



Major Energy Users Inc.

13 August 2012

Mr Warwick Anderson
General Manager-Network Regulation
Australian Energy Regulator
GPO Box 3131
CANBERRA ACT 2601

By email: AERInquiry@aer.gov.au

Submission re: Murraylink application for a revenue reset

Dear Mr Anderson

The Major Energy Users Inc (MEU) welcomes the opportunity to comment on the Murraylink application for a revenue reset review currently under consideration by the AER. The MEU is an organisation representing major gas and electricity users operating in all states in Australia. Member companies are familiar with the operations of electricity transmission and distribution assets and importantly, have experiences in negotiating with electricity transmission companies.

The MEU is concerned with the application from Murraylink as it imposes increased costs for the provision of the link against a backdrop of falling electricity consumption and very low growth (if any) in electricity demand. The most recent report by AEMO supports this observation and the AER needs to reflect this change in usage of electricity in the NEM.

The MEU affiliate (Electricity Consumers Coalition of SA – ECCSA) was involved in the decision to allow Murraylink to convert to a regulated interconnection asset. The ECCSA was not content with the ACCC decision to allow Murraylink to become regulated nor with the valuation of the asset. The ACCC essentially allowed Murraylink to be valued as if it were able to transfer some 200 MW of power in both directions (from SA to Victoria and vice versa). In practice, Murraylink seldom provides this capability at times when the capacity is most needed. The ACCC made allowance for the asset value based on assumptions that the transmission capability in the Victorian and SA regions would be increased to allow Murraylink to operate at its maximum capacity when most needed.

However, the assets needed in the two regional transmission systems were not upgraded as assumed by the ACCC and therefore Murraylink has never been able

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to provide the service required by consumers. The region transmission upgrades were only needed to make Murraylink operate at its full potential rather than for any underlying regional needs. With this in mind, the decision to build Murraylink where it is was totally inappropriate. To require consumers to continue to pay full value for a service that does not provide the benefits assumed by the ACCC because of inappropriate site selection is not efficient.

The decision made by the AEMC in 2006 locks in the value of Murraylink, despite that this is overstated for the value of the service it provides. Therefore the AER is constrained to use the AEMC valuation for the roll forward calculation. Having accepted that the value is overstated, the AER can address some of this inequity by recognising that the capex sought by Murraylink for the next period (AA2) should be kept to the minimum.

Murraylink invested some \$1,118,000 in the past ten years, of which more than half (\$640k) is to be spent in 2012. This implies that there is little need for capex at all for the interconnector and the fact that such a large proportion is forecast to be spent in the final year seems to indicate that Murraylink is trying to create a view that increasing amounts of capex are needed for AA2. In fact Murraylink is forecasting capex of \$13,587,000 in AA3, which is an annual rate twice the amount forecast for 2012. There is a clear indication that Murraylink is seeking unnecessary amounts of capex for AA2. A brief overview of the capex projects provided by Murraylink to substantiate this thirteenfold increase in capex does not provide convincing arguments that such capex will increase the value of the service provided by Murraylink to consumers. In this regard the AER must only allow capex which is prudent and which provides a definable benefit to consumers when compared to the increase in cost that is sought.

In its application, Murraylink provides details for capex to be incurred to address a number of design shortcomings that should have been addressed at the time of construction, or if not then, when the ACCC provided its valuation for the provision of the assets. The ACCC approach to valuation was predicated on the facility provided meeting basic requirements. To set the regulatory value for Murraylink, the ACCC calculated the cost of another alternative (alternative 3)¹ to provide the same service that Murraylink provides. This alternative 3 was not based on a DC link as was built by Murraylink but on another design entirely. Although Murraylink is now stating that its DC link design was inadequate at the time of construction this does not warrant consumers paying more for capital to address these design shortcomings. In fact, the method used by the ACCC in setting an asset value assumed that the assets would have provided a fully operational and appropriate facility.

