assets (the physical asset use) becomes transaction cost intensive and erodes the value of the secondary revenue stream.

Assessing the secondary revenue stream in proportion to the overall revenue also introduces considerable issues. This approach also imposes considerable transaction costs.

The MEU considers that a higher level approach is required which has less need to rely on detailed cost assessments of the shared assets and which reduce the apparently intensive asset costing that the new rules seem to impose on NSPs and the AER.

Question 9

Should the guidelines include a fixed cost reduction proportion? If so, what should the proportion be? Should the guidelines set out another approach?

A fixed sharing of the benefit provides certainty to all involved, but also (as noted in an earlier question) raises the question as to what is the fixed proportion to be applied to – the net benefit, the gross benefit, the third party payment? Further, should the fixed amount vary with the size of the revenue from the secondary service provided?

As noted in section1, the MEU considers that consumers should get all of the secondary revenue from use of the assets they are already paying for, although the NSP should be able to recover its costs (perhaps with a profit margin) they incur in providing the unregulated revenue. The concern is that such an approach might not provide sufficient incentive to the NSP to seek secondary use of the assets.

Also there is an incentive for the NSP to maximise its costs for providing the service (reducing the net benefit) and to increase regulated costs to allow the unregulated service to be provided. In most cases, the costs the NSP incurs in the providing the unregulated service are incurred at the time of establishing the secondary service,

The trouble with setting a fixed proportion lies with what is an equitable approach – is 50/50 fair? Should it be 30/70 to match the opex incentive? Any sharing reduces the essential right consumers have to all of the secondary revenue.

On balance the MEU considers that a sliding scale should be applied with a smaller element going to the NSP the larger the revenue stream from the third party.

The MEU provides in section 6 an alternative approach which addresses all of these issues and returns to consumers what the MEU considers is equitable

6. A possible solution

The MEU has considered the issues raised in the Issues Paper and in the MEU commentary above, especially in section 1 above.

One of the striking issues that has become apparent is that the new rules as currently crafted are likely to require considerable intrusion into the NSP costs that it incurs in relation to the unregulated revenue obtained from regulated assets. Further, the approach is likely to require considerable transaction costs to enable to program to be workable – these costs will significantly erode the benefits consumers might otherwise get from secondary use of the regulated assets.

Consumers consider that they are entitled to all of the unregulated revenue that comes from the use of the assets they pay for. Consumers are also very concerned that the unregulated revenue can be significantly eroded by transaction costs incurred in assessing the net benefit of the unregulated revenue stream, allocating costs and then implementing a sharing process complete with trigger.

The new Rules require that this unregulated revenue needs to be material and the benefits shared between the NSP and consumers. The Rules also require the regulator to calculate NSP costs and revenue ex ante at the start of a new regulatory period.

The MEU has considered a concept that it has not fully developed which might address all of these aspects.

If during any regulatory period, an NSP has to opportunity to obtain unregulated revenue from a third party, it can do so and retain all of the benefits from this during the regulatory period. This provides a strong incentive for the NSP to enter into arrangements that deliver benefits from third parties for the maximum amount possible. Once established the NSP would advise the regulator of the arrangement and the long term contractual commitments.

At the start of the next regulatory period, all of the unregulated revenue (less any NSP costs required for managing the unregulated service) is removed from the allowed revenue awarded by the regulator. This allows the allowed revenue to be adjusted ex ante with the full benefit of the arrangement integrated into the revenue stream.

The administration costs for such an arrangement would be minimal and would not require the setting of a trigger. The model (as would the AER approach) has to be modified to address lump sum payments made by the third parties in lieu of annual payments.

While not fully developed, the MEU considers that such an arrangement has the potential to address the requirements of the Rules, provide an incentive to NSPs and to meet the expectations of consumers. The MEU would be pleased to discuss this concept in more detail.

The MEU considers that in its assessment of the various issues raised in the Issues paper and the difficulties that the new rules impose on what should be a fairly straight forward matter, there are some quite constraining aspects of the new rules that cause an inequitable outcome for both consumers and NSPs. In particular, the new Rules constrain the approach by imposing considerable transaction costs in order to make what should be a simple concept workable.

With this in mind, the AER should consider if they are being inappropriately constrained in developing a workable solution to this issue by poorly crafted rules. If this is the case, the AER should propose to the AEMC some rule changes that would make easier implementing the task they have been given.