For Murraylink to now advise that the facility needs upgrading to meet basic design requirements does not warrant the inclusion of additional capex to achieve this outcome. The projects detailed by Murraylink I section 7.7 are either aspects that are required to make the DC link more reliable (but which would not needed for an AC

¹ See Murraylink Transmission Company Application for Conversion and Maximum Allowed Revenue ACCC 1 October 2003, chapters 3 and 4

link on which the asset values was based) or are features that should have been provided in the original design but are now identified as necessary – ie they are not required as a result of step changes in externally imposed requirements.

Murraylink also seeks approval of a contingent project allowance in the event that one of the assessed projects for augmenting interconnection between SA and Victoria. The AER should not allow for this to be allowed in the Murraylink allowance because of the inherent uncertainty of each of the proposals addressed by ElectraNet and AEMO for this increased interconnection. The earliest that such an augmentation will occur is 2019-2020, which is in the latter stages of Murraylink AA2. If Murraylink is of the view that it might need to carryout tasks associated with this augmentation, then it should only seek a regulatory period of 5 years and thereby have a better understanding of what might be needed when this project timing and scope is more fully formed. To commit consumers to the possibility of an investment that might or might not be needed, with uncertain timing and uncertain scope for work that, at the earliest, might need to be implemented in 8 years time, is unnecessary and adding risks to consumers that are unwarranted.

In regard to opex, the MEU is concerned that the actual opex saw a step increase in 2010/11 when APA sold part Murraylink to others. The allowed opex must be efficient. Just because a sale of assets has occurred this does not justify a step increase in opex. If the opex before the sale was seen as being efficient, then the efficient opex after a sale should be no different. In fact, the increase in opex for this reason should be seen as a related party transaction structured to increase costs to consumers, and not one which results in efficient opex.

The MEU recognises that the WACC parameters set for electricity transmission firms allows little scope for change from those set at the WACC review in 2009. The only aspect of the WACC parameters that has any flexibility is the setting of the debt risk premium. The MEU notes that Murraylink has sought a debt risk premium of 393 bp, which is the same as the DRP sought by APA in its recent application for another of its regulated assets – Gasnet. In the response to the Gasnet application the Energy Users Coalition of Victoria – EUCV (EUCV is another affiliate of MEU) – commented that the debt risk premium should be no more than ~200 bp. In appendix 1, we append the EUCV comments on the Gasnet application and observe the MEU considers these comments to be just as applicable to the Murraylink claim as they are to the Gasnet claim.

Yours faithfully



David Headberry
Public Officer

APPENDIX 1

Comments made by EUCV to AER regarding Gasnet application for a debt risk premium of 393 bp

Debt risk premium

Of all the parameters in the WACC development, the issue of debt risk premium (DRP) is the aspect that consumers have found to be most contentious and least understandable from a regulatory point of view.

There is no doubt that regulatory decisions made since the onset of the GFC in 2007 have provided a DRP at a level greatly in excess of the actual cost of debt acquired by regulated firms. Government owned networks have been granted allowances for the cost of debt at 200-300 bp above the cost they actually incurred, and privately owned firms have been granted debt costs some 100-200 bp above their actual costs.

The Gas Rules require the rate of return to be efficient and to reflect best practice. There can be no doubt that that recent regulatory decisions by the AER have not provided efficient levels for the cost of debt. The AER itself has noted that the cost of debt incurred by energy networks have been significantly below the benchmarks they have used and as a result have attempted to introduce new data into the approach they have conventionally used. Appeals to the ACT have resulted in these attempts being found to be inconsistent and the ACT has even suggested that the basic approach used by the AER for assessing the debt risk premium might be flawed.

Despite the fact that the outcomes of their approach delivers patently incorrect and excessively high DRP values, the AER has continued to use a methodology which requires interpolation and extrapolation of a non-transparent data set which itself is based on a very few data inputs. Such an approach cannot be demonstrated to produce an efficient outcome.

The Gas Rules are considerably less prescriptive than the Electricity Rules and do permit the AER to use other approaches to developing a debt risk premium. The EUCV considers that the AER has a responsibility to consumers not to continue the use of a flawed process that delivers a DRP well above the efficient level.

The EUCV has reviewed the annual reports of the four privately owned gas network firms operating in Victoria. The outcome of this review is tabulated below² providing

² Whilst it is recognized that each of the separate networks are part of a larger group, the information does not differentiate the different types of infrastructure (eg DUET has a much wider asset type base than the others) and APA Group has mainly gas assets, many of these are unregulated. With this in mind, a regulated energy network monopoly would be expected to have a lower risk profile than other assets in the parent businesses and therefore the debt risk premium for the regulated entities will be lower

the actual DRPs (compared to the 10 year CGS) for the parents of the Victorian gas transport businesses.

Actual DRP (bp)	Credit rating ³	Debt/assets	2008	2009	2010	2011	Av'ge
ACCC allowed			299	299	299	299	299
ESCV allowed			215	215	215	215	215
APA (Gasnet)	BBB	69%	100	310	240	300	235
DUET (Multinet)	BBB-	80%	80	160	190	200	160
SP Ausnet	A-	66%	-50	80	60	50	35
Envestra	BBB-	81%	150	330	220	290	250
Arithmetic Average	BBB	74%	70	220	180	210	170

This EUCV analysis provides some interesting observations:

- The allowance provided by the AER considerably exceeds the actual premium incurred by Gasnet and that provided by the ESC exceeded the average cost incurred by the distribution businesses.
- That the credit ratings of all the businesses reflect higher gearings for the businesses but that the credit rating of BBB+ is more reflective of a higher gearing than 60% debt/assets
- The calculated DRP varies year on year but that the main cause of this is not so much a variation in the cost of the debt but more that the movement of the DRP reflects the year on year movement of the risk free rate
- None of the actual debt risk premiums reached the level of 392 bp claimed by Gasnet in its application or even the 380 bp the AER allowed for NT Gas
- Efficiently acquired debt is well below the benchmark sought by Gasnet and well below the benchmark DRP allowed in recent revenue rests

The Rules are clear that in determining:

“... a rate of return on capital ... it will be assumed that the service provider meets benchmark levels of efficiency; and uses a financing structure that meets benchmark standards as to gearing and other financial parameters for a going concern and reflects in other respects best practice”

An efficient debt risk premium does not provide an outcome which is demonstrably higher than the costs actually incurred by a “going concern”. The AER approach uses just one form of assessing the debt risk premium and as most businesses use a portfolio approach to the provision of debt (in terms of tenor, source and expiry date), so an efficient financing structure is not based on one source of debt with a fixed tenor and start date used by the AER. The fact that all businesses use a portfolio approach to the provision of their debt (other than government owned

³ Sourced from ERA draft decision on Western Power Table 71, page 174

networks which get their debt from the government treasury corporations) demonstrates that this is a more efficient practice.

There is no doubt that the approach used by the AER to establish a debt risk premium (and used by Gasnet in its application) is flawed and delivers a DRP well in excess of the actual costs incurred by an efficient service provider. Further the fact that gas firms have consistently been able to acquire debt at a cost well below the allowances provided by the AER shows that there are more efficient methods of debt acquisition than the approach used by the AER.

The Gas Law and the Gas Rules are specific that the costs allowed a service provider are to be efficient. To award a debt risk premium that is demonstrably not efficient is not in accordance with the Law or Rules and the AER must deny the approach proposed by Gasnet and implement an approach that does deliver an efficient outcome.

The EUCV considers that the market evidence indicates that the debt risk premium should be no more than 170 bp above the 10 year CGS or 195 bp above the 5 year CGS. This value of DRP compares favourably with the value of 203 bp (vs the 5 year CGS) calculated in the ERA draft decision for Western Power